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CORPORATIONS AND PARTNERSHIPS

by

James C. Chadwick*

THIS Article begins with a discussion of partnership law developments, continues into a discussion of corporation law developments, and concludes with a discussion of securities law developments.

I. PARTNERSHIP LAW DEVELOPMENTS

A. General Analysis

This discussion of partnership law developments generally follows the "cradle to grave" sequence used in prior years' Surveys and is characteristic of the formats of the Texas Uniform Partnership Act (TUPA)¹ and the Texas Uniform Limited Partnership Act (TULPA).² Cases involving alleged breaches of fiduciary duty among partners, replacement of general partners by limited partners, and an application of the partnership by estoppel rules to two corporations engaged in a single business enterprise highlight the cases arising during the survey period.

B. Formation and Existence of a Partnership

Three cases arising during the survey period involved whether certain relationships between persons constituted a partnership. In *Medallion Homes, Inc. v. Thermar Investments, Inc.*³ two corporations, Thermar Investments, Inc. and C. Foster Wooten, Inc., desired to acquire and develop a real estate subdivision known as Quail Forest. Thermar, acting as the financier, entered into a contract for the sale of certain lots in the subdivision with the owner of the subdivision, First City National Bank of Houston. The contract granted Thermar the right to purchase and resell certain lots in the subdivision, but prohibited assignment by Thermar without the prior written consent of First City. Notwithstanding the nonassignability clause in the contract, Thermar executed a document that purported to assign to Wooten an undivided one-half interest in the contract.⁴

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1. TEX. REV. CIV. STAT. ANN. art. 6132b (Vernon 1970).

2. *Id.* art. 6132a.

3. 698 S.W.2d 400 (Tex. App.—Houston [14th Dist.] 1985, no writ).

4. Thermar executed the assignment document with the expectation that First City

During the period that the contract between Thermar and First City was in force, Thermar entered into a contract for the sale of certain Quail Forest lots to Medallion Homes, Inc. The assignment document, however, clouded the title of the property and rendered Thermar unable to convey clear title to the Quail Forest lots to Medallion as the contract required.⁵

Medallion brought actions against Thermar and Wooten for damages resulting from an alleged breach of contract under the Texas Deceptive Trade Practices Act (DTPA).⁶ Medallion also asserted that the relationship between Thermar and Wooten constituted a partnership formed to acquire and develop the subdivision in an effort to impute to Thermar responsibility for Wooten having recorded the assignment document.⁷ The trial court found that no partnership existed, and Medallion appealed the decision.

The appellate court reviewed the trial court record and concluded that Thermar and Wooten clearly had intended at one point in time to form a partnership to acquire and develop the subdivision.⁸ Thermar's and Wooten's intent, however, was frustrated because First City never consented to the purported assignment of the contract. Hence, the purported assignment was invalid. Because the acquisition and development of the subdivision could not be carried out without a valid assignment of the contract, the appellate court concluded that the parties had nothing on which to base the partnership.⁹ Accordingly, the appellate court affirmed the trial court's decision that no partnership existed.¹⁰

*Alstan Corporation v. Board of Administration of Chimney Corners Townhouses*¹¹ involved two corporations that developed a residential housing complex known as Chimney Corners Townhouses. Alstan Corporation, a construction company experienced in the construction of multifamily projects, served as the general contractor in charge of constructing the complex. Stan Miller, president of Alstan, had been at all times the general manager of Alstan's operations. Miller and his father each owned fifty percent of Alstan and twenty-five percent of Miller & Dryden, Inc. (M&D), a corporation formed solely for the purpose of owning the complex during its development stage. Kenny Dryden owned the remainder of M&D.

would approve the assignment. First City, however, did not approve the assignment. Thermar's purported assignment of the subdivision contract to Wooten therefore was invalid.

5. Thermar and First City later terminated their contract by agreement. First City ultimately sold the subdivision to Mac-Carey Properties, Inc. Medallion then purchased several of the lots from Mac-Carey at a price higher than that provided in its original contract with Thermar.

6. The Texas Deceptive Trade Practices Act § 17.50(a)(2) provides that a consumer may maintain an action if the breach of an express or implied warranty is a producing cause of actual damages. TEX. BUS. & COM. CODE ANN. § 17.50(a)(2) (Vernon Supp. 1987).

7. Medallion based this claim on § 6(1) of TUPA, which defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit." TEX. REV. CIV. STAT. ANN. art. 6132b, § 6(1) (Vernon 1970).

8. 698 S.W.2d at 404.

9. *Id.* The court cited no legal authority for its conclusion. Arguably, the court relied on the absence of a business to be carried on. See TEX. REV. CIV. STAT. ANN. art. 6132b, § 6(1) (Vernon 1970).

10. 698 S.W.2d at 404.

11. 713 S.W.2d 130 (Tex. App.—Austin 1986, no writ).

During the construction of the complex, Miller, in his capacity as general manager of Alstan, made certain changes in the roof design of the townhouses. These changes caused leaks, which damaged several townhouses. The board of administration of the complex demanded that Alstan and M&D remedy the problem caused by the roof design. Upon their refusal to do so, the board brought an action in district court against Alstan and M&D to recover damages caused by defective workmanship in the construction of the roofs and drainage systems.

After a jury trial, the district court rendered judgment that the board recover \$422,000 against Alstan and M&D, jointly and severally.¹² Alstan appealed on the ground that there was no evidence in the record to support a finding that the two corporations were engaged in a joint venture.¹³ Specifically, Alstan contended that there had been no evidence presented that indicated the existence of an agreement between the corporations to share profits and losses from the development of the complex. On appeal, the court relied heavily on a short segment of Dryden's testimony in which he indicated that he was Alstan's "partner" in the project.¹⁴ The court concluded that Dryden's admission of partnership with Alstan was an implication that an agreement existed between the two to divide the profits and losses from the project. Therefore, the admission was of probative force, despite its somewhat conclusory or composite fact nature.¹⁵ As a result, the appellate court affirmed the trial court's judgment and held Alstan liable for the damages to the same extent as M&D.¹⁶

In *Russell v. French & Associates, Inc.*¹⁷ the court considered whether cer-

12. The board's pleadings, which alleged that Alstan and M&D had entered into a joint venture to build and sell the Chimney Corners Townhouse complex, prompted the district court's imposition of joint and several liability.

13. The four required elements of a Texas joint venture are: (1) a community of interest in the venture; (2) an agreement to share profits; (3) an agreement to share losses; and (4) a mutual right to control or manage the enterprise. *Ayco Dev. Corp. v. G.E.T. Serv. Co.*, 616 S.W.2d 184, 186 (Tex. 1981). Alstan did not appeal on the ground that the evidence was insufficient to support the verdict.

14. 713 S.W.2d at 133. The court also relied on admissions that Miller had received construction draws from the project and that Dryden received a real estate commission through M&D in connection with the deal. *Id.* at 134.

15. *Id.* The appellate court used as primary authority for this conclusion a Texas opinion dating from 1856 which held that when an unimpeached witness states a fact as his own knowledge, it must be taken that he had competent means of information and knowledge of the fact, unless the contrary appears. *Kottwitz v. Bagby*, 16 Tex. 656, 662 (1856).

16. 713 S.W.2d at 134. Regarding the issue of community of interest, the appellate court held that the interlocking ownership between Alstan and M&D constituted evidence thereof. *Id.* Regarding the issue of mutual right of control, the appellate court held that the loose fashion in which Miller managed the corporations constituted evidence thereof when coupled with the interlocking ownership. *Id.*

17. 709 S.W.2d 312 (Tex. App.—Texarkana 1986, writ ref'd n.r.e.) The TSA does not apply to transactions between joint venturers. *Brown v. Cole*, 291 S.W.2d 704, 709 (Tex. 1956); *Vick v. George*, 671 S.W.2d 541, 546 (Tex. App.—San Antonio 1983), *rev'd on other grounds*, 686 S.W.2d 99 (Tex. 1984). The TSA defines a security to include an investment contract. TEX. REV. CIV. STAT. ANN. art. 581-4(A) (Vernon 1987). When the term is applied to a joint venture, the Texas courts look to the meaning of "investment contract." *Russell*, 709 S.W.2d at 314. The United States Supreme Court has defined an investment contract as an arrangement consisting of three elements: (1) a common enterprise, in which a person (2) expects to receive profits (3) solely from the efforts of the promoter or a third party. *SEC v.*

tain interests in oil and gas wells constituted interests in a joint venture and, therefore, were exempt from the Texas Security Act (TSA). In *Russell*, an operator agreed to drill oil and gas wells on certain leases and to convey the working interests in the wells to a partnership. The partnership would, in turn, provide federal income tax benefits to a group of investors of which French & Associates, Inc. was a member.

After the commencement of drilling operations, the investor group became dissatisfied with the arrangement and refused to pay the drilling costs incurred by the operator. The operator then sued the investor group for the operating costs. The investor group counterclaimed against the operator and brought a third-party action against Russell, a promoter, seeking rescission of the agreement on the grounds of misrepresentation under the TSA and common law fraud. The trial court rendered judgment against Russell and the operator for rescission and for return of \$1,440,000 of purchase money.¹⁸ Russell and the operator appealed, contending that the trial court erred in granting a rescission because the partnership constituted a joint venture and the investor group failed to show that the interests they purchased therein constituted securities covered by the TSA.

The appellate court concluded that of the four required elements of a joint venture, only the control element posed a genuine issue.¹⁹ Whether the parties had a mutual right of control of management of the enterprise was not a clear issue in light of the limited involvement of the investors in the venture. The appellate court, however, held the arrangement to be a joint venture as a matter of law based on evidence that (1) the venture agreement described the operator and the investor group as joint venturers, (2) the venture agreement provided that the operator and the investor group would each have a fifty percent vote on matters concerning the business of the venture and (3) the investor group had exercised powers under the venture agreement to remove an operator and replace it with another.²⁰ The transactions between the parties therefore were exempt from the TSA.

C. Partner by Estoppel

When a person represents himself, or consents to another representing

Howey Co., 328 U.S. 293, 299 (1946). The sale of an interest in a true joint venture or general partnership generally does not involve the sale of a security because the venturers or partners have the power to participate in the management of the entity and, therefore, the third element of an investment contract is missing. The Texas Supreme Court has found that a party owning a joint interest in a well, who did not retain any joint participation, control, or operation of the mining effort, was not a joint venturer as a matter of law. *Ayco Dev. Corp. v. G.E.T. Serv. Co.*, 616 S.W.2d 184 (Tex. 1981).

18. The court also awarded punitive damages in the amount of \$500,000, attorneys' fees of \$19,000, and interest in the amount of \$266,973. Regarding the operator's claim against French & Associates, the trial court entered a take-nothing judgment.

19. 709 S.W.2d at 315. See *supra* note 13 for a list of the four elements of a joint venture. The appellate court determined that the wells themselves formed a community of interest for the venture. The court had no difficulty in determining that the parties had agreed to divide profits in accordance with the interest owned in the wells and bear the expenses in proportion to the interest owned. 709 S.W.2d at 315.

20. *Id.*

him, as either a partner in an existing partnership or a partner with one or more persons not actual partners, he is liable to the person or persons to whom the representation is made.²¹ This theory of liability, known as partnership by estoppel, surfaced in *Paramount Petroleum Corp. v. Taylor Rental Center*.²² In *Paramount Petroleum Corp.*, the court held Paramount Petroleum Corporation liable to Taylor Rental Center for invoices pertaining to Paramount Steamship Company, Ltd., a corporation with whom it shared the common goal of restoring a ship.

During the restoration, several individuals on separate occasions approached Taylor to rent pumps and sandblasting equipment for use on the ship. Each time, Taylor would verify the identity and authority of the person making the rental request and, if such were proper, Taylor would release the equipment.²³ Taylor would then issue an invoice to Paramount Steamship.

After Taylor failed to receive payment for several invoices pertaining to rentals made in connection with restoring the ship, it brought an action against Paramount Petroleum. The trial court entered judgment in favor of Taylor, and Paramount Petroleum appealed on the grounds that Paramount Steamship, and not Paramount Petroleum, was the entity liable for the invoices. The appellate court affirmed the judgment of the trial court, holding that both the partnership by estoppel theory²⁴ and the single business enterprise theory²⁵ supported the trial court's judgment.²⁶

The appellate court analyzed partnership by estoppel as consisting of two elements: (1) a representation by a person or entity that it is a member of a partnership and (2) reliance on the representation by someone in extending credit to the partnership.²⁷ Evidence that Paramount Petroleum (1) identified itself as "Paramount" in conversations with Taylor, (2) requested that Taylor send invoices to "Paramount" at a post office box which Paramount Petroleum shared with Paramount Steamship and (3) permitted Paramount

21. TEX. REV. CIV. STAT. ANN. art. 6132b, § 16(1) (Vernon 1970).

22. 712 S.W.2d 534 (Tex. App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.).

23. The first such request was made by a captain who gave Taylor a telephone number to obtain credit information. When Taylor called the number, a person answered the telephone saying "Paramount," verified that Paramount had employed the captain, and verified that it had authorized him to rent equipment on its behalf. The person also told Taylor to send the invoices to "Paramount" at its Houston post office box. The second rental request was made by a captain who presented to Taylor his business card, which bore the name "Paramount Steamship Company."

24. See *supra* note 21 and accompanying text.

25. See *infra* note 30 and accompanying text.

26. The parties tried the case before the court without a jury, and neither party requested or filed findings of fact or conclusions of law. Therefore, the trial court's judgment implied all fact findings necessary to support the judgment. 712 S.W.2d at 536 (citing *Goodyear Tire & Rubber Co. v. Jefferson Constr. Co.*, 565 S.W.2d 916, 918 (Tex. 1978)). The appellate court added that the trial court's judgment should be affirmed if it could be upheld on any legal theory supported by the evidence. *Id.* This loose standard, along with the no evidence test the court was required to use, made it almost certain that the appellate court would affirm the judgment of the trial court. *Id.* Accordingly, the court's language about a single business enterprise theory carries less precedential value than it might otherwise.

27. *Id.*

Steamship to occupy Paramount Petroleum's office space without separately listing Paramount Steamship as an occupant of that space, indicated to the court that Paramount Petroleum had represented itself as a member of a partnership with Paramount Steamship. Additional evidence of Taylor's use of Paramount Petroleum's telephone number to confirm the authority of the person renting the equipment and use of Paramount Petroleum's address for invoices, indicated to the court that Taylor had relied on Paramount Petroleum's representation in extending credit for rentals made in connection with restoring the ship. The court concluded that this evidence was sufficient to justify holding Paramount Petroleum liable to Taylor under the theory of partnership by estoppel. Independent of the partnership by estoppel theory, the appellate court analyzed the relationship between Paramount Petroleum and Paramount Steamship under the single business enterprise theory.²⁸ Based on the holdings of two prior Texas courts of civil appeals cases,²⁹ the court fabricated the legal principle that "when corporations are not operated as separate entities but rather integrate their resources to achieve a common business purpose, each constituent corporation may be held liable for debts incurred in pursuit of that business purpose."³⁰ Factors that the court listed as important in determining whether constituent corporations have not been maintained as separate entities include: common employees; common offices; centralized accounting; payment of wages by one corporation to another corporation's employees; common business name; services rendered on behalf of another corporation; undocumented transfers of funds between corporations; and unclear allocation of profits and losses.³¹ The appellate court concluded that the record contained sufficient evidence of these factors to justify an implied finding that Paramount Petroleum and Petroleum Steamship operated as a single business enterprise.

The single business enterprise theory advanced by the *Paramount* court provides an additional theory of liability to an aggrieved party who is unable to prove a cause of action under either a partnership by estoppel theory or a disregard of the corporate entity theory because of a lack of reliance on the particular defendant's actions.³² The holding in *Paramount* is significant because of its potentially broad applicability to businesses that have common

28. The single business enterprise theory is an equitable principle that Texas courts have used to justify their results in hard cases. The theory holds that if two or more business enterprises cloak themselves with the appearance of being a single business enterprise, then the courts should treat them as such. See *Allright Texas, Inc. v. Simons*, 501 S.W.2d 145, 150 (Tex. Civ. App.—Houston [1st Dist.] 1973, writ ref'd n.r.e.); *Murphy Bros. Chevrolet Co. v. East Oakland Auto. Auction*, 437 S.W.2d 272, 275-76 (Tex. Civ.App.—El Paso 1969, writ ref'd n.r.e.).

29. See *Allright*, 501 S.W.2d at 150; *Murphy Bros.*, 437 S.W.2d at 275-76.

30. 712 S.W.2d at 536. This legal principle is merely a remedy imposed by the court to cure a perceived injustice arising where a party cannot prove partnership by estoppel, alter ego, or another similar theory of recovery.

31. 712 S.W.2d at 536.

32. In *Paramount* there was no evidence that Taylor had relied at all on the creditworthiness of Paramount Petroleum in extending credit to Paramount Steamship. In fact, the case discloses no evidence that Taylor even knew of the existence of Paramount Petroleum until after Paramount Steamship failed to pay its invoices when due.

interests in a single project. For example, a real estate development company which uses several affiliated companies, such as a management company, a construction company, a financing company, etc., with similar names to carry out the common business purpose of constructing and operating a project is a prime candidate for the application of the *Paramount* holding.

D. Rights and Duties of Partners

1. *Amendments to Limited Partnership Agreement. Reilly v. Rangers Management, Inc.*³³ involved the validity of certain amendments to a limited partnership agreement. Rangers Management, Inc. and CCK, Inc., the general partners in Texas Rangers, Ltd.,³⁴ proposed to amend the limited partnership agreement to change the price for which newly issued partnership units could be issued and to permit the partnership to issue an unlimited number of units.³⁵ Michael Reilly, one of Texas Rangers' seventeen limited partners, objected to the validity of the proposed amendments, the issuance of new units and the dilution of his interest. Reilly claimed that the proposed amendments could not be adopted consistent with the provisions of the limited partnership agreement without the unanimous consent of the limited partners because the proposed amendments would adversely affect the general liability of the limited partners and change the manner in which the partnership allocated profits and losses and distributed partnership funds and assets.³⁶

Rangers Management and CCK brought an action to have the proposed amendments declared adopted and also to have the limited partnership agreement, as amended, declared in full force and effect.³⁷ The district court granted summary judgment in favor of Ranger management and CCK. Reilly appealed on the grounds that the proposed amendments required the unanimous consent of the limited partners under the terms of the limited partnership agreement.

The court of appeals overruled each of Reilly's grounds of error and af-

33. 30 Tex. Sup. Ct. J. 333 (April 1987).

34. Texas Rangers, Ltd. was a limited partnership created to purchase and operate an American League baseball franchise known as the Texas Rangers. The initial general partner was Ranger Management, but later CCK was admitted as a second general partner.

35. Under the limited partnership agreement, no more than 300 partnership units could ever be issued and the price per unit was set to be no less than \$50,000 each.

36. The agreement required the unanimous consent of the limited partners for any amendment that would (1) adversely affect the general liabilities of the limited partners, (2) change the method of allocation of the profits or losses of the partnership, or (3) change the method of distribution of the partnership funds or assets. Any other amendments to the agreement required the approval of the holders of a two-thirds percentage interest in the partnership. At the time the general partners proposed the amendments for adoption, RMI and CCK owned an 83.78% percentage interest in the partnership. RMI and CCK and five limited partners voted in favor of the proposed amendments. One limited partner voted against the proposed amendments. Eleven partners, including Reilly, did not vote.

37. See TEX. REV. CIV. STAT. ANN. art. 2524-1 (repealed 1985) now codified at TEX. CIV. PRAC. & REM. CODE § 37.004 (Vernon 1986).

firmed the district court's judgment.³⁸ Regarding the general liability argument, the court of appeals stated that for an amendment to adversely affect the general liability of limited partners, the amendment must make a limited partner liable beyond his partnership contribution.³⁹ Since the proposed amendments did not require that the limited partners increase their partnership contributions, they did not adversely affect the general liability of limited partners.⁴⁰ Accordingly, the court of appeals concluded that the proposed amendments did not adversely affect the general liabilities of the limited partners.⁴¹

Concerning allocations of profits and losses, Reilly argued that the possibility of an unlimited number of partners who would share in profits and losses in proportion to their interests changed the very basis of the method of allocation. The court of appeals acknowledged that Reilly was correct in recognizing that the more partners there are, the lesser amount each will receive of the profits, but pointed out that an increase in the number of partners did not change the method of allocation of profits and losses.⁴² Instead, it simply changed the number of people to whom the partnership allocated profits and losses.⁴³ Accordingly, the court of appeals concluded that the method of allocation of profits and losses would not change as a result of the proposed amendments.

With respect to the distribution contention, Reilly asserted that the proposed amendments allowed a dilution that would potentially reduce or eliminate the distribution to which a partner was previously entitled, and that this diminution constituted a change in the "distribution of the partnership funds or assets."⁴⁴ The appellate court acknowledged that the sale of more partnership units would potentially reduce or eliminate the distribution of funds and assets; however, the court refused to conclude that a change in the method of distribution had occurred.⁴⁵

Reilly's final contention was that TULPA section 10 barred the admission of additional limited partners absent a provision in the certificate to the contrary; therefore, the law required unanimous consent to adopt the proposed amendments.⁴⁶ The court of appeals concluded that the proposed amend-

38. 717 S.W.2d 442 (Tex. App.—Fort Worth 1986, writ granted).

39. *Id.* at 447.

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.* at 448. The court gave the following example of a change in the method of allocation: a change in the provision so that the managing general partner received as his share a different percentage. Another example would be an amendment that gave the general partners a set amount rather than allocating to them their share in proration to their relative interest in the partnership.

44. *Id.*

45. *Id.* TEX. REV. CIV. STAT. ANN. art. 6132a, § 10 (Vernon 1970).

46. TEX. REV. CIV. STAT. ANN. art. 6132a, § 10 (Vernon 1970). In support of the same contention, Reilly asserted that sections 25(b)(3) and 26(a)(2) of the TULPA required that all limited partners must sign and swear to an amendment before it can be adopted. The appellate court acknowledged that while this additional support was an accurate statement of the law, Reilly and other limited partners assigned the original agreement that contained a power of attorney giving the general partners the power to sign any validly adopted amendment for the

ments did not give the general partner the right to admit people as limited partners. Rather, the proposed amendments merely allowed for the issuance of more than the previous maximum of 300 units, without specifying who would buy them.⁴⁷ Because the proposed amendments did not alter the general partner's authority to admit people as limited partners, the court reasoned that the law did not require unanimous consent to adopt the proposed amendments.⁴⁸

Reilly applied for and received a writ of error from the Texas Supreme Court.⁴⁹ Reilly asserted that the limited partnership agreement was at least ambiguous with respect to the unanimous consent provision and that the district court, for that reason, was improper in granting summary judgment against him. The court agreed with Reilly and remanded the case to the district court for trial on the grounds that the interpretation of the limited partnership agreement was a question of fact for the jury.⁵⁰

The supreme court looked at the limited partnership agreement as a whole in light of the circumstances existing at the time the parties entered the agreement to determine whether the intention of the parties as evidenced by the agreement was ambiguous. Pertinent to the court's inquiry was the rule of construction that "a court should construe contracts from a utilitarian standpoint bearing in mind the particular business activity sought to be served and need not embrace strained rules of interpretation which would avoid ambiguity at all cost."⁵¹ Also relevant was the rule that "[c]ourts will avoid when possible and proper a construction which is unreasonable, inequitable, and oppressive."⁵²

Reading the limited partnership agreement in a light most favorable to Reilly, the supreme court determined that (1) the limited partnership agreement evidenced the limited partners' intent to protect their limited partnership interests from dilution and (2) a reasonable and utilitarian construction of the unanimous consent provision was that the parties intended that it would insure against a nonconsensual dilution of a limited partner's interest.⁵³ Elimination of such a protection without the unanimous consent of the limited partners, the court concluded, was potentially oppressive.⁵⁴ Accordingly, the supreme court held that a fact issue existed as to whether the amendments required unanimous approval and remanded the case to the district court for trial.⁵⁵ Three justices dissented and would have had the court affirm the decision of the court of appeals on the grounds that the

limited partners. The general partners therefore did not need the actual signature of each limited partner on the agreement to validly adopt the proposed amendments. See *id.* § 33.

47. 717 S.W.2d at 450.

48. *Id.*

49. 30 Tex. Sup. Ct. J. 140 (Jan. 14, 1987).

50. *Id.* at 335-36.

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.* at 336.

limited partnership agreement was clear and unambiguous.⁵⁶

*Aztec Petroleum Corporation v. MHM Company*⁵⁷ involved a group of limited partners who amended their limited partnership agreement to allow replacement of the general partner and conversion of the general partner's interest to that of a special limited partner pursuant to an explicit amendment power set forth in the limited partnership agreement.⁵⁸ The issue before the court was whether this action by the limited partners violated the TUPA, the TULPA, contract law, or the partnership agreement.

Aztec Petroleum Corporation was the initial general partner of a limited partnership. The limited partners became disenchanted with Aztec's performance as general partner and sought to replace Aztec with MHM Company. The limited partnership agreement, however, contained no specific provision addressing the removal of the general partner. The limited partners attempted to circumvent this problem by proposing an amendment to the limited partnership agreement that would permit the holders of seventy percent or more of the partnership units by affirmative vote to convert Aztec from a general partner to a special limited partner and to replace Aztec with a new general partner.⁵⁹ The limited partners approved the proposed amendment over the objection of Aztec and then proceeded to convert Aztec to a special limited partner and install MHM as the new general partner. Aztec, however, refused to step aside as general partner and filed suit against MHM. The trial court granted summary judgment in favor of MHM, and Aztec appealed.

In the appellate court Aztec challenged its removal and the substitution of MHM as general partner on statutory and contractual grounds. Aztec's first

56. *Id.*

57. 703 S.W.2d 290 (Tex. App.—Dallas 1985, no writ).

58. The provision of the partnership agreement regarding amendments permitted the owners of 10% or more of the limited partnership units to submit a written proposal for the amendment to the general partner, whereupon the general partner was required to transmit a verbatim statement of the proposed amendment to the limited partners, accompanied by the general partner's recommendation for passage or defeat of the amendment. The limited partners would then vote on the amendment and if the owners of 70% or more of the limited partner units voted in favor of the amendment, the amendment became effective.

59. The critical proposed amendment provided:

6.6 *Removal and Replacement of a General Partner.* Upon receipt by the General Partner of written notice of removal from Limited Partners holding either 70% or more of the Units or 70% or more in interest of the Sharing Ratios of the Limited Partners (the "Removal Notice"), Aztec Petroleum Corp. or any successor General Partner to Aztec Petroleum Corp. as General Partner (the "Removed General Partner") shall be removed as General Partner of the Partnership. The Removal Notice shall be given to the General Partner as provided for in Section 11.1 of this Agreement. The Limited Partners signing the Removal Notice shall designate in the Removal Notice a new general partner (the "Substitute General Partner") to serve as General Partner under this Agreement. Effective as of 6:00 p.m., Dallas, Texas time, on the day of receipt of the Removal Notice, which day shall be referred to hereinafter as the "Removal Date," the Partnership interest of the Removed General Partner shall be converted automatically to a Special Limited Partnership interest as described in Section 6.7 and the Removed General Partner shall no longer be General Partner and shall have no right or authority to act on behalf of or bind the Partnership.

statutory ground was that MHM could not legitimately become a partner without Aztec's consent because the TUPA precludes a person from becoming a member of a partnership without the consent of all the partners.⁶⁰ The appellate court, however, concluded that since the parties' rights and duties were set forth in the limited partnership agreement the foregoing part of the statute was not applicable.⁶¹ Relying on prior Texas law, the appellate court held that in such a situation the limited partnership agreement controls, not the TUPA, and that courts may look to the TUPA only for guidance.⁶² Accordingly, the TUPA did not require that Aztec consent before the limited partners could replace it as a general partner.

Aztec's second statutory ground was that its removal violated the TUPA and the TULPA because all of the limited partners did not approve of the removal.⁶³ Aztec claimed that the statutes require that all limited partners must consent before a general partner may be removed and replaced. The court once again disagreed with Aztec's interpretation of the statutes, concluding that the statutes limit only the powers of a *general partner* to admit another general partner.⁶⁴ The statutes, however, do not limit the powers of the *limited partners* when the partnership agreement may be amended by seventy percent of the limited partnership units and such a majority has adopted an amendment permitting removal and substitution of a general partner.⁶⁵ Accordingly, the appellate court held that the limited partners' action in amending the limited partnership agreement and removing Aztec did not violate either the TUPA or the TULPA.⁶⁶

Aztec's first contract law challenge was that its identity as the only general partner was a fundamental element of the limited partnership agreement. Aztec claimed that the parties obviously intended, and basic principles of contract law dictated, that unanimous consent would be required before a new general partner could be substituted. Although the appellate court agreed with Aztec's assertion as a matter of general contract law, the limited partnership agreement specifically provided that a less than

60. *Id.* at 292. TEX. REV. CIV. STAT. ANN. art. 6132b, § 18(1)(g) (Vernon 1970).

61. 703 S.W.2d at 293.

62. *Id.* See *Park Cities Corp. v. Byrd*, 534 S.W.2d 668, 672 (Tex. 1976). In the present case the court noted that the limited partnership agreement differed from the TUPA in two respects. First, the agreement permitted upon the approval of 70% of the partners additional partners to join the partnership. Second, the agreement permitted amendment of the limited partnership agreement upon the approval of 70% of the limited partnership units and did not limit the scope of amendments so as to preclude an amendment calling for the replacement of a general partner. Based on these differences, the court concluded that the limited partnership agreement, rather than the TUPA, controlled. 703 S.W.2d at 293.

63. See TEX. REV. CIV. STAT. ANN. art. 6132a, § 10(a) (Vernon 1970), which provides:

A general partner shall have all the rights and powers and be subject to all the restrictions and liabilities of a partner in a partnership without limited partners, except that without the written consent or ratification of the specific act by all the limited partners, a general partner or all of the general partners have no authority to:

.....

(5) Admit a person as a general partner.

64. 703 S.W.2d at 293.

65. *Id.*

66. *Id.* at 295.

unanimous vote of the limited partners could ratify an amendment to the limited partnership agreement. Furthermore, the TUPA specifically authorizes such a provision.⁶⁷ The limited partnership met any unanimity required by contract law when all the parties to the limited partnership agreement consented to be bound by any amendments passed by seventy percent of the limited partners.⁶⁸

Aztec's second contract law challenge was that the limited partnership agreement itself required unanimous consent before replacement of the general partner. Aztec based its contention on provisions of the limited partnership agreement that provided for liquidation of the limited partnership upon the withdrawal, dissolution, or bankruptcy of the general partner, and also provided for the powers of the limited partners under those circumstances. The court rejected Aztec's contention, noting that those sections of the limited partnership agreement did not address the situation of the forcible removal of a general partner.⁶⁹ Aztec, in relying on the TULPA, ignored the fact that the fundamental rights, duties, and obligations of the parties to the contract were not excepted from the limited partnership agreement amendment provisions.⁷⁰ Once Aztec agreed to the contract that included the provision allowing for the seventy percent amendment approval, Aztec could not then create an exception for what it saw as a fundamental element of the contract.⁷¹ Consequently, the appellate court ruled that the limited partners' actions in removing and replacing Aztec as general partner did not violate contract law.⁷²

Finally, Aztec contended that the removal and replacement by the limited partners violated the express terms of the limited partnership agreement regarding the restrictions on the limited partners' participation in the management of the limited partnership⁷³ and that changing the general partner amounted to interference by the limited partners with the management of the limited partnership. The appellate court dealt two blows to these contentions. First, the court cited statutory authority which provided that "exercising a right to amend a partnership agreement does not constitute taking part in the control of the business by the limited partners."⁷⁴ Second, the

67. TUPA § 18(a) provides that the rights and duties of partners in relation to the partnership are subject to any agreement between them. TEX. REV. CIV. STAT. ANN. art. 6132b, § 18(a) (Vernon 1970).

68. 703 S.W.2d at 294.

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.* at 295.

73. Aztec relied upon § 7.1 of the limited partnership agreement, which stated: *No Right to Participate in Management.* Except as otherwise expressly provided herein, the Limited Partners shall have no right to, nor shall they, bind the Partnership or take any part in or interfere with the conduct, control or management of the Partnership's business.

703 S.W.2d at 294.

74. *Id.* at 295 (discussing TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b)(5)(B) (Vernon Supp. 1987)). TULPA § 8(b)(5)(B) provides:

(b) A limited partner does not take part in the control of the business by virtue of possessing or exercising a power to:

provision of the limited partnership agreement upon which Aztec relied included the phrase "[e]xcept as otherwise expressly provided herein."⁷⁵ The appellate court explained that even if replacing a general partner amounted to taking part in the control of the business, once the limited partnership adopted the amendment providing for removal, replacing Aztec fell within the "except as herein provided" language of the limited partnership agreement.⁷⁶ Consequently, the appellate court upheld the limited partners' actions in removing Aztec as general partner.

The *Aztec* case illustrates the reverence which Texas courts attach to the seeming sacrosanctity of the partnership agreement. A controlling block of partners, bridled only by their fiduciary duty among themselves, may add or delete provisions of the partnership agreement to suit their fancy so long as they have the requisite number of votes to carry an amendment to the partnership agreement.

2. *Joint Venture Management.* In *RGS, Cardox Recovery, Inc. v. Dorchester Enhanced Recovery Co.*⁷⁷ construction of an unusually worded voting provision in a joint venture agreement enabled the owners of a minority interest to deadlock the management of the joint venture. The provision read as follows: "No Management Committee meeting may be held or action taken unless voting members representing aggregate venture percentages of at least seventy-five percent (75%) are present and voting, and all decisions except as otherwise herein provided shall be by majority vote."⁷⁸ At a meeting of the management committee of the joint venture, a vote was called on the issue of whether RGS should be installed as field operator of the oil and gas operations of the joint venture rather than Dorchester Enhanced Recovery Company. Dorchester and others owning an aggregate interest in excess of twenty-five percent in the joint venture announced that with respect to changing operators each was "present, but not voting." RGS and others, representing, in aggregate, approximately fifty-four percent of the ownership interest in the venture, voted to remove Dorchester as field operator of the operations, and to install RGS in the position.

RGS brought a declaratory judgment action seeking either reformation or interpretation of the joint venture agreement. RGS claimed that the disputed provision required a quorum in order to transact business, and that after the quorum had been reached, the management committee could con-

.....
 (5) Approve, individually or by a majority of the limited partners (by number, financial interest, or as otherwise provided in the certificate), material matters that are stated in the certificate, such as:

.....
 (B) Amendment of the partnership certificate or agreement.

TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b)(5)(B) (Vernon Supp. 1987).

75. 703 S.W.2d at 295.

76. *Id.* The court stated: "We cannot see how proposing, voting on and approving an amendment to the partnership agreement in the exact method provided within it can violate the express terms of the partnership agreement." *Id.*

77. 700 S.W.2d 635 (Tex. App.—Corpus Christi 1985, writ ref'd n.r.e.).

78. *Id.* at 637.

duct such business as was approved by the owners of a majority of the interests represented. Dorchester moved for summary judgment, urging that the provision was unambiguous. The trial court granted Dorchester's summary judgment motion, holding the language unambiguous upon the fact that the joint venture agreement required at least seventy-five percent of the joint venture interest be present and voting on each issue before business could be conducted.

The appellate court upheld the trial court's decision.⁷⁹ The court interpreted the first phrase of the voting provision, which clearly controlled when an action could be taken, as requiring voting members representing at least a seventy-five percent interest to be both *present and voting*.⁸⁰ The court interpreted the second phrase of the voting provision as specifying the percentage vote necessary to approve any such action.⁸¹ Reading the two provisions together, the court concluded that the owners of a majority in interest must vote in favor of an action in order to approve the action, but that the owners of at least seventy-five percent of the joint venture interest must be present and voting on such action in order for the vote to be effective.⁸² That the provision might be burdensome or awkward was not a problem for the courts.⁸³ Since the parties agreed to the provision, each party had the right to rely on compliance with the provision as agreed.⁸⁴

3. *Right to an Account. Cornell & Company v. Pace*⁸⁵ addressed the issue of whether a deceased partner's widow could sue other partners for conversion. Two partnerships, Cornell & Company and Cornell Investment Company of Amarillo, consisted of the same six certified public accountants.⁸⁶ James C. Pace was a partner in both partnerships until August 31, 1981, when he withdrew from the partnerships to start another accounting firm comprised of unrelated persons. In October 1981, Pace committed suicide.

The partnerships in which Pace was a partner were continuing businesses involving a multitude of transactions and a complexity of accounts. A detailed accounting was necessary to adjust the partners' accounts and a formal accounting was necessary to determine each partner's interest. Pace's widow, acting individually and as independent executrix of Pace's estate, sued for an accounting to recover the unpaid value of Pace's interests in the partnerships. She also alleged that partners and the partnerships had converted the value of Pace's interests in the partnerships since the partners and the partnerships had failed to provide her with Pace's share of the partnerships' assets. This allegation was apparently in recognition of the complex

79. *Id.* at 640.

80. *Id.* at 638-39.

81. *Id.* at 639.

82. *Id.*

83. *Id.*

84. *Id.*

85. 703 S.W.2d 398 (Tex. App.—Amarillo 1986, writ ref'd n.r.e.).

86. Cornell & Company was a CPA partnership and Cornell Investment Company was a partnership formed to own and lease real property.

accounts of the partnerships and in response to difficulty in reaching an agreeable accounting. The trial court entered judgment for Pace's widow, and the partners appealed. The case presented the classical situation of a partner, his personal representative, or his surviving spouse being barred from suing another partner for conversion until an accounting has been completed. Until the completion of the accounting, the only remedy available to such a person is a suit for an accounting.⁸⁷ The general rule that an accounting is a condition precedent to an action based on partnership claims to ascertain the amounts recoverable dictates this result.⁸⁸ Hence, Pace's widow could not commence an action for conversion for money represented by a general debt from the partnerships until such time as the suit for an accounting had been completed.

E. Dissolution

*Thomas v. American National Bank*⁸⁹ addressed the issue of whether a joint venture known as Southwestern Cinema had dissolved prior to refinancing a \$360,000 loan it had entered into with American National Bank ("American"), thereby excusing two former members of the joint venture from liability for the repayment of the loan. Charles F. Thomas, B.J. McCombs, and the PGR Investment Company formed Southwestern Cinema to purchase and distribute two motion pictures. Each venturer owned one-third of Southwestern Cinema and PGR was the managing venturer. PGR was a partnership that consisted of Celso Gonzalez and three other individuals. Gonzalez was the managing partner of PGR. Gonzalez, under the express authority of the Southwestern Cinema joint venture agreement, could finance the venture by borrowing up to a maximum of \$500,000. In 1981, Southwestern Cinema obtained a loan of \$360,000 from Parkdale State Bank.

Thomas, McCombs, and PGR were all partners in Southwestern Cinema at the time of the loan transaction and acknowledged that they were individually liable as such for the Parkdale indebtedness. Shortly thereafter, Thomas and McCombs became disenchanted with their involvement in the venture because of their inability to obtain information from Gonzalez with regard to their interests. In the early part of 1982, Thomas told Gonzalez that he and McCombs wanted out of Southwestern Cinema. The three of them subsequently agreed that Thomas and McCombs would assign their interests in Southwestern Cinema to Gonzalez in his individual capacity.

In May 1982, and on behalf of Southwestern Cinema, Gonzalez negotiated a new loan with American and paid off the Parkdale indebtedness with the proceeds. Southwestern Cinema, however, failed to repay the American loan when it came due. As a result, American demanded payment from the partners of Southwestern Cinema individually. American then brought an action against Southwestern Cinema and its partners to collect on the loan.

87. 703 S.W.2d at 403.

88. *Id.*

89. 704 S.W.2d 321 (Tex. 1986).

The trial court granted American's motion for summary judgment against Southwestern Cinema, Thomas, McCombs, PGR and the partners of PGR, jointly and severally. The court based this finding on the fact that Southwestern Cinema had not dissolved prior to the time of the loan from American. The court of appeals affirmed the trial court judgment, holding Thomas and McCombs liable on the note to American because they had not effectively withdrawn from Southwestern Cinema.⁹⁰ Thomas and McCombs petitioned the Texas Supreme Court for, and received, a writ of error.

The key issue addressed by the supreme court involved whether withdrawal from the partnership by a number of partners sufficient to dissolve the partnership contractually, coupled with an assignment of their interests to a remaining partner, was sufficient to dissolve the partnership. American strongly urged that the partnership in this case was not dissolved because the assignment of the partnership interests by Thomas and McCombs to Gonzalez did not of itself dissolve the partnership.⁹¹ The supreme court, however, focused on the dissolution provisions of the TUPA,⁹² rather than the assignment provisions and concluded that the withdrawal by Thomas and McCombs from the partnership caused a change in the relation of the partners since they ceased to be associated in the carrying on of the business.⁹³ Therefore, the partnership dissolved as of the date of withdrawal.⁹⁴ Furthermore, even if the remaining partners had elected to continue the partnership, the entity would still have dissolved as to the partners who withdrew from the business.⁹⁵ Relying on decisions in other states that have applied this rule in the context of a simultaneous dissolution and transfer of interest, the court concluded the express will of the outgoing partner to dissolve the partnership controls.⁹⁶

The supreme court also addressed the issue of what constituted sufficient notice of a partner's desire to withdraw from a partnership. The court held that there is no requirement that notice of dissolution, a matter relating to partnership affairs, be communicated to each member of a joint venture since "notice to any partner of any matter relating to partnership affairs . . . operates as notice to or knowledge of the partnership."⁹⁷ Relying on an early Texas Supreme Court case that held it not necessary to have a distinct agreement between all the members regarding the precise time of a dissolution,⁹⁸ the court determined that any of the partners in the firm could have dissolved the partnership in any manner.⁹⁹ The court noted that its conclusion was in accordance with decisions of other states that the giving of notice

90. 694 S.W.2d 543, 551 (Tex. App.—Corpus Christi 1985), *rev'd*, 704 S.W.2d 321 (Tex. 1986).

91. See TEX. REV. CIV. STAT. ANN. art. 6132b, § 27(1) (Vernon 1970).

92. *Id.* §§ 29, 31.

93. 704 S.W.2d at 323.

94. *Id.* at 323-24.

95. *Id.*

96. *Id.* at 324.

97. *Id.* (quoting TEX. REV. CIV. STAT. ANN. art. 6132b, § 12 (Vernon 1970)).

98. See *Green v. Waco State Bank*, 74 Tex. 2, 14 S.W. 252 (1890).

99. 704 S.W.2d at 324.

to other partners accomplished dissolution and that no particular form of notice is required.¹⁰⁰

An alternative ground upon which the supreme court could have based its holding is section 35 of the TUPA, which limits the power of a partner to bind a partnership after dissolution to (1) acts appropriate for winding up partnership affairs or completing transactions unfinished at dissolution and (2) acts with persons who were creditors of the partnership at or prior to dissolution, or persons who had knowledge of the partnership, who were not on notice that a dissolution had taken place.¹⁰¹

F. Procedural Matters

1. *Jurisdiction. Colwell Realty Investments, Inc. v. Triple T Inns of Arizona, Inc.*¹⁰² discussed the issue of whether sufficient contacts existed between the general partner of an Arizona limited partnership and the State of Texas to warrant Texas' exercise of personal jurisdiction over the Arizona limited partnership in a contract action brought by a Texas corporation. The only contacts the general partner had with Texas were that (1) it consented to the substitution of the Texas corporation as a limited partner in place of a California corporation, (2) it engaged in partnership activities that it knew would require the consent of the Texas limited partner, and (3) it caused foreseeable injuries to the Texas limited partner by proceeding with its activities without receiving consent from the Texas limited partner. In affirming the trial court's dismissal of a suit against the general partner for lack of personal jurisdiction, the appellate court held that a nonresident cannot be held subject to a forum's jurisdiction merely by contracting with a resident of that forum.¹⁰³ Similarly, acts performed outside of the forum which were in breach of the contract were irrelevant to the issue of personal jurisdiction. The appellate court added that a forum does not have jurisdiction over a nonresident general partner merely because the forum is the limited partner's state of incorporation.¹⁰⁴ The appellate court examined such factors as "prior negotiations, contemplated future consequences, terms of the contract, and the parties' actual course of dealing"¹⁰⁵ to determine whether the general partner's consent to the substitution purposefully established minimum contacts in Texas sufficient to subject it to jurisdiction in Texas, and concluded that it did not.¹⁰⁶

100. *Id. See, e.g., Webster & Co. v. Nestle*, 669 P.2d 1046 (Colo. App. 1983) (withdrawal of a partner); *Babray v. Carlino*, 2 Ill. App. 3d 241, 276 N.E.2d 436 (1971) (verbal agreement to dissolve); *Cave v. Cave*, 81 N.M. 797, 474 P.2d 480 (1970) (mutual consent to dissolve evidenced by acts); *Nicholes v. Hunt*, 273 Or. 255, 541 P.2d 820 (1975) (telephone call advising partner that business relationship was at an end was sufficient at dissolution); *Timmermann v. Timmermann*, 272 Or. 613, 538 P.2d 1254 (1975) (oral notice).

101. TEX. REV. CIV. STAT. ANN. art. 6132b, sec. 35.

102. 785 F.2d 1330 (5th Cir. 1986).

103. *Id.* at 1334.

104. *Id.*

105. *Id.*

106. *Id.*

*Texas Commerce Bank, N.A. v. Interpol '80 Limited Partnership*¹⁰⁷ involved the issue of whether a Colorado limited partnership that had contracted with a Colorado corporation to purchase and exploit Texas natural resources was subject to the jurisdiction of the State of Texas in a contract action brought by a Texas banking association, which was the assignee of accounts receivable of the Colorado corporation. The court concluded that the contract from which the suit arose, a partially performed contract for the limited partnership to purchase and exploit Texas oil and gas interests, was sufficient to satisfy the requirement that a nexus must exist between the cause of action and the limited partnership's contacts with Texas.¹⁰⁸ Furthermore, the limited partnership had purposefully availed itself of the privilege of conducting activities in Texas by entering into the contract concerning Texas oil and gas interests,¹⁰⁹ by reserving in the contract the rights to maintain its own representatives at the well site, and by agreeing that Texas law would govern any disputes arising out of the contract.¹¹⁰ Therefore, the court held that the Colorado corporation was subject to the jurisdiction of Texas courts.

II. CORPORATION LAW DEVELOPMENTS

A. Piercing the Corporate Veil

The Texas Supreme Court in *Castleberry v. Branscum*¹¹¹ held by a narrow five-to-four majority that constructive fraud by the shareholders of a closely held corporation, in liquidating the corporation without paying the corporation's notes to a redeemed shareholder, constituted inequitable treatment sufficient to justify piercing the corporate veil.¹¹² Accordingly, the court imposed personal liability for the payment of the notes on the shareholders.¹¹³ The *Castleberry* case is important because it substantially broadens the grounds for piercing the corporate veil in a contract case.

Castleberry involved a furniture moving business started in 1980 by Joe A. Castleberry, Byron Branscum and Michael G. Byboth. Castleberry, Branscum, and Byboth later incorporated the business as Texan Transfers, Inc. Shortly after the incorporation of Texan Transfers, Branscum formed a competing business, Elite Moving. Castleberry did not approve of Elite Moving competing with Texan Transfers and became disenchanted with his business relationship with Branscum. In order to relieve the tension between the parties, Texan Transfers redeemed Castleberry's stock in exchange for a \$42,000 unsecured promissory note from the corporation. Neither Branscum nor Byboth personally guaranteed the payment of the note.

After the redemption, Branscum and Byboth permitted Elite Moving to

107. 703 S.W.2d 765 (Tex. App.—Corpus Christi 1985, no writ).

108. *Id.* at 771.

109. *Id.* at 773.

110. *Id.*

111. 721 S.W.2d 270 (Tex. 1986).

112. *Id.* at 275.

113. *Id.*

take over increasing amounts of Texan Transfers' business. Branscum and Byboth also permitted Texan Transfers to loan Elite Moving its trucks and employees without written rental agreements or other records to show how much Elite Moving owed Texan Transfers for the use of the trucks and employees.¹¹⁴ Over time, Texan Transfers' business declined dramatically and Elite Moving's business operated at a relatively successful level.

Texan Transfers paid the first installment (\$1,000) on the note to Castleberry, but defaulted on the remaining \$41,000. Shortly thereafter, Castleberry sued Texan Transfers, Branscum, and Byboth to recover on the note. Castleberry's lawsuit prompted Byboth and Branscum to terminate Texan Transfers' contract with its most important customer, Freed Furniture, and to start another furniture moving company, Custom Carriers, Inc. Branscum and Byboth negotiated Custom Carriers a contract with Freed Furniture to make the same deliveries as Texan Transfers formerly handled and at the same rate. After the termination of the Freed Furniture contract, Texan Transfers no longer had a significant amount of business. This prompted Branscum and Byboth to liquidate it, selling all of its trucks to individuals who later became independent contractors for Custom Carriers. Branscum and Byboth paid themselves "back salaries" with the proceeds of the liquidation.

In Castleberry's complaint he alleged personal liability against Branscum and Byboth on the note under an alter ego theory.¹¹⁵ The trial court instructed the jury that Texan Transfers could become the alter ego of Branscum and Byboth if they used the corporation as a sham to perpetrate a fraud or if they failed to follow one or more corporate formalities. The instruction defined fraud not as actual fraud, which requires an intent to deceive, but as constructive fraud—"an act, omission or concealment that involves a breach of a legal duty, trust or confidence justly reposed and that is injurious to another person, or by which an undue or unconscionable advantage is taken."¹¹⁶ The trial court rendered judgment against Texan Transfers based on a jury finding that Branscum and Byboth used Texan Transfers as a sham to perpetrate a fraud, and disregarded the corporate fiction to hold Branscum and Byboth individually liable on the note.¹¹⁷ The appellate court reversed, holding that no evidence supported the jury's findings; that the instruction submitted to the jury was defective; and that the issues should not have been submitted to the jury because a disregard of the corporate fiction is solely a question of law.¹¹⁸ In November 1985, the Texas Supreme Court, in a *per curiam* decision, initially denied Castleberry's application for writ of error, but the court later reversed itself on Castleberry's motion for

114. Additionally, Branscum and Byboth declined to advertise on behalf of Texan Transfers in any manner, but permitted Elite Moving to advertise.

115. Some evidence indicated that Branscum and Byboth failed to follow some corporate formalities.

116. 721 S.W.2d at 276.

117. *Id.* at 271.

118. *Id.*

rehearing on the denial of the writ.¹¹⁹ A sharply divided supreme court then proceeded to reverse the appellate court's judgment and affirm the trial court's decision, holding that (1) there was sufficient evidence to support the jury's findings, (2) although the submitted jury charge was defective, the defendants waived all objections, and (3) disregarding the corporate fiction is a fact question for the jury.¹²⁰

The court's opinion is unclear with respect to the nature and extent of its holding.¹²¹ As a result, at least three possible readings of the supreme court's opinion are plausible: (1) that a showing of constructive fraud is sufficient to pierce the corporate veil in a contract case; (2) that a showing of mere unfair or inequitable treatment is sufficient to justify the imposition of an equitable remedy; or (3) that the court simply accepted the test used in the trial court because no proper objection was raised to it. One thing that is clear, however, from the supreme court's opinion is that equitable considerations play a major role in the determination of whether a court will disregard the corporate existence.

The dissenting opinion in *Castleberry* is far from timid in its challenges to the soundness of the majority opinion, attacking it as making "hypertechnical" arguments and stretching the imagination in uncovering a method to support a jury finding in the face of an admittedly defective jury charge.¹²² Whether *Castleberry* had suffered an actionable wrong, however, was not a point of contest between the justices. The issue, rather, was whether *Castleberry* had jumped through the proper hoops in his quest for a recovery. The majority based its opinion on the theory that constructive fraud is a sufficient ground to disregard the corporate entity and to support a recovery from the perpetrators of the constructive fraud.¹²³ The dissent, however, would require a complaining party to establish facts that parallel a more pigeon holed pleading requirement in order to recover.¹²⁴

The importance of the supreme court's opinion is twofold. First, the opinion substantially broadens the grounds upon which a court may disregard corporate existence in a contract case. Second, it retreats from the court's previously stringent standard announced last survey period in *Lucas v.*

119. 29 Tex. Sup. Ct. J. 123 (Jan. 11, 1986).

120. 721 S.W.2d at 275-77.

121. Much of the ambiguity results from the fact that *Castleberry's* theories of liability and the jury instructions did not align themselves well with the facts of the case.

122. 721 S.W.2d at 280-81 (Gonzalez, J., dissenting).

123. As stated by the court:

[T]he purpose in disregarding the corporation fiction "is to prevent use of the corporate entity as a cloak for fraud or illegality or to work an injustice, and that purpose should not be thwarted by adherence to any particular theory of liability" . . . "When this [disregarding the corporate fiction] should be done is a question of fact and common sense . . ."

Id. at 273 (quoting).

124. The dissenting opinion conceded that the facts of the case probably supported a cause of action for recovery under such theories as denuding of corporate assets or constructive trust. The dissent, however, was adamant in its conclusion that the facts failed to support the actual theory of law pleaded by *Castleberry*, that of alter ego, and that *Castleberry* never even pleaded sham to perpetuate a fraud, the theory upon which he ultimately recovered. *Id.* at 280.

*Texas Industries, Inc.*¹²⁵ In *Lucas* the court held that in a contract case the plaintiff who seeks to disregard the corporate entity must show some deception or fraud in order to prevail.¹²⁶ The *Castleberry* decision effectively dilutes *Lucas* by holding that a mere showing of constructive fraud, which exists whenever inequity or unfairness is at hand, is sufficient to justify piercing the corporate veil and imposing personal liability on the shareholders who perpetrate the constructive fraud.¹²⁷

Similarly, the supreme court has shown a reluctance to hang an aggrieved party on his pleadings in a disregard of the corporate entity case. As is evident from the majority opinion, all bases for ignoring the corporate existence could well become fungible if the court is willing to construe pleadings in a fashion most likely to bring the ultimate question of liability to the jury. The court's emphasis on equitable considerations coupled with its eagerness to bring the question of liability before the jury indicates that much of the regiment of theories for disregarding the corporate existence can hereafter be grouped under a single heading: constructive fraud.¹²⁸

On a practical level it appears that since the question of piercing the corporate veil is now firmly entrenched as a question of fact, proper jury issues and instructions are of primary importance to practitioners and lower courts. In this regard, both *Castleberry* and *Lucas* provide insightful reading. The residual messages of *Castleberry* from a practitioner's standpoint are that the plaintiff in a piercing the corporate veil case will now have an easier time surviving a motion for summary judgment on the issue of shareholder liability and that a defendant must recognize the importance of making a proper objection to an improper jury charge on that issue. *Castleberry* stands for the proposition that a plaintiff in a piercing the corporate veil case should separately and specifically plead each basis for disregarding the corporate entity in order to ensure that the jury has the opportunity to consider each such issue.

Rose v. Intercontinental Bank, N.A.,¹²⁹ a pre-*Castleberry* Texas court of appeals decision, held that a showing of bad faith is sufficient to overcome the deception or fraud standard for piercing the corporate veil in a contract case.¹³⁰ Ebb Rose was an officer and shareholder of two corporations: a corporation in the business of selling automobiles and a corporation in the business of leasing automobiles.¹³¹ Steve King was a personal assistant to

125. 696 S.W.2d 372 (Tex. 1984).

126. *Id.* at 374.

127. The dissenting opinion would retain the distinction between the standard applied in a contract case and a tort case. Additionally, the dissenting opinion supported the defendant's point of error regarding a defective jury charge.

128. It is interesting that the Texas Supreme Court, which in *English v. Fischer*, 660 S.W.2d 52 (Tex. 1983), strongly expounded the maxim that Texas imposed no general duty of good faith on parties to a contract, has now bent over backwards to rescue a party that has been treated inequitably under a contract. It is evident that the court in *Castleberry* has engaged in double-speak or has not considered the logical extension of its holding.

129. 705 S.W.2d 752 (Tex. App.—Houston [1st Dist.] 1986, writ ref'd n.r.e.).

130. *Id.* at 754.

131. His wife, son and two daughters owned the remaining shares.

Rose and managed the corporations. The sales corporation and the leasing corporation maintained checking accounts at Intercontinental Bank and Jetero Bank, respectively. King was the only person authorized to write checks on the corporate accounts.

In 1977 Rose sold all of the assets of the sales corporation to a third-party purchaser.¹³² King stayed on with Rose after the sale, continuing to operate the leasing corporation while winding up the affairs of the sales corporation. During the winding-up period, King issued several checks at Rose's request, making the checks out to Rose or to "Cash." King also wrote several checks payable to himself. The evidence showed that King wrote checks on both accounts to make payments on lease cars used by Rose, his family members, and friends. Rose made a \$10,000 down payment on his yacht with proceeds from the sales corporation's account, and Rose's daughter used cash from this account to repay a \$75,000 loan from the sales corporation. These withdrawals were made from the account despite the fact that the assets of the sales corporation had been sold and its affairs were being wound up. There was also testimony that Rose authorized advances to King in excess of \$100,000 out of the sales corporation's account.

In December 1979, Intercontinental Bank discovered that King's check writing activities had created an overdraft of \$283,331.15 in the sales corporation's account. Checks written on uncollected funds accounted for the overdraft. To cover negative balances, King had written checks back and forth between the leasing corporation's account at Jetero Bank and the sales corporation's account at Intercontinental Bank. On December 27, 1979, Jetero Bank, after discovering the overdrafts, froze the leasing corporation's account and thereby caused the overdraft of the sales corporation's account at Intercontinental Bank.

Intercontinental Bank brought an action against Rose, seeking to recover for the overdraft, alleging (1) that Rose was the sales corporation's alter ego, (2) that the sales corporation possessed insufficient assets to cover its transactions, and (3) that Rose used the checking accounts of the two corporations to perpetrate a fraud. In support of its contention Intercontinental Bank relied on a court of appeals decision which held that a sole shareholder guilty of grossly unfair manipulation of the corporate enterprise in his individual interest cannot be allowed to interpose the separate identity of the corporation to insulate himself from personal liability.¹³³ The trial court entered judgment against Rose based on a jury finding that he was the alter ego of the sales corporation. Rose appealed the trial court's judgment on the grounds that there was either no evidence or insufficient evidence to support the jury's finding on the theory of alter ego and that the trial court erred in submitting an alter ego charge to the jury.

132. The evidence indicated that the sales corporation was experiencing financial difficulties at the time of the sale and that corporate assets had to be sold and money had to be injected into the corporation by Rose's daughter to consummate the sale.

133. See *Tigrett v. Pointer*, 580 S.W.2d 375 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.).

In support of Rose's contentions on appeal, he asserted that in a contract alter ego case the law as set forth in *Lucas*¹³⁴ and *Torregrossa v. Szelc*¹³⁵ requires the complaining party to show that the individual used the corporation as a vehicle to perpetrate a fraud. Furthermore, Rose relied on the facts that he was not active in the management of the sales corporation, that he was not authorized to write checks on the corporate accounts, and that he put more money into the sales corporation than he took out, in an effort to show that he did not personally use the corporations to perpetrate a fraud. The appellate court overruled Rose's no evidence point, relying on the evidence mentioned above and also the additional evidence that on each occasion the sales corporation's account became overdrawn Rose agreed to personally inject funds into the account and that, absent the suspicious withdrawals, the sales corporation could have successfully wound up its business.¹³⁶

The appellate court disposed of Rose's insufficiency contention in two parts. First, it rejected Rose's legal theory that fraud was the only basis for submitting the alter ego theory to a jury in a contract action by holding that a showing of mere bad faith is sufficient.¹³⁷ The appellate court viewed the use or misuse that a shareholder makes of the corporate form as determinative of whether the shareholder will be insulated from personal liability and set forth the rule that "[f]ailure to distinguish between corporate property and personal property and use of corporate funds to pay personal expenses without proper accounting is a basis for submitting the issue of alter ego" to the jury.¹³⁸

Second, the appellate court concluded that the affirmative evidence put forth by Rose was insufficient to dislodge the jury finding where the record showed that Rose knew that Intercontinental Bank relied upon his assurances and credit and that Rose was aware that, should King borrow funds from the sales corporation, Rose would be required to sign a personal guaranty.¹³⁹ The appellate court held that the fact Rose was not actively involved in the day-to-day management of the sales corporation was not dispositive of the issue and concluded that such a fact did not contradict a finding of alter ego.¹⁴⁰ The appellate court additionally noted that when Rose, as an officer, manipulated the sales corporation's account during the winding up of its affairs, Rose breached a fiduciary duty:

[w]inding up the affairs of an insolvent corporation is an exceptional situation. In this situation, a jury could find that manipulation of the corporate bank account by an officer of the corporation justifies piercing the corporate veil.

.....

134. 696 S.W.2d 372 (Tex. 1984).

135. 603 S.W.2d 803 (Tex. 1980).

136. 705 S.W.2d at 754.

137. *Id.* at 755.

138. *Id.*

139. *Id.*

140. *Id.*

. . . We hold that facts that show that an exceptional circumstance existed between a creditor and a majority stockholder of a corporation, and that also show a lack of good faith dealings by that majority shareholder with that creditor, provide a sufficient basis to pierce the corporate veil.¹⁴¹

Rose also challenged the form and substance of the trial court's alter ego charge to the jury on the grounds that it was a global submission containing surplusage and an improper definition.¹⁴² In order to prevail Rose had to object properly to the charge and show that the variance between the pleadings and the evidence offered at trial was substantial, misleading, constituted surprise, and was prejudicial.¹⁴³ The appellate court, however, rejected Rose's challenge on the grounds that (1) his objection failed to point out which portions of the proof constituted the variance alleged,¹⁴⁴ and (2) there was in fact no such variance as was alleged.¹⁴⁵

*Wheat v. Delcourt*¹⁴⁶ involved a suit for breach of a contract to build a townhouse in which the buyer sought to pierce the corporate veil of the seller's successor to recover damages. On February 7, 1978, Delcourt, the buyer, signed an earnest money contract with Custom Contemporaries, Inc. ("CCI"), whereby CCI agreed to construct a townhouse for Delcourt for \$90,000. Wheat acquired title to the property on May 3, 1979, by foreclosing on a deed of trust lien securing a personal note given to Wheat by CCI's president David Carl. The next day, Wheat transferred the property to Pacemaker Homes, Inc., a corporation of which he was director, treasurer, and the sole shareholder, in exchange for a \$121,000 promissory note.

On June 4, 1979, Wheat sent Delcourt a letter informing him that Pace-maker Homes had taken over the completion of the townhouse for the price of \$95,000 plus extras in the amount of \$4,000. The letter stated that Pace-maker Homes would proceed with the construction and requested confirma-

141. *Id.* at 755-56.

142. The court instructed the jury as follows:

You are instructed that among the factors to be considered in determining if a corporation is the alter ego of an individual are whether the affairs of the corporation are indistinguishable from the individual's personal affairs and whether the individual acted in such a manner as to lead others to reasonably believe that the corporation had reference to the individual. In order to be the alter ego of an individual, the corporation must be used by the individual as an unfair device to achieve an inequitable result or as a sham to perpetrate a fraud, or to avoid a personal liability.

Id. at 756 (emphasis by the court).

143. *Id.* at 755; see *Scott v. Atchison, T. & S.F. Ry.*, 572 S.W.2d 273 (Tex. 1978).

144. Rose's objection to the charge was as follows:

The submission of these issues in the global form that they are being submitted is in a violation of *Scott vs. Atchison Topeka & Santa Fe Railroad* in that the Plaintiff has pled certain factors that he considered to be alter egos in his Pleadings. Some of these we have had evidence on; some have not On that basis, Your Honor, it would be impossible for the court on that basis if the jury made a finding on Issue No. 1 and Issue No. 2.

705 S.W.2d at 755.

145. *Id.*

146. 708 S.W.2d 897 (Tex. App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.).

tion of the earlier agreed purchase price.¹⁴⁷ The letter also asked Delcourt for evidence of his financing arrangements for the sale.

On October 11, 1979, Wheat sent Delcourt another letter, this time terminating the contract because Delcourt had failed to furnish evidence of his financing arrangements and Wheat could not construct the townhouse for the agreed purchase price. In November 1979, Sundero Construction Company, owned by Wheat's father, acquired the property by foreclosing on a first deed of trust lien. The lien secured a note given by CCI to Pennamco, Inc. Sundero subsequently purchased this note.

Delcourt sued Wheat and filed a *lis pendens* on the property. In February of 1980, however, Sundero sold the property to Emma Shields for \$125,000. Delcourt then sued Wheat, Pacemaker Homes, CCI, Sundero and Shields for breach of contract. At trial, Delcourt waived his plea for specific performance and sought damages from the corporate defendants and Wheat, individually, under a theory of *alter ego*.

In its answers to special issues the jury found that (1) Delcourt entered into a contract with CCI to buy the townhouse, (2) Pacemaker Homes, through Wheat, assumed CCI's obligations under the contract and ultimately breached the contract and (3) Pacemaker Homes was Wheat's *alter ego*. The jury awarded Delcourt \$36,500 in damages and the trial court entered judgment on the verdict. Wheat appealed.

The court of appeals found that the evidence was sufficient to support the jury's finding of *alter ego*.¹⁴⁸ First, Wheat was the director, president, treasurer, and sole shareholder of Pacemaker Homes, Inc. Second, the sole meeting of the directors and shareholders was held on the day he formed the corporation. All subsequent corporate action and shareholder action was done by unanimous consent.¹⁴⁹ Third, Wheat testified that he did not know who was the secretary or treasurer or how many directors there were and that he could not identify the directors. Fourth, the court noted that the evidence of Pacemaker Homes' capitalization was conflicting.¹⁵⁰ Wheat claimed that Pacemaker held the title to a substantial amount of land and improvements; the record, however, showed that Wheat, acting through Pacemaker Homes, was unable to finish the townhouses due to lack of funds. Pacemaker was also unable to borrow the capital necessary to finish the homes.

Other factors notwithstanding, the most compelling evidence of *alter ego* was the transfer of the property to Pacemaker Homes and the later acquisition of that property by Sundero. Wheat, as an individual, had loaned David Carl money to complete the property. In exchange for the loan, Wheat received a note from Carl secured by a deed of trust lien on the property. Just one day later Wheat deeded the property to his corporation, Pace-

147. After Delcourt received the letter he continued to work with Wheat's homebuilder concerning details of the construction.

148. 708 S.W.2d at 900.

149. In his answers to interrogatories, Wheat stated that no shareholder meetings were held.

150. 708 S.W.2d at 900.

maker Homes, in exchange for a note for \$122,235.30. In August of 1979, four months later, Wheat's father formed Sundero Construction Company for the purpose of buying the outstanding first lien on the property and foreclosing on the lien. This action cut off any possible claims still outstanding against CCI that had been assumed by Pacemaker Homes. Wheat's father testified that, with all such claims cleared, Wheat, through Pacemaker Homes, would be able to borrow the money to complete the property. Sundero purchased the first lien and foreclosed on it, acquiring the property. At that time, Wheat pretended to transfer \$121,000 to Sundero, Sundero pretended to transfer the sum back to Pacemaker, and Pacemaker pretended to transfer it to Wheat. This mere "bookkeeping transaction," as described by Wheat, transferred all outstanding obligations to Wheat.

The court held that the evidence was sufficient to support the jury's finding of alter ego, stating that "the rapid time frame in which these transactions occurred provided evidence to the jury that [Wheat] was attempting to avoid an existing legal obligation."¹⁵¹ The court, in further support of its holding, noted that Sundero's sale of the property to Emma Shields was conditioned upon the closing taking place only through a title company owned by Wheat's father.¹⁵² Sundero made the sale under this condition, despite Wheat's and his father's knowledge that Delcourt had filed a *lis pendens* against the property. Finally, the court concluded that when an individual attempts to use a corporation to evade an existing legal obligation, a finding of alter ego is justified.¹⁵³

*Great American Homebuilders, Inc. v. Gerhart*¹⁵⁴ involved the imposition of personal liability upon the president of a sham corporation under the Deceptive Trade Practices Act (DTPA)¹⁵⁵ for misrepresentations made on behalf of the corporation by the president to a third party. Although the appellate court held that there was insufficient evidence to support the trial court's finding that the corporation was a sham,¹⁵⁶ the court also held that the president was personally liable for his misrepresentations to the third party even though he performed the acts as an agent for the corporation.¹⁵⁷ Furthermore, since the third party's cause of action was under the DTPA, no proof of fraud, trickery, artifice, or device was required.¹⁵⁸ The statute deems the misrepresentation itself a deceptive act.¹⁵⁹ If taken literally, this case means that an agent of a corporation exposes himself to personal liability for all damages caused by an incorrect factual statement to a consumer, regardless of the agent's intent, and the agent's principal is also liable if the agent was acting within the scope of his duties.

151. *Id.*

152. *Id.*

153. *Id.*

154. 708 S.W.2d 8 (Tex. App.—Houston [1st Dist.] 1986, writ ref'd n.r.e.).

155. TEX. BUS. & COM. CODE ANN. §§ 17.41-.63 (Vernon Supp. 1987).

156. 708 S.W.2d at 8.

157. *Id.* at 11.

158. *Id.*

159. *Id.*

In *Aztec Management & Investment Co. v. McKenzie*¹⁶⁰ homeowners sued Aztec and its president, Johnson, for Aztec's breach of its contractual duty to furnish water to residential lots. The trial court rendered judgment against Aztec and against Johnson personally under an alter ego theory. On appeal, the homeowners argued that Johnson's own statements regarding "my water service"¹⁶¹ and similar statements constituted judicial admissions that Aztec was Johnson's alter ego. The appellate court, however, held that Johnson's statements were not sufficiently deliberate, clear, or unequivocal to constitute judicial admissions of alter ego status. Furthermore, the appellate court held that even if Johnson had stated that he believed he was personally liable for the corporation's debts, that statement would not amount to a judicial admission that the corporation was his alter ego.¹⁶²

The appellate court went on to state that the corporate fiction will be ignored only under "compelling circumstances" and then set forth the applicable tests for determining whether particular circumstances are sufficiently compelling.¹⁶³ The "blending" theory, which was previously rejected in *Lucas*¹⁶⁴ and subsequently modified in *Castleberry*,¹⁶⁵ generally would suffice to impose personal liability on a shareholder even absent a showing of fraud or constructive fraud.¹⁶⁶ Similarly, the court stated that the "corporate formality" theory, the "inadequate formality" theory and the "inadequate capitalization" theory would suffice.¹⁶⁷ Nonetheless, the court reversed the trial court's decision, holding that there was no evidence concerning blending of the corporate and individual identities.¹⁶⁸ The court noted that merely because one individual owned all of the stock of the company does not of itself make the corporation that individual's alter ego.¹⁶⁹ Furthermore, merely showing that the corporation lost money does not in itself prove undercapitalization.¹⁷⁰

*O'Berry v. McDermott, Inc.*¹⁷¹ involved an attempt by a tort victim to obtain service of process against a parent corporation by serving a subsidiary corporation based on the theory that the subsidiary was the alter ego of the parent. Fluor Ocean Services, Inc., a subcontractor of McDermott International, Inc., employed O'Berry as an oil worker. McDermott International was the contractor for Union Oil Company of Thailand and was constructing a platform in the Gulf of Thailand. O'Berry sustained a work-related injury and sued McDermott International, Fluor, Union Oil Company of

160. 709 S.W.2d 237 (Tex. App.—Corpus Christi 1986, no writ).

161. *Id.* at 238.

162. *Id.*

163. *Id.* at 239.

164. 696 S.W.2d 372 (Tex. 1984).

165. 721 S.W.2d 270 (Tex. 1986); *see supra* notes 111-128 & accompanying text.

166. 709 S.W.2d at 239. It is apparent from the text of the opinion that the appellate court did not have access to the *Lucas* case. Furthermore, it should be noted that the instant case preceded the *Castleberry* case.

167. *Id.*

168. *Id.*

169. *Id.*

170. *Id.*

171. 712 S.W.2d 206 (Tex. App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.).

Thailand, and Union Oil Company of California in Harris County, Texas. O'Berry attempted service of process on Union Oil Company of Thailand by serving Union Oil Company of California, on the theory that Union Oil of Thailand was the alter ego of Union Oil of California. The trial court sustained Union Oil Company of Thailand's special appearance and quashed service of process against it. On appeal, the sole question was whether such an alter ego relationship existed.

The court, citing *Gentry v. Credit Plan Corp.*,¹⁷² listed fourteen factors that O'Berry claimed raised a fact issue as to whether the two companies had an alter ego relationship.¹⁷³ The court held, however, that even where these factors do exist they do not rise to the level of any evidence of alter ego.¹⁷⁴ Reiterating the Texas Supreme Court's holding in *Lucas*, the appellate court stated that, in a tort case where the issue of alter ego is to be determined, the test is whether "the corporation responsible for the plaintiff's injury is capable of paying a judgment upon proof of liability."¹⁷⁵ It is only where a court determines that a corporation is undercapitalized in light of the nature and risk of its business that the court should consider piercing the corporate veil in a tort case.¹⁷⁶

The court applied the *Lucas* test to the facts at hand and concluded that the factors listed could not have induced O'Berry to fall victim to a basically unfair device by which Union Oil Company of Thailand's corporate entity was used to achieve an inequitable result.¹⁷⁷ Accordingly, the court affirmed the trial court's grant of a summary judgment in favor of Union Oil Company of California.¹⁷⁸

*United States v. D.K.G. Appaloosas, Inc.*¹⁷⁹ concerned an attempt by shareholders to pierce the veil of their own corporation. Bruce Griffin and his wife were the sole shareholders of a corporation. The federal government attempted forfeiture of a ranch and various items of personal property which were held in the name of the corporation on the grounds that they had been purchased with monies earned from illegal narcotics transactions.

172. 528 S.W.2d 571 (Tex. 1975).

173. The factors were:

1) the parent caused the incorporation of the subsidiary; 2) the parent owned most of the stock of the subsidiary; 3) the companies had common or overlapping directors and officers; 4) the parent or another subsidiary provided financial records services to the subsidiary; 5) the companies used the same corporate officers; 6) the parent and the subsidiary engaged in the same business; 7) the companies filed consolidated tax returns; 8) the subsidiary was regarded as a division of the parent; 9) the parent maintained employee benefits for the subsidiary; 10) the parent capitalized and financed the subsidiary; 11) the parent made business decisions for the subsidiary; 12) the public or trade regarded the parent and subsidiary as one business unit; 13) the parent paid expenses or losses of the subsidiary; and 14) the parent and subsidiary made informal intercorporate loans or book transactions. 718 S.W.2d at 207.

174. *Id.*

175. *Id.* at 207.

176. *Id.* at 207-08.

177. *Id.*

178. *Id.*

179. 630 F. Supp. 1540 (E.D. Tex. 1986).

The Griffins objected to the attempted forfeiture on the grounds that the property was owned by them and that individually they had entered a pre-plea agreement with the government to the effect that no forfeiture of their individual property would be attempted. Upon a trial on the question of who owned the ranch and other property, the jury found that the Griffins individually owned it and, therefore, it was not subject to forfeiture.

The government moved for a judgment notwithstanding the verdict on the grounds that it would be inequitable to allow Griffins to pierce their own corporate veil and thereby establish individual ownership of the property in question. The court held, however, that the Griffins did not rely on such a theory and that other evidence sufficiently supported the jury's finding that the Griffins owned the property individually.¹⁸⁰ The evidence showed (1) Bruce Griffin negotiated most of the purchases and profited from all the money therefor, (2) he held himself out as owner and most people treated him as such, and (3) the government presented no evidence to show that he was acting merely as an agent of the corporation.¹⁸¹ With regard to the realty, the court held that, although there was a jury issue as to ownership, it was raised and decided in Griffin's favor.¹⁸² Furthermore, there was sufficient evidence in support of the verdict to avoid a motion for judgment notwithstanding the verdict.¹⁸³

Finally, the court held that the government was not entitled to rely on a corporate veil argument because the law on that subject is designed to protect persons who rely on the existence of a distinct corporate entity, and the government did not so rely.¹⁸⁴ Furthermore, "[t]he government is not the type of party intended to be protected by a refusal to pierce a corporate veil, and Griffin is not the type of party intended to be punished by the same."¹⁸⁵ In dicta, the court affirmed the rule that shareholders cannot hide behind the corporate veil, then discard it when it is no longer useful, but stated that Griffin had never succeeded in hiding behind the corporate veil in the first place, since the corporations had never owned any of the property.¹⁸⁶

B. Pre-Incorporation Problems

*A to Z Rental Center v. Burris*¹⁸⁷ involved an individual who signed rental and sales contracts for his corporation, but failed to disclose the corporate name. Consequently, the court held him personally liable on the contracts.¹⁸⁸ On December 30, 1983, Lloyd Burris filed an assumed name certificate in Travis County that indicated that he was doing business as B&S Construction. On February 25, 1984, Burris and Steve Inscore applied for

180. *Id.* at 1557.

181. *Id.*

182. 630 F. Supp. at 1558.

183. *Id.*

184. *Id.*

185. *Id.* at 1559.

186. *Id.*

187. 714 S.W.2d 433 (Tex. App.—Austin 1986, writ ref'd n.r.e.).

188. *Id.* at 436.

credit from A to Z Rental under the firm name of B&S Construction, Inc., a corporation Burriss and Inscore had planned to form. Unable to incorporate as B&S Construction, Inc. because that name had already been reserved by another company, Burriss and Inscore incorporated as Burriss & Inscore Construction, Inc., on March 2, 1985. During April, May and July 1984, B&S Construction bought or leased equipment from A to Z under various rental and purchase contracts. On five of these contracts, the line headed "Lessee" bore Burriss's personal signature. In September 1984 Burriss & Inscore Construction, Inc. filed an assumed name certificate in Travis County claiming that the corporation operated under the name of B&S Construction, Inc. After A to Z failed to receive payments under the contracts, it sued Burriss personally for the amounts owing. The trial court entered a take nothing judgment against A to Z, and A to Z appealed.

The appellate court reversed and remanded the case to the trial court on two grounds: first, Burriss was liable as an agent in the name of a fictitious or nonexistent principal with respect to the contracts entered into before the date of incorporation; second, Burriss was liable as an agent of an undisclosed principal with respect to the contracts entered into after the date of incorporation.¹⁸⁹ The key factor in the appellate court's eyes was that A to Z had no knowledge of Burriss' true principal, Burriss & Inscore Construction, Inc.¹⁹⁰ The appellate court stated that Burriss thus had failed to disclose sufficient information concerning the identity of his principal to escape personal liability on the contracts.¹⁹¹

C. *Liability of Corporation for Acts of its Agents*

*Ford Motor Co. v. Durrill*¹⁹² is another in the long line of cases involving an automobile fuel tank that burst into flames as a result of a rear end collision and inflicted fatal burn injuries on a child passenger. William and Shirley Durrill brought a wrongful death and survival action against Ford Motor Company following an accident in which their daughter sustained fatal burn injuries from a fuel tank explosion and fire. The trial court entered judgment, after remittitur, on a jury verdict of approximately \$6.8 million actual damages and \$100 million exemplary damages. The exemplary damages award was based on a finding by the jury that Ford was grossly negligent. Ford then appealed.

In the appellate court, Ford contended that a corporation, as a matter of law, may not be held grossly negligent, and therefore, the gross negligence finding became immaterial. Since "the essence of gross negligence is a mental attitude or state of mind which a corporation itself cannot have,"¹⁹³ Ford asserted that it could not be held liable for gross negligence unless the

189. *Id.*

190. *Id.* at 435.

191. *Id.* at 436.

192. 714 S.W.2d 329 (Tex. App.—Corpus Christi 1986, no writ).

193. *Id.* at 333.

Durrills had produced evidence of knowledge, state of mind, or acts or omissions of an individual Ford employee regarding the design of the fuel tank.

The appellate court reviewed Texas case law and determined that it was contrary to Ford's argument.¹⁹⁴ The review showed that corporations may be held liable for gross negligence without a specific finding that any particular individual was grossly negligent.¹⁹⁵ The court distinguished this case from those in which managerial or supervisory personnel authorized or ratified the negligent or intentional conduct that led to corporate liability.¹⁹⁶ Here, Ford management, as a group, made the complex company policy decisions which led to the design of the fuel tank. The responsibility for the decision could not be imputed to a specific division, single manager or individual engineer. Accordingly, the court found it proper to hold Ford accountable for gross negligence.¹⁹⁷

D. Fiduciary Duty of Full Disclosure

*Miller v. Miller*¹⁹⁸ provided a Texas court with the first opportunity to address the issue of whether an officer and director of a corporation who purchases stock from a shareholder of the corporation has a general fiduciary duty to disclose to the shareholder, prior to the purchase of the stock, any knowledge he may have of information affecting the value of the stock. The *Miller* case arose in the context of a separation and the subsequent divorce from his wife of a shareholder, officer and director of a telecommunications equipment company.

Judy and Howard Miller separated on July 15, 1978. During 1978, Howard, along with three other engineers, considered the possibility of forming a new company to design and manufacture the "IBX," a novel electronic switching system. In January 1979 the four formed such a company, InteCom, Inc. and each received a twenty-five percent interest therein. Each twenty-five percent interest was represented by 250 shares of the common stock of the company. Later, InteCom issued additional shares to the four founders. The new issue resulted in Howard having a total of 710,355 shares. InteCom then enlisted Exxon Enterprises, Inc. to provide financial backing, and Exxon agreed to invest \$1.5 million in InteCom in exchange for 1.5 million shares of stock. Exxon, which based its investment decision largely on the four founders' abilities, required in a shareholders' agreement

194. *Id.*

195. See *Ford Motor Co. v. Nowak*, 638 S.W.2d 582 (Tex. App.—Corpus Christi 1982, writ ref'd n.r.e.) (gross negligence award of \$4 million upheld against Ford Motor Company without predicate of liability upon the acts of individual Ford employees); *International Armament Corp. v. King*, 674 S.W.2d 413 (Tex. App.—Corpus Christi 1984), *aff'd*, 686 S.W.2d 595 (Tex. 1985) (punitive damages award of \$1,500,000 upheld against a corporation that manufactured guns); *Rawlings Sporting Goods Co. v. Daniel*, 619 S.W.2d 435 (Tex. Civ. App.—Waco 1981, writ ref'd n.r.e.) (punitive damage award of \$750,000 upheld against a corporation which manufactured football helmets).

196. 714 S.W.2d at 334.

197. *Id.* at 338.

198. 700 S.W.2d 941 (Tex. App.—Dallas 1985, writ ref'd n.r.e.).

that Howard and his associates remain in control and keep an interest in InteCom.

On April 10, 1979, Howard filed a petition for divorce. The next day, Howard gave Judy the shareholders agreement, asking her to take it home and have it returned to him signed by the next morning. Howard never explained the agreement to Judy and failed to disclose to her certain information regarding the agreement. Judy read the agreement, signed it, and never asked Howard or anyone else any questions about it. The agreement by its terms gave Howard the right to acquire Judy's community interest in the shares for \$2,500.

On August 23, 1980, Howard and Judy were divorced. For approximately two years after the divorce, Judy never complained about the agreement. After reading an electronics magazine, however, Judy discovered that the stock in InteCom was worth more than she had earlier believed. With this information, Judy filed suit against Howard on October 20, 1982, seeking rescission of the shareholders agreement and partition of the 710,355 shares owned by Howard at the time of the divorce and alternatively, actual and exemplary damages. She based these requests for relief on theories of actual fraud and constructive fraud by breach of a confidential or fiduciary duty. In Howard's answer to the suit, he denied Judy's interest in the stock and counterclaimed for attorneys' fees and a decree requiring specific performance of the purchase price. Additionally, Howard attempted to exercise his option to purchase Judy's shares in the company.

The case was tried to a jury, which found that Howard had made two false and material misrepresentations to Judy, but that Howard did not make them with the intention that Judy rely on them in deciding whether to sign the shareholders' agreement.¹⁹⁹ The jury also found that Howard had failed to disclose certain facts to Judy that were material, but, again, without the intention of inducing Judy to sign the agreement.²⁰⁰ In response to the claim of breach of fiduciary duty brought by Judy against Howard, the jury found (1) when Howard presented the agreement to Judy, a strict confidential relationship existed between the two; (2) when Howard presented the agreement to Judy, Howard acted in good faith; and (3) the corporate interest of InteCom was consistent with the stock restrictions placed on Judy by the agreement pertaining to transfer and ownership of her interest.²⁰¹ Additionally, the jury found that under the facts and circumstances of the case the agreement was not fair to Judy.²⁰²

199. The false and material representations that Howard made to Judy were that the shareholders agreement was an agreement between Exxon and the founders that placed certain restrictions on the stock, and was an agreement to get InteCom started. *Id.* at 944.

200. The material undisclosed facts were (1) that Exxon had contributed \$1.5 million to InteCom in exchange for 1.5 million shares, (2) that upon the divorce the agreement required Judy to sell to Howard and others any and all interest that she had in Intecom, (3) that the shares of the InteCom stock held in Howard's name at that time had a fair cash market value, and (4) that InteCom was in the process of developing the IBX system, which if successfully developed would be in great demand. *Id.*

201. *Id.*

202. *Id.*

The trial court ruled as a matter of law that Judy and Howard held the 710,355 shares of InteCom stock as tenants in common. Since the shares of InteCom stock had not been divided in the divorce decree, the court ordered the stock evenly divided between Howard and Judy. However, the trial court also disregarded certain findings of the jury, validated the shareholders' agreement, and required Judy to sell her shares to Howard at the agreed price.

Judy appealed the trial court's refusal to rescind the shareholders agreement, contending that the finding of a confidential relationship between Howard and her established a fiduciary duty on the part of Howard. Judy additionally argued that this fiduciary duty cast on Howard the burden to show that the agreement was fair to her and that his failure to discharge the burden provided sufficient grounds for rescission. The appellate court found no Texas authority on the issue of whether a person who is an officer and director of a corporation has a general fiduciary duty to disclose to a stockholder his knowledge of information affecting the value of the stock before purchasing it from the shareholder.²⁰³ The court then turned to the law of other states for guidance and found a split among those authorities.²⁰⁴

The majority rule is that a director or officer does not stand in a fiduciary relation with a stockholder in respect to his stock.²⁰⁵ Therefore, a director or officer under the majority rule has the same right as any other shareholder to trade freely in the corporation's stock.²⁰⁶ A significant minority of courts have held that a director or officer does stand in a fiduciary relation with a stockholder in respect to his stock.²⁰⁷ Under this rule, a director or officer cannot properly purchase stock from a stockholder unless he first provides the stockholder with the benefit of any official knowledge he has of information regarding the value of the stock.²⁰⁸ Still other courts, while recognizing the majority rule as a general principle, impose on the officer or director a limited fiduciary duty to disclose any knowledge he has of special facts relating to the business of the corporation—such as mergers, assured sales, etc.—which could affect the stock's value.²⁰⁹

The appellate court applied the special facts variation of the majority rule and concluded that before Howard could contract with Judy regarding the InteCom stock, he had a duty to disclose to her (1) the details of the Exxon transaction, and (2) the possibility of an increase in the value of the stock if

203. *Id.* at 945-46.

204. *Id.*

205. See *Schuur v. Berry*, 285 Mich. 654, 281 N.W. 393 (1938); *Seitz v. Frey*, 152 Minn. 170, 3A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1168.1, at 283 (rev. perm. ed. 1985).

206. *Id.*

207. See *Dawson v. National Life Ins. Co.*, 176 Iowa 342, 157 N.W. 929 (1916); *Jacobson v. Yaschik*, 249 S.C. 577, 155 S.E.2d 601 (1967); 3A W. FLETCHER, *supra* note 205, § 1168.2 at 288-89.

208. *Id.*

209. 700 S.W.2d at 946; see *Strong v. Repide*, 213 U.S. 419 (1909); *Hobart v. Hobart Estate Co.*, 29 Cal. 2d 412, 159 P.2d 958 (1945); 3A W. FLETCHER, *supra* note 205, § 1171, at 293-94.

InteCom could develop a successful IBX.²¹⁰ Howard became aware of these special facts as a director and officer of the corporation and these facts were not available to Judy. Based on findings that a confidential relationship existed between Howard and Judy and that Howard failed to disclose special facts regarding InteCom that were known to him in his official capacity, the appellate court held that Howard did not deal fairly with Judy in regard to his acquiring rights in her shares of InteCom stock.²¹¹

The second step in the appellate court's analysis was to determine which party bore the burden of proof concerning the fairness or unfairness of the shareholders agreement as between Judy and Howard and whether that duty had been discharged. The court relied on *Johnson v. Peckham*,²¹² the leading Texas case on this question, which held that a partner selling his interest in the partnership to another partner did not have the burden to establish reliance on the purchasing partner to make full and complete disclosure of all important information as to value. The appellate court applied a presumption of unfairness to transactions between a fiduciary and a party to whom he owes a fiduciary duty of disclosure and concluded that Howard had the burden of proving the fairness of the shareholders agreement to Judy.²¹³

In determining whether Howard had met his burden of proving the fairness of the agreement, the appellate court reviewed Texas case law and concluded that the proper standard was that the fiduciary must show that he acted in good faith and that the transaction was "fair, honest and equitable."²¹⁴ The appellate court noted that breach of such a fiduciary duty is

210. 700 S.W.2d at 946.

211. *Id.*

212. 132 Tex. 148, 120 S.W.2d 786 (Tex. 1938). *Johnson* concerned a partner's duty to disclose to a co-partner, whose interest he was purchasing, facts affecting the value of the partnership property. *Id.* In *Johnson* the supreme court held that because of the fiduciary relationship, the purchasing partner had the "absolute duty" to disclose to the selling partner material facts within his knowledge and that such a sale would be sustained "only when it is made in good faith, for a fair consideration and as full and complete disclosure of all important information as to value." *Id.* at 151-52, 120 S.W.2d at 787. Accordingly, the court held that the selling partner did not have the burden to establish reliance on the purchasing partner to make such disclosure and that the trial court had properly refused the requested issue inquiring whether the purchaser relied on the seller to make such disclosure. *Id.*

213. 700 S.W.2d at 946. The appellate court's analysis is consistent with that of other Texas courts that have cast on the fiduciary the burden to establish fairness. *See, e.g.*, *Texas Bank & Trust Co. v. Moore*, 595 S.W.2d 502, 509 (Tex. 1980); *Archer v. Griffith*, 390 S.W.2d 735, 740 (Tex. 1964); *Ginther v. Taub*, 570 S.W.2d 516, 525 (Tex. Civ. App.—Waco 1978, writ ref'd n.r.e.). Howard had also contended that he had negated any causal relation between the nondisclosures and any damage to Judy because Judy admitted on cross-examination that she would have signed the agreement even if all of the facts had been disclosed. The appellate court, however, rebuffed Howard's contention by holding that if the facts known to Howard were material in the sense that a reasonable person under the same or similar circumstances would attach importance to them in determining his course of conduct or action, then Howard had a fiduciary duty to disclose them, which could not be excused on the ground that Judy had failed to establish her reliance on Howard's duty to disclose them. 700 S.W.2d at 948. The court then went further and stated that based on its reading of *Johnson* and other relevant authority, Howard also had the burden to prove that knowledge of these facts would not have deterred Judy from signing the agreement if, indeed, Howard could be excused from his breach of fiduciary duty on this ground. *Id.*

214. 700 S.W.2d at 947. As articulated by the Texas Supreme Court in Stephens County

commonly referred to as "constructive fraud," and next proceeded to distinguish this case from cases involving constructive fraud in which the party asserting it bears the entire burden of proof.²¹⁵

The appellate court turned to hornbook law and adopted the following inquiries as relevant considerations in determining whether a transaction between a fiduciary and his beneficiary was fair: (1) Had the fiduciary made full disclosure? (2) Was the consideration adequate? (3) Was independent advice available to the beneficiary? (4) Had the fiduciary benefitted or profited at the expense of the beneficiary?²¹⁶ The appellate court synthesized these elements into the omnibus rule that a "transaction is unfair if the fiduciary significantly benefits from it at the expense of the beneficiary as viewed in the light of the circumstances existing at the time of the transaction."²¹⁷ The appellate court, in light of the above principles, determined that sufficient evidence supported the jury's finding that the transaction was unfair because (1) it was undisputed that Howard did not make full disclosure and that Judy did not have independent advice, (2) the finding on the adequacy of the consideration issue, although complicated because of Exxon's participation, was within the province of the jury, and (3) the provisions of the shareholders' agreement gave Howard rights superior to those of Judy and justified the inference that Howard gained a benefit at Judy's expense.²¹⁸

Although the holding in *Miller* speaks broadly enough to send chills up the spine of any lender or investment house that has required shareholder continuity as a condition of its financing, the case's peculiarities should effectively limit its precedential value to situations that bear the same peculiarities. For example, Howard presented no independent evidence regarding whether the shareholders agreement in its then existing form was a condition precedent to Exxon's funding of InteCom.²¹⁹ Based on this lack of evidence, the court concluded that Exxon might have waived the provisions concerning options on divorce of the founders.²²⁰ Absent independent evidence, the court held that it had no way of knowing whether the options were required by Exxon or indispensable to its participation.²²¹ Similarly, Howard failed to present any evidence on the issue of whether he had taken advantage of Judy in having her execute the shareholders agreement. The court inferred that Howard could have succeeded in proving that the shareholders agreement was fair to Judy if he presented evidence that he had not gained any benefit

Museum, Inc. v. Swenson, 517 S.W.2d 257 (Tex. 1974), the issues are whether the fiduciary "had made reasonable use of the confidence placed in him and whether the transactions were ultimately fair and equitable." 517 S.W.2d at 261.

215. 700 S.W.2d at 947.

216. *Id.*

217. *Id.*

218. *Id.* at 947-48. Regarding the third point underpinning the court's conclusion in this regard, it appeared particularly important to the appellate court that Howard had an option to purchase Judy's shares, but Judy had no corresponding option or offsetting benefit. *Id.* at 948.

219. *Id.* Although Howard testified that Exxon required the agreement, the court concluded that his testimony, coming from an interested party, did not conclusively establish that Exxon would not have considered a modification of the agreement. *Id.*

220. *Id.*

221. *Id.*

from the shareholders agreement at Judy's expense.²²²

In terms of planning in light of the holding in *Miller*, prudence would dictate that in each instance that an uninformed party is required to sign a shareholders agreement, the informed parties who are officers or directors of the corporation or who have a confidential relationship with the spouse should make it a point to explain all of the relevant provisions in detail. The informed parties who are officers or directors should also consider hiring independent legal counsel to represent the uninformed party in connection with the transaction. Although as a practical matter spouses on good terms will sign almost anything that the other spouse requests he or she sign, this case suggests that it is wise to have as much window dressing surrounding the transaction as possible at one's disposal in the event of subsequent litigation.

E. Corporate Opportunity Doctrine

Corporate officers and directors are fiduciaries as to the corporation, and as such are under an obligation not to usurp corporate opportunities to obtain personal gain.²²³ This rule is known as the corporate opportunity doctrine. In *Imperial Group (Tex), Inc. v. Scholnick*²²⁴ a Canadian real estate company brought an action to recover profits realized personally by one of its officers and directors from the purchase and sale of real estate. Ira Scholnick, Imperial's vice president of marketing, research and development since April 1979, was responsible for all aspects of Imperial's business in the United States. In the fall of 1982 Scholnick began commuting to Dallas twice a month for the purposes of reviewing the market and locating land suitable for apartment development. Between the fall of 1982 and the date of his resignation from Imperial in the spring of 1984, Scholnick involved himself in several transactions regarding tracts of land in Dallas that were in Imperial's line of business. Imperial sued Scholnick for alleged breaches of fiduciary duty in connection with the transactions and sought to recover profits realized personally by Scholnick. Additionally, Imperial sought funds and properties held in his name. The court held that with respect to one transaction, Scholnick had breached his fiduciary duty of disclosure to Imperial and was liable to Imperial notwithstanding the fact that Imperial would not have pursued the transaction even if it had known about it.²²⁵ Additionally, the court engaged in a detailed analysis of the corporate opportunity doctrine and the method for determining whether a transaction is within the normal line of a company's business.²²⁶ Although the court's holding in *Imperial* breaks no new law, it is a useful reference for analyzing the exposure of an officer or director of a real estate company who engages in transactions for his own benefit.

222. *Id.*

223. *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 576-77 (Tex. 1963).

224. 704 S.W.2d 358 (Tex. App.—Tyler 1986 writ ref'd n.r.e.).

225. *Id.* at 363.

226. *Id.* at 362-67.

F. Irrevocable Proxies

Under article 2.29(C) of the Texas Business Corporation Act a proxy is revocable unless it expressly states that it is irrevocable and is "otherwise made irrevocable by law."²²⁷ *Zollar v. Smith*²²⁸ is the first Texas case interpreting the requirement that a proxy must otherwise be made irrevocable by law. *Zollar* involved whether William C. Smith and George R. Gibbons could revoke their proxy to Gerald M. Zollar.²²⁹ The proxy stated that it was for a period of ten years and that it was intended to be an irrevocable proxy. Smith and Gibbons sued to revoke the proxy. The trial court granted summary judgment for Smith and Gibbons, and Zollar appealed.

The appellate court reviewed three sources and concluded that in order for a proxy to be irrevocable, the proxy must either be "coupled with an interest" or "given as security."²³⁰ To determine what constituted "coupled with an interest" or "given as security" for proxy agreements, the court turned to the law of agency. The court held that the following three requirements must be met: (1) the agent or proxyholder must have given value, assumed obligations or incurred liability in connection with the proxy transaction; (2) the principal either must have requested or consented to the foregoing actions of the agent or proxyholder; and (3) the exercise of the proxy power must be viewed by the agent or proxyholder as a means of reimbursement, indemnity or protection.²³¹

Relying on an uncontradicted affidavit by Zollar, the appellate court held that he met the three requirements.²³² Zollar satisfied the first requirement as a matter of law by having contributed \$1,000 to the corporation so that the corporation could begin its business.²³³ This payment constituted a sufficient commitment to the corporation and a substantial parting of value on behalf of the proxyholder. Zollar satisfied the second requirement as a matter of law by his affidavit, which contained an uncontradicted statement that he paid his \$1,000, plus additional investments, to the corporation at either the request of Gibbons and Smith, or with their consent.²³⁴ Zollar satisfied the third requirement as a matter of law also by his affidavit, which stated that the proxy "was required by me and taken to secure the value tendered by me . . . to [the corporation]"²³⁵

227. TEX. BUS. CORP. ACT ANN. art. 7.09(A) (Vernon 1980).

228. 710 S.W.2d 155 (Tex. App.—Eastland 1986, no writ).

229. Smith, Gibbons, and Zollar were shareholders in GRG Operating, Inc. The proxy permitted Zollar to vote the stock of Smith and Gibbons. At the time the parties entered into the proxy, Zollar was president and a director of the corporation.

230. 710 S.W.2d at 157.

231. *Id.* at 158.

232. *Id.*

233. According to Zollar's affidavit, Zollar paid the \$1,000 at either the request of Smith and Gibbons, or with their consent.

234. 710 S.W.2d at 158.

235. *Id.*

G. Transfers of Shares

*Pesch v. First City Bank*²³⁶ addressed the question of whether a party seeking to enforce his right to obtain or reclaim possession of a certificated security under the Texas Business and Commerce Code must show irreparable harm in order to have a court enjoin the transfer of the security to another person.²³⁷ Despite specific language in the statute that the right "may be specifically enforced and the transfer . . . enjoined,"²³⁸ the federal district court concluded that the requirements for obtaining a preliminary injunction in federal court are a federal procedural standard and, under *Erie Railroad v. Tompkins*²³⁹ principles, applied the federal law requirement that the complaining party show irreparable harm.²⁴⁰ The court also rejected the complaining party's assertion that his shares had unique characteristics that entitled him to an injunction.

It is important to note that in reaching its decision the court ignored two Texas court of appeals cases²⁴¹ that arguably supported the proposition that equity will enjoin the transfer of stock shares because the loss of stock shares represents irreparable injury to a stockholder.²⁴² The court concluded that neither case provided enough facts concerning the stock in question to require the conclusion that the court was *Erie*-bound to follow them.²⁴³ Also, the court was "not prepared to hold . . . that a shareholder's subjective, unexplained desire to keep his shares constitutes irreparable injury in each and every case."²⁴⁴

H. Liquidation

The question faced by the Texas court of appeals in *Burnett v. Chase Oil & Gas, Inc.*²⁴⁵ was whether a district court acting under article 7.09 of the Texas Business Corporation Act may order dissolution of a solvent corporation, and distribute its assets to stockholders, without payment and discharge, or without providing for payment and discharge, of unliquidated or disputed claims against the corporation. The *Burnett* case began when a voting deadlock occurred between the parties, C.C. Burnett and Gaylord Hughey, Sr. After more than a year of deadlock, Burnett brought suit for a receiver to be appointed under the Texas Business Corporation Act,²⁴⁶ hoping that the action would rehabilitate the corporation. Hughey cross-claimed and sought the appointment of a receiver for the limited purpose of liquidating the assets and dissolving the corporation. The receiver attempted

236. 637 F. Supp. 1539 (N.D. Tex. 1986).

237. See TEX. BUS. & COMM. CODE ANN. § 8.315(c) (Vernon Supp. 1986).

238. 637 F. Supp. at 1542.

239. 304 U.S. 64 (1938).

240. 637 F. Supp. at 1546.

241. *McDonnell v. Campbell-Taggart Associated Bakeries, Inc.*, 376 S.W.2d 915 (Tex. Civ. App.—Dallas 1964, no writ); *Spencer v. James*, 31 S.W. 540 (Tex. Civ. App.—1895, no writ).

242. 637 F. Supp. at 1546.

243. *Id.*

244. *Id.* at 1547.

245. 700 S.W.2d 737 (Tex. App.—Tyler 1985, no writ).

246. TEX. BUS. CORP. ACT ANN. art. 7.05 (Vernon 1980).

to rehabilitate the corporation for eighteen months, but then concluded that it was impossible and recommended dissolution.

The receiver's report indicated that three lawsuits were pending against the corporation and recommended that the court assign the corporation's interest in the suits to the stockholders in their individual capacities. In its decree, the trial court provided merely that the corporation's assets be distributed according to the receiver's liquidation plan. The trial court made no special provision for the satisfaction or discharge of the claims against the corporation represented by the lawsuits.

On appeal Burnett claimed that the trial court erred when it entered its final order of dissolution without providing for satisfaction of the obligation created by the pending lawsuits. The court noted that whether a district court may order such a dissolution without providing for payment of claims in the form of pending lawsuits was a question of first impression in Texas.²⁴⁷ The question before the court was whether article 7.09(A),²⁴⁸ which required a court to discharge "all debts, obligations, and liabilities" before ordering dissolution, included provision for discharge of claims from pending lawsuits.

After a thorough analysis of the statute, the court concluded that under relevant case law and equitable principles, article 7.09(A) did require a court to provide for satisfaction of claims based on pending lawsuits before dissolving a solvent corporation.²⁴⁹ The court looked to the law of decedent's estates and bankruptcy in determining the receiver's duty to both pursue claims on behalf of the corporation as well as to defend it against external claims.²⁵⁰ Applying these principles, the court decided that causes of action against the corporation must be considered among its liabilities.²⁵¹

In reaching its decision the court also considered the duties of a corporation undergoing a voluntary dissolution under article 6.04 of the Texas Business Corporation Act.²⁵² The court noted that under article 6.04 a corporation must prove that it has discharged, or provided for discharge of, all debts, obligations and liabilities before dissolution.²⁵³ A court-ordered dissolution could scarcely be required to do less, the court reasoned.²⁵⁴

247. 700 S.W.2d at 739.

248. TEX. BUS. CORP. ACT ANN. art. 7.09(A) (Vernon 1980), which addresses involuntary dissolution, reads:

In proceedings to liquidate the assets and business of a corporation, when the costs and expenses of such proceedings and all debts, obligations, and liabilities of the corporation shall have been paid and discharged and all of its remaining property and assets distributed to its shareholders, or, in case its property and assets are not sufficient to satisfy and discharge such costs, expenses, debts, and obligations, when all the property and assets have been applied so far as they will go to their payment, the court shall enter a decree dissolving the corporation, whereupon the existence of the corporation shall cease.

249. 700 S.W.2d at 740.

250. *Id.* at 741.

251. *Id.* at 742.

252. *Id.* at 741; see TEX. BUS. CORP. ACT ANN. art. 6.04 (Vernon 1980).

253. 700 S.W.2d at 744.

254. *Id.* at 743.

The court also considered the two traditional principles behind requiring discharge of all corporate debts before dissolution: protection of creditors, and orderly and fair distribution of assets to shareholders.²⁵⁵ To ignore the court's duty to discharge, or provide for discharge of liabilities such as pending lawsuits, would violate both of these principles. Creditors might be cheated as corporate assets disappeared, and even if creditors were not cheated, shareholders with assets in their hands would be forced to assume more liabilities than shareholders who liquidated their assets. In conclusion, the court stated that the clear language of the statute and the legislative intent behind the statute showed that "a clear legislative determination [existed] that provision be made at liquidation for the satisfaction of all existing liabilities, both absolute and contingent, before distribution of the remaining assets, if any, to the stockholders."²⁵⁶

I. *Dissolution and the Trust Fund Doctrine*

*Thompson v. A.G. Nash & Co., Inc.*²⁵⁷ involved a claimant who sought to enforce a judgment against a corporation that has been dissolved during the original litigation and against the corporation's shareholders. On August 6, 1981, A.G. Nash & Company (Nash) commenced litigation against Van Insurance Agency, Inc. (Old Van). Without Nash's knowledge, the directors and shareholders of Old Van had changed its name to Van County Insurance Agency, Inc. (New Van), and voluntarily dissolved New Van on September 24, 1982. On July 14, 1983, the court signed and entered a summary judgment in the litigation in favor of Nash against Old Van for approximately \$4,700. Each shareholder received cash from the dissolution of New Van in excess of \$4,700. On September 21, 1983, Nash filed a suit against New Van and its shareholders to recover the money Old Van owed to Nash. The trial court entered summary judgment in favor of Nash. The shareholders appealed.

The dissolution provisions of the Texas Business Corporation Act controlled the appellate court's disposition of the appeal.²⁵⁸ Particularly important was article 7.12, which provides that the voluntary dissolution of a corporation "shall not take away or impair any remedy available to or against such corporation, its officers, directors, or shareholders, for any right or claim existing, or any liability incurred, prior to such dissolution if action or other proceedings thereon are commenced within three years after the date of such dissolution."²⁵⁹ The appellate court noted that although the shareholders dissolved the corporation during the pendency of the proceedings, the shareholders continued to defend the suit in the corporate name and the trial court rendered judgment against the corporation. Under these facts, the appellate court held that the judgment fixed the liability of the

255. *Id.*

256. *Id.* at 745.

257. 704 S.W.2d 822 (Tex. App.—Tyler 1985, no writ).

258. *Id.* at 824.

259. TEX. BUS. CORP. ACT ANN. art. 7.12 (Vernon 1980).

shareholders to the extent that each received cash or property of the corporation in distribution of its assets upon dissolution.²⁶⁰ The summary judgment evidence established that when the corporation dissolved, each shareholder received funds in excess of the judgment against the corporation in violation of the Texas Business Corporation Act. Accordingly, the appellate court affirmed the trial court's judgment.²⁶¹

J. Derivative Actions

*Renfro v. Federal Deposit Insurance Company*²⁶² involved a federal court's dismissal of a shareholders' derivative action in the context of a failed national bank. The shareholders of National Bank of Odessa, a national bank under the receivership of the Federal Deposit Insurance Corporation (FDIC), notified the FDIC of their intention to sue the former officers and directors of the bank to recover damages the shareholders incurred as a result of the bank failure. The notice also called upon the FDIC to bring suit against the bank's former officials "[i]n the event that the FDIC owns the causes of action."²⁶³ Two months later the shareholders filed a complaint alleging that they had received no response to their demand. The FDIC, acting as receiver, removed the case to federal court, moved to intervene, and sought dismissal of the shareholders' action. The trial court granted the motions, allowing the FDIC to bring its own actions, and the Fifth Circuit affirmed.²⁶⁴

On appeal the shareholders contended that the FDIC's alleged failure to answer their demand letter justified their bringing a derivative action. The Fifth Circuit overruled their claims, citing the well known principle that a derivative action is a remedy of last resort by shareholders to enforce corporate actions.²⁶⁵ The court noted that, before shareholders may bring a derivative action, they must have exhausted all the means possible for them to obtain redress.²⁶⁶

The court held that the shareholders' complaint had failed to show their efforts, if any, to obtain relief from the directors, and why the relief was unavailable.²⁶⁷ The court noted that in their complaint the shareholders had merely alleged that in April 1984 they had made two demands on the FDIC to file suit, and that they filed suit in June without further contact when the FDIC failed to respond to their demands.²⁶⁸ These allegations were insufficient since the shareholders had not claimed that the FDIC had refused to

260. 704 S.W.2d at 824.

261. *Id.*

262. 773 F.2d 657 (5th Cir. 1985).

263. *Id.* at 658.

264. *Id.*

265. *Id.*

266. *Id.* at 659 (citing *Hawes v. Contra Costa Water Co.*, 104 U.S. 450 (1882)). This result obtains because only the corporation has standing to sue both those inside and outside the corporation for actionable wrongs committed against it. *Id.* (citing Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746, 748 (1960)).

267. *Id.* (citing Fed. R. Civ. P. 23.1).

268. *Id.*

proceed or that the FDIC was not acting in good faith. The shareholders had alleged only that the FDIC did not respond to their demand. When the court dismissed the shareholders' suit, the FDIC brought its own suit on behalf of the corporation against the bank officials on the same grounds.

The court in its opinion emphasized both the need for shareholders to pursue seriously an intracorporate remedy before attempting to bring a derivative action and the requirement that shareholders expend reasonable efforts to assist the corporation in bringing suit.²⁶⁹ The court held that the bank's shareholders failed to expend these efforts, noting that the shareholders had only informed the FDIC of the identity of the prospective defendants.²⁷⁰ The shareholders had not given the FDIC any factual allegations to support their claims of wrongdoing by bank officials, but instead had made only conclusory charges. The shareholders' demand letter also contained every hint that they might share their information with the FDIC, if the FDIC acted promptly in filing suit.

The court held that the shareholders' efforts to make the FDIC file suit were pro forma and, therefore, inadequate as a matter of law, because (1) the demand letter merely informed the FDIC of the shareholders' intent to file suit without asking for a response and (2) the shareholders took no action to assist the FDIC in their investigation.²⁷¹ Finally, the court noted that the FDIC was properly bringing the suit that the shareholders sought.²⁷² In light of these facts the court affirmed the trial court's dismissal of the shareholders' suit.²⁷³

K. Municipal Corporation

In *Gates v. City of Dallas*²⁷⁴ the Texas Supreme Court addressed the issue of whether a municipal corporation could be held liable for statutory attorneys' fees in connection with its wrongful retention of health insurance benefits from one of its employees. Charles Gates, a city employee, sued the City of Dallas for unpaid health insurance benefits. The trial court, in a partial summary judgment, allowed the employee to receive the unpaid accrued benefits. Additionally, the parties agreed, in partial settlement, that the city would pay future claims under the plan. The sole issue that went to trial involved the determination of the recovery of attorneys' fees.

The trial court, relying on article 2226²⁷⁵ of the Texas Revised Civil and article 1.14-1(7),²⁷⁶ of the Texas Insurance Code required the city to pay \$120,000 as the amount of reasonable attorneys' fees. The city appealed the trial court's judgment, and the court of appeals reversed the award of attorneys' fees and affirmed the trial court decision in all other respects. Gates

269. *Id.*

270. *Id.*

271. *Id.* at 660.

272. *Id.*

273. *Id.*

274. 704 S.W.2d 737 (Tex. 1986).

275. TEX. REV. CIV. STAT. ANN. art. 2226 (Vernon 1970).

276. TEX. INS. CODE ANN. art. 1.14-1(7) (Vernon 1970).

then appealed to the Texas Supreme Court. The supreme court reviewed the relevant case law and legislation and concluded that municipal corporations involved in proprietary functions were intended by the legislature to fall within article 2226.²⁷⁷ The court stated that the underlying purpose of the statute is to encourage contracting parties to acknowledge and pay their debts and to discourage parties from pursuing the very type of unnecessary litigation in which the city forced Gates to engage.²⁷⁸ Accordingly, the Texas Supreme Court reversed and remanded the case to the court of appeals for a determination of the sole issue of whether the amount of the attorneys' fees awarded by the trial court was reasonable.²⁷⁹

L. Service of Process Under the Texas Long-Arm Statute

*Fairmount Homes, Inc. v. Upchurch*²⁸⁰ involved whether specific pleadings filed in connection with a DTPA action alleged facts that, if true, would make the opposing party amenable to process under the Texas long-arm statute.²⁸¹ The controversy arose because the plaintiff pleaded merely that the defendant did not maintain a place of regular business in Texas and had no designated agent on whom service of citation could be made, rather than expressly alleging that the defendant was a foreign corporation. The court concluded that this deficiency was not fatal because the allegations gave the defendant adequate notice of the pending suit and sufficiently put the defendant on notice that the plaintiff was suing a foreign corporation.²⁸² The court held that if it is apparent from the petition that a foreign corporation is involved, it is not necessary to allege in the petition that a foreign corporation is the defendant.²⁸³

M. Liability Arising from Impaired or Terminated Corporate Privileges

Under Texas law a corporation can forfeit its corporate privileges through failure to pay Texas franchise taxes.²⁸⁴ One consequence of the forfeiture of those privileges is that the corporation is denied the right to sue in state court.²⁸⁵ The corporation may, however, revive its privileges and its access to the courts by obtaining reinstatement of its corporate charter through payment of delinquent franchise taxes.²⁸⁶ *Midwest Mechanical Contractors,*

277. 704 S.W.2d at 740.

278. *Id.*

279. *Id.*

280. 704 S.W.2d 521 (Tex. App.—Houston [14th Dist.]), *modified*, 711 S.W.2d 618 (Tex. 1986).

281. TEX. REV. CIV. STAT. ANN. art. 2031b-3 (Vernon 1964) *repealed and superseded* by TEX. CIV. PRAC. & REM. CODE ANN. § 17.044 (1986). This provision appoints the secretary of state as the registered agent for any foreign corporation that does business in the state without maintaining a regular place of business or designated agent for service of process in the state. For a discussion of the requirement of a factual allegation supporting jurisdiction, see *Whitney v. L&L Realty Corporation*, 500 S.W.2d 94 (Tex. 1973).

282. 704 S.W.2d at 524.

283. *Id.*

284. TEX. TAX CODE ANN. § 171.251 (Vernon Supp. 1987).

285. *Id.* § 171.252 (Vernon 1982).

286. *Id.* §§ 171.253.313-314.

*Inc. v. Commonwealth Construction Co.*²⁸⁷ involved whether the revival of a corporation's privileges retroactively validated its motion for a stay of litigation until after arbitration. The court noted that Texas law did not clearly answer the question and that other jurisdictions have reached differing conclusions under similar statutes regarding the effect of revival of a corporate charter upon actions taken during the period of revocation.²⁸⁸ However, Texas courts have construed the denial of access provision as allowing the assertion or granting of purely negative defenses or defensive relief.²⁸⁹ The court concluded that a request for defensive relief is generally sought in a motion for a stay and, therefore, avoided the retroactivity issue.²⁹⁰ The court held that the motion to stay litigation until after arbitration was valid.²⁹¹ The Federal Court of Appeals for the Fifth Circuit reached a similar conclusion regarding a motion for stay of arbitration in *Ommani v. Doctor's Associates, Inc.*,²⁹² which involved a foreign corporation that had no Texas Certificate of Authority to transact business in the state.

A second consequence of forfeiture of corporate privileges is that each director or officer of the corporation becomes personally liable for each debt of the corporation that is incurred or created in Texas after the event giving rise to the forfeiture occurs and before the corporate privileges are revived.²⁹³ *River Oaks Shopping Center v. Pagan*²⁹⁴ involved the issue of whether a debt of a corporation arising from a lease contract for real property was created or incurred after the corporation forfeited its right to do business in Texas. The court noted that Texas law was clear that "the liability imposed under the statute is only for debts contracted after the forfeiture of the right to do business and has no application to the renewal of obligations arising prior thereto."²⁹⁵ Furthermore, precedent exists for the proposition that if a lease agreement is executed before the corporation forfeited its right to do business, the corporation's debt will relate back to the promise to pay made in the leasing agreement.²⁹⁶ Accordingly, the court concluded that the obligation to pay rent under the lease agreement evidenced an intent

287. 801 F.2d 748 (5th Cir. 1986).

288. *Id.* at 752.

289. *Id.* See *Rimco Enter. v. Texas Elec. Serv. Co.*, 599 S.W.2d 362, 364 (Tex. Civ. App.—Fort Worth 1980, writ ref'd n.r.e.); *Bryan v. Cleveland Sand & Gravel Co.*, 139 S.W.2d 612, 613 (Tex. Civ. App.—Beaumont 1940, writ ref'd); *Maloney Mercantile Co. v. Johnson County Sav. Bank*, 121 S.W. 889, 890 (Tex. Civ. App. 1909, no writ).

290. 801 F.2d at 752.

291. *Id.* The court pointed out the difference between a mere motion to stay proceedings pending arbitration and a petition to compel arbitration. The court suggested that even the latter may be available to a corporate party that has forfeited its corporate privileges under state law, since only Congress has the prerogative of defining the jurisdiction of federal courts. *Id.*

292. 789 F.2d 298 (5th Cir. 1986).

293. TEX. TAX CODE ANN. § 171.255 (Vernon 1982). The liability of a director or officer is in the same manner and to the same extent as if the director or officer were a partner and the corporation were a partnership.

294. 712 S.W.2d 190 (Tex. App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.).

295. *Id.* at 192, see *Schwab v. Schlumberger Well Surveying Corp.*, 145 Tex. 379, 382, 198 S.W.2d 79, 81 (Tex. 1946).

296. See *Curry Auto Leasing v. Byrd*, 683 S.W.2d 109 (Tex. App.—Dallas 1984, no writ).

that each party, upon the signing of the instrument, would have immediately vested rights that would be binding and given full force after its execution.²⁹⁷ The court added that the obligation to pay rent was created or incurred at the time the parties executed the lease agreement, notwithstanding the fact that the rent became payable in advance on the first day of each month of the lease term.²⁹⁸

III. SECURITIES LAW DEVELOPMENTS

A. Federal Law Developments

1. *Tender Officers; SEC Amendments to Rule 13e-4 and Regulations 14D and 14E.* In Securities Act Release No. 33-6653²⁹⁹ the Securities and Exchange Commission (SEC) adopted amendments to the rules governing issuer and third-party tender offers. The amendments made three significant modifications to existing law. First, the amendments require that an issuer or third-party tender offer must extend to all persons owning shares of the class of securities subject to the offer. This provision is known as the "all-holders" rule. The SEC originally proposed the all-holders rule in 1985 in response to the federal district court's decision in *Unocal Corp. v. Pickens*.³⁰⁰ In *Unocal* the court upheld the action of a corporate issuer faced with a hostile tender offer in making a defensive self-tender offer to all of the shareholders except the hostile holder. The amendment enacting the all-holders rule was effective immediately. Second, the amendments require that all tendering security holders must be paid the highest consideration offered to any other security holder during the offer. This requirement provides for the equivalent of the "most favored nation" treatment to all tendering security holders. Third, the amendments revised the existing rules concerning minimum offering periods and withdrawal rights. The two latter amendments became effective August 18, 1986.

2. *Recovery of Damages. Randall v. Loftsgaarden*³⁰¹ involved whether a rescissionary damages recovery by a defrauded tax shelter investor must be reduced by any tax benefits the investor received from the investment. The Eighth Circuit Court of Appeals held in an en banc decision that such tax benefits represented income received which was required to be offset against the investor's recovery under section 12(2) of the Securities Act of 1933 (Securities Act). The court also held that the "actual damages" limitation of Section 28(a) of the Securities Exchange Act of 1934 (Exchange Act) requires that tax benefits be deducted from any rescissionary recovery made under section 10 of the Exchange Act.³⁰² The investors successfully petitioned the United States Supreme Court for a writ of certiorari. The

297. 712 S.W.2d at 192.

298. *Id.*

299. Fed. Sec. L. Rep. (CCH) ¶ 84,016 (1986).

300. 608 F. Supp. 1081 (C.D. Cal. 1985).

301. 106 S. Ct. 3143, 92 L. Ed. 2d 525 (1986).

302. *Austin v. Loftsgaarden*, 768 F.2d 949 (8th Cir. 1985).

Supreme Court reversed, holding that a defrauded tax shelter investor who recovers rescissory damages under section 12(2) of the Securities Act or section 10(b) of the Exchange Act need not deduct his tax benefits from his recovery of rescissory damages.³⁰³ In so holding, the Court effectively allowed the defrauded tax shelter investor to receive both his money back from the investment and any tax benefits therefrom.³⁰⁴

3. *Statute of Limitations.* The Securities and Exchange Act of 1934 does not fix a specific period of limitations within which a private litigant must bring a suit for damages, and no federal statute of limitations is generally applicable to private suits for damages under rule 10b-5. Courts, however, have fixed appropriate limitations periods as a matter of federal common law. Five years ago in *Wood v. Combustion Engineering, Inc.*,³⁰⁵ the Court of Appeals for the Fifth Circuit determined that the appropriate statute of limitations period for 10b-5 claims in Texas was two years.³⁰⁶ In *Corwin v. Marney, Orten Investments*³⁰⁷ the Fifth Circuit was called upon to reconsider the *Wood* decision in the context of a suit brought by investors who lost money in an office building project. The appellate court held that the 1977 and 1979 amendments to the Texas blue sky law did not alter the conclusion reached in *Wood* because the two major considerations of *Wood*—reliance and scienter—had not changed.³⁰⁸ The appellate court recognized, however, that the three subsidiary factors of *Wood* have all changed.³⁰⁹ First, the Texas blue sky law now includes a due diligence defense. Second, sellers have remedies available, as well as buyers. Third, a new provision specified that tender made at any time prior to entry of a judgment would satisfy the requirement of tender as a prerequisite to recovery. The court held that “[w]hile these subsidiary considerations make the Blue Sky law marginally more similar to 10b-5, we do not find the essential pillars of *Wood* to be weakened.”³¹⁰ Accordingly, the appellate court found no difficulty in reaffirming *Wood* and holding that the statute of limitations period for 10b-5 actions was two years.³¹¹

B. State law Developments

1. *Liability as Seller of Securities.* In *Dahl v. Pinter*³¹² the Fifth Circuit

303. 106 S. Ct. at 3155, 92 L. Ed. 2d at 544.

304. The apparent windfall to the defrauded tax shelter investor is somewhat illusory because the investor must subsequently pay federal income tax on the amount of his recovery.

305. 643 F.2d 339 (5th Cir. 1981).

306. *Id.* at 346.

307. 788 F.2d 1063 (5th Cir. 1986).

308. *Id.* at 1067.

309. *Id.*

310. *Id.* at 1067-68.

311. *Id.* at 1068. Interestingly, the two-year statute of limitations addressed in both *Wood* and *Corwin* has been amended to four years since the cause action arose in *Corwin*. See TEX. CIV. PRAC. & REM. CODE ANN. § 16.003 (Vernon Supp. 1987). It remains to be seen whether federal courts will begin to apply the new four-year statute of limitations for 10b-5 claims brought in Texas.

312. 787 F.2d 985 (5th Cir. 1986), *cert. granted*, ___ U.S. ___ (1987).

Court of Appeals considered whether an uninformed but enthusiastic layman, who knowingly encouraged friends and family to purchase unregistered securities, was precluded from recovering his investment under the doctrines of unclean hands, in pari delicto, or estoppel. The court also considered whether that same layman was a seller of securities. Dahl purchased certain oil and gas investments, and encouraged his friends and family to purchase similar investments from Pinter. Dahl's enthusiasm for the investments was critical in obtaining the sales. Dahl helped every other purchaser to sign their contracts, which stated that the securities were unregistered. There was no evidence, however, that Dahl knew it was illegal not to register securities.

When the investments turned sour Dahl and his fellow investors sued Pinter under federal and state securities laws. The federal district court allowed the investors to recover the purchase price of the securities, holding that the securities were illegal because of Pinter's failure to register them. Pinter appealed, claiming that section 12(1) of the Securities Act of 1933 classified Dahl as a "seller," thereby, implicating Dahl as being also liable. Pinter also alleged that the equitable doctrines of unclean hands, in pari delicto and estoppel barred Dahl from recovery.

First, the appellate court held that the equitable defenses of unclean hands, in pari delicto and estoppel did not prevent Dahl from recovering against Pinter.³¹³ The court reasoned that, even though Dahl knew that the securities were unregistered, he did not know that the lack of registration was a violation of the securities laws. As a consequence, Dahl did not engage in any culpable conduct which would preclude him from recovery for having unclean hands or for being in pari delicto. The court also held that estoppel did not bar Dahl from recovery since allowing his suit would not frustrate the purposes of the Securities Act.³¹⁴

Second, the appellate court held that, although Dahl technically fit the definition of a seller of securities, his conduct did not fall within the purview of the statute.³¹⁵ Dahl was technically a seller of securities because his participation in the sales transaction was a substantial factor in causing the transaction to take place. The fact that Dahl did not know the sale was illegal did not protect him from liability; however, the court reasoned that the Securities Act was not intended to punish a seller of securities who does so, not for profit or personal benefit, but for the benefit of the buyer.³¹⁶ The court stated "[w]e believe that a rule imposing liability (without fault or knowledge) on friends and family members who give one another gratuitous advice on investment matters unreasonably interferes with well established patterns of social discourse. Absent express direction by Congress, we decline to impose liability for mere gregariousness."³¹⁷ The court likewise

313. *Id.* at 988.

314. *Id.* at 989-90.

315. *Id.* at 991.

316. *Id.*

317. *Id.*

found that Dahl was not a seller under the Texas securities law and affirmed the district court's refusal to assess damages against Dahl.³¹⁸

Circuit Judge Brown dissented, arguing that Dahl was indeed a seller under the Securities Act, since he was the motivating force behind the investors' purchases.³¹⁹ Brown noted that the statute only requires that the seller be a "substantial factor" in bringing about the sale—no culpability is required.³²⁰ In order to protect the public, Brown reasoned, even ignorant sellers like Dahl must be held liable. Brown also argued that Dahl's role in bringing about the sale made him "mutually at fault" so that Dahl should be barred from recovery against Pinter under the *in pari delicto* defense.³²¹ In conclusion, Brown argued that allowing persons such as Dahl to knowingly sell unregistered securities, without being liable, endangers the public and encourages securities law violations.³²² Brown contended that the majority result in *Dahl* thus allows "sophisticated investors" like Dahl to invest safely in and sell unregistered securities.³²³ If the investment succeeds, Dahl reaps a profit, and if it fails, he is safe from liability. Allowing this kind of result is therefore against the public interest and encourages violation of securities law. Brown thus supported a strict liability application of the securities laws to the situation at hand.³²⁴

C. Regulation of Brokers and Dealers

1. *Magnum Corp. v. Lehman Brothers Kuhn Loeb, Inc.*³²⁵ involved the fiduciary duty of a broker to his investors. Lehman Brothers contacted magnum Corporation and other purchasers about buying stock in RPM, Inc. Magnum was interested and agreed to buy 32,000 shares at \$13.375 a share. The orders did not have an exact price or time limitation. Shortly after Magnum agreed to buy the shares, Lehman Brothers decided to begin buying RPM stock for its own account. This decision crowded the market and caused the price of RPM to rise to \$15.75 a share. Lehman Brothers did not inform Magnum of the price change or of its role in the change, but proceeded to buy the 32,000 shares at \$15.75 a share. Magnum and the other investors complained unsuccessfully and then brought suit.

The trial court found that Lehman Brothers breached its fiduciary duty to Magnum by failing to inform Magnum of the change in the market's condition due to their entry. The court awarded the plaintiffs \$76,000 in damages, the difference between what they actually paid (\$15.75 a share) and what they should have paid (\$13.375 a share). The Fifth Circuit affirmed, stating that Magnum and the other plaintiffs were entitled to be told about Lehman Brothers' entry into the market and the resulting change in its condition, so

318. *Id.*

319. *Id.* at 994 (Brown, J., dissenting).

320. *Id.*

321. *Id.*

322. *Id.*

323. *Id.*

324. *Id.* at 995.

325. 794 F.2d 198 (5th Cir. 1986).

they could choose not to buy RPM stock, to buy less, or to place their orders somewhere else.³²⁶

326. *Id.* at 201.

