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Corporations

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CORPORATIONS

by

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MANY significant developments in Texas Corporation Law occurred during the current annual Survey period, particularly with respect to the enactment of merger provision amendments and shareholder liability and action provision amendments to the Texas Business Corporation Act ("TBCA"). In addition, Texas courts rendered several noteworthy decisions during the current annual Survey period.

I. LEGISLATIVE DEVELOPMENTS

The Texas Legislature during its 1989 regular session modernized Texas Corporation Law by extensively amending the TBCA, the Texas Business & Commerce Code ("TBCC"), the Texas Non-Profit Corporation Act ("TNPCA"), and the Texas Miscellaneous Corporation Laws Act ("TMCLA").

A. Issuance of Rights or Options to Purchase Shares Without Consideration

Prior to the 1989 amendments to article 2.14-1 of the TBCA, corporate lawyers questioned whether a corporation could issue rights or options to acquire its shares to its shareholders, directors, or employees without consideration. This question arose because the terms of article 1.02 of the TBCA provided that a right or option¹ to acquire a corporation's shares did not constitute a "distribution"² and did not meet the implied requirement of the prior article 2.14-1 that the issuance of such a right or option be issued for consideration.³ Accordingly, the legislature amended article 2.14-1 of the TBCA to provide that rights or options to purchase a corporation's shares may be issued to shareholders, directors, or employees without consideration

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1. This prohibition was also of concern because of its possible application to convertible debt issues. However, as with rights or options issued to a corporation's shareholders, directors, or employees, the amendments to article 2.14-1 have eliminated this concern.

2. "'Distribution' means a transfer of money or other property (except its own shares or rights to acquire its own shares) . . ." TEX. BUS. CORP. ACT ANN. art. 1.02A(8) (Vernon Supp. 1990).

3. TEX. BUS. CORP. ACT ANN. art. 2.14-1 (Vernon Supp. 1989).

if, in the judgment of the corporation's board of directors, the issuance of those rights or options is in the interests of the corporation.⁴

B. Limitations on Liability of Shareholders for Contractual Obligations of the Corporation

In response to the Texas Supreme Court's decision in *Castleberry v. Branscum*⁵ and its progeny, such as the Dallas court of appeals decision in *Speed v. Eluma International, Inc.*,⁶ the Texas Legislature passed a bill during the last regular session that eliminated failure to observe corporate formalities, constructive fraud, and "sham to perpetrate a fraud"⁷ as bases for shareholder liability for the contractual obligations of the corporation. In addition, by eliminating sham to perpetrate a fraud as a basis for shareholder liability for the contractual obligations of a corporation⁸ the Legislature effectively eliminated the "alter ego" theory⁹ of corporate disregard as defined in *Castleberry*.¹⁰ New TBCA article 2.21 makes it clear that a shareholder of a Texas corporation will not be liable for any contractual obligation of a corporation unless the shareholder has expressly agreed by means of a guarantee or similar contractual arrangement to be liable for the obligation, has perpetrated an actual fraud¹¹ upon the obligee primarily for the shareholder's direct personal benefit,¹² or is expressly liable for the obligation under another statute.¹³ Therefore, to pierce the corporate veil and hold the

4. TEX. BUS. CORP. ACT ANN. art. 2.14-1 (Vernon Supp. 1990).

5. 721 S.W.2d 270 (Tex. 1986).

6. 757 S.W.2d 794 (Tex. App.—Dallas 1988, writ denied).

7. In the *Castleberry* case, the court held the shareholders of a Texas corporation liable for a contractual liability of the corporation on a theory of "constructive fraud", *Castleberry*, 721 S.W.2d at 273, which the *Speed* court defined as "the breach of some legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate confidence, or to injure public interests." *Speed v. Eluma International, Inc.*, 757 S.W.2d 794 at 796 (Tex. App.—Dallas 1988, writ ref'd).

8. TEX. BUS. CORP. ACT ANN. art. 2.21A(2) (Vernon Supp. 1990).

9. In a recent Houston court of appeals case, *Rosen v. Matthews Construction Company, Inc.*, 777 S.W.2d 434 (Tex. App.—Houston [14th Dist.] 1989, writ requested), upon evaluating the structure of the trial court's jury instructions, the court of appeals stated that it was led "inescapably to the conclusion that alter ego and sham are merely variations on the same theme." (emphasis added) *Id.* at 441 n. 2.

10. In an excellent analysis of the pre-1989 legislative case law concerning the various theories of "piercing the corporate veil", Robert W. Hamilton concludes that as a result of the 1989 legislative developments, "the elimination of broad principles of 'constructive fraud' and 'alter ego' in contract cases should also reduce the current emphasis on 'piercing the corporate veil' as a kind of panacea for most corporate/shareholder problems in Texas." 43 *Corporate Counsel Rev.* 1, 22 (1989).

11. The elements of common law fraud in Texas are:

- 1) a material representation was made; 2) the material representation was false;
- 3) when the speaker made the material representation, he knew it was false or made it recklessly without any knowledge of its truth and as a positive assertion;
- 4) the speaker made the material representation with the intention that it should be acted upon by the party to whom it was made; 5) the party acted in reliance upon the material misrepresentation; and 6) the party thereby suffered injury.

Trenholm v. Ratcliff, 646 S.W.2d 927, 930 (Tex. 1983).

12. TEX. BUS. CORP. ACT ANN. art. 2.21A(2) (Vernon Supp. 1990).

13. Such other statutes would presumably include the Deceptive Trade Practices Act, the Fraudulent Transfer Provisions of the TBCA, and the Texas Securities Act.

shareholders of a Texas corporation liable for a contractual obligation of the corporation based upon fraud, sham, or alter ego, an obligee now has the burden to prove three onerous elements. First, the obligee must prove that the shareholder caused the corporation to be used for the purpose of perpetrating, and did perpetrate, an actual fraud on the obligee. Second, the obligee must prove that the shareholder perpetrated the actual fraud *primarily* for the personal benefit of the shareholder. Lastly, the obligee must prove that the benefit to the shareholder was direct and personal, rather than for the benefit of the corporation or any third party. Additionally, the legislature made it clear that Texas case law with respect to piercing the corporate veil to hold shareholders liable for the contractual obligations of Texas corporations applied only to Texas corporations. The legislature amended Section A of article 8.02 of the TBCA to conform Texas case law with other authorities¹⁴ regarding the question of whether the law of the jurisdiction of incorporation or the law governing the obligation of a corporation determines shareholder liability for the obligations of a corporation.¹⁵ The liability of shareholders of a foreign corporation qualified to transact business in Texas for debts, liabilities, and obligations of the corporation, other than those assumed by agreement or imposed by statute, is now clearly governed by the laws of the foreign corporation's jurisdiction of incorporation.¹⁶ In light of the Texas Legislature's failure to limit specifically the applicability of article 8.02 to contractual obligations, as it did with the revisions to article 2.21, it seems equally clear that article 8.02 applies to the ability of an obligee to hold the shareholders of a foreign corporation liable for the corporation's noncontractual liabilities—including those based upon tort. Since articles 2.21 and 8.02, as amended, each provide a remedy and not a right or a cause of action,¹⁷ these amended articles should apply to actions tried after August 28, 1989, even though the right or cause of action arose prior thereto.¹⁸

C. *Limitations of Actions for Violation of Preemptive Rights*

The amendments to the TBCA during the Survey period also included an amendment to article 2.22-1 designed to assist corporations that issued shares for cash without providing shareholders an opportunity to exercise their preemptive rights when the corporation is unable to obtain waivers of the preemptive rights that were violated.¹⁹ Prior to the effective date of this

14. See RESTATEMENT (SECOND) CONFLICT OF LAWS § 306 (1971) [hereinafter "Restatement"]; *Muran v. Harrison*, 91 F.2d 310 (D.C. Cir. 1937).

15. TEX. BUS. CORP. ACT ANN. art. 8.02A (Vernon Supp. 1990).

16. TBCA article 8.02A provides in relevant part that "*only* the laws of the jurisdiction of incorporation of a foreign corporation shall govern . . . the liability, if any, of shareholders of the foreign corporation for the debts, *liabilities*, and obligations of the foreign corporation for which they are not otherwise liable by statute or agreement." (emphasis added) *Id.*

17. See *Rosen v. Matthews Construction Company, Inc.*, 777 S.W.2d 434 at 437 (Tex. App.—Houston [14th Dist.] 1989, writ requested).

18. See *Bayliss v. Cernock*, 773 S.W.2d 384 at 387 (Tex. App.—Houston [14th Dist.] 1989, writ denied).

19. TEX. BUS. CORP. ACT ANN. art. 2.22-1 (Vernon Supp. 1990).

amendment, a corporation's shareholders had no assurance that any actions that they were required to take, or that they planned to take, were duly authorized both by the requisite number of shareholders entitled to vote on such matters and by those that were entitled to notice of such shareholders' action. In these circumstances, the amendment to article 2.22-1 of the TBCA limits the rights of a shareholder to bring an action for violation of his preemptive rights unless the action is brought within the earlier of (i) one year after the date the shareholder is given notice of the violation by mailing the notice to the shareholder at his address as it appears on the share transfer records and (ii) four years after the date of the violation or August 28, 1989, whichever is later.²⁰

D. Election of Directors by Plurality

The new amendments distinguish the vote required for the election of directors of a Texas corporation from the vote required for other shareholder action.²¹ Under prior law, if a single director was to be elected at a meeting of shareholders from a slate of more than two nominees, the possibility existed that none of the nominees would receive the required affirmative vote of a majority of the shares cast in the election and therefore no director would be elected.²² Section C of article 2.28 of the TBCA now provides that, unless otherwise provided in the articles of incorporation, directors shall be elected by a plurality²³ of the votes cast by shareholders entitled to vote in the election of directors at a meeting at which a quorum is present.²⁴

E. Voting by Proxy

The TBCA has been further amended to provide that a shareholder's proxy in the form of a telegram, telex, cablegram, or similar transmission constitutes a proxy executed in writing by that shareholder for purposes of the TBCA.²⁵ The amendments to article 2.29C further provide that any photographic, photostatic, facsimile, or similar reproduction of any shareholder proxy so executed in writing is sufficient to meet the requirements of the article.²⁶ The amendments to article 2.29C now also provide that if an irrevocable proxy is noted conspicuously on a certificate representing certificated shares,²⁷ the irrevocable proxy may be enforced against transferees of

20. TEX. BUS. CORP. ACT ANN. art. 2.22-1C (Vernon Supp. 1990).

21. TEX. BUS. CORP. ACT ANN. art. 2.28 (Vernon Supp. 1990).

22. TEX. BUS. CORP. ACT ANN. art. 2.28 (Vernon Supp. 1989).

23. The nominee who receives the greatest number of votes cast in the election for that director position will be elected.

24. TEX. BUS. CORP. ACT ANN. art. 2.28C (Vernon Supp. 1990).

25. TEX. BUS. CORP. ACT ANN. art. 2.29C (Vernon Supp. 1990). With these amendments, a telex, cablegram, or similar transmission presumably is tantamount to "executed in writing" and "signed in writing" for purposes of the TBCA, even though the person transmitting such item has done so without a manual signature.

26. *Id.*

27. With respect to uncertificated shares, an irrevocable proxy must be disclosed in the notice and pursuant to section D of article 2.19. *See* TEX. BUS. CORP. ACT ANN. art. 2.19 (Vernon Supp. 1990).

those shares. In the absence of such notation, an irrevocable proxy is ineffective against both a transferee for value who does not have actual knowledge of the existence of the proxy at the time of transfer and any other transferee, whether or not for value, so long as that person does not have actual knowledge of the existence of the proxy.²⁸

F. Distributions to Shareholders

The amendments to the TBCA during the Survey period also included a provision that allows directors, when making "adequate provision"²⁹ for the payment of a corporate obligation upon a voluntary dissolution, to fulfill their duties under article 6.04 by relying in good faith and with ordinary care upon the financial statements of persons who assume the obligation of the corporation by becoming contractually obligated to pay it.³⁰ The effect of the amendment is now to allow corporations that voluntarily dissolve to sell assets to a third person who assumes the liabilities associated with those assets and then to distribute the proceeds of the sale to their shareholders in final liquidation.³¹ The corporation's directors, who in the exercise of ordinary care rely in good faith upon financial or other information that supports the ability of the third person to satisfy those liabilities assumed, can do so without fear of being held jointly and severally liable under article 2.41A(1) of the TBCA for the proceeds distributed to shareholders to the extent they would otherwise be required to meet the liabilities assumed.³²

G. Corporate Records

To remedy the implications of an ambiguous Attorney General's Opinion,³³ which suggests that a Texas corporation must keep its corporate and stock transfer records in Texas, the Texas Legislature amended article 2.44 of the TBCA. The amended article provides that the corporate and stock transfer records may be kept at either the principal place of business of a corporation or the office of its transfer agent or registrar, either or both of which may be located outside the State of Texas.³⁴

28. TEX. BUS. CORP. ACT ANN. art. 2.29C (Vernon Supp. 1990).

29. The TBCA requires directors of a corporation, prior to making any distributions to shareholders during liquidation, to pay or discharge all of the corporation's obligations or make "adequate provision for payment and discharge thereof . . ." TEX. BUS. CORP. ACT ANN. art. 6.04A(3) (Vernon Supp. 1990).

30. TEX. BUS. CORP. ACT ANN. art. 2.41C(3) (Vernon Supp. 1990).

31. *Id.*

32. Presumably, the amendment to article 2.41C(3) would not affect the obligation of the corporation in dissolution to ensure adequate provision for undischarged liabilities or the availability of any assets remaining or subsequently collected by the corporation to satisfy the liabilities of the corporation assumed by the third person, nor should such amendment affect the ability of creditors to recover from shareholders those amounts distributed in violation of article 2.38 of the TBCA in reliance upon the Uniform Fraudulent Transfer Act or the "trust fund theory". See *Hunter v. Fort Worth Capital Corp.*, 620 S.W.2d 547, 550 (Tex. 1981).

33. Op. Att'y Gen. No. V-673 (1948) was based upon TEX. REV. CIV. STAT. ANN. art. 1358 (repealed).

34. TEX. BUS. CORP. ACT ANN. art. 2.44A (Vernon Supp. 1990).

H. *The New Texas Merger Statutes*

In a sweeping and unprecedented revision to the TBCA's merger statutes, the Texas Legislature amended Part Five of the TBCA³⁵ to provide, among other matters, for the possibility of multiple surviving corporations in a merger³⁶ and the merger with Texas business corporations of non-profit corporations, limited partnerships, and general partnerships to the extent that the statutes under which those entities are created permit such a transaction.³⁷ In addition to providing for the survival of multiple corporations or other entities and permitting transactions that previously were effected through multiple conveyances of assets and assumption of liabilities to be effected by means of a single statutory merger, the amendments to article 5.01 of the TBCA also included the possibility of the division of a corporation's assets and liabilities among multiple surviving or new corporations or other entities.³⁸

1. *Share Exchanges*

The Texas Legislature also amended Part Five of the TBCA to provide for share exchanges.³⁹ In effect duplicating a "triangular merger" without the necessity of creating a new subsidiary of the acquiring corporation and thereafter merging the acquired corporation into that subsidiary, a share exchange allows the acquired entity to submit a plan to a vote of shareholders whereby each outstanding share of the acquired corporation is deemed to have been exchanged for a number of the acquiring entity's shares at a specified time following the approval of the holders of at least two-thirds of the acquired corporation's shares entitled to vote on the exchange.⁴⁰ Each shareholder of the acquired entity is entitled to dissent from the share exchange transaction as provided in article 5.11 of the TBCA.⁴¹ As in the case of the merger statutes, the legislature provided that so long as the laws pursuant to which the constituents are created so permit, the acquiring and acquired entities participating in the share exchange may be Texas business corporations or "other entities".⁴²

2. *Shareholder Approval*

Another important legislative change in Part Five of the TBCA is the provision eliminating the right of holders of non-voting shares of a Texas corporation to vote on a plan of merger or exchange unless: (i) in the case of

35. For a detailed analysis of the application of the new Texas merger statutes and the relationship to other statutes, see Huff, *The New Texas Business Corporation Act Merger Provisions*, 21 St. Mary's L.J. 109 (1989).

36. TEX. BUS. CORP. ACT ANN. art. 5.01 (Vernon Supp. 1990).

37. See TEX. BUS. CORP. ACT ANN. art. 1.02A(13) (Vernon Supp. 1990).

38. Pursuant to TEX. BUS. CORP. ACT ANN. art. 1.02A(13) (Vernon Supp. 1990), "other entity" includes general partnerships.

39. TEX. BUS. CORP. ACT ANN. art. 5.02A (Vernon Supp. 1990).

40. TEX. BUS. CORP. ACT ANN. art. 5.03E (Vernon Supp. 1990).

41. TEX. BUS. CORP. ACT ANN. art. 5.11A(3) (Vernon Supp. 1990).

42. TEX. BUS. CORP. ACT ANN. art. 5.02A (Vernon Supp. 1990).

a merger, the plan of merger contains a provision that if contained in an amendment to the articles of incorporation would require a class vote; (ii) in the case of a share exchange, the class of shares is to be acquired in the share exchange; or (iii) the holders of the shares are entitled by the articles of incorporation to vote as a class for the merger or exchange.⁴³ Under prior law, the holders of all voting and non-voting shares were entitled to vote as a single class on a plan of merger and were provided with a class vote if the plan of merger contained a provision that if contained in an amendment to the articles of incorporation would require a class vote.⁴⁴ The one significant exception to the new requirements of a shareholder vote in connection with a plan of merger applies to the shareholders of a sole surviving corporation where: (i) each share of the corporation outstanding immediately prior to the effective time of the merger will be outstanding immediately after the effective time of the merger; (ii) the plan of merger does not amend the surviving corporation's articles of incorporation; and (iii) either (A) the number of participating shares⁴⁵ (including participating shares issuable upon conversion of any other securities issued pursuant to the merger) will not exceed 20% of the number of participating shares outstanding immediately prior to the merger, or (B) the number of voting shares⁴⁶ (including voting shares issuable upon conversion of any other securities issued pursuant to the merger) will not exceed by more than 20% of the number of voting shares outstanding immediately prior to the merger.⁴⁷

3. *Effective Date*

Prior law provided that a merger or consolidation became effective upon the issuance of a certificate of merger or consolidation by the Texas Secretary of State.⁴⁸ The legislature amended article 5.05 to provide that unless some time later than the time of issuance of a certificate of merger, consolidation, or share exchange is specified as the effective time, then the merger, consolidation, or share exchange will become effective upon the date the certificate of merger, consolidation, or share exchange is issued by the secretary of state.⁴⁹ Therefore, parties to a merger, consolidation, or share exchange may now fix the effective time of a merger, consolidation, or share exchange to become effective as of some future date to accommodate regulatory requirements, to complete listings of securities, or for other purposes.

43. TEX. BUS. CORP. ACT ANN. art. 5.03F (Vernon Supp. 1990).

44. TEX. BUS. CORP. ACT ANN. art. 5.03B (Vernon Supp. 1989).

45. Participating shares are defined in article 5.03H(1) as those shares entitled to participate without limitation in distributions. TEX. BUS. CORP. ACT ANN. art. 5.03H(1) (Vernon Supp. 1990).

46. TEX. BUS. CORP. ACT ANN. art. 5.03G (Vernon Supp. 1990). Voting shares are defined in article 5.03H(2) as those shares entitled to vote unconditionally for the election of directors.

47. TEX. BUS. CORP. ACT ANN. art. 5.03 (Vernon Supp. 1990).

48. TEX. BUS. CORP. ACT ANN. art. 5.05 (Vernon Supp. 1989).

49. TEX. BUS. CORP. ACT ANN. art. 5.05 (Vernon Supp. 1990).

4. Dissenter's Rights

Under revised TBCA article 5.11, only shareholders entitled to vote on a plan of merger or exchange are entitled to dissenter's rights, and then only to the extent that the merger or exchange does not involve the receipt by the shareholder of shares that are publicly traded.⁵⁰ The theory of the Delaware law upon which the new Texas dissenter's rights provisions are based is that providing a right of dissent and appraisal is not necessary for shareholders who are able to liquidate their investment at an independently established public market that adequately establishes "fair value".⁵¹ However, unlike the Delaware General Corporation Law,⁵² the Texas Legislature did not provide for the payment of any cash to shareholders for fractional shares pursuant to a plan of merger.⁵³

5. Effect of Merger or Share Exchange

The new Texas merger statutes also provide that, in accordance with the terms of a plan of merger, any transfer or assignment for property law purposes and any allocation of liabilities and obligations will occur by operation of law, without any express "transfer" or "assignment" of the rights, title, or interests to the real estate or other property⁵⁴ and without any express assumption by the parties to which any liabilities or obligations are allocated.⁵⁵ Presumably, any allocation of property effected in a plan of merger would constitute a transfer or conveyance for purposes of the fraudulent transfer laws⁵⁶ or under any applicable contractual restrictions without affecting any existing liens upon any allocated assets.⁵⁷ The party to which a particular obligation is allocated will be primarily liable for that obligation and no

50. TEX. BUS. CORP. ACT ANN. art. 5.11 (Vernon Supp. 1990). Dissenter's rights will not be available to a shareholder if (i) at the record date for determining shareholders entitled to vote on the plan of merger or the plan of exchange the shareholder's shares are part of a class of shares that are listed on a national securities exchange or held of record by not less than 2,000 holders and (ii) the shareholder is not required by the plan to accept any consideration for his shares other than shares of a corporation that will be listed on a national securities exchange or held of record by not less than 2,000 holders immediately after the effective time of the merger or exchange, TEX. BUS. CORP. ACT ANN. art. 5.11B (Vernon Supp. 1990).

51. Although the amendment to article 5.11 eliminated dissenter's rights with respect to certain transactions, it did not change the exclusivity aspect of the statute or imply that a shareholder who does not have the right to dissent could seek monetary damages absent fraud. Accordingly, a shareholder of a public corporation who receives solely shares of stock of another public corporation in a merger may not seek an appraisal for his shares or any other monetary remedy with respect to the merger absent fraud. See Huff, *The New Texas Business Corporation Act Merger Provisions*, 21 St. Mary's L.J. 109, 150-54 (1989).

52. DEL. CODE ANN. tit. 8, § 262 (1974 & Supp. 1989).

53. TEX. BUS. CORP. ACT ANN. art. 5.11 (Vernon Supp. 1990).

54. Property transferred will, however, be subject to any existing liens on the property, TEX. BUS. CORP. ACT ANN. art. 5.06A(2) (Vernon Supp. 1990), even though the entity to which the assets are allocated may not be the entity to which the debt giving rise to the lien is allocated.

55. *Id.*

56. TEX. BUS. CORP. ACT ANN. art. 5.15 (Vernon Supp. 1990). TEX. BUS. & COM. CODE ANN. § 24.001 et. seq. (Vernon Supp. 1990).

57. See Huff, *The New Texas Business Corporation Act Merger Provisions*, 21 St. Mary's L.J. 109, n. 33 and accompanying text and 122-34 (1989).

other party will be liable for that obligation, absent a specific term to the contrary in the plan of merger or exchange, any other applicable contractual provision, or any applicable law imposing liability.⁵⁸ Any obligation that is not otherwise specifically allocated pursuant to the plan of merger or exchange is allocated pro rata among the surviving or new parties based upon the number of surviving or new parties, rather than their continuing percentage interest in the assets allocated, and each such surviving or new entity is jointly and severally liable to the obligee of the unallocated obligation for the entire obligation.⁵⁹ In no event, however, may a shareholder become personally liable for the obligations of any entity as a result of the merger without that shareholder's express consent.⁶⁰ In those instances in which there are multiple resulting or surviving entities, the surviving entity named as obligated to pay the fair value of the shares of any shareholder of a Texas corporation that perfects its right to dissent under article 5.11 of the TBCA is deemed to have appointed the Secretary of State of Texas as its agent for service of process and to have agreed to comply with the provisions of article 5.11 of the TBCA.⁶¹

6. *Effect of Merger and Exchange Amendments on Other Statutes*

Article 5.15 of the TBCA makes clear that the legislature did not intend for the provision permitting multiple surviving or new parties in a merger or exchange to affect the existing rights of creditors of the corporation prior to the merger or exchange.⁶² In addition, such creditors will still have the benefit of fraudulent transfer laws as well as any contractual restrictions in effect prior to the merger.⁶³ To the extent that the merger (i) involves a transfer of assets for less than "fair consideration" or "reasonably equivalent value", or (ii) involves multiple new or surviving entities that results in the insolvency of one of those entities or causes that entity to become unable to meet its debts as they become due or to be inadequately capitalized, the merger may constitute a fraudulent transfer or conveyance subject to the Uniform Fraudulent Transfer Act,⁶⁴ the Uniform Fraudulent Conveyance Act,⁶⁵ and the United States Bankruptcy Code.⁶⁶

58. TEX. BUS. CORP. ACT ANN. art. 5.06A(3) (Vernon Supp. 1990).

59. TEX. BUS. CORP. ACT ANN. art. 5.06C (Vernon Supp. 1990).

60. TEX. BUS. CORP. ACT ANN. art. 5.06A(3) (Vernon Supp. 1990).

61. TEX. BUS. CORP. ACT ANN. art. 5.01D (Vernon Supp. 1990).

62. TEX. BUS. CORP. ACT ANN. art. 5.15 (Vernon Supp. 1990).

63. TEX. BUS. CORP. ACT ANN. art. 5.15 (Vernon Supp. 1990). Given the broad definition of "transfer" and "conveyance" under the Uniform Fraudulent Transfer Act, the Uniform Fraudulent Conveyance Act, and the United States Bankruptcy Code of 1978, as amended, a merger with multiple surviving or new parties should constitute a transfer or conveyance within the description of "party with an asset" as contemplated by each of the statutory enactments, notwithstanding the language of article 5.06 of the TBCA that such a merger will occur without a "transfer" or "assignment".

64. UNIFORM FRAUDULENT TRANSFER ACT, 7A U.L.A. 639 (1985).

65. UNIFORM FRAUDULENT CONVEYANCE ACT, 7A U.L.A. 427 (1985).

66. 11 U.S.C. §§ 101-1330 (1982 & Supp. V 1987). For a discussion of the application of the fraudulent transfer laws to merger transactions under the Texas statute and other laws, see Huff, *The New Texas Business Corporation Act Merger Provisions*, 21 St. Mary's L.J. 109, 122-134. In that article, the author examines the circumstances under which a merger could con-

7. Short-Form Mergers

The Texas Legislature amended the merger statute to provide for a "downstream"⁶⁷ "short-form"⁶⁸ merger between a subsidiary corporation and its parent.⁶⁹ Prior to the 1989 amendments article 5.16 of the TBCA contemplated only a short-form merger of a subsidiary into its parent without the approval of the subsidiary's shareholders or directors. As amended, however, article 5.16A allows a short-form merger to occur with the subsidiary being the surviving entity without approval of the subsidiary's shareholders or directors as long as any shareholder and director action on the part of the parent corporation is taken.⁷⁰

I. Shareholder Action by Consent

The Texas Legislature amended article 9.10A of the TBCA⁷¹ to provide the holders of shares who would otherwise have the ability to effect shareholder action at a meeting of shareholders with the ability to take that action without the necessity of complying with the formalities of notice and of holding a meeting. A corporation's articles of incorporation may now expressly provide that its shareholders may take action by a written consent signed by the holders of only that number of shares required by law or by the articles of incorporation or by-laws to be cast at a meeting of shareholders to effect that shareholder action.⁷² To be effective, the written consent as executed by less than all of the holders of a corporation's shares must be delivered to the corporation within 60 days from the date the first consent was obtained,⁷³ and prompt notice of the shareholder action taken by less than unanimous consent must be given to the shareholders who did not execute consents to the action.⁷⁴ Therefore, except in the case of extraordinary corporate transactions, shareholder action may now be taken by written consent of the holders of a majority of all shares entitled to vote with respect to that action, if the articles of incorporation permit written consents by less than all shareholders and do not require a supermajority vote for the action. Shareholder action by unanimous written consent of the holders of all of a corporation's outstanding shares continues to be effective under the TBCA, whether or not specifically authorized by the corporation's articles of incor-

stitute a fraudulent transfer or conveyance under the Uniform Fraudulent Transfer Act, the Uniform Fraudulent Conveyance Act, and the Bankruptcy Code and the remedies that might be available to an affected creditor. *See also*, Levin and Ginsburg, *Corporate Mergers, Acquisitions and Leveraged Buyouts. Summary of Basic Tax, SEC, Corporate and Accounting Considerations*, 1 Acquisition and Mergers 1989, 70, 720-56 (1989) (Practising Law Institute).

67. A "downstream" merger is a merger of a parent corporation into a surviving subsidiary corporation.

68. A "short-form" merger is the merger of a subsidiary corporation with its parent corporation, which owns 90% or more of the outstanding voting shares of the subsidiary corporation.

69. TEX. BUS. CORP. ACT ANN. art. 5.16A (Vernon Supp. 1990).

70. *Id.*

71. TEX. BUS. CORP. ACT ANN. art. 9.10A (Vernon Supp. 1990).

72. TEX. BUS. CORP. ACT ANN. art. 9.10A(1) (Vernon Supp. 1990).

73. TEX. BUS. CORP. ACT ANN. art. 9.10A(2) (Vernon Supp. 1990).

74. TEX. BUS. CORP. ACT ANN. art. 9.10A(4) (Vernon Supp. 1990).

poration, without the notification requirements applicable to less than unanimous shareholder action by written consent.⁷⁵

J. Limitations on Director Liability

In furtherance of its legislation enacted during the 1987 regular session, the Texas Legislature further modernized Texas corporation law regarding director liability limitations and indemnification by amending the definition of "corporation" contained in article 1302-7.06 of the TMCLA to extend to virtually all Texas limited liability organizations.⁷⁶ This extension was effected by adding to the definition of corporation "any . . . organization incorporated or organized under the laws of this state that is governed in whole or in part by"⁷⁷ the TBCA, the TNPCA, or the TMCLA.⁷⁸ Significantly, the legislature for the first time adopted the concept of "comparative liability" of directors by adopting the phrase "*to the extent the director is found liable*" (emphasis added).⁷⁹ Therefore, a director may be found liable in part for breach of duty of care and in part for breach of duty of loyalty, and, therefore, not personally liable for monetary damages attributable to the breach of duty of care—only for monetary damages attributable to the breach of the duty of loyalty.⁸⁰ Finally, the amendments to article 1302-7.06.B(2) during the Survey period align Texas law with the Delaware General Corporation Law concept that the business judgment rule is not available as a defense to a breach of the duty of care if the director is shown to have acted in "bad faith".⁸¹ This change was effected by eliminating the implication in article 1302-7.06 prior to the 1989 amendments that "bad faith" alone constitutes an actual breach of duty.⁸²

K. Loans to Officers and Directors of Texas Non-Profit Corporations

The legislature amended article 1396-2.02 of the TNPCA to empower a Texas not for profit corporation to make loans only to officers who are not also directors of not for profit corporations for the limited purpose of financing the officer's residence or, provided the loan does not exceed a specified percentage of the officer's annual salary, for any other purpose.⁸³ Therefore, loans to directors (including directors who are also officers) of not for profit corporations remain prohibited.

75. TEX. BUS. CORP. ACT ANN. art. 9.10B (Vernon 1980).

76. TEX. REV. CIV. STAT. ANN. art. 1302-7.06 (Vernon Supp. 1990).

77. *Id.*

78. Article 1302-7.06 was further amended to provide that article 1302-7.06 may be adopted by inclusion in articles of incorporation, organization, or association as originally filed with the Secretary of State, rather than solely by articles of amendment as previously required. TEX. REV. CIV. STAT. ANN. art. 1302-7.06B (Vernon Supp. 1990).

79. *Id.*

80. TEX. REV. CIV. STAT. ANN. art. 1302-7.06B(1) (Vernon Supp. 1990).

81. TEX. REV. CIV. STAT. ANN. art. 1302-7.06B(2) (Vernon Supp. 1990).

82. TEX. REV. CIV. STAT. ANN. art. 1302-7.06(B) (Vernon Supp. 1990).

83. TEX. REV. CIV. STAT. ANN. art. 1396-2.02A(6) (Vernon Supp. 1990).

L. *Bold-Faced Contractual Foreign Choice of Law or Forum Provisions*

Recognizing that section 35.53 of the TBCC prior to the amendment⁸⁴ provided a trap for the unwary and was unjustified when applied to negotiated choice of law and forum provisions, the Texas Legislature amended the section to limit its applicability to contracts involving the sale, lease, exchange, or other disposition for value of goods for consideration of \$50,000.00 or less.⁸⁵ Therefore, now only in such instances where a foreign choice of law or forum is contained in such a contract executed by a Texas party will the choice of law or forum provision be voidable, unless set out in bold-faced, capitalized, underlined, or otherwise in such a manner that a reasonable person against whom the provision may operate would notice.⁸⁶

M. *Covenants Not to Compete*

In response to the reformulation by the Texas Supreme Court in *Hill v. Mobile Auto Trim, Inc.*⁸⁷ of the criteria to be applied in determining whether covenants not to compete are enforceable in Texas, the Texas Legislature added a new Subchapter E to Chapter 15 of the TBCC. New Subchapter E codifies the criteria for enforceability of covenants not to compete,⁸⁸ provides evidentiary standards with respect to the enforceability of those covenants,⁸⁹ and mandates judicial reformation of otherwise enforceable covenants not to compete that are unreasonable as written with respect to the scope of the activity to be restrained or as to the time or geographic limitations imposed.⁹⁰ The effect of the amendment to Chapter 15 of the TBCC is to modify substantially the four-part test applied by the Texas Supreme Court in *Hill* and to clearly eliminate the "common calling" limitation, the "special training or knowledge" requirement, and the "would suffer irreparable harm as a result of the breach" requirement that were acknowledged by the Texas Supreme Court in *DeSantis v. Wackenhut Corp.*⁹¹ Specifically, section 15.50 of the TBCC sets forth the two exclusive requirements under Texas law for a covenant not to compete to be enforceable.⁹² The first requires that the covenant must be ancillary to an otherwise enforceable agreement. The second requires that the covenant contain reasonable limitations as to time, geographic area, and scope of activity to be restrained that

84. TBCC § 35.53 provided that to be enforceable a contractual provision involving a Texas resident that chose a foreign law or forum must be in "bold-faced" print. TEX. BUS. & COM. CODE ANN. § 35.53 (Vernon Supp. 1989).

85. TEX. BUS. & COM. CODE ANN. § 35.53 (Vernon Supp. 1990). The legislature also clarified what other methods of making the choice of law provision conspicuous would be acceptable for purposes of § 35.53.

86. *Id.*

87. 725 S.W.2d 168 (Tex. 1987). See discussion in Gray, Vletas, and Waters, *Annual Survey of Texas Law: Corporations and Partnerships*, 43 Sw. L.J. 221 at 243-46 (1989).

88. TEX. BUS. & COM. CODE ANN. § 15.50 (Vernon Supp. 1990).

89. TEX. BUS. & COM. CODE ANN. § 15.51 (Vernon Supp. 1990).

90. *Id.*

91. 31 Tex. Sup. Ct. J. 616, — S.W.2d — (July 13, 1988, rehearing granted). See discussion in 43 Sw. L.J. 221 at 243 (1989).

92. TEX. BUS. & COM. CODE ANN. § 15.50 (Vernon Supp. 1990).

do not impose a greater restraint upon the promissor than is necessary to protect the goodwill or other business interest of the promisee.⁹³

Section 15.51 sets forth evidentiary procedures in actions to enforce the remedies of damages and injunctive relief available to a promisee seeking to enforce a covenant not to compete.⁹⁴ The burden of proving the reasonableness of the limitations set forth in a covenant not to compete now depends upon the character of the contract to which the covenant is ancillary. If the covenant is ancillary to a personal service contract between an employer and an employee, the burden of proof is placed upon the employer to show that the limitations imposed by the covenant are reasonable under the circumstances of the particular employment situation.⁹⁵ Facts that could be presented to substantiate, but which are clearly not the only facts necessary to prove, the reasonableness of the limitations of the covenant would include an employer's investment in an employee through training or the imparting of knowledge with respect to the employer's business. The reasonableness of the limitations might also be established by evidence that the employment relationship is so intertwined with the employer's confidential or proprietary information that a failure to enforce the covenant could result in harm to the employer's business or goodwill. On the other hand, to be held unenforceable as written, the burden of proof is upon the promissor to show that a covenant not to compete ancillary to an agreement providing for the sale of the stock or assets of a business, the sale of a franchise, the formation of a partnership, the lease of property, or any other contract that is not a personal service contract contains limitations as to time, territory, and scope of activity that are greater than those necessary to protect the goodwill or other business interest of the promisee.⁹⁶ Significantly, if the promisee requests that the covenant be reformed by the court, the TBCC now provides that courts *must* reform covenants that are ancillary to otherwise enforceable agreements but are found to contain unreasonable limitations as written to make the time, territory, and activity limitations reasonable.⁹⁷

To discourage employers from imposing unreasonably broad limitations upon employees with the expectation that a court will reform the limitations, section 15.51 allows a court to award attorney's fees and court costs to employees who can overcome the difficult burden of proving both that the employer (i) had actual knowledge at the time of entering into the agreement that its limitations were not reasonable as to time, territory, or scope of activity to be restricted and (ii) is now seeking to enforce the covenant to a greater extent than is necessary to protect its goodwill or other business interests.⁹⁸ In addition, in accordance with the Texas Supreme Court's decision in *Weatherford Oil Tool Co. v. Campbell*,⁹⁹ section 15.51 provides that

93. *Id.*

94. TEX. BUS. & COM. CODE ANN. § 15.51 (Vernon Supp. 1990).

95. *Id.*

96. *Id.*

97. *Id.*

98. *Id.*

99. 340 S.W.2d 950, 952-53 (Tex. 1960).

in all suits to enforce covenants not to compete, if the court reforms the limitations, the promisee is entitled to injunctive relief to the extent the limitations are reformed, but not to monetary damages incurred prior to the date of reformation.¹⁰⁰

Finally, new Subchapter E to Chapter 15 of the TBCC by its terms applies to covenants entered into on, before, and after August 28, 1989.¹⁰¹ However, since new Subchapter E of Chapter 15 provides a remedy and not a right or cause of action, even absent the applicability provision it should apply to actions tried after August 28, 1989, even though the right or cause of action arose prior thereto.¹⁰²

II. CASE LAW DEVELOPMENTS

A. Corporate Disregard

Even before the salient case of *Castleberry v. Branscum*,¹⁰³ the leniency of Texas courts in disregarding the corporate entity was recognized.¹⁰⁴ Within the current annual Survey period, the rationale espoused by the court in *Castleberry*¹⁰⁵ became even more firmly entrenched. *Castleberry* became the foundation upon which mortises and tenons united to form the joints of the structure for disregarding corporate entities. Cases decided during the Survey period have enabled this structure to attain new heights. However, the post-*Castleberry* cases so greatly expanded upon the bases for corporate disregard that the Texas Legislature responded by effectively dismantling the pilasters supporting *Castleberry* itself. As discussed previously, the recent legislative enactments shielding shareholders from a corporation's contractual obligations when constructive fraud, sham, alter ego, or failure to adhere to corporate formalities is alleged have all but eliminated the supports of *Castleberry*.¹⁰⁶

In *Klein v. Sporting Goods, Inc.*,¹⁰⁷ a Texas court of appeals held the sole shareholder liable for the corporation's unsecured debts by finding that the

100. TEX. BUS. & COM. CODE ANN. § 15.51(c) (Vernon Supp. 1990).

101. TEX. BUS. & COM. CODE ANN. § 15.51 (Vernon Supp. 1990).

102. Bayliss v. Cernock, 773 S.W.2d 384 at 387 (Tex. App.—Houston [14th Dist.] 1989, writ denied).

103. 721 S.W.2d 270 (Tex. 1986).

104. Minchen v. Van Trease, 425 S.W.2d 435, 437 (Tex. Civ. App.—Houston [14th Dist.] 1968, writ ref'd n.r.e.).

105. *Castleberry* permits disregarding of the corporate fiction (or "piercing the corporate veil") when the corporate form has been used as a part of a basically unfair device to achieve an inequitable result, and more specifically: (1) when the fiction is used as a means of perpetrating fraud (including constructive fraud, which is defined as the breach of some legal or equitable duty); (2) where a corporation is organized and operated as a mere tool or business conduit of another corporation (the "alter ego" theory); (3) where the corporate fiction is resorted to as a means of evading an existing legal obligation; (4) where the fiction is employed to achieve or perpetrate a monopoly; (5) where the fiction is used to circumvent a statute; or (6) where the fiction is relied upon as a protection of crime or to justify wrong. In addition, as a footnote the court listed inadequate capitalization as another basis. *Castleberry*, 721 S.W.2d at 271-72.

106. TEX. BUS. CORP. ACT ANN. art. 2.21A(2), (3) (Vernon Supp. 1990).

107. 772 S.W.2d 173 (Tex. App.—Houston [14th Dist.] 1989, writ denied).

shareholder had engaged in constructive fraud.¹⁰⁸ Edward Klein, the appellant, was the sole shareholder, director, and chief executive officer of the Gun Exchange, which was a retail firearms dealership. Its inventory was pledged to secure a \$622,500 debt owed by the Gun Exchange to InterFirst Bank, which Klein had personally guaranteed. Appellees were unsecured creditors of the Gun Exchange and were owed approximately \$231,000. InterFirst Bank informed Klein that it would foreclose upon the inventory and hold Klein personally liable for any deficiency.

Knowing that the foreclosure sale would probably result in a deficiency and therefore would require payment on his personal guaranty, Klein incorporated the Gun Store, obtained a line of credit, and purchased the Gun Exchange's inventory at the foreclosure sale for \$650,000, even though the inventory was only valued at \$400,000. After the sale, the only remaining asset of the Gun Exchange was its bank account containing approximately \$12,000, which was paid to Klein for loans he allegedly made to the Gun Exchange. Upon not being paid, appellees proceeded against Klein under a constructive fraud theory, and the jury found Klein had used the corporate fiction of the Gun Exchange as a sham to perpetrate a fraud on appellees.¹⁰⁹ In a decision rendered prior to the 1989 amendments to article 2.21A of the TBCA,¹¹⁰ the court agreed the jury's finding of constructive fraud was legally and factually sufficient to be upheld.¹¹¹ The court reasoned that the jury could have found the foreclosure sale to be the method by which obligations to creditors were avoided and that the Gun Store was merely a continuation of the Gun Exchange.¹¹² By proving constructive fraud, the appellees were able to disregard the corporate fiction and thus cause the debts of the Gun Exchange to become the debts of Klein.¹¹³

From the facts presented, the Gun Exchange was unable to pay its unsecured creditors even if it had not ceased to operate and had not transferred substantially all of its assets pursuant to the foreclosure sale. The unsecured creditor appellees' position was no worse than if Klein had continued to attempt to operate the insolvent Gun Exchange with its inventory having been foreclosed upon. With no assets remaining in the Gun Exchange and no personal guarantee of Klein, appellees faced a dismal situation as unsecured creditors. No indication exists that appellees would have been paid "but for" Klein's actions, and therefore his actions did not appear to be the proximate cause of injury to appellees.¹¹⁴ The jury, however, turned appellees' adversity into victory by securing for appellees the equivalent of a per-

108. *Id.* at 176.

109. *Id.* at 175.

110. TEX. BUS. CORP. ACT ANN. art. 2.21A (Vernon Supp. 1990). *See supra* note 12 and accompanying text.

111. *Klein*, 172 S.W.2d at 176.

112. *Id.*

113. *Id.* at 176-77.

114. Whether this is the correct standard for damages in this action is currently undecided. *See Seaside Indust., Inc. v. Cooper*, 766 S.W.2d 566, 570 (Tex. App.—Dallas 1989, n.w.h.); *Speed v. Eluma International, Inc.*, 757 S.W.2d 794, 799 (Tex. App.—Dallas 1988, writ denied).

sonal guarantee from Klein, something neither party had bargained for when they contracted. This abuse of the doctrine of corporate disregard, which granted unsecured creditors benefits that would not have otherwise existed, explains the response of the Texas Legislature in amending articles 2.21A and 8.02 of the TBCA. Prior to this legislation, constructive fraud leading to corporate disregard arose because of the breach of some legal or equitable duty. No legal duty arose from Klein to appellees and equity should not have been imposed to grant appellees more benefits than they would have received if the status quo had been maintained.

Another case involving piercing the corporate veil decided by a Texas court of appeals during the Survey period is *Rosen v. Matthews Construction Company, Inc.*¹¹⁵ In *Rosen* the court found that to recover damages from the shareholder of a corporation, a claimant must prove not only the basis for piercing the corporate veil but also the commission of some actionable wrong by the corporation that is the basis for claimant's damages.¹¹⁶ The facts revealed that in March 1979, Matthews Construction Company entered into a contract with Houston Pipe & Supply Company (HP&S) of which Harvey Rosen was president and sole shareholder. Matthews sued HP&S on June 21, 1979, for breach of the contract and obtained a judgment for approximately \$300,000 on July 26, 1982.¹¹⁷ When Matthews was unable to collect on the judgment, he filed suit against Rosen on February 20, 1984, and was subsequently awarded damages by the trial court.¹¹⁸

The first issue presented to the court was whether the alter ego and constructive fraud bases for corporate disregard, as enunciated in *Castleberry*, created an independent cause of action.¹¹⁹ The running of the statute of limitations made this issue important. Since the actual breach of contract, for which the cause of action against the corporation accrued, occurred more than four years prior to the bringing of the present suit seeking to pierce HP&S's corporate veil, Matthews sought to establish that the corporate disregard theories of constructive fraud, sham to perpetrate a fraud, and alter ego were separate causes of action that could withstand the affirmative defense of the statute of limitations. In rejecting this contention, the court looked at "well-settled Texas law" in determining that such bases only provided the means for an injured party to pursue a remedy against an additional defendant who would otherwise be immune.¹²⁰

Additionally, based upon the Texas Supreme Court's decision in *Gentry v.*

115. 777 S.W.2d 434 (Tex. App.—Houston [14th Dist.] 1989, writ requested).

116. *Id.* at 438.

117. *Id.* at 435.

118. *Id.*

119. *Id.* at 436.

120. *Id.* at 437. The court also rejected the "odd language" in *Seaside Industries and Speed* that suggested a cause of action could be maintained based solely on piercing the corporate veil. *Rosen* at 437. The court viewed the language as being in contradiction of the Dallas court of appeals post-*Castleberry* case of *Equinox Enterprises, Inc. v. Associated Media, Inc.*, 730 S.W.2d 872 (Tex. App.—Dallas 1987, no writ), wherein the court stated, "[w]e recognize that alter ego is not a cause of action, but merely a means of imposing individual liability where it would not otherwise exist". *Id.* at 877.

Credit Plan Corp. of Houston,¹²¹ Matthews argued that the statute of limitations had tolled commencing with the filing of the original suit against HP&S in 1979. The supreme court held in *Gentry* that the filing against the corporation would toll the limitations statute as to alter ego defendants, "because the seemingly separate entities were in a sense identical".¹²² In a footnote to *Gentry*,¹²³ however, the supreme court declined to endorse the theory that an alter ego defendant could be added after a judgment had become final on appeal. Seizing upon this language, the court in *Rosen* endorsed the distinction that limitations should be suspended to provide a claimant with his day in court but not to provide the claimant with a second opportunity after he had exhausted his original process.¹²⁴ According to the court, this distinction permitted the two countervailing policies of redress and finality to be respected.¹²⁵ Consequently, even though Matthews was able to pierce the corporate veil, he was not able to secure a judgment against Rosen since the limitations period had expired.¹²⁶

B. Choice of Law

In *Uniwest Mortgage Co. v. Dadecor Condominiums, Inc.*,¹²⁷ the United States Court of Appeals for the Fifth Circuit recognized the adoption by the Texas Supreme Court in *DeSantis v. Wackenhut*¹²⁸ of section 187 of the *Restatement (Second) Conflict of Laws* and applied that section to determine whether the usury laws of Texas or of Colorado governed the rights and duties of the parties to a guaranty that contained a Colorado choice of law provision.¹²⁹

Brett Davis, appellant and president of appellant Dadecor Condominiums, Inc., executed a guaranty agreement with appellee Uniwest guaranteeing the indebtedness of Dadecor to Uniwest. Concurrently and pursuant to a promissory note, Dadecor borrowed \$550,000 from Uniwest but subsequently defaulted on the loan. Uniwest sued both Davis, as guarantor, and Dadecor under the terms of the guaranty and the note, both of which were to be governed by Colorado law. After determining that the guaranty did not fall within the ambit of the Uniform Commercial Code,¹³⁰ the court examined section 187 of the *Restatement* as purportedly adopted by the Texas Supreme Court.¹³¹ Although clause (b) of subsection (2) of section

121. 528 S.W.2d 571 (Tex. 1975).

122. *Rosen*, 777 S.W.2d at 441.

123. *Gentry*, 528 S.W.2d at 575 n.2.

124. *Rosen*, 777 S.W.2d at 441.

125. *Id.*

126. *Id.* at 442.

127. 877 F.2d 431 (5th Cir. 1989).

128. 31 Tex. Sup. Ct. J. 616, — S.W.2d — (July 13, 1988, rehearing granted).

129. *Uniwest*, 877 F.2d at 435.

130. *Id.* at 434-35.

131. In *DeSantis*, the Supreme Court of Texas purported to adopt section 187 of the *Restatement* as the choice of law rule in contracts that are not governed by the Uniform Commercial Code. *DeSantis*, 31 Tex. Sup. Ct. J. at 618. Subsection (2) of section 187 provides in effect that:

[t]he law of the state chosen by the parties to govern their contractual rights and

187 of the *Restatement* called for a determination of whether the state whose law would apply in the absence of an effective choice of law had a "materially greater interest" than the chosen state "in the determination of the particular issue," the court stated that Colorado law would apply unless the interest of the State of Texas "in the contract" was materially greater than that of the State of Colorado.¹³² In making that determination, the court examined the relationship of each state to the transaction in light of the contacts set forth in subsection (2) of Section 188 of the *Restatement*. The court concluded that the facts of the case did not support a characterization of the State of Colorado or the State of Texas as "the place of contracting" or "the place of negotiation of the contract".¹³³ However, on the basis that Dadecor was a Texas corporation with its principal place of business in Texas, Davis was a resident of Texas, Uniwest had its principal place of business in Colorado, and the performance of the contract occurred in Colorado, the court concluded "as a matter of law that Texas' interest in the contract is not *materially* greater than Colorado's interest in the contract".¹³⁴ Since the court reached such a conclusion, it was unnecessary to determine whether the guaranty violated a fundamental policy of Texas (i.e. usury) under Section 187 of the *Restatement* as adopted in *DeSantis*.¹³⁵

duties will be applied . . . unless either (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or (b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188 [of the *Restatement*], would be the state of the applicable law in the absence of an effective choice of law by the parties.

In *DeSantis*, the court applied section 187 of the *Restatement* to determine whether Texas law or Florida law applied to a noncompetition agreement between a Texas employee and his former employer that restricted the employee from engaging in a common calling. The noncompetition agreement provided that it would be governed by the laws of Florida. *DeSantis*, 31 Tex. Sup. Ct. J. at 618-20. The court equated the requirement of clause (a) of subsection (2) of section 187 that there be a "substantial relationship" between the state whose law was chosen and the parties or the transaction with the requirement of prior Texas choice of law rules that there be a "reasonable relationship" between the parties and that state. *DeSantis*, 31 Tex. Sup. Ct. J. at 618. On the basis that the employer's corporate headquarters were located in Florida and the employee was interviewed and hired in that state, the court held that a "reasonable relationship" existed between the parties and the State of Florida. *DeSantis*, 31 Tex. Sup. Ct. J. at 618.

Clause (b) of subsection (2) of section 187 of the *Restatement* provides in effect that even if the application of the chosen state's law would be contrary to a fundamental policy of some other state, that fact will not invalidate the parties' choice of law unless (i) the other state has a "materially greater interest" in the issue than the chosen state and (ii) under section 188 of the *Restatement*, the other state's law would apply in the absence of the parties' choice of law. *Restatement* section 187(2)(b). However, in *DeSantis*, the court interpreted § 187 of the *Restatement* to mean that "the law of the chosen state must not be contrary to a fundamental policy" of the State of Texas. *DeSantis*, 31 Tex. Sup. Ct. J. at 618. It is unclear whether the court intended this interpretation to apply even if the State of Texas does not have a materially greater interest in the issue than the state whose law was chosen and even if the local law of the State of Texas would not be the applicable law in the absence of an effective choice of law.

132. *Uniwest*, 877 F.2d at 435.

133. *Id.* at 436.

134. *Id.*

135. *Id.*

C. Derivative Actions

The Corpus Christi court of appeals held in *Cathey v. First City Bank of Aransas Pass*¹³⁶ that, pursuant to the exception to the general rule, a plaintiff shareholder may use acts committed against his corporation by defendants that personally affected him to prove that the defendants conspired to personally destroy him.¹³⁷ Appellant, C. M. Cathey, Sr., was the sole shareholder, president and chairman of Aranco, Inc. and G.G.I., Inc., which corporations the court determined were so intrinsically connected with appellant that to drive one out of business would clearly cause adverse effects to the other.¹³⁸ Cathey pled numerous facts in alleging First City Bank of Aransas Pass (the "Bank") and the codefendants had conspired to drive him out of business. Included among the allegations was the failure to properly credit Cathey's and G.G.I.'s accounts at the Bank for \$28,000.00 when notes were called by the Bank, thereby causing default on such notes.

The court stated that, as a general rule a shareholder may not pursue a cause of action to redress or prevent wrongful acts to a corporation in his own name or right, "nor by him in the name of the corporation itself."¹³⁹ This is so even though the injuries may have the effect of depreciating or destroying the value of the stock of the corporation.¹⁴⁰ An exception is permitted, however, when the wrongful acts are not only against the corporation but also are violations of duties owing by third parties directly to the injured shareholder.¹⁴¹

The court granted Cathey the opportunity to prove to the trial court that the Bank's and other codefendants' acts against Cathey's corporations were a "conspiratorial subterfuge to destroy him personally by driving him out of business."¹⁴² The court, however, appeared to base its reasoning more on its concern that exclusion of such conspiratorial acts against Cathey's corporations from evidence would create an incomplete picture of the alleged conspiracy for the jury to hear, "as though it occurred in a vacuum."¹⁴³ Thus, only those acts against the corporations that affected Cathey personally could be admitted into evidence.¹⁴⁴ Moreover, all of the acts complained of, except for the failure to credit the proper accounts, were barred by the statute of limitations.¹⁴⁵ As this act had been severed from the summary judgment granted the Bank and the other codefendants, the court affirmed the trial court's judgment.¹⁴⁶

136. 758 S.W.2d 818 (Tex. App.—Corpus Christi 1988, writ denied).

137. *Id.* at 821.

138. *Id.* at 821.

139. *Id.* at 820.

140. *Id.*

141. *Id.*

142. *Id.* at 821.

143. *Id.*

144. *Id.*

145. *Id.* at 822.

146. *Id.*

D. Indemnification

In *Bayliss v. Cernock*¹⁴⁷ the court provided some helpful insight into the mechanics of the indemnification provisions contained in article 2.02-1 of the TBCA.¹⁴⁸ Geoffrey Bayliss and Donald Van Delinder organized Reservoirs, Inc. in 1977 to expand their oil and gas exploration services. Paul Cernock was elected president of Reservoirs and together with Bayliss and Mrs. Cernock constituted the Board of Directors of Reservoirs. The ownership of the initial issue of 3,000 shares of Reservoirs' stock consisted of: Cernock—56% (of which 5% was reserved for the "key man"¹⁴⁹), Bayliss—8%, Van Delinder—8%, Geochem Laboratories, Inc.—20%, and Steven Brown—8%.

At the August 1980 shareholders' meeting, the shareholders discovered Cernock had issued an additional 2,520 shares of Reservoirs' stock to himself, 300 shares to John Neasham and 180 shares to John Thomas at less than fair market value, thereby diluting the remaining shareholders' interest in half. At the meeting, the shareholders elected Neasham to a position as a director. By then, Bayliss was no longer a director. Appellants Bayliss, Van Delinder, and Geochem subsequently filed a shareholders' derivative suit against Cernock, Neasham, and Thomas based upon the breach of their fiduciary duties as directors in issuing the 3,000 additional shares at less than fair market value.¹⁵⁰ Prior to trial appellants dismissed Neasham and Thomas from the lawsuit. At trial, the court rendered judgment against Cernock for (i) \$65,646, representing the difference between the fair market value of the 2,520 additional shares issued to Cernock and the price he paid for such shares and (ii) \$30,111.50, representing the amount Reservoirs advanced Cernock for attorney's fees in defending the suit.¹⁵¹

The trial court also granted Neasham and Thomas indemnification by Reservoirs for their attorneys' fees and expenses and granted Cernock indemnification by Reservoirs for his expenses but not for his attorney's fees.¹⁵² Appellants first sought to overturn the holding by arguing that the Texas indemnification statute was not applicable because its effective date was preceded by the filing of the suit.¹⁵³ The court disagreed, finding that the Texas indemnification statute did not affect appellants' cause of action for breach of fiduciary duty but only provided for indemnification of directors and officers.¹⁵⁴ As such, the Texas indemnification statute provided a remedy and not a right or a cause of action. Remedy statutes were to be applied to actions tried after their effective date "even though the right or

147. 773 S.W.2d 384 (Tex. App.—Houston [14th Dist.] 1989, writ denied).

148. TEX. BUS. CORP. ACT ANN. art. 2.02-1 (Vernon Supp. 1990) [hereinafter, the "Texas indemnification statute"].

149. *Bayliss*, 773 S.W.2d 385.

150. *Id.* at 386.

151. *Id.*

152. *Id.* at 387-88.

153. *Id.* at 387.

154. *Id.*

cause of action arose prior thereto."¹⁵⁵ Citing *McCain v. Yost*,¹⁵⁶ the court affirmed that "[a] statute is to be applied retroactively unless the application of the law would take away or impair vested rights acquired under existing law."¹⁵⁷ Therefore, the Texas indemnification statute was applicable.

With respect to Neasham and Thomas, appellants contended that a condition precedent to indemnification was the requirement of filing a request for indemnification. The court disagreed since, by virtue of their dismissal, Neasham and Thomas were wholly successful in the lawsuit.¹⁵⁸ The court, however, did agree with appellants' next contention. Neasham's and Thomas' listing of attorneys' fees was filed subsequent to the jury's verdict and was not introduced into evidence.¹⁵⁹ The appellate court ruled that, even though Neasham and Thomas were entitled to indemnification, the reasonableness of their expenses was not subjected to challenge by appellants and thus could not be included as part of the trial court's judgment.¹⁶⁰

Cernock did file with the trial court an application for indemnification for both "his attorney's fees and any reasonable expenses he incurred in defending the lawsuit."¹⁶¹ The trial court limited indemnification to reasonable expenses and required reimbursement by Cernock of the \$30,111.50 advanced by Reservoirs for Cernock's attorney's fees.¹⁶² The appellants asserted that Cernock was not entitled to indemnification for even his allowed reasonable expenses. The court of appeals found the trial court to have properly exercised its discretion in granting indemnification for reasonable expenses, but that it could not have granted indemnification for attorney's fees since Cernock was found liable on the basis of improperly receiving a personal benefit.¹⁶³

Appellees raised the final issue decided by the court. Reservoir's bylaws provided for indemnification of directors and officers unless they had been found guilty of willful misfeasance or malfeasance. Cernock was guilty of

155. *Id.* (citing *Villiers v. Republic Financial Services, Inc.*, 602 S.W.2d 566, 570 (Tex. Civ. App.—Texarkana 1980, writ ref'd n.r.e.)).

156. 155 Tex. 174, 284 S.W.2d 898 (1955).

157. *Bayliss*, 773 S.W.2d at 387.

158. *Id.*; see also TEX. BUS. CORP. ACT ANN. art. 2.02-1H (Vernon Supp. 1990) ("A corporation shall indemnify a director against reasonable expenses incurred by him in connection with a proceeding in which he is a named defendant or respondent because he is or was a director if he has been wholly successful, on the merits or otherwise, in the defense of the proceeding.")

159. *Bayliss*, 773 S.W.2d at 388.

160. *Id.*

161. *Id.*

162. *Id.*

163. *Id.* TEX. BUS. CORP. ACT ANN. art. 2.02-1J (Vernon Supp. 1990) provides in pertinent part:

If, upon application of a director, a court of competent jurisdiction determines, after giving any notice the court considers necessary, that the director is fairly and reasonably entitled to indemnification in view of all the relevant circumstances, . . . the court may order the indemnification that the court determines is proper and equitable; but if the person is found liable to the corporation or is found liable on the basis that personal benefit was improperly received by the person, the indemnification shall be limited to reasonable expenses actually incurred by the person in connection with the proceeding.

neither.¹⁶⁴ The Texas indemnification statute prior to 1983 was not exclusive, and Cernock was therefore entitled to indemnification for attorney's fees based upon the bylaws.¹⁶⁵ The prior Texas indemnification statute, however, was inapplicable to the present case and, therefore, the appellate court examined the current statute.¹⁶⁶ The court found that Reservoirs' bylaws extended beyond what it believed was permitted by the current Texas indemnification statute in that a director who improperly received a personal benefit could obtain indemnification for attorney's fees.¹⁶⁷ As such, the court held that the provision contained in the bylaws was inconsistent with the Texas indemnification statute and therefore the Texas indemnification statute as construed by the court controlled.¹⁶⁸ Since the court found the Texas indemnification statute limited indemnification to reasonable expenses and not attorney's fees,¹⁶⁹ the trial court's judgment was affirmed.¹⁷⁰

The court's holding, however, ignored the express language of the Texas indemnification statute. The court differentiated between expenses and attorneys' fees; but this differentiation is inconsistent with the terms of the Texas indemnification statute as in effect since 1983. The term "expenses" is defined in such statute as including court costs and attorneys' fees.¹⁷¹ This holding resulted in further complications. The court, by finding that Reservoir's bylaws went beyond the Texas indemnification statute because attorneys' fees were not a part of expenses, limited indemnification to reimbursement of expenses pursuant to Section J of the Texas indemnification statute.¹⁷² But since the Texas indemnification statute included attorneys' fees within the definition of "expenses", the limitation for purposes of attorneys' fees was not applicable and thus the bylaws were consistent with the Texas indemnification statute.

In addition, if Reservoir's bylaws containing the indemnification provision at issue had been approved by Reservoir's shareholders (which is not clear from the case), then the bylaws would not be inconsistent with Section M of the Texas indemnification statute¹⁷³ as such provision would meet the re-

164. *Bayliss*, 773 S.W. 2d at 391.

165. *Id.* at 390-91.

166. TEX. BUS. CORP. ACT ANN. art. 2.02-1M (Vernon Supp. 1990) states:

A provision for a corporation to indemnify or to advance expenses to a director who was, is, or is threatened to be made a named defendant or respondent in a proceeding, whether contained in the articles of incorporation, the bylaws, a resolution of shareholders or directors, an agreement, or otherwise . . . is valid only to the extent it is consistent with this article as limited by the articles of incorporation, if such a limitation exists.

167. *Bayliss*, 773 S.W.2d at 391.

168. *Id.*

169. TEX. BUS. CORP. ACT ANN. art. 2.02-1H (Vernon Supp. 1990)

170. *Bayliss*, 773 S.W.2d at 391.

171. TEX. BUS. CORP. ACT ANN. art. 2.02-1A(3) (Vernon Supp. 1990).

172. TEX. BUS. CORP. ACT ANN. art. 2.02-1J (Vernon Supp. 1990). See *supra* note 163.

173. TEX. BUS. CORP. ACT ANN. ART. 2.01-1M (Vernon Supp. 1990).

A provision for a corporation to indemnify or to advance expenses to a director who was, is, or is threatened to be made a named defendant or respondent in a proceeding, whether contained in the articles of incorporation, the bylaws, a resolution of shareholders or directors, an agreement, or otherwise, except in accordance with Section R of [the Texas indemnification statute], is valid only to

quirements of Section R of the Texas indemnification statute.¹⁷⁴

From the brief discussion of the language contained in Reservoir's bylaws, the bylaws appear to contain a mandatory contractual obligation on the part of Reservoir to provide indemnification; therefore, Cernock could have been reimbursed for his attorney's fees under Section E of the Texas indemnification statute.¹⁷⁵ The court, however, may have viewed the bylaw provision as permissive, and Cernock, knowing he could not obtain indemnification under any of the criteria set forth in Section F of the Texas indemnification statute,¹⁷⁶ requested the court to grant indemnification for his attorney's fees.

Assuming further that the court found no contractual right to exist under Reservoir's bylaws, the court could have reached its decision by applying Section J of the Texas indemnification statute and determining that indemnification for Cernock's attorney's fees was not proper and equitable. However, the court did not do so and thus the misconstruction of the term "expenses" under the Texas indemnification statute resulted in unnecessary complications in an otherwise enlightening decision.

the extent it is consistent with this article as limited by the articles of incorporation, if such a limitation exists.

174. As a part of the 1987 amendments to the Texas indemnification statute, corporations are permitted to "purchase and maintain insurance or any other arrangement on behalf of any person" serving in almost any capacity on behalf of the corporation, "*whether or not* the corporation would have the power to indemnify against that liability under [the Texas indemnification statute]." (emphasis added) TEX. BUS. CORP. ACT ANN. art. 2.02-1R (Vernon Supp. 1990). The one requirement to maintain any other arrangement is to obtain shareholder approval but such requirement is applicable only if the insurance or other arrangement is with a person that is not regularly engaged in the business of providing insurance coverage. *Id.* Thus, indemnification arrangements not contained in the express language of the Texas indemnification statute can be enacted if the shareholders of the corporation vote to approve such arrangements. For further discussions of the Texas indemnification statute since its enactment in 1983, see Hamilton, *Annual Survey of Texas Law: Corporations and Partnerships*, 38 Sw. L.J. 235 at 235-48 (1984); Hamilton, *Annual Survey of Texas Law: Corporations and Partnerships*, 40 Sw. L.J. 219 at 237-38 (1986); Chadwick, *Annual Survey of Texas Law: Corporations and Partnerships*, 42 Sw. L.J. 249 at 267 (1988).

175. TEX. BUS. CORP. ACT ANN. ART. 2.02-1E (Vernon Supp. 1990) provides in pertinent part that, "[a] person may be indemnified . . .; but if the person is found liable . . . on the basis that personal benefit was improperly received by the person, the indemnification . . . is limited to reasonable expenses actually incurred by the person in connection with the proceeding"

176. TEX. BUS. CORP. ACT ANN. ART. 2.02-1F (Vernon Supp. 1990) states:
A determination of indemnification . . . must be made:

(1) by a majority vote of a quorum consisting of directors who at the time of the vote are not named defendants or respondents in the proceeding;

(2) if such a quorum cannot be obtained, by a majority vote of a committee of the board of directors, designated to act in the matter by a majority vote of all directors, consisting solely of two or more directors who at the time of the vote are not named defendants or respondents in the proceeding;

(3) by special legal counsel selected by the board of directors or a committee of the board by vote as set forth in Subsection (1) or (2) of this section, or, if such a quorum cannot be obtained and such a committee cannot be established, by a majority vote of all directors; or

(4) by the shareholders in a vote that excludes the shares held by directors who are named by defendants or respondents in the proceeding.

