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CORPORATIONS

by

J. Leon Lebowitz*

THERE were no dramatic developments in the law of corporations during the survey period, but several legislative innovations and judicial refinements occurred that deserve comment. This survey will first consider the new legislation, followed by a discussion of two areas of corporate law affected both by new statutes and cases, and will conclude with an examination of the more noteworthy cases decided during the survey period.

I. LEGISLATIVE DEVELOPMENTS

In General. Only a few laws regarding corporate or related enterprises were passed during the regular legislative session; of these, two can be categorized as general in nature. One statute amended the Texas Business Corporation Act (TBCA)¹ to permit triangular mergers and is discussed in more detail in Part II.² The other clarified the meaning of "person," as used in the Texas Securities Act,³ to overcome the result of a recent case narrowly construing the term.⁴ The clarification is treated in Part III,⁵ along with other Texas securities law developments.

Among the new laws passed only one, the triangular merger amendments to the TBCA, was sponsored by the Committee on Revision of Corporation Laws of the State Bar's Section on Corporation, Banking and Business Law.⁶ Another of the Committee's proposals designed to clarify some aspects of the muddled law of corporate guaranties in Texas was introduced, but died in committee.⁷ The two measures were the only ones viewed by the bar committee as

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¹ TEX. BUS. CORP. ACT ANN. arts. 1.01-11.01 (1956).

² See text accompanying notes 76-144 *infra*.

³ TEX. REV. CIV. STAT. ANN. arts. 581-1 to -39 (1964).

⁴ *Dempsey-Tegeler & Co. v. Flowers*, 465 S.W.2d 208 (Tex. Civ. App.—Beaumont), *rev'd*, 472 S.W.2d 112 (Tex. 1971).

⁵ See discussion at text accompanying notes 146-84 *infra*.

⁶ Drury, *Amendments to Corporations Laws*, 33 TEX. B.J. 961 (1970); Section on Corporation, Banking and Business Law, State Bar of Texas, *Report of Committee on Revision of Corporation Laws*, 34 TEX. B.J. 519 (1971).

⁷ The proposal would have amended Texas Miscellaneous Corporations Laws Act, TEX. REV. CIV. STAT. ANN. art. 1302-2.06B (1962), by eliminating the present language that validates guaranties only among parent, subsidiary, and affiliated corporations in a 100-percent stock ownership relationship. The proposal provided instead that any corporation may "make guaranties respecting contracts, securities and other obligations" of others if the guarantor corporation can reasonably be expected to benefit therefrom, directly or indirectly, with the judgment of the directors to be conclusive on the question of corporate benefit in the absence of fraud. However, guaranties for the benefit of officers and directors would still have been prohibited. H.B. 390, 57th Tex. Leg., Reg. Sess. (1971).

The validity of corporate guaranties has been a troublesome problem in Texas mainly because the Texas courts tend to see the transaction as one in which the corporation pledges its credit for another without receiving any direct benefit, even though some indirect benefit such as promoting customer or employee goodwill might be gained. As a consequence, the weight of Texas authority regards a corporate guaranty as an ultra vires transaction subject, however, to the limitations on use of the ultra vires defense spelled out in TEX. BUS. CORP. ACT ANN. art. 2.04 (1956), which effectively preclude the corporation or the other party to the transaction from successfully raising the issue. *Cooper Petroleum Corp. v. LaGloria Oil & Gas Co.*, 423 S.W.2d 645 (Tex. Civ. App.—Houston [14th Dist.] 1968), *rev'd on other grounds*, 436 S.W.2d 889 (Tex. 1969), *discussed in* Amsler, *Corporations, Annual*

needing immediate enactment, pending completion of a comprehensive review the group is making of the TBCA and the Texas Miscellaneous Corporation Laws Act⁸ to determine if the corporation laws of Texas should be changed in light of statutory developments elsewhere.⁹ The TBCA was hailed as a prime example of modern corporate legislation when adopted in 1955, literally bringing Texas out of the stagecoach era.¹⁰ Since then a seemingly endless process of corporation law revision elsewhere has produced a number of innovations that are worth considering. For example, while the TBCA was among the first statutes regulating stock transfer restrictions and shareholders agreements as a means of recognizing some of the problems of the close corporation, several states now have much more comprehensive provisions that liberate the closely held enterprise from many of the strictures and formalisms Texas still requires of all corporations.¹¹ Hopefully the Committee's current labors will result in a much-needed revision of the TBCA, but this must await comment in a future *Annual Survey*.

Professional Associations. Although technically not a corporation, the professional association comes as close to one as the medical profession, whose members alone can form such an association in Texas,¹² can make it—at least for federal income tax purposes. Nevertheless, the Internal Revenue Service has thus far refused to play along, despite its grudging acceptance of most organi-

Survey of Texas Law, 23 SW. L.J. 98, 103 (1969); *Empire Steel Corp. v. Omni Steel Corp.*, 378 S.W.2d 905 (Tex. Civ. App.—Fort Worth 1964), *error ref. n.r.e.*, discussed in 43 TEXAS L. REV. 792 (1965), and 3 BULL. OF THE SECTION ON CORPORATION, BANKING & BUSINESS LAW, Nov. 1964, at 1. For a more detailed discussion of the corporate guaranty problem see Slover, *Enforceability of Guaranties Made by Texas Corporations*, 10 SW. L.J. 134 (1956); Comment, *The Guaranty: A Dilemma for Corporate Managers*, 23 SW. L.J. 872 (1969); Comment, *Ultra Vires Under the Texas Business Corporation Act*, 40 TEXAS L. REV. 677, 688 (1962). And see Pearce, *Corporate Guaranties—A Rationale for Enforceability*, 5 BULL. OF THE SECTION ON CORPORATION, BANKING & BUSINESS LAW, Jan. 1967, at 1.

⁸ TEX. REV. CIV. STAT. ANN. arts. 1302-1.01 to -5.19 (1962).

⁹ See Drury, *supra* note 6, at 961.

¹⁰ See Shepperd, *Stage Coach Law*, 13 TEX. B.J. 595 (1950). The title refers to the circumstance that under the pre-TBCA statutory law Texas corporations were limited to a single purpose which had to be chosen from among those enumerated in ch. 205, § 1, [1961] Tex. Laws 408; thus a bus company had to be incorporated under subdivision 66: "to establish and maintain a line of stages." There were enough other archaic provisions in the old Texas corporate law to amply justify the characterization given. See Bailey, *Need for Revision of the Texas Corporation Statutes*, 3 BAYLOR L. REV. 1 (1951); Belsheim, *The Need for Revising the Texas Corporation Statutes*, 27 TEXAS L. REV. 659 (1950).

¹¹ See, e.g., DEL. CODE ANN. tit. 8, §§ 341-56 (Supp. 1968); FLA. STAT. ANN. §§ 608.70-77 (1965); MD. ANN. CODE art. 23, §§ 100-11 (1971). For example, why should Texas still insist on having three incorporators or require at least a three-man board of directors for the one- or two-man business that chooses to incorporate? For a general treatment of the developing trend in close corporation legislation see F. O'NEAL, *CLOSE CORPORATIONS* §§ 1.13-1.14c (2d ed. 1971); Folk, *Corporation Statutes: 1959-1966*, 1966 DUKE L.J. 875, 946.

¹² TEX. ATT'Y GEN. OP. NO. M-551 (1970). Section 3 of the Texas Professional Association Act, TEX. REV. CIV. STAT. ANN. art. 1528f (Supp. 1972), limits its application to professional services which by law cannot be performed by a corporation. Since all other professionals except physicians, surgeons and other doctors of medicine (who are expressly excluded) may incorporate under the Texas Professional Corporation Act, TEX. REV. CIV. STAT. ANN. art. 1528e (Supp. 1972), the attorney general has properly ruled that after Jan. 1, 1970, the effective date for the Professional Corporation Act, the TPAA applies only to individuals licensed by the Texas State Board of Medical Examiners. See Hall, Gissel & Blackshear, *Professional Incorporation in Texas—A Current Look*, 48 TEXAS L. REV. 84, 96 (1970).

zations of doctors, lawyers, and other professionals formed under state professional association or corporation acts as entities taxable as corporations.¹³ As detailed in last year's *Survey*,¹⁴ a Texas professional association (along with those organized in Illinois and Pennsylvania) "may or may not" qualify for classification as a corporation in a given instance.¹⁵

In an obvious effort to make the resemblance so striking that not even the Service can fail to discern a corporate being, a new section 25 has been added to the Texas Professional Association Act (TPAA). That section makes the TBCA applicable to professional associations except to the extent it conflicts with the TPAA, which takes precedence.¹⁶ Professional associations are to have the same powers, privileges, duties, restrictions, and liabilities of business corporations except as enlarged or restricted by the TPAA.¹⁷ Section 24 of the TPAA, which made the statutory and common law of partnerships applicable to associations formed under the TPAA, and which probably led the Treasury to hedge on the Texas professional association in Revenue Ruling 70-101,¹⁸ was deleted.

To further assure the presence of another corporate attribute deemed important by the Service,¹⁹ a new section 24 was substituted which, while preserving individual liability for malpractice or other wrongful acts in providing professional services, makes the association (but not the individual members

¹³The rearguard action of the Internal Revenue Service in refusing to consider professional organizations as corporations for tax purposes despite the almost unanimous judicial decisions to the contrary has been dealt with extensively in the literature. For brief descriptions of the struggle see Hall, Gissel & Blackshear, *supra* note 12, at 86-92; Hamilton, *Corporations and Partnerships, Annual Survey of Texas Law*, 24 Sw. L.J. 91, 94-96 (1970). The Treasury's initial concession appeared in Treasury Information Release 1019 (1969), followed shortly by a more definitive statement in Rev. Rul. 70-101, 1970-1 CUM. BULL. 278, as amplified in Rev. Rul. 70-455, 1970-2 CUM. BULL. 297.

¹⁴Hamilton & Shields, *Corporations, Annual Survey of Texas Law*, 25 Sw. L.J. 88, 104-05 (1971).

¹⁵Rev. Rul. 70-101, 1970-1 CUM. BULL. 278, 280.

¹⁶Ch. 118, § 6, [1971] Tex. Laws 889 (codified at TEX. REV. CIV. STAT. ANN. art. 1528f, § 25 (Supp. 1972)).

¹⁷*Id.* The language in the new § 25 is taken almost verbatim from § 5 of the Texas Professional Corporation Act, TEX. REV. CIV. STAT. ANN. art. 1528e (Supp. 1972).

¹⁸1970-1 CUM. BULL. 278; see Hall, Gissel & Blackshear, *supra* note 12, at 97, warning that the partnership provision could raise tax problems. Indeed, the amended "Kintner" regulations rationalized that any entity, especially a professional service organization, subject to a statute corresponding to the Uniform Partnerships Act could hardly be treated as a corporation. Treas. Reg. § 301.7701-2(h), T.D. 6797, 1965-1 CUM. BULL. 553. The Service's restrictive approach was well characterized by Judge Gewin in *Kurzner v. United States*, 413 F.2d 97 (5th Cir. 1969), where, in refusing to apply the amended regulations, he commented that not only were the requisite corporate elements defined more restrictively, but "the real stiletto amongst the fronds was the exclusion of entities subject to a partnership act; the prevalence of such acts ensured the exclusion of most professional groups." *Id.* at 105.

¹⁹Treas. Reg. § 301.7701-2, T.D. 6797, 1965-1 CUM. BULL. 553, lists six major characteristics which distinguish a corporation from other organizations: (1) associates; (2) conducting a business and dividing the resulting profits; (3) continuity of life; (4) centralization of management; (5) liability for corporate debts limited to corporate property; and (6) free transferability of interests. An organization seeking to be taxed as a corporation need not have all of these elements, but more of these corporate characteristics must be present than not. See 7 J. MERTENS, *LAW OF FEDERAL INCOME TAXATION* § 38.10 (1967). Prior to the Treasury's concession in Revenue Ruling 70-101, the "Kintner" regulations, which still have not been superseded, refused to recognize the professional service organization as a corporation, despite state laws enabling incorporation or association of such groups, because it was deemed not to have enough of the required major corporate characteristics of a business corporation. T.D. 6797, 1965-1 CUM. BULL. 553.

other than the tortfeasor) liable for wrongful acts by an officer or employee acting in the course of his employment.²⁰ Aside from its tax implications, the new section, along with the deletion of former section 24, which made partnership law applicable to professional associations, represents a substantial change in the potential liabilities of physicians who belong to medical partnerships, and in itself may be a compelling reason to associate under the TPAA.²¹ Another requisite corporate characteristic, continuity of existence, was likewise strengthened by requiring the articles of association to provide that no member of the association shall have power to dissolve the body by an independent act on his part.²² Formerly inclusion of the provision in the articles was discretionary. Finally, a professional association is forbidden the use of any name which contravenes the law or medical ethics.²³

With the changes thus adopted in the TPAA, Texas professional associations should now possess sufficient attributes of centralized management, continuity of existence, and limited liability to be classified as corporations for federal income tax purposes. Although transferability of interests is still somewhat limited in that shares or units of ownership can only be transferred to persons licensed to perform the same type of professional service as that for which the association was formed,²⁴ this provision is found in virtually every professional service organization statute, including all those now recognized by the Service.²⁵ In a

²⁰ Ch. 118, § 5, [1971] Tex. Laws 888 (codified at TEX. REV. CIV. STAT. ANN. art. 1528f, § 24 (Supp. 1972)).

²¹ Although under § 14 of the Texas Uniform Partnership Act (TUPA), TEX. REV. CIV. STAT. ANN. art. 6132b (1970), the partnership entity is initially responsible for the wrongful acts or omissions of a partner acting within the scope of the partnership business, under § 15 individual partners who themselves are not at fault are, nevertheless, jointly and severally liable for such acts. Since the TUPA no longer governs, individual liability has been eliminated for the nonparticipating associates. While this change in the law may well have been made to provide the limited liability characteristic to enable the association to be treated as a corporation for tax purposes, a recent court of civil appeals opinion may also have been responsible. The case suggested that a medical partnership, and by way of dictum the partners themselves, could be held liable for the act of an individual partner in alienating the affection of a patient's wife if tacit consent of the partnership could be shown. *Maclay v. Kelsey-Seybold Clinic*, 456 S.W.2d 229 (Tex. Civ. App.—Houston [1st Dist.] 1970), *aff'd on other grounds*, 466 S.W.2d 716 (Tex. 1971) (holding partner's act outside scope of partnership practice; finding any consent inferred from silence or inaction by partnership after learning of partner's misconduct insufficient to support vicarious liability; but agreeing that the partnership should not be given summary judgment because on the record it might be liable under the theory that it failed to exercise ordinary care in protecting (a) patients from harm resulting from tortious conduct on clinic premises, or (b) families of patients from tortious interference with family relations). 466 S.W.2d at 719-20. See Comment, *Piracy on the Matrimonial Seas—The Law and the Marital Interloper*, 25 SW. L.J. 594 (1971); Note, *Partnership—A Duty to Prevent a Copartner from Alienating the Affections of a Patient's Wife is Owed by a Medical Partnership to the Families of Its Patients*, 9 HOUSTON L. REV. 152 (1971).

²² Ch. 118, § 3, [1971] Tex. Laws 888, *amending* TEX. REV. CIV. STAT. ANN. art. 1528f, § 8(c) (Supp. 1972). The TPAA already provided for continuity as a separate entity apart from its members for the term of the association or until dissolved by a two-thirds vote, despite the death, insanity, incompetency, conviction, resignation, withdrawal, transfer, retirement or expulsion of a member, or the admission of a new member. TEX. REV. CIV. STAT. ANN. art. 1528f, § 8(B) (Supp. 1972).

²³ Ch. 118, § 2, [1971] Tex. Laws 888, *amending* TEX. REV. CIV. STAT. ANN. art. 1528f, § 4 (Supp. 1972).

²⁴ TEX. REV. CIV. STAT. ANN. art. 1528f, § 10 (Supp. 1972).

²⁵ 4 Z. CAVITCH, BUSINESS ORGANIZATIONS WITH TAX PLANNING § 82.03[2], at 439 (1971), citing applicable statutes. Cavitch notes that in most statutes the limitation on transfer to a qualified professional is expressly provided; in others it is inferred from provisions requiring a disqualified person to sever his connection with the corporation immediately or stating that no unqualified person may have an ownership interest in the organiza-

recent ruling the Service classified a professional association of doctors organized under the Pennsylvania law²⁶ (regarded as equally suspect with the Texas Act in Revenue Ruling 70-101) as a corporation, although its bylaws required that any assignment to an outsider (who must also be a doctor) had to be preceded by offers to sell to the association and its members.²⁷

In light of these developments and in view of the fact both professional corporations and associations are now largely governed by the TBCA,²⁸ there seems to be little reason to continue having two statutes on the subject. Physicians elsewhere organize under the same professional service corporation statutes that govern other professions.²⁹ Surely Texas doctors can do the same.

Insurance Holding Company System Regulatory Act. One outgrowth of the late-departed conglomerate craze has been the development of state insurance holding company legislation. The laws, sought both by insurers and state insurance administrators,³⁰ endeavor to regulate efforts by outside noninsurance concerns, which are tempted by the liquidity and low return on capital of many insurance companies, to acquire or gain control of insurers through various

tion. *See also id.* § 81.03[4]; CCH, PROFESSIONAL CORPORATIONS HANDBOOK ¶ 4021 (1971). Moreover, in a number of cases which the Government lost in trying to sustain the revised "Kintner" regulations, the fact that shares in the corporations or associations in question could only be transferred to other professionals was not deemed critical. *See, e.g.,* O'Neill v. United States, 410 F.2d 888 (6th Cir. 1969) (rejecting Government's argument that shares were not freely transferable because they could only be transferred to other professionals permitted to become employees of the corporation, and noting that restrictions on transfer are not uncommon in closely held corporations); Kurzner v. United States, 413 F.2d 97, 107 (5th Cir. 1969) ("even though the act confines transferability of shares to professionals and requires approval of a transfer by a majority vote of shareholders, transferability of the shares of a professional corporation is no more restricted than many—if not most—closely held corporations"); Holder v. United States, 289 F. Supp. 160 (N.D. Ga. 1968), *aff'd per curiam*, 412 F.2d 1189 (5th Cir. 1969). Since the Service has stated that a professional service organization will be treated as a corporation in any case arising in the same state and having facts similar to the cases above cited (and others), Rev. Rul. 70-101, 1970-1 CUM. BULL. 278, there is no reason to believe the TPAA's limited transferability provision should deter a finding of corporate resemblance.

²⁶ Professional Association Act, PA. STAT. ANN. tit. 15, §§ 12601-19 (1967). Pennsylvania has since adopted a Professional Corporation Law, the provisions of which are applicable to professional associations which elect to accept its provisions. *Id.* §§ 2902-14 (Supp. 1971).

²⁷ Rev. Rul. 71-277, 1971-1 CUM. BULL. 422.

²⁸ One consequence of being governed by the TBCA is that a professional association will undoubtedly have to designate a registered office and registered agent pursuant to arts. 2.09 and 3.02a(10) of the TBCA. *See* TEX. ATT'Y GEN. OP. No. M-551 (1970), so ruling in reference to professional corporations.

²⁹ Every state (but not the District of Columbia) has adopted professional corporation or association laws, or both. Aside from Alabama, New Hampshire, and South Carolina, which only have professional association acts, but under which all professionals can associate, Texas is the only state in which physicians cannot incorporate. P-H CORP. ¶ 1205 (1971); CCH, PROFESSIONAL CORPORATIONS HANDBOOK ¶ 4001 (1971).

³⁰ The impetus for the legislation has come from the National Association of Insurance Commissioners, which in 1969 adopted model legislation for an Insurance Holding Company System Regulatory Act (NAIC Model Act), 2 NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS PROCEEDINGS 738 (1969) [hereinafter cited as NAIC PROCEEDINGS], reprinted in Miller, *Holding Company Regulation*, in OPERATING DIVERSIFIED INSURANCE COMPANIES 7, 20 (1971). Since 1969 at least 31 states have either adopted or were considering the Act or similar legislation, and, except for New York and Wisconsin, all the statutes adopted or being considered are based on the NAIC Model Act in whole or in part. Wolke, *Insurance Companies as Parents and Subsidiaries*, 1970 ABA INSURANCE, NEGLIGENCE & COMPENSATION LAW SECTION 166 n.1 [hereinafter cited as ABA INSURANCE LAW SECTION]; *Report of the 1970-71 Committee on Property Insurance Law*, 1971 ABA INSURANCE LAW SECTION 533, appendix I, at 541.

means such as tender offers or mergers. The statutes also deal with the recent trend within the insurance industry itself towards restructuring into holding company systems, both to fend off outsiders and, somewhat belatedly, to reap and keep within the family the benefits derivable from diversification and to obtain more profitable employment of the substantial internal financial resources so coveted by others.³¹ In keeping with this trend and possibly due to concern with forestalling yet another crisis of confidence within the Texas insurance industry through takeovers by corporate raiders or stock manipulators, a comprehensive law regulating the acquisition of control of Texas insurers through holding companies and other devices has been added to the Texas Insurance Code.³² Named the Insurance Holding Company System Regulatory Act (IHCA),³³ the statute is a fairly sophisticated piece of legislation in terms of the control concepts³⁴ and takeover techniques recognized and some

³¹ Although some conglomerates or large noninsurance corporations have taken over insurance companies in recent years, the primary movement into holding company arrangements has come from within the industry. Reasons include a desire for diversification, escape from regulation, better access to capital markets, the demand for "one-stop" or "super-market" or "department store" financial services, enabling mutual companies to go public via downstream subsidiaries, and warding off outsiders. For discussion of the insurance holding company trend and recent legislation see Barger, *The Insurance Holding Company: The Aftermath—Living With the Legislation*, 1970 ABA INSURANCE LAW SECTION 185; Denenberg, *Meeting the Insurance Crisis of Our Cities: An Industry in Revolution*, 1970 INS. L.J. 205, 218; Kemper, *Insurance Holding Companies: Economic and Management Factors*, 1969 ABA INSURANCE LAW SECTION 323; Miller, *supra* note 30, at 9; Wolke, *Curing the Cure—Insurance Holding Companies*, 6 FORUM 95 (1971); Wolke, *supra* note 30; Zimmerman, *Antitrust and the Insurance Holding Company*, 1969 ABA INSURANCE LAW SECTION 329.

Although internal pressures are the primary reason for the insurance holding company movement, attempts, sometimes successful, by outsiders to gain financing for various investment schemes do occur and frequently lead to litigation. *See, e.g.*, SEC v. National Bankers Life Ins. Co., 324 F. Supp. 189 (N.D. Tex. 1971); Manney & Co. v. Texas Reserve Life Ins. Co., 407 S.W.2d 345 (Tex. Civ. App.—Dallas 1966); Inter-Continental Hotel Corp. v. Moody, 411 S.W.2d 578 (Tex. Civ. App.—Houston 1967), *error ref. n.r.e.* Such takeovers are by no means confined to Texas. *See, e.g.*, Superintendent of Ins. v. Bankers Life & Cas. Co., 92 S. Ct. 165 (1971); Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971).

³² Ch. 356, § 1, [1971] Tex. Laws 1334 (codified at TEX. INS. CODE ANN. art. 21.49 (Supp. 1972)).

³³ The Texas statute is an amalgam of the 1969 New York enactment, N.Y. INS. LAW §§ 69a-k (McKinney Supp. 1971), and the NAIC Model Act, although more comprehensive than either.

³⁴ Control is defined in terms of the power to direct or cause the direction of management and business policies, whether through voting securities or otherwise, except as exercised because of a corporate office or official position. A presumption of control follows from ownership of, or power to vote, 10% or more of the voting securities, although the presumption can be rebutted by showing that control does not exist in fact. However, after a proper hearing the commissioner can determine that control exists in fact, even in the absence of the presumption, when an individual or business organization either alone or pursuant to an agreement exercises directly or indirectly such a controlling influence over the management or corporate policies of an insurer that recognizing his or its control status becomes necessary or proper in the public interest or for the protection of policyholders or stockholders. TEX. INS. CODE ANN. art. 21.49-1 (Supp. 1972).

The control definition is taken from § 1(c) of the NAIC Model Act, although the Texas act adds the language, indicated above, granting power to find that control exists whenever a controlling influence is exercised. The NAIC Model Act definition is said to be taken from the Savings & Loan Holding Company Amendments of 1967, 12 U.S.C. § 1730(a)(2) (1971), 12 C.F.R. § 583.26 (1971), in order to gain the benefit of judicial interpretation of existing legislation and regulation. *See* Barger, *supra* note 31, at 188. However, in view of the considerable difference in language between the NAIC Model Act definition and that in the cited federal savings and loan legislation, that hoped-for result seems quite tenuous. In fact, the NAIC Model Act (and Texas) definition of control in terms of ability to direct management and corporate policies seems to be derived instead from a similar definition

of the imaginative administrative procedures³⁵ and sanctions³⁶ prescribed.

The Act first enunciates a statement of policy, largely hortatory in nature, which in essence declares that diversification and expansion into multifinancial services are in the interests of policyholders and shareholders.³⁷ It then declares

found in federal securities regulation. See, e.g., SEC rule 405: "The term 'control' . . . means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 230.405(f) (1971). See also SEC rule 12b-2, 17 C.F.R. § 240.12b-2 (1971); Trust Ind. Act rule 0-2, 17 C.F.R. § 260.0-2 (1971); Reg. S-X, 17 C.F.R. § 210.1-02 (1971). For a definitive treatment of the meaning of "control" as used in federal securities legislation and regulation see 2 L. LOSS, *SECURITIES REGULATION* 764 (2d ed. 1961). And see H. SOWARDS, *FEDERAL SECURITIES ACT* § 4.04[2] (1971); Enstam & Kamen, *Control and the Institutional Investor*, 23 *BUS. LAW.* 289 (1968); Sumner, *Who's In "Control"?*—S.E.C., 21 *BUS. LAW.* 559 (1966); Comment, *The Mutual Fund and Its Management Company: An Analysis of Business Incest*, 71 *YALE L.J.* 137 (1961); Comment, *The Meaning of "Control" in the Protection of Investors*, 60 *YALE L.J.* 311 (1951); cf. Berle, *"Control" in Corporate Law*, 58 *COLUM. L. REV.* 1212 (1958).

Use of the 10% figure as a determinant of control or the lack thereof is probably derived from the insider-trading provisions of § 16(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(a) (1971), and is found in similar regulatory legislation in Texas. Thus, in *TEX. INS. CODE ANN.* arts. 1.29 (Supp. 1972) (likewise enacted in 1971 and commented on in the text at notes 54-59 *infra*) and 21.48 (Supp. 1972) (regulating insider transactions and insider securities trading) control is defined in terms of direct or indirect beneficial ownership of 10% of any class of equity security of an insurer. Article 21.48 is the codification of the Insurance Company Insider Trading and Proxy Regulation Act, ch. 222, §§ 1-14, [1965] *Tex. Laws* 435, enacted in response to the 1964 amendment to the Securities Exchange Act of 1934, which exempted insurance companies from the registration requirements of § 12(g) of that Act, provided the state of domicile regulated insider trading in substantially the same manner prescribed in § 16 of the 1934 Act. Securities Exchange Act of 1934, § 12(g)(2)(G), 15 U.S.C. § 781 (1971). See L. LOSS, *supra*, at 2741-60 (Supp. 1969), for a discussion of the origin and application of the § 12(g)-(2)(G) insurance securities exemption.

The same percentage is also used in the Texas Banking Code. *TEX. REV. CIV. STAT. ANN.* art. 342-401 (Supp. 1972) requires notification be given the Banking Commissioner whenever title to more than 10% of the outstanding stock of a state bank is transferred, but there appears to be no provision calling for administrative approval of the transfer. State banks insured by the Federal Deposit Insurance Corporation must also notify the Federal Reserve Bank of its district whenever a change occurs in outstanding voting stock that will result in control or a change of control; however, a change of ownership involving less than 10% of the outstanding voting stock is not considered a change of control. 12 C.F.R. § 250.180 (1971). National banks notify the Comptroller of the Currency of a change. 12 C.F.R. §§ 15.1, 15.2 (1971).

³⁵ The statute has detailed provisions prescribing procedures for obtaining, amending, terminating or disclaiming registration (§ 3); approval of extraordinary dividends or distributions, and specified transactions within the holding company system (§§ 4(c), (d)); approval of acquisition or retention of control or merger with a domestic insurer (§ 5(d)), or disapproval after a public hearing (§ 5(d)); examination of the records of registrants (§ 9); and promulgation of rules and regulations under the act by the State Board of Insurance (§ 11); see text at note 50 *infra*. Pursuant to § 17(a), judicial review of administrative action continues to be governed by *TEX. INS. CODE ANN.* art. 1.04 (1963), and should the commissioner fail to act or make a determination, mandamus may be sought from the Travis County district court (§ 17(c)).

³⁶ A variety of sanctions are available for violations of the act: injunctions (§ 12(a)); prohibition against voting of control securities (§ 12(b)); sequestration of voting securities (§ 12(c)); criminal proceedings (fine up to \$10,000 for insurer; fine up to \$5,000 and possibly up to two years imprisonment for individuals) (§ 13); receivership (§ 14); revocation, suspension, or nonrenewal of an insurer's license (§ 15); nullification and restoration to status quo of unauthorized transactions (§ 16).

³⁷ Pursuant to § 1(a) insurers should be permitted to: "(1) engage in activities which would enable them to make better use of management skills and facilities; (2) have free access to capital markets which could provide funds for insurers to use in diversification programs; (3) implement sound tax planning conclusions; and (4) serve the changing needs of the public and adapt to changing conditions of the social, economic, and political environment, so that insurers are able to compete effectively and to meet the growing public demand for institutions capable of providing a comprehensive range of financial services." The policy statement, including the recitation of adverse consequences from the abuse

that these same interests are or may be adversely affected by acquisitions of control (a) by persons who would improperly use their power, (b) that would violate the antitrust laws, (c) would cause the controlled insurer to enter into unfair and unreasonable transactions with affiliated companies, or (d) would jeopardize the financial condition of the insurer by payment of excessive dividends.³⁸ These potential abuses are regulated as follows.

(1) *Registration.* Every insurer licensed to do business in the state which is part of a holding company system³⁹ must file a registration statement with the Commissioner of Insurance detailing the nature of its relationship to its parent and affiliates within the system.⁴⁰ Foreign and nondomestic insurers are exempt from registration if required to disclose similar information by the laws of their own jurisdiction and are governed by comparable standards.⁴¹ Registration will provide little public disclosure, however, in that the information contained in the registration statement is confidential and may not be made public without the consent of the insurer unless the commissioner determines publication is in the interests of the public, shareholders, or policyholders.⁴²

(2) *Transactions within the system.* Standards are prescribed for material transactions by registered insurers with their holding companies, subsidiaries, or affiliates. The standards require (a) fair and equitable terms, (b) reasonable charges and fees for services performed, (c) clear and accurate records, (d) equitable allocation of expenses paid and payments received, and (e) proper regard for the insurer's surplus in terms of its liabilities and financial needs in paying dividends or making distributions within the system.⁴³ To that end, extraordinary dividends,⁴⁴ sales, purchases, exchanges, loans or extensions of credit, investments, reinsurance treaties or agreements, systematic rendering of services, or other material transactions within the system must either gain the commissioner's prior written approval or notice must be given the commissioner of intent to enter into such transactions.⁴⁵ The commissioner may disapprove any of these transactions if contrary to the act's standards or if the interests of policyholders are adversely affected.⁴⁶

of control summarized in the text, is taken almost verbatim from a set of alternative provisions for the NAIC Model Act. 2 NAIC PROCEEDINGS 750 (1969).

³⁸ TEX. INS. CODE ANN. art. 21.49-1, § 1(b) (Supp. 1972); see note 37 *supra*.

³⁹ An insurance holding company system is defined as one which consists of two or more affiliated persons, one or more of whom is an insurer (§ 2(g)). An affiliate in turn is defined as a person that directly or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, a person (§ 2(a)). "Person" includes individuals, corporations, partnerships, associations and other named entities but does not include a securities broker performing no more than the usual and customary broker's function (§ 2(i)).

⁴⁰ TEX. INS. CODE ANN. art. 21.49-1, § 3(a) (Supp. 1972).

⁴¹ *Id.* The section is taken from NAIC Model Act § 4(a) and is designed to relieve the necessity of registering in other states whose laws "mirror" the model act type of legislation. See Barger, *supra* note 31, at 190.

⁴² TEX. INS. CODE ANN. art. 21.49-1, § 10 (Supp. 1972).

⁴³ *Id.*, § 4a.

⁴⁴ An extraordinary dividend or distribution is one which, when taken with other dividends or distributions made within the preceding 12 months, exceeds the greater of 10% of the insurer's surplus or its net gain from operations, if a life or title insurer, or net investment income for other insurers. Stock dividends are not included. *Id.* § 4(c)(2); see Barger, *supra* note 31, at 198.

⁴⁵ TEX. INS. CODE ANN. art. 21.49-1, §§ 4(c)(1), 4(d) (Supp. 1972).

⁴⁶ *Id.*, § 4(d)(4).

(3) *Acquisition or retention of control of or merger with domestic insurers.*

No person can seek to acquire control of a Texas domestic insurer (or its parent unless the latter is primarily engaged in business other than insurance) by means of tender offers, exchanges, market or private purchases of securities, mergers or otherwise, without first notifying the commissioner and filing a statement containing certain prescribed information. This information must also be sent to the insurer and by the latter to its shareholders. The person seeking control must thereafter obtain the commissioner's approval of the takeover.⁴⁷ Such approval will be granted unless after a public hearing the commissioner finds that: (a) after the change of control the insurer's license to write insurance would be affected; (b) the Texas antitrust laws would be violated; (c) the acquirer's financial condition is such as might jeopardize the financial stability of the insurer or prejudice its policyholders or remaining shareholders; (d) the terms of the acquisition are unfair or unreasonable to security holders; (e) the plans or proposals which the acquirer has for the insurer after the takeover, such as liquidation, sale of assets, merger, or other material changes would be unfair, prejudicial, hazardous, or unreasonable and not in the public interest; (f) the competence, trustworthiness, experience, and integrity of those taking control are such that the takeover would be against the interest of policyholders or the public; or (g) the acquisition or merger would violate any other Texas law or the laws of other states or the United States.⁴⁸ No matter when control is acquired, any violations of the act or other demonstration of untrustworthiness by the insurer, its holding company, or controlling person, or by directors or officers of either, along with any violations of the Texas antitrust laws, may ultimately result in revocation of the insurer's or an affiliate's certificate of authority.⁴⁹ In addition, nonregistered insurers must provide information after November 1, 1971, concerning their present control status and notify the commissioner if it thereafter knows or has reason to know some other person is seeking its control.⁵⁰

As thus detailed, the Insurance Holding Company System Regulatory Act imposes sweeping controls over the acquisition or control of insurance companies by growth-minded enterprises, the proverbial wheeler-dealer, or others. Undoubtedly a number of problems will arise in its application and adminis-

⁴⁷ *Id.*, § 5(a)(1).

⁴⁸ *Id.*, § 5(d).

⁴⁹ *Id.*, § 5(g). This provision is not in the NAIC Model Act, but is taken substantially from paragraph 3 of § 69-f of the New York law. N.Y. INS. LAW § 69-f (McKinney Supp. 1971). Cf. CAL. INS. CODE § 1215.11 (West Supp. 1971) permitting the commissioner to seize the business of an insurer whenever a violation of the California Insurance Holding Company System Regulatory Act, CAL. INS. CODE §§ 1215-1215.14 (West Supp. 1971), threatens its solvency or makes further transaction of its business hazardous to policyholders, creditors, shareholders, or the public.

⁵⁰ TEX. INS. CODE ANN. art. 21.49-1, § 5(h) (Supp. 1972), based on paragraph 5 of N.Y. INS. LAW § 69-f (McKinney Supp. 1971). Nonetheless, certain mergers, consolidations, conversions into other legal structures, or total reinsurance takeovers already requiring administrative approval are specifically exempted from the new control procedures. TEX. INS. CODE ANN. art. 21.49-1, § 5(f) (Supp. 1972). The provision exempts from all of § 5's requirements (a) efforts to procure or acquisitions of unissued and non-outstanding stock, (b) nine specified types of combinations or changes in legal structure already subject to regulation, and (c) any proposed or consummated acquisition which the commissioner by order exempts as not affecting or influencing a change of control or because the transaction is not comprehended within the purposes of § 5.

tration, both under the Act itself and the comprehensive regulations which have been provisionally adopted to implement its provisions.⁵¹ Some seem certain to involve the relationship between the Act and federal securities regulation,⁵² depending upon the takeover technique used.⁵³ No doubt future *Annual Surveys* will catalogue these developments.

Prohibited Activities by Insurance Company Insiders. In addition to dealing with threatened takeovers and abuses within insurance company holding systems, the legislature also placed a significant limit on the ability of insiders of an individual insurance company to use its assets as a means of financing other acquisitions or to reap other benefits from their control. A new article was added to the Insurance Code⁵⁴ that prohibits any director, officer, or controlling shareholder⁵⁵ of a Texas insurance company from receiving any payment of money or valuable thing, directly or indirectly, for his participation in any purchase, sale, or exchange of property or loan made by his company or one of

⁵¹ On November 24, 1971, the Texas State Board of Insurance adopted a set of temporary and provisional regulations under the IHCA and held a public hearing on their continuation or adoption as permanent regulations. To date they have not been adopted in final form, although there is no reason to believe they will not be. The provisional regulations are based on a set of model regulations proposed by the National Association of Insurance Commissioners, 2 NAIC PROCEEDINGS 1055 (1970), derived in turn from California's and New York's regulatory procedures and forms, but are much more comprehensive in scope because much of the Act itself has been assimilated into the regulations. Copies of the regulations may be obtained from the State Board of Insurance, 1110 San Jacinto, Austin, Texas 78701.

⁵² See 5 L. LOSS, *supra* note 34, at 2745-60 (Supp. 1969) for a discussion of the possible conflict between federal and state regulation of insurance company securities. And see SEC v. National Secs., Inc., 393 U.S. 453 (1969), sustaining the paramouncy of federal regulation of insurance company securities (as distinguished from insurance business) in allowing the SEC to bring an action based on rule 10b-5, 17 C.F.R. § 240.10b-5 (1971), attacking a merger between two insurance companies because of improper proxy solicitation.

⁵³ Since, as indicated in note 34 *supra*, Texas has adopted adequate regulatory legislation to exempt the securities of its domestic insurers from registration under § 12(g)(2)(G) of the Securities Exchange Act, 12 U.S.C. § 78l (1971), the tender-offer provisions of that Act, 15 U.S.C. § 78n(d), (e), (f) (1971), should not be applicable if the tender-offer route is used for the acquisition, inasmuch as those provisions apply only to securities registered under § 12 of the Act. The same would be true with respect to compliance with the proxy rules authorized under §§ 14(a)-(c) of the Securities Exchange Act, 12 U.S.C. § 78N, reg. 14A, 17 C.F.R. §§ 240.14a-1 to 240.14a-103 (1971), in the event the domestic issuer has to solicit proxies to carry out a merger, consolidation, or sale of assets, although compliance with the proxy provisions of the Texas Insurance Code would be necessary. TEX. INS. CODE ANN. art. 21.48, § 5 (Supp. 1972). However, if the Texas insurer's voting securities are listed on a national securities exchange, the federal tender-offer and proxy rules would come into operation since such securities must be registered under § 12(b) of the 1934 Act, 15 U.S.C. § 78l(b) (1971). Also, an acquisition handled by an exchange of securities between the insurer's shareholders and the acquiring company will require registration of the exchange offer under the 1933 Securities Act, 15 U.S.C. §§ 77a-77aa (1971), as well as the Texas Securities Act, TEX. REV. CIV. STAT. ANN. arts. 581-1 to -39 (1964). At the same time it should be noted that the exemption under § 12 of the Securities Exchange Act applies only to insurance companies, not to insurance holding companies. 5 L. LOSS, *supra* note 34, at 2746 (Supp. 1969). However, § 5(c) of the IHCA recognizes the possible impact of federal securities regulation by providing for alternative filing of documents used for registration under the 1933 Act or disclosure under the 1934 Act in lieu of the statement called for in § 5(a) of the Act.

⁵⁴ Ch. 301, § 1, [1971] Tex. Laws 721 (codified at TEX. INS. CODE ANN. art. 1.29 (Supp. 1972)).

⁵⁵ TEX. INS. CODE ANN. art. 21.49-1, § 1(a) (Supp. 1972); see discussion of control in note 37 *supra*.

its subsidiaries, or from having any pecuniary interest in any such transaction. Furthermore, the insurance company may not make any loan for or guarantee the financial obligation of any of the designated insiders.⁵⁶ Exceptions are made for benefits or dividends received by the insider as a policyholder or shareholder, compensation or participation in fringe benefits as an employee, payment for professional services rendered beyond the normal duties of employment, any other arms-length transaction not prohibited by law previously approved by the Insurance Commissioner, or any other transaction within an insurance company holding system or otherwise that is not illegal and meets the test of being "fair and proper."⁵⁷ Despite its breadth, the new statute probably does no more than reflect the current state of law concerning the fiducial responsibilities of all corporate insiders.⁵⁸ On the other hand, because insurance is a regulated industry, enunciation of the standards in a statute is more likely to lead to the imposition of administrative sanctions for violations than in the ordinary corporation managerial misconduct situation. By the same token, a court may be more inclined to completely negate a transaction which the statute prohibits, rather than treat it as merely voidable or ultra vires in nature.⁵⁹

Miscellaneous Legislation. An additional franchise tax was levied during the legislative session in continuation of the recent legislative practice of making

⁵⁶ TEX. BUS. CORP. ACT ANN. arts. 2.02A(6), 2.41A(4) (Supp. 1972) similarly prohibit Texas corporations from lending money to officers and directors, but is silent on controlling shareholders. In *Whitten v. Republic Nat'l Bank*, 397 S.W.2d 415 (Tex. 1965), art. 2.02A(6) was held to be a limitation on corporate power and not a positive prohibition; hence, a loan to an officer was ultra vires and not illegal. See Pelletier, *Corporations, Annual Survey of Texas Law*, 21 Sw. L.J. 134, 150 (1967); Note, *Bank Not Liable for Requiring a Corporate Client To Commit an Ultra Vires Act—TBCA 2.04A By-Passed*, 20 Sw. L.J. 861 (1966); Note, *Corporation Denied Recovery of Corporate Funds Used by Officer in Payment of Personal Debt*, 43 TEXAS L. REV. 796 (1965).

⁵⁷ TEX. INS. CODE ANN. art. 1.29(c) (Supp. 1972); cf. *id.* art. 21.49-1, § 4(a)(1) (material transactions by insurers within holding company system to be "fair and equitable"); TEX. REV. CIV. STAT. ANN. arts. 581-7, 581-10 (1964) ("fair, just and equitable" standard for registrations by coordination and qualification). The language seems to codify the fairness rule, already recognized by the Texas courts as the prevailing standard when managerial conflicts of interest arise. See, e.g., *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963); *Popperman v. Rest Haven Cemetery, Inc.*, 162 Tex. 255, 345 S.W.2d 715 (1961); *Tennison v. Patton*, 95 Tex. 284, 67 S.W. 92 (1902). See also *Hamilton & Shields*, *supra* note 14, at 94; *Lebowitz, Director Misconduct and Shareholder Ratification in Texas*, 6 BAYLOR L. REV. 1, 17 (1953); *Lebowitz, Recent Decisions on Fiduciary Duties to Corporations*, 2 BULL. OF THE SECTION ON CORPORATION, BANKING & BUSINESS LAW, May 1963, at 1; Pelletier, *supra* note 56; Comment, *The Interested Director in Texas*, 21 Sw. L.J. 794, 801 (1967). The Texas view is in accord with the majority of jurisdictions. See H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 465 (2d ed. 1970) [hereinafter cited as HENN].

⁵⁸ See generally Bayne, *The Fiduciary Duty of Management: The Concept in the Courts*, 35 U. DET. L.J. 561 (1958); Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control*, 65 MICH. L. REV. 259 (1966); Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); Israels, *Are Corporate Powers Still Held in Trust?*, 64 COLUM. L. REV. 1446 (1964); Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966); Sealy, *The Director as Trustee*, 1967 C.A.M.B. L.J. 83; Tarver, *Arrogance of Corporate Power: A Study of the Evolution of the Fiduciary Duty Owed by Management to the Corporation or Its Shareholders*, 42 TUL. L. REV. 155 (1967).

⁵⁹ Cf. *Whitten v. Republic Nat'l Bank*, 397 S.W.2d 415 (Tex. 1965); *Inter-Continental Hotel Corp. v. Moody*, 411 S.W.2d 578 (Tex. Civ. App.—Houston 1967), *error ref. n.r.e.*

that tax a primary source of revenue from business sources.⁶⁰ Nonprofit corporations organized to provide housing and care for the elderly were specifically exempted from the franchise tax.⁶¹ A more limited revenue measure effected a substantial increase in the filing fees for filing documents with the Secretary of State under the Texas Uniform Limited Partnership Act.⁶²

Two minor changes were made in the laws governing the corporate structure of state banks. One clarified the present prohibition against bank stock held by the bank itself in a fiduciary capacity or otherwise being voted or counted for quorum purposes, by specifying that the prohibition does not apply when the voting rights to the stock are vested in a person or party other than the bank.⁶³ The other increases from three to fifteen days the notice that must be given the State Banking Commissioner whenever more than ten percent of the outstanding shares of a state bank are being transferred.⁶⁴ Another amendment to the Banking Code enables national and private banks, as well as state banks, to utilize the services of employees or stockholders who are notaries in taking acknowledgments or proofs of written instruments in which the bank has an interest, by removing any question of the notary's disqualification arising from a possible conflict of interest because of his employment or stock ownership.⁶⁵ A similar exemption from disqualification was made for notaries employed by or owning stock in corporations having more than 1,000 shareholders; provided the notary-stockholder owns no more than one-tenth of one percent of the outstanding shares.⁶⁶ Unfortunately, these piecemeal changes leave the validity of acknowledgments taken by notaries who are employees or stockholders of nonbanking institutions or corporations with 1,000 shareholders or less in the same uncertain state which the legislature itself recognized exists⁶⁷ in the present decisional law.⁶⁸

⁶⁰ Ch. 292, art. 3, §§ 1-2, [1971] Tex. Laws 1199. For the period ending Apr. 30, 1972, the additional tax is 45.45% of the regular tax payable; after May 1, 1972, the additional tax increases to 54.54%.

⁶¹ Ch. 414, §§ 1-2, [1971] Tex. Laws 1553.

⁶² TEX. REV. CIV. STAT. ANN. art. 6132a (1970). The fee for filing the limited partnership certificate was increased from \$25 to an amount equal to $\frac{1}{2}$ of 1% of the partnership contributions, but no less than \$100 and no more than \$2,500. Ch. 501, § 1, [1971] Tex. Laws 501. New fees are imposed for filing an amended certificate not calling for additional contributions (\$100) and cancellations (\$25); an amendment providing for additional contributions has the same filing fee as the original certificate. *Id.* § 2, at 501.

⁶³ Ch. 483, § 1, [1971] Tex. Laws 1690, *amending* Texas Banking Code, TEX. REV. CIV. STAT. ANN. art. 342-402 (1959).

⁶⁴ Ch. 482, § 1, [1971] Tex. Laws 1689, *amending* Texas Banking Code, TEX. REV. CIV. STAT. ANN. art. 342-401 (1959).

⁶⁵ Ch. 325, § 1, [1971] Tex. Laws 1282, *amending* Texas Banking Code, TEX. REV. CIV. STAT. ANN. art. 342-509a (1959).

⁶⁶ Ch. 594, § 1, [1971] Tex. Laws 1953 (codified at TEX. REV. CIV. STAT. ANN. art. 6602a (Supp. 1972)).

⁶⁷ Ch. 594, § 2, [1971] Tex. Laws 1953 (emergency clause reciting "the fact that there exists some question as to the present authority of employees and stockholders with minor stockholder interest to take acknowledgments in the normal course of business activities of the corporation").

⁶⁸ The general rule in Texas is that one who is financially or beneficially interested in a transaction is disqualified from taking an acknowledgment concerning the transaction. *Phillips v. Brazosport Sav. & Loan Ass'n*, 366 S.W.2d 929 (Tex. 1963). The extent to which a pecuniary and beneficial interest exists is usually determined on a case-by-case basis, depending basically on whether the interest is direct or indirect. As a consequence, Texas decisions on the subject are not always consistent. See Comment, *Notaries: Qualifications and Disqualifications*, 14 BAYLOR L. REV. 299 (1962).

In the corporate field an acknowledgment taken by an ordinary employee who is paid

Finally, enabling legislation permitting the creation of state business development corporations was passed,⁶⁹ presumably, after thirteen years, to gain the benefit of favorable provisions of the Small Business Investment Act of 1958.⁷⁰ The federal law allows the Small Business Administration to loan funds to such companies to match those borrowed from their institutional members to finance business development.⁷¹ At the time the federal legislation was passed about half the states had such companies or were considering permitting their creation.⁷² Typically the business development corporation lends money to small businesses being established or relocated in the state and derives the funds loaned from various financial institutions, such as banks or insurance companies, which normally comprise its membership, on the basis of an agreement pledging the member institutions to supply funds on call on a pro rata basis. Under the Texas Act any financial institution can become a member and make loans to the corporation.⁷³ The corporation may be organized under either the TBCA or the Texas Non-Profit Corporation Act.⁷⁴ Since at least twenty-five persons

on a salary basis or whose income is not directly affected by the transaction involved is generally sustained against an attack that the instrument acknowledged or proved is invalid because of the employer's interest in the underlying transaction. *Anderson v. Pioneer Bldg. & Loan Ass'n*, 163 S.W.2d 421 (Tex. Civ. App.—Waco 1942), *error ref.*; *United Sav. Bank v. Frazier*, 116 S.W.2d 933 (Tex. Civ. App.—Dallas 1938); *Red River Nat'l Bank v. Latimer*, 110 S.W.2d 232 (Tex. Civ. App.—Texarkana 1937); *Colthar v. Dickens Nat'l Farm Loan Ass'n*, 56 S.W.2d 261 (Tex. Civ. App.—Amarillo 1933), *error dismissed*; *Sethman v. Liberty Nat'l Bank*, 55 S.W.2d 644 (Tex. Civ. App.—San Antonio 1932), *error dismissed*; *Cory v. Groves-Barne Lumber Co.*, 325 S.W.2d 492 (Tex. Civ. App.—Dallas 1930); *Creosoted Wood Block Paving Co. v. McKay*, 241 S.W. 549 (Tex. Civ. App.—Dallas 1922), *error ref.* On the other hand, if the notary is also an officer or director of the corporation interested in the transaction, the acknowledgment or other proof of the instrument in question will be treated as void. *Sharber v. Atlanta Nat'l Bank*, 130 Tex. 296, 109 S.W.2d 1042 (1937) (vice president); *W.C. Belcher Land Mortgage Co. v. Taylor*, 212 S.W. 647 (Tex. Comm'n App. 1919), *judgment adopted* (dictum); *Towery v. Plainview Bldg. & Loan Ass'n*, 72 S.W.2d 948 (Tex. Civ. App.—Amarillo 1934), (general manager); *First State Bank v. Stubbs*, 48 S.W.2d 446 (Tex. Civ. App.—Galveston 1932) (cashier); *Montgomery v. Heath*, 283 S.W. 324 (Tex. Civ. App.—Amarillo 1926), *aff'd in part*, 291 S.W. 855 (Tex. Comm'n App. 1927), *holding approved* (officer in both grantor and grantee corporations); *Workman's Mut. Aid Ass'n v. Monroe*, 53 S.W. 1029 (Tex. Civ. App. 1899), *error ref.* (director and attorney); *Bexar Bldg. & Loan Ass'n v. Heady*, 21 Tex. Civ. App. 154, 50 S.W. 1079 (1899), *error ref.* (secretary); *Miles v. Kelley*, 16 Tex. Civ. App. 147, 40 S.W. 599 (1897) (managing agent). The status of a notary who is only a stockholder and not a director or officer is less certain. Although the rule is sometimes stated that a stockholder is not qualified to take an acknowledgment of an instrument to which his corporation is a party or has a beneficial interest, in nearly every instance the stockholder involved was also an officer. Only one Texas case really supports the statement, and it may be doubtful authority because the notary there was both a stockholder in the building and loan association which made the loan secured by a deed of trust and the general manager and stockholder of a lumber company to whom the proceeds of the loan were paid. *Towery v. Plainview Bldg. & Loan Ass'n*, *supra*. See Annot., 51 A.L.R. 1529 (1927). Cf. *Phillips v. Brazosport Sav. & Loan Ass'n*, *supra*, holding that the fact that one of the associates signing articles of association for a building and loan association took the acknowledgments of the 51 other associates did not invalidate the association's charter.

⁶⁹ Ch. 853, §§ 1-13, [1971] Tex. Laws 2601 (codified at TEX. REV. CIV. STAT. ANN. art. 1528g, §§ 1-12 (Supp. 1972)).

⁷⁰ Pub. L. No. 85-699, tit. V, 72 Stat. 696 (1959); 15 U.S.C. §§ 695, 696 (1971).

⁷¹ H.R. REP. NO. 2060, 85th Cong., 2d Sess. 15 (1958), *reprinted in* 2 U.S. CODE CONG. SERV., 85th Cong., 2d Sess. 3678, 3685 (1958).

⁷² *Id.* at 17.

⁷³ TEX. REV. CIV. STAT. ANN. art. 1528g, § 5(a) (Supp. 1972). A financial institution is defined as any banking corporation, trust company, building and loan association, governmental agency, insurance company, or related corporation, partnership, foundation, or other institution primarily engaged in lending or investing funds. *Id.*, § 1(3).

⁷⁴ *Id.*, § 2(b).

are needed to form the corporation, incorporation is expressly made subject to the provisions of the Texas Securities Act.⁷⁵

II. MERGERS AND CONSOLIDATIONS

Triangular Mergers. Some important changes in the TBCA were made during the 1971 legislative session to facilitate use of the so-called "triangular" or "three-way" merger. The primary impetus for the legislation, sponsored by the State Bar's Committee on Revision of Corporation Laws, as noted earlier,⁷⁶ came from changes made in the Internal Revenue Code in 1968 and 1971 recognizing such mergers as tax-free reorganizations.⁷⁷ The TBCA revision demonstrates again the magnetic pull of the Internal Revenue Code in conforming state business associational statutes into its own patterns of regulation.

Prior to 1968 a parent corporation (*P*) desiring to acquire another corporation (*T*) through an exchange for *P*'s stock, but preferring to have *T* taken over by one of its subsidiaries (*S*),⁷⁸ faced an anomalous situation if it wanted the reorganization treated as a nontaxable transaction. Although its stock as a parent corporation could be utilized in two of the three basic forms of acquisition recognized as taxfree reorganizations under section 368 of the Internal Revenue Code,⁷⁹ *i.e.*, the type B stock-for-stock acquisition⁸⁰ or the type C stock-

⁷⁵ *Id.*, § 2(a).

⁷⁶ See note 4 *supra*.

⁷⁷ Section on Corporation, Banking and Business Law, State Bar of Texas, *Report of Committee on Revision of Corporation Laws*, 34 TEX. B.J. 519 (1971).

⁷⁸ One reason might be to avoid the necessity of having a shareholders' meeting to approve the acquisition if the merger route were followed. Cf. TEX. BUS. CORP. ACT ANN. art. 5.03 (1956). Another could be the desire to insulate *P* from liability for unexpected or potential liabilities of *T* incurred before the acquisition.

⁷⁹ INT. REV. CODE OF 1954, § 368. The section defines six types of reorganization given taxfree status. The first three deal with corporate acquisitions; the last three with essentially internal combinations and separations, recapitalizations, or mere changes in identity, form, and place of organization. All six are commonly identified by the order in which they are listed in § 368(a)(1). Reorganization has a broad meaning in tax law, being used to cover a variety of corporate readjustments, rather than being limited to a restructuring necessitated by financial adversities, which is the more usual connotation of the term in corporation law. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 14-4 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE].

The term "taxfree" is, of course, not completely accurate. It means essentially that recognition of gain or loss in a transaction given that status will be postponed until the securities received through one of the specified exchanges are ultimately disposed of. To that end the basis of the property or securities surrendered in the taxfree exchange is carried over to the property or securities received. However, in some instances a taxpayer may receive, in addition to stock, cash or other property known as "boot" upon which he will be taxable immediately. The reason given for the special treatment of these exchanges and similar exceptions to the general rule requiring recognition of all gains and losses is the assumption "that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated." Treas. Reg. § 1.1002-1 (1957).

The reorganization provisions of § 368 have meaning only in relation to other sections of the Internal Revenue Code, such as § 354 (nonrecognition of gain and loss in exchanges of securities), § 356 (nonrecognition of gain or loss in exchanges of property for stock or other securities), §§ 356, 357 (treatment of "boot" and liabilities in reorganization exchanges), §§ 358, 362(b) (substituted basis rules in reorganization exchanges), §§ 381, 382 (treatment of carry-over of net operating loss, profits, earnings, and other tax attributes to a successor corporation). BITTKER & EUSTICE 14-9. There are also certain judicially imposed requirements that must also be satisfied, such as a continuity of interest, a proper business purpose, the step-transaction doctrine, and continuity of business enterprise. See notes 103-06 *infra*. See generally BITTKER & EUSTICE ¶¶ 14.01-57; A. CHOKA, *BUYING,*

for-assets transaction,⁸¹ P's shares could not be employed in an A-type statutory

SELLING, AND MERGING BUSINESSES 119-60 (2d ed. 1969) [hereinafter cited as CHOKA]; J. CHOMMIE, LAW OF FEDERAL INCOME TAXATION 492-525 (1968) [hereinafter cited as CHOMMIE]; D. KAHN, BASIC CORPORATE TAXATION 115-75 (1970) [hereinafter cited as KAHN]; J. MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 20.81-99 (rev. ed. 1965) [hereinafter cited as MERTENS]; Fox & Fox, *Corporate Acquisition and Mergers*, 13 BUS. ORGANIZATIONS §§ 4.01-.07 (1971) [hereinafter cited as Fox & Fox]; Galvin, *Corporate Reorganizations—Some Current Developments*, 42 TEXAS L. REV. 421 (1964); Sinrich & Baller, *Payment in Buyer's Stock—Tax-Free Acquisitions of Business—The Tax-Free Reorganization*, in 1 BUSINESS ACQUISITIONS: PLANNING & PRACTICE 463 (J. Herz & C. Baller eds. 1971) [hereinafter cited as Sinrich & Baller].

⁸⁰ INT. REV. CODE OF 1954, § 368(a)(1)(B):

The acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition).

The stock-for-stock transaction is the simplest of all the recognized forms of acquisition and is frequently used by public corporations to take over closely held enterprises. Sinrich & Baller 469; see Taft, *Acquiring the Closely-Held Corporation*, 44 ST. JOHN'S L. REV. 1144 (special ed. 1970). But from the standpoint of the consideration that can be used for an acquisition, it is the most limited since only voting stock of either the acquiring company or its parent, but not both, can be used. See Treas. Reg. § 1.368-2 (1955). The requirement is strictly construed, and the payment of even a small amount of cash to shareholders of the acquired corporation will cause the acquisition to be treated as a taxable transaction even as to shareholders who only received stock. *Turnbow v. Commissioner*, 368 U.S. 337 (1961). For a criticism of the *Turnbow* decision see Toll, *Transfers of Boot in Stock-for-Stock Acquisitions*, 15 U.C.L.A.L. REV. 1347 (1968). However, cash can be paid in lieu of fractional shares. *Mills v. Commissioner*, 331 F.2d 321 (5th Cir. 1964). Also, subscription or stock rights, warrants, stock options, and rights under stockholder agreements do not constitute voting stock and cannot be employed. Cf. Treas. Reg. § 1.354-1(e) (1955). It is necessary, too, that the acquiring corporation have control of the acquired company after the transaction. Control is defined in section 368(c) to mean the ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total of all other classes. This has been interpreted by the Internal Revenue Service to mean that the acquiring corporation must obtain at least 80% of each class of nonvoting shares and not just 80% of the total of such shares. Rev. Rul. 59-259, 1959-1 CUM. BULL. 115-16. However, it is not necessary for the requisite percentage of shares to be obtained in a single exchange. The shares may be acquired in a series of transactions taking place in a relatively short period of time, such as 12 months. Treas. Reg. § 1.368-2(c) (1955). This is sometimes referred to as a "creeping acquisition," and the taking over of control is referred to as "creeping control." See MacLean, *Creeping Acquisitions*, 21 TAX L. REV. 345 (1965); Galvin, *supra* note 79, at 424. The acquisition will also be recognized despite the fact that the acquiring company has held a stock position in the acquired company for some time, and even if the shares had been purchased or obtained through use of nonvoting securities, provided the time interval is sufficiently long to avoid application of the step-transaction doctrine. See note 105 *infra*.

If P desires to effectuate the exchange through S using P's shares, it may either transfer its shares to S in return for S's shares or some other consideration and then have S make the exchange with T, or else P may make the exchange directly with T and transfer the acquired stock to S. INT. REV. CODE OF 1954, § 368(a)(2)(C); see CHOKA 125. See generally BITTKER & EUSTICE ¶ 14.13; CHOMMIE 502; KAHN 162; MERTENS § 20.89; Fox & Fox § 4.03.

⁸¹ INT. REV. CODE OF 1954, § 368(a)(1)(C):

The acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to liability, shall be disregarded.

The exchange of voting stock-for-assets acquisition is probably the most time-consuming of the various merger techniques because of the paperwork involved in drafting bills of sale, deeds, and the like, but remains popular when privately held enterprises are being taken over because, unlike a statutory merger, the purchasing corporation is not obligated to assume all or any of the selling corporation's liabilities. Sinrich & Baller 471. Another difference is that

merger or consolidation⁸² of *S* and *T*. The situation was not critical because *P*

usually only the shareholders of the selling corporation must vote to approve the transaction, rather than the shareholders of both corporations in the instance of a merger. Compare TEX. BUS. CORP. ACT ANN. art. 5.10 (Supp. 1972), with *id.* art. 5.03.

To qualify as a taxfree reorganization, "substantially all of the properties" of the selling corporation must be acquired. How much property must be transferred to come within the meaning of the phrase cannot be precisely determined. Instead, "the nature of the properties retained by the transferor, the purpose of retention, and the amount thereof" should all be considered. Rev. Rul. 57-518, 1957-2 CUM. BULL. 253. For an advanced ruling the IRS takes the view that the assets transferred must represent at least 70% of the fair market value of the gross assets and at least 90% of the fair market value of net assets held by the transferor immediately before the transfer. Rev. Proc. 34, § 3.01, 1966-2 CUM. BULL. 1232-33; see *Commissioner v. First Nat'l Bank*, 104 F.2d 865 (3d Cir. 1939) (86% meets "substantially all" test); *Arctic Ice Mach. Co.*, 23 B.T.A. 1223 (1931) (68% does not meet test). While normally the selling corporation will dissolve after the sale, distributing the purchasing corporation's shares in liquidation, it may decide to continue in operation as an investment company. However, "the substantially all" test is more likely to be strictly construed as to any assets it retains. BITTKER & EUSTICE 14-42.

In contrast to a B-type reorganization and despite the statutory language first quoted limiting the consideration for the acquisition to solely for voting stock, the acquiring corporation may give other consideration or "boot" if it acquires all of the assets and the property acquired for voting stock has a fair market value which is at least 80% of all of the property of the selling corporation. INT. REV. CODE of 1954, § 368(a)(2)(B). Since in a C-type reorganization it is the selling corporation that receives the stock in exchange for its assets, it will be taxable on any "boot" received unless it distributes the "boot" to its shareholders who will then be taxable. INT. REV. CODE of 1954, § 361(b)(1); KAHN 169. However, in calculating "boot," any liabilities assumed by the transferee or to which any assets acquired are subject must be included (although disregarded to determine if the acquisition is solely for voting stock). As a consequence, very few C-type reorganizations will involve payment of "boot" because normally the liabilities assumed or to which the acquired assets are subject will exceed the 20% limit. *Sinrich & Baller* 471. Also, unlike the B-type situation, if the acquiring corporation owns any stock in the selling corporation at the time of the exchange, the transaction will not qualify as a C-type reorganization because the consideration is deemed to be not solely for voting stock of the acquiring company, but also for the stock of the acquired company, which would be treated as a taxable liquidation distribution, unless the value of the stock being reacquired can be fitted into the 20% boot exception. *Bausch & Lomb Optical Co. v. Commissioner*, 267 F.2d 75 (2d Cir. 1959). For a discussion of the *Bausch & Lomb* doctrine and methods of avoiding it see BITTKER & EUSTICE 14-115; Fox & Fox § 4.04[3][e].

A triangular stock-for-assets exchange, in which *P* desires to have *S* acquire *T*'s assets, can be handled in several ways and still qualify as a C-type reorganization. *P* can exchange its stock for *T*'s assets and then transfer them to *S*, INT. REV. CODE of 1954, § 368(a)(2)(C), or *P* can issue its own stock to *S* in exchange for *S*'s stock and then have *S* use *P*'s stock to acquire *T*'s assets; or in the second situation *S* might then transfer *T*'s assets to one of its own subsidiaries. BITTKER & EUSTICE 14-49. There is a danger in the second situation, however, in that the basis to *S* for *P*'s stock given to it may be zero, in which event when *S* transfers *P*'s stock to *T* for *T*'s assets, there may be a taxable gain. For this reason the first procedure is the one generally followed. CHOKA 127. See generally BITTKER & EUSTICE § 14.14; CHOMMIE 502; KAHN 168; MERTENS § 20.90; Fox & Fox § 4.04.

⁸² Section 368(a)(1)(A) defines "reorganization" to include "a statutory merger or consolidation." INT. REV. CODE of 1954, § 368. Because the simple statement contains none of the qualifying language used in connection with B- and C-type reorganizations, the A-type merger is the most flexible and liberal of the taxfree reorganizations. For example, the acquired corporation does not have to transfer substantially all its assets as in the C-type "practical" merger. Stock used to effectuate the merger by the acquiring corporation need not be voting stock as in types B and C; any combination of voting or nonvoting stock is permissible. Moreover, a considerable amount of cash, property, or debt securities may be given to the shareholders of the nonsurviving corporation, although taxable to them as "boot." However, the continuity-of-interest test will still apply, see note 103 *infra*, but may be satisfied if the shareholders of the disappearing corporation receive at least 50% of the value of the total amount of stock of their corporation outstanding at the time of the merger. Rev. Proc. 34, § 3.02, 1966-2 CUM. BULL. 1233. Even before the 1968 and 1971 amendments permitting triangular mergers, see notes 81, 88 *infra*, a parent corporation could transfer assets acquired in a merger to a subsidiary. INT. REV. CODE of 1954, § 368(a)(2)(C). A merger of the subsidiary into the parent, known as an "upstream merger," or of the parent into the subsidiary, known as a "downstream merger," may also qualify

could accomplish the same result in two steps by having *T* merge into *P* and then transfer the assets acquired from *T* to *S* without affecting the taxfree status of the reorganization.⁸³ Still there appeared to be no reason for treating a merger differently from the other forms of reorganization in which the parent's stock was permitted to be used without tax consequences simply because the parent preferred having its subsidiary employ that form of combination as the means for handling the acquisition. In 1968 Congress decided to correct the divergency by adding a new subparagraph (D) to section 368(a)(2) of the Internal Revenue Code, permitting a corporation to acquire another in a taxfree statutory merger by giving in exchange for the stock of the acquired company the stock of the acquiring company's parent instead of its own.⁸⁴

Suppose, however, that for business or legal reasons *P* would rather have *T* continue as a separate corporate entity and, therefore, wants *S* to merge into *T* on a taxfree basis, and not vice versa. If *P* were willing to use solely its voting stock to effect the exchange and not resort to cash or other consideration, this sort of merger could qualify as a B-type taxfree reorganization.⁸⁵ Conversely, if *P* had acquired even a small amount of *T*'s stock for cash before the merger of *S* into *T*, taxfree treatment would be doubtful.⁸⁶ On the other hand, if the newly authorized hybrid A-type merger⁸⁷ could be employed, then both non-voting stock of the parent can be used and a certain amount of other consideration or "boot" can be paid.⁸⁸ Unfortunately, the 1968 change was so worded that only a forward merger of *T* into *S* could qualify under the new provisions and not the reverse merger of *S* into *T*.⁸⁹ In 1971 Congress decided to rectify this situation too, frankly acknowledging there was no reason why a merger in one direction (*S* into *T*) should be taxable, while a merger in the other direction (*T* into *S*) was not.⁹⁰ A new subparagraph (E) was added to section 368(a)(2), which recognizes the taxfree status of reverse triangular mergers taking place after December 31, 1970, whenever voting stock of a parent is

as an A-type reorganization, although an "upstream" merger with an 80% owned subsidiary will be governed by the nonrecognition provisions of § 332. BITTKER & EUSTICE 14-110. See generally BITTKER & EUSTICE § 14.12; KAHN 160; MERTENS § 20.88; Fox & Fox § 4.02.

⁸³ S. REP. NO. 1653, 90th Cong., 2d Sess. (1968).

⁸⁴ Act of Oct. 22, 1968, Pub. L. No. 90-621, § 1, 82 Stat. 1310, amending INT. REV. CODE of 1954, § 368(a)(2)(D), also amending § 368(b), defining the term "party to a reorganization" to include the parent corporation in the forward triangular merger.

⁸⁵ Rev. Rul. 67-448, 1967-2 CUM. BULL. 144. If the terms of the merger are that the stock of *T* is changed into stock of *P*, minority shareholder interests are eliminated except for appraisal rights as dissenters. Cf. TEX. BUS. CORP. ACT ANN. arts. 5.11-13 (Supp. 1972). This is referred to as a "forced 'B' reorganization," Dailey, *Federal Income Tax Consequences*, in MERGERS AND ACQUISITIONS 209, 218 (J. McCord ed. 1969), or a "reverse B" merger. Sinrich, *Payment of Purchase Price in Stock—Tax-Free Reorganizations*, in HOW TO HANDLE ACQUISITIONS IN THE CURRENT MARKET 143, 153 (R. Needham ed. 1971).

⁸⁶ S. REP. NO. 91-1533, 91st Cong., 2d Sess. (1970); see note 77 *supra*.

⁸⁷ So characterized in BITTKER & EUSTICE 14-50.

⁸⁸ The merger of *T* into *S* in exchange for stock of *P*, so long as no stock of *S* is used, is given the same taxfree recognition as the more conventional merger of *T* into *P*; i.e., non-voting stock or other securities can be used and up to 50% of the consideration paid can constitute "boot." INT. REV. CODE of 1954, § 368(a)(2)(D). See note 79 *supra*.

⁸⁹ Section 368(a)(2)(D) refers to the transactions as one in which the acquired corporation, *T*, is merged into the acquiring corporation, *S*.

⁹⁰ S. REP. NO. 91-1533, 91st Cong., 2d Sess. (1970).

used in exchange for the controlling stock of the acquired corporation into which the parent's subsidiary has been merged.⁹¹

It is against this background that the changes made in the TBCA to accommodate the triangular merger must be examined. In all, three amendments were necessary. Two are virtually identical in language and amend the procedures spelled out for mergers and consolidations, respectively.⁹² Under the former TBCA provisions a triangular merger was precluded because in whatever plan of merger or consolidation the constituent corporations adopted, the shares converted under the plan had to be for securities or obligations of the corporation surviving the merger or the new corporation resulting from the consolidation. Thus, by implied exclusion neither the securities or obligations of another corporation nor any other consideration, such as cash, could be used.⁹³ As changed, in language taken almost verbatim from the Delaware General Corporation Law,⁹⁴ the plan of merger or consolidation is to specify the manner and basis of converting shares of the constituent corporations into shares, rights,⁹⁵ or other securities or obligations of the surviving or new corporation, and:

[I]f any shares of *either merging corporation* are not to be converted solely into shares, rights, other securities or obligations of the surviving [new] corporation, the cash, property, shares, rights, other securities or obligations of any other corporation which the holders of such shares are to receive in exchange for, or upon conversion of, such shares and the surrender of the certificates evidencing them, which cash, property, shares, rights, other securities or obligations of any other corporation may be in addition to or in lieu of shares, rights, other securities or obligations of the surviving [new] corporation.⁹⁶

As a consequence, if *P* now wants to acquire *T*, a Texas corporation,⁹⁷ but de-

⁹¹ Act of Jan. 12, 1971, Pub. L. No. 91-693, 84 Stat. 2077, *amending* INT. REV. CODE of 1954, § 368(a)(2)(E), *also amending* § 368(b) to include the parent corporation in the reverse triangular merger in the term "party to a reorganization."

⁹² Ch. 276, §§ 2, 3, [1971] Tex. Laws 1173, *amending* TEX. BUS. CORP. ACT ANN. arts. 5.01B(4), 5.02B(4) (Supp. 1972).

⁹³ In limiting the conversion of shares into "shares or other securities or obligations" of the surviving or new corporation, the TBCA tracked the wording of then §§ 65 and 66 of the Model Business Corporation Act. 3 ABA MODEL BUS. CORP. ACT ANN. §§ 65, 66 (1960). The model act was extensively revised in 1969; the equivalent provisions are now §§ 71 and 72. As amended, the two sections presently permit the conversion of the shares of the constituent corporations "into shares, obligations or other securities" of the surviving or new corporation "or of any other corporation or, in whole or in part, into cash or other property." 2 ABA MODEL BUS. CORP. ACT ANN. §§ 71, 72 (2d ed. 1971).

⁹⁴ DEL. CODE ANN. tit. 8, § 251 (Supp. 1968).

⁹⁵ The inclusion of "rights" of the surviving or new corporation into which shares may be converted is new. The term was not listed in either arts. 5.01B(4) or 5.02B(4) of the TBCA, nor is it found in the Delaware provision except in reference to rights or securities of any other corporation, along with cash or property, which may be used in addition to or in lieu of shares or other securities of the survivor or successor. Although the term "securities" as used in the amended TBCA and Delaware provisions is probably broad enough to encompass rights, the phrase was probably added to be in harmony with the inclusion of rights of another corporation as a separate category of consideration for conversion of shares in a merger or consolidation. The Texas Securities Act does not specifically mention rights in its detailed definition of a "security" or "securities." TEX. REV. CIV. STAT. ANN. art. 581-4 (1964); the Federal Securities Act of 1933 does. 15 U.S.C. § 77b(1) (1964).

⁹⁶ Ch. 276, §§ 2, 3, [1971] Tex. Laws 1173 (emphasis added).

⁹⁷ If either *T* or *S* is a foreign corporation, use of the triangular merger may depend on whether such a merger can be effected under the laws of the state of its incorporation. From the standpoint of the domestic corporation, TEX. BUS. CORP. ACT ANN. art. 5.07 (1956) permits the merger or consolidation of Texas and foreign corporations. If *P* is a foreign corporation, too, there may be a question whether its stock or securities meet the terms of

sires to have it merge with *S*, another Texas corporation, or have *T* and *S* consolidate to form a new subsidiary, *X*, the shareholders of *T* may receive *P* stock or securities or obligations in addition to, or, as is more likely for tax reasons,⁹⁸ in lieu of the stock of *S* or *X*. The reverse merger of *S* into *T* is also covered; for by using the phrase "either merging corporation," emphasized in the language just quoted, shares of the surviving corporation (*T*), as well as the merged corporation (*S*), may be converted into stock or other securities or another corporation (*P*) as part of the plan of merger.

Despite the sweep of the two amendments which seemingly allow just about any kind of consideration to be given the shareholders of the corporations being merged or consolidated, some definite limits remain. For example, under federal tax law to qualify for the forward merger allowed in section 368(a)(2)-(D) three specific tests must be met: (1) *S* must acquire substantially all of the properties of *T*;⁹⁹ (2) the transaction must be one that would have qualified as a type A reorganization if *T* had been merged into *P* instead;¹⁰⁰ and (3) no stock of *S*¹⁰¹ can be used in the transaction.¹⁰² Similarly, for the reverse merger allowed in section 368(a)(2)(E) to be given taxfree treatment (1) *T* must hold substantially all of the properties of itself and *S* (other than stock of *P* distributed in the transaction), and (2) the shareholders of *S* must exchange an amount of stock sufficient for control¹⁰³ for voting stock¹⁰⁴ in *P*.¹⁰⁵ In

being the "shares, rights, other securities or obligations of *any other corporation*" as used in amended arts. 5.01B(4) and 5.02B(4) (emphasis added), in view of the definition of "corporation" in art. 1.02A(1) as meaning a domestic corporation and not a foreign corporation. Arguably, art. 5.07B(1) may contain language broad enough to allow the securities of a foreign corporation to be used. But if *T* and *S* are both Texas corporations, then art. 5.07 would not be applicable even if *P* were a foreign corporation. This is because technically *P* is not the corporation being merged or consolidated, although in reality it is a party to the combination.

⁹⁸ To gain taxfree recognition for the forward triangular merger "no stock of the acquiring corporation [*S* or *X*] is [to be] used." INT. REV. CODE of 1954, § 368(a)(2)(D). Of course, in the reverse merger situation no shares of *S* could be used for the conversion since *T*, and not *S*, is the surviving corporation.

⁹⁹ This is essentially the same requirement for a C-type reorganization. INT. REV. CODE of 1954, § 368(a)(1)(C). See note 78 *supra*.

¹⁰⁰ It is not clear whether this requirement means that the triangular merger will not be given recognition if for some reason state law precludes a merger of *T* into *P*, or whether the continuity-of-interest doctrine, see note 103 *infra*, must have been satisfied if such a direct merger had taken place. See BITTKER & EUSTICE 14-52; Ginsburg, *Acquisitive Reorganizations*, in TAX FREE REORGANIZATIONS AND OTHER CORPORATE ACQUISITIONS 43 (1969).

¹⁰¹ While stock of *S* cannot be used, see note 95 *supra*, the stock of *P* that is exchanged need not be voting stock, unlike the B-, C-, and reverse-merger-type reorganizations. Moreover, a certain amount of "boot" can be paid to *T*'s shareholders consistent with the continuity-of-interest doctrine. BITTKER & EUSTICE 14-52.

¹⁰² INT. REV. CODE of 1954, § 368(a)(2)(D). See generally BITTKER & EUSTICE ¶ 14.15; Ginsburg, *supra* note 100, at 36; Levin, *The New Subsidiary-Merger Statute and Other Current Problems in Acquisitions*, 47 TAXES 779 (1969); Lowenstein, "A" Reorganizations: Technical Requirements for Compliance Under the New Law, 30 J. TAXATION 169 (1969); Shores, *The Role of the Subsidiary in Corporate Reorganization*, 18 DRAKE L. REV. 175 (1969); Sinrich & Baller 477; Walsh & Gerard, *Planning Possibilities in Using Parent's Stock in a Corporate Acquisition*, 30 J. TAXATION 168 (1969).

¹⁰³ "Eighty percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of all shares of all other classes of stock of the corporation." INT. REV. CODE of 1954, § 368(c).

¹⁰⁴ This is similar to the requirement for a B-type stock-for-stock reorganization, except that 20% of the shares can be acquired for other consideration as in type C.

¹⁰⁵ INT. REV. CODE of 1954, § 368(a)(2)(E). See generally BITTKER & EUSTICE ¶ 14.15; Flyer, *An Analysis of the New A Reorganization: Its Operation and Planning Po-*

either instance the completed merger must satisfy the various judicially or regulatory-imposed tests of continuity of interests,¹⁰⁶ business purpose,¹⁰⁷ step transaction,¹⁰⁸ and continuity of business enterprise.¹⁰⁹ While in addition to stock

vential, 35 J. TAXATION 30 (1971); Seno, *The Reverse Triangular "A" Merger, An Important New Reorganization Tool*, 49 TAXES 296 (1971); Sinrich, *supra* note 85, at 152.

¹⁰⁶ The continuity-of-proprietary-interest test seeks to assure that from the standpoint of the shareholders of the acquired corporation, the transaction given taxfree treatment is a reorganization which in essence is no more than a mere change of legal form in which business is done, and not in reality a taxable sale of their stock. *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933). To that end, the shareholders of the transferor corporation must not only retain a continuing proprietary interest in the enterprise taking over their corporation, but such interest must also comprise a substantial portion of the consideration they receive in the exchange. *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951); *cf. Treas. Reg. § 1.368-1(b)* (1955). Basically this means in a triangular merger situation that the shareholders of *T* must receive some equity interest in *P*, although cash or nonvoting preferred can also be used. *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935). The Internal Revenue Service requires for advance ruling purposes that the shareholders of the acquired corporation (*T*) receive shares of the acquiring corporation (*S*) or its parent (*P*) equal in value to at least 50% of the value of all of *T*'s stock formerly outstanding. Rev. Proc. 66-34, § 3.02, 1966-2 CUM. BULL. 1233. The shareholders of *T* are considered as a group to satisfy the 50% requirement; thus, some shareholders can receive all cash and others stock only. *Id.* Since in B- and C-type reorganizations the primary or sole consideration must be voting stock of *S* or *P*, these forms implicitly meet the continuity-of-interest test. The test, therefore, has its primary significance in A-type mergers or consolidations or the hybrid triangular mergers. However, if the shareholders of *T* have a prearranged plan to sell their *S* or *P* shares immediately after the acquisition, or in the event that a substantial number of sales take place shortly thereafter, then whatever the form of reorganization, its taxfree status may be endangered. *Cf. Rev. Rul. 66-23*, 1966-1 CUM. BULL. 67; *see BITTKER & EUSTICE* 14-22. *See generally BITTKER & EUSTICE* § 14.11; CHOMMIE 503; KAHN 145; 3 MERTENS § 20.59; Brookes, *The Continuity of Interest Test in Reorganization—A Blessing or A Curse?*, 34 CALIF. L. REV. 1 (1946); Baker, *Continuity of Interest Requirement in Reorganizations Re-examined—The Hickok Case*, N.Y.U. 18TH INST. ON FED. TAX. 761 (1960); Fox & Fox § 4.05[3]; Maxwell, *Continuity of Interest in Recapitalizations and Mergers*, 40 TAXES 1003 (1962); Sinrich & Baller 485.

¹⁰⁷ It is essential that the reorganization be for a valid business purpose and not a scheme having no economic reality devised principally for tax avoidance, or which abruptly departs from normal reorganization procedures, or is sham or illusory. *Treas. Reg. § 1.368-1(c)* (1955). In short, the transaction cannot be one "masquerading as a corporate reorganization." *Gregory v. Helvering*, 293 U.S. 465, 470 (1935). However, in evaluating the nontax-avoidance motives of the participants, the business purpose of the shareholders as well as the corporation involved can be considered. *Parshelsky's Estate v. Commissioner*, 303 F.2d 14 (2d Cir. 1962). On the other hand, absence of a tax-avoidance motive does not of itself show the existence of a business purpose. *Cf. Commissioner v. Wilson*, 353 F.2d 184 (9th Cir. 1965) (a § 355 case). *See generally BITTKER & EUSTICE* 14-98; 3 MERTENS §§ 20.55-58; Bittker, *What Is "Business Purpose" in Reorganizations*, N.Y.U. 8TH INST. ON FED. TAX. 134 (1950); Fox & Fox § 4.05[1]; Lipnick, *Business Purpose and Income Taxes: From Gregory to Goldstein*, 46 TAXES 698 (1968); Michaelson, *"Business Purpose" and Tax-Free Reorganization*, 61 YALE L.J. 14 (1952).

¹⁰⁸ The step-transaction doctrine requires that in evaluating the taxable or nontaxable nature of a given event, such as a reorganization, all the steps taken by the parties be examined to determine its true nature. The doctrine is found throughout income tax law, and in particular may operate to create or deny tax-exempt status to a given reorganization. *BITTKER & EUSTICE* 14-102. The process of integrating a series of related transactions can occur in a number of contexts. For example, in a C-type reorganization in which substantially all of the transferor's assets must be acquired, a disposition of some of the assets by the transferor shortly before the exchange may defeat the tax-exempt status of the latter. *See, e.g., Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937), *cert. denied*, 305 U.S. 605 (1938); Rev. Rul. 70-140, 1970-1 CUM. BULL. 73; *BITTKER & EUSTICE* § 14.52. Similarly, a B-type reorganization may not be recognized if shortly before a stock-for-stock exchange, the acquiring corporation purchased some of the acquired corporation's stock for cash; thus, defeating the solely for voting stock requirement of § 368(a)(1)(B). Wintrub, Graichen & Keidan, *Tax Aspects of Corporate Acquisitions in Conglomerate Mergers and Acquisitions: Opinion & Analysis*, 44 ST. JOHN'S L. REV. 1114, 1118 (special ed. 1970). Conversely, a series of acquisitions of the acquired corporation's stock solely for voting stock of the acquiring corporation will qualify for B-type treatment once the requisite 80% of

of *P*, cash, property, or other securities constituting taxable "boot" can be used without destroying the taxfree status of the triangular reorganization, the tax consequences arising from the receipt of boot by *T*'s shareholders may well be such as to dictate using either a completely taxable form of reorganization¹¹⁰ or a type B reorganization¹¹¹ instead.

Another significant limitation is found in the third of the TBCA changes adopted, which amends article 2.16A, stating that shares are deemed to be issued when the legal consideration for their issuance has been paid to the corporation, by adding "or to a corporation of which *all* of the outstanding shares of each class are owned by the corporation."¹¹² As a consequence, to use a triangular merger in Texas in which *T* is to be merged into *S* in exchange for *P*'s stock, *S* must be a wholly owned subsidiary of *P*, even though for purposes of section 368, eighty percent control would suffice.¹¹³ Nevertheless, the

the acquired company's shares have been obtained in determining if the acquiring corporation is in control "immediately after" the final acquisition. Treas. Reg. § 1.368-2(c) (1955). The step-transaction doctrine can also be used to convert one form of reorganization into another, *e.g.*, in a B-type stock-for-stock acquisition the acquired corporation is immediately liquidated under the same plan of reorganization. The Service views the transaction as a direct acquisition of assets for stock which must satisfy the requirements of § 368(a)(1)(C). Treas. Reg. § 1.382(b)-1(a)(6) (1962); Rev. Rul. 67-274, 1967-2 CUM. BULL. 141. To date, the Service has not published a comprehensive statement of its position on step transactions, Sinrich & Baller 489, and there is no universally accepted test for application of the doctrine. BITTKER & EUSTICE 14-102. *See generally* BITTKER & EUSTICE 14-101; CHOMMIE 500, 518; KAHN 147; 3 MERTENS §§ 20.161-166; Fox & Fox § 4.05[4]; Hobbett, *The Step Transaction Doctrine and Its Effect on Corporate Transactions*, 19 TUL. TAX INST. 102 (1970); Jacobs, *Supreme Court Further Restricts the Step Transaction Doctrine*, 29 J. TAXATION 2 (1968); Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, N.Y.U. 12TH INST. ON FED. TAX. 247 (1953).

¹⁰⁹ "Requisite to a reorganization under the Code [is] a continuity of the business enterprise under the modified corporate form . . ." Treas. Reg. § 1.368-1(b) (1955). Hence, if the acquiring corporation completely terminates its business activity or interrupts it so that continuity is broken, the transaction is more properly a taxable liquidation rather than a reorganization. BITTKER & EUSTICE 14-100. The continuity-of-business test is met, however, if the acquiring corporation carries on some business, even if not the same as that carried on before the reorganization. Rev. Rul. 63-29, 1963-1 CUM. BULL. 77. *See generally* BITTKER & EUSTICE 14-100; CHOMMIE 505; 3 MERTENS § 20.54; Fox & Fox § 4.05[2]; Tarleau, "Continuity of the Business Enterprise" in *Corporate Reorganization and Other Corporate Readjustments*, 60 COLUM. L. REV. 792 (1960).

¹¹⁰ A taxable form of reorganization or acquisition can occur in several ways. It may be one that does not meet the requisites of any of the tax-free forms of reorganization recognized in § 368, in which event a taxable asset acquisition will be treated under the liquidation rules. BITTKER & EUSTICE ¶ 14.57. More likely the transaction will either be one in which the stockholders sell all their holdings to the acquiring company for cash or consideration other than stock, or else the assets of the corporation being acquired will be sold on a similar basis either by the corporation or by the shareholders after distribution to them. If the business being sold is unincorporated, the transaction will be taxable in any event since the tax-free reorganization provisions apply only to transfers by corporations or corporate shareholders. Upon a sale gain or loss is recognized, INT. REV. CODE OF 1954, §§ 61, 165(a), 1001, and the purchaser generally gains a new basis for the stock or assets bought. INT. REV. CODE OF 1954, § 1012. A taxable transaction may have advantages to the acquiring corporation if, for example, the seller's basis for its assets is lower than the purchase price or if the seller does not want to dilute its stock ownership; similarly, the selling corporation or its shareholders may want to deduct unrealized losses, or may have a high basis for their stock, or would prefer cash rather than stock of the acquiring company. Fox & Fox 5-4. *See generally* Fox & Fox 5-1 to -38; Ness, *Taxable Transactions*, in 1 BUSINESS ACQUISITIONS: PLANNING & PRACTICE 181 (J. Hertz & C. Baller eds. 1971); Wintrub, Graichen & Keiden, *supra* note 108, at 1121.

¹¹¹ The problem of "boot" is avoided in a B-type reorganization since the exchange must be solely for the voting stock of *S* or *P*. INT. REV. CODE OF 1954, § 368(a)(1)(B).

¹¹² Ch. 276, § 1, [1971] Tex. Laws 1173 (emphasis added).

¹¹³ INT. REV. CODE OF 1954, § 368(c) defines control for the reorganizations covered by § 368 as 80% ownership. *See* note 103 *supra*.

reason for confining the triangular merger to a 100-percent ownership situation is understandable in view of the constitutional problem a triangular merger raises.

Article XII, section 6 of the Texas Constitution forbids the issuance of stock or bonds except for money paid, labor done, or property *actually* received, and makes all fictitious increases of stock and indebtedness void. The constitutional provision insofar as stock is concerned is further codified in TBCA article 2.16A, which adds that shares may not be issued until the full consideration fixed as provided by law has been paid. The problem these provisions present in a triangular merger is obvious. In the ordinary merger of *T* into *P* whatever shares of *P*'s stock that are used to effect the merger are paid for in effect by the assets of *T* which *P* actually receives as a result of the merger. But if *T* merges into *S* solely or partially in exchange for *P*'s stock, the consideration for the issuance of *P*'s stock, *i.e.*, *T*'s assets, is received not by *P* but by another entity, *S*, even if it is one wholly owned by *P*. In theory at least *P* and *T* are separate corporate entities and normally will be so regarded in Texas law.¹¹⁴ Therefore, if *P* issues its stock and receives nothing directly in return, it can be argued that its action violates the constitutional requirement that stock not be issued for property unless it is "actually received." The requirement is one rather strictly interpreted by the Texas courts,¹¹⁵ as in a case decided during the survey period setting aside a substantial issuance of stock paid for by \$10 in cash and an executory sublease contract subject to a primary condition remaining unfulfilled at the time the stock was issued on the grounds that valid consideration had not passed in the form of "property actually received."¹¹⁶

If the transaction is viewed realistically, however, there is no doubt that *P* and its shareholders gain the same economic benefit from *P*'s shares being issued to have *T*'s assets acquired by a wholly owned subsidiary as they would if the same shares were employed to consummate a direct merger of *T* into *P*, or to effect an exchange for controlling shares in *T* so that *T* can thereafter be merged into *S*. To the extent *T*'s assets have any worth at all, it is obvious that *S*'s acquisition of them will necessarily enhance the value of one of *P*'s assets,

¹¹⁴ *Bell Oil & Gas Co. v. Allied Chem. Corp.*, 431 S.W.2d 336 (Tex. 1968); *Thompson v. Sinkler*, 295 S.W.2d 509 (Tex. Civ. App.—Beaumont 1956), *rev'd on other grounds*, 356 U.S. 326 (1958); *State v. Swift & Co.*, 187 S.W.2d 127 (Tex. Civ. App.—Austin 1945), *error ref.*; see *Hamilton, The Corporate Entity*, 49 TEXAS L. REV. 979, 991 (1971).

¹¹⁵ *United Steel Indus., Inc. v. Manhart*, 405 S.W.2d 231 (Tex. Civ. App.—Waco 1966), *error ref. n.r.e.* (stock issued for property not actually received cancelled). See also *Fulton v. Abramson*, 369 S.W.2d 815 (Tex. Civ. App.—Dallas 1963) (issuance of stock for interest in nonexistent partnership improper, but stockholder estopped against creditors to resist paying for stock as unpaid stock subscription); *Rowan v. Texas Orchard Dev. Co.*, 181 S.W. 871 (Tex. Civ. App.—Galveston 1915), *error ref.* (shareholders who paid nothing for stock liable to creditors); *Houston Fire & Marine Ins. Co. v. Swain*, 114 S.W. 149 (Tex. Civ. App. 1908) (officer liable for fraud in issuing and paying for shares with forged securities); *cf. Champion v. Commissioner*, 303 F.2d 887 (5th Cir. 1962) (stock paid for with check when maker has insufficient funds not validly issued).

¹¹⁶ *Vermilion Parish Peat Co. v. Green Belt Peat Moss Co.*, 465 S.W.2d 950 (Tex. Civ. App.—Dallas 1971), *error ref. n.r.e.* The sublease given as consideration for the issue of 40% of the corporation's shares was subject to a provision that it was not to become effective until the corporation received \$600,000 in cash or its equivalent as capital contributions. *But cf. Cole v. Adams*, 92 Tex. 173, 46 S.W. 790 (1898), which holds that an executory contract is valid consideration for a stock issuance. However, the facts show the contract in *Cole* was later performed, which may explain the difference in result even though the validity of consideration should be tested as of the time the shares are issued.

i.e., its stock investment in *S*, even though the appreciation in value as a result of the merger may not be realized until *S* is sold or liquidated. But even if not immediately realized, the increase in worth of this asset of *P* ought to have sufficient tangibility to be regarded as property received within the meaning of the constitution. Furthermore, from an accounting standpoint *P*'s investment in *S* would surely have to be written up to offset the increase in its capitalization resulting from the issuance of the shares to *T* because of the underlying assets *S* has obtained. Why should not the same gain constitute consideration paid to *P* for the issuance of its shares?¹¹⁷

¹¹⁷ Whether enhancement in property value will constitutionally support the issuance of stock to reflect the appreciation is not clear in Texas. In support of the argument made in the text see *Cole v. Adams*, 92 Tex. 173, 46 S.W. 790 (1898) (on certified question answering that retained earnings as well as option and executory contract would support issuance of stock, but not passing on contention that increases in value of land purchased by corporation before stock issued would also constitute proper payment therefor). *But cf.* *Cole v. Adams*, 19 Tex. Civ. App. 507, 49 S.W. 1052 (1898) (same facts, refusing to recognize appreciation in value of property and franchises as a valid part of consideration for which stock was sold, although giving credit for retained earnings). See also *Pacific Am. Gasoline Co. v. Miller*, 76 S.W.2d 833 (Tex. Civ. App.—Amarillo 1934) (intangible assets comprising going-concern worth and future earning capacity, among other assets, valid consideration for issuance of stock and debt securities; and so long as some value was present, securities were not "fictitious issues" proscribed by TEX. CONST. art. XII, § 6).

There are authorities, however, indicating that stock cannot be issued on the basis of an appreciation in asset values. See *Cole v. Adams*, 19 Tex. Civ. App. 507, 49 S.W. 1052 (1898); *Adams v. Farmers Gin Co.*, 114 S.W.2d 583 (Tex. Civ. App.—Eastland 1938) (rejecting argument that purported undistributed dividend in an amount equal to value of land on which gin stood and proceeds of fire insurance on destroyed gin which had been "loaned back" to corporation by all stockholders could be considered stock dividend, because nothing had been paid nor property received for such stock); *Houston Cemetery Co. v. Drew*, 36 S.W. 802 (Tex. Civ. App. 1896), *error dismissed* (dictum). See also TEX. ATT'Y GEN. OP. No. V-1520 (1962), ruling on the basis of the three cases just cited that TEX. CONST. art. XII, § 6 prohibits a corporation from issuing capital stock as a dividend based on the appreciated value of the corporate assets. *Cf.* *Dealers Granite Corp. v. Faubion*, 18 S.W.2d 737 (Tex. Civ. App.—Austin 1929) (enhancement of value of assets does not constitute "net profits" of business, as used in contract, from out of which plaintiff was to be paid for property transferred to corporation). For divergent views on whether under pre-TBCA statutes an increase in the value of assets would have supported payment of any kind of dividend, see 2 I. HILDEBRAND, TEXAS CORPORATIONS 324, 328, 331 (1942) (indicating it would), and Rain, *The Fund Available For Corporate Dividends in Texas*, 26 TEXAS L. REV. 273, 292 (1948) (indicating it would not, relying in part on the *Dealers Granite Corp.* case).

On the other hand, the TBCA seems to permit the declaration of stock dividends on the basis of asset revaluation. See TEX. BUS. CORP. ACT ANN. arts. 2.38A(3) (permitting stock dividends to be declared and paid out of unrestricted surplus of the corporation); 1.02A(12) (defining surplus as the excess of net assets over stated capital); 1.02A(10) (defining net assets as the amount by which total assets, excluding treasury shares, exceed total debts); and 2.41C (allowing the directors in determining the amount available for any dividend or distribution to consider the assets at their book value, presumably including any write-up of asset values that had previously entered on the books) (1956). Nor is revaluation surplus excluded from the definition of any of the permissible surpluses in the TBCA, as in some of the corporation statutes of other states, as noted below. Moreover, it can be argued that even cash and property dividends are now payable when an unrealized gain results from an asset write-up in view of the deletion of the word "realized" as a modifier of "gains and losses" in the definition of earned surplus in art. 1.02A(13) when that subsection was amended in 1967. Ch. 657, § 1, [1967] Tex. Laws 1718; see Amsler, *supra* note 7, at 59. Because of the change, the TBCA wording has reverted to the Model Business Corporation Act's definitions of earned surplus and capital surplus (except for the TBCA's special category of reduction surplus), and the draftsmen of the model act were deliberately ambivalent on the propriety of using revaluation surplus or unrealized gains for dividend purposes. 1 ABA MODEL BUS. CORP. ACT ANN. 36 (2d ed. 1971). Several of the model act's draftsmen and other commentators seem to agree that unrealized appreciation may be a legal source for payment of even ordinary dividends, although not necessarily agreeing on its desirability. W. CARY, CASES & MATERIALS ON CORPORATIONS 1505 (4th ed. 1969); HENN 652 n.46; D. HERWITZ, BUSINESS PLANNING 335 (1966); Bugge, *Unrealized Appreciation as a Source*

Using the underlying asset value of *P*'s ownership of its subsidiary to support the issuance of *P*'s shares has an analogy in the Texas cases involving attempts to pay for shares with promissory notes. Both by statute and case law a promissory note is not considered property of sufficient quality to be valid consideration for the issuance of shares.¹¹⁸ Yet if the promissory note is secured by a mortgage or deed of trust, the property-received requirement has been held satisfied,¹¹⁹ because the land securing and underlying the note is property that can be appropriated if necessary to satisfy the obligation given to pay for the issuance of shares. Actually, from the standpoint of being able to get at the underlying assets if needed to pay off creditors, for whose benefit the constitutional provision was adopted,¹²⁰ *P* is in a better position than the corporation whose shares are paid for by a secured note. In the latter situation the corporation must await a default in the payment of the note before proceeding against the underlying property. But after a triangular merger *P*, through its absolute control over its wholly owned subsidiary, can obtain *T*'s former assets whenever it chooses in several ways. It may dissolve *S*,¹²¹ for example, or merge with it.¹²² It may have *S* distribute the assets by way of partial liquidation¹²³ or in the form of a property dividend.¹²⁴ True, if *S* is in-

of Shareholder Distributions Under the Wisconsin Business Corporation Law, 1964 WIS. L. REV. 292; Carrington, *Experience in Texas with the Model Business Corporation Act*, 5 UTAH L. REV. 292 (1957); Garrett, *Capital and Surplus Under the New Corporation Statutes*, 23 LAW & CONTEMP. PROB. 239, 259 (1958); Gibson, *Surplus, So What? The Model Act Modernized*, 17 BUS. LAW. 476 (1962); Hackney, *The Financial Provisions of the Model Business Corporation Act*, 70 HARV. L. REV. 1357, 1380 (1959); Seward, *Earned Surplus—Its Meaning and Use in the Model Business Corporation Act*, 38 VA. L. REV. 435, 440-43 (1952); Note, *Cash Dividends Payable from Unrealized Appreciation of Fixed Assets—A Reconsideration of Randall v. Bailey*, 20 U. PITT. L. REV. 632 (1959).

As to the use of revaluation surplus to permit the issue of stock dividends, see 1 ABA MODEL BUS. CORP. ACT ANN. 925 (2d ed. 1971); R. BAKER & B. CARY, *CASES & MATERIALS ON CORPORATIONS* 1307 (3d ed. 1959); H. BALLANTINE, *CORPORATIONS* 484 (rev. ed. 1946); N. LATTIN, *LAW OF CORPORATIONS* 553 (2d ed. 1971); Bugge, *supra*, at 311; Hackney, *supra*, at 1381. Several state corporation statutes expressly permit use of unrealized appreciation as a source for stock dividends. ILL. REV. STAT. ch. 32, § 157.41c (1965); IOWA CODE § 496A.41 (1962); MICH. COMP. LAWS § 21.22 (1963); N.C. GEN. STAT. §§ 55-49(d), 55-51 (1965); OHIO REV. CODE ANN. § 1701.33(A) (1964). Arkansas and California explicitly bar recognition of unrealized appreciation for stock dividends. ARK. STAT. ANN. § 64-402 III (1947); CAL. CORP. CODE § 1505 (West 1955).

¹¹⁸ TEX. BUS. CORP. ACT ANN. art. 2.16B (1956); *Dunagan v. Bushey*, 152 Tex. 630, 263 S.W.2d 148 (1953); *Kanaman v. Gahagan*, 111 Tex. 170, 230 S.W. 141 (1921); *Washer v. Smyer*, 109 Tex. 398, 211 S.W. 985 (1919); *Thompson v. First State Bank*, 109 Tex. 419, 211 S.W. 977 (1919); 2 I. HILDEBRAND, *supra* note 117, § 283.

¹¹⁹ *General Bonding & Cas. Ins. Co. v. Moseley*, 110 Tex. 529, 222 S.W. 961 (1920); *Lumpkin v. Brown*, 229 S.W. 498 (Tex. Comm'n App. 1921), *judgment adopted*; *Langdeau v. Dick*, 356 S.W.2d 945 (Tex. Civ. App.—Austin 1962), *error ref. n.r.e.*; *Brownfield State Bank v. Hudson*, 73 S.W.2d 140 (Tex. Civ. App.—Amarillo 1934), *error ref.*; *Penland v. Schramm*, 232 S.W. 259 (Tex. Civ. App.—Austin 1921), *error ref.*; see I. HILDEBRAND, *supra* note 117, § 283; Comment, *Some Problems Raised by Issuing Stock for Overvalued Property and Services in Texas*, 40 TEXAS L. REV. 376, 386 (1962).

¹²⁰ "The term 'property' . . . used in this section of the Constitution . . . means property readily capable of being applied to the debts of the corporation. As a rule it should be property of the kind adapted to the charter uses of the corporation and which it may legally acquire." *Washer v. Smyer*, 109 Tex. 398, 404, 211 S.W. 985, 986 (1919); *accord*, *Woodson v. McAllister*, 119 F.2d 924 (5th Cir.), *appeal dismissed*, 314 U.S. 703 (1941).

¹²¹ TEX. BUS. CORP. ACT ANN. arts. 6.02, 6.03 (Supp. 1972).

¹²² *Id.* art. 5.16 provides for the "short form" merger of a 90% owned subsidiary into the parent without need for a shareholders' vote by either corporation. See *Hamilton*, *supra* note 13.

¹²³ TEX. BUS. CORP. ACT ANN. art. 2.40A (1956).

¹²⁴ *Id.* art. 2.38A(1).

solvent *P*'s options will be more limited, but the chances are that if *P* must liquidate its investment in *S* to pay off its own creditors, it will be insolvent too, in which event *P* and *S* are likely to be considered a single entity for the benefit of the creditors of both in view of *P*'s total ownership of *S*.¹²⁵

The underlying theme behind the taxfree reorganization provisions of the Internal Revenue Code suggests another rationale to sustain amended article 2.16A. Following the general philosophy of federal tax legislation of regarding substance and not form,¹²⁶ section 368 treats all the various combinations it provides for as having essentially the same end result, namely, the acquisition of one corporation by another, whether the acquiring corporation through use of its own shares directly obtains the assets or control of the other corporation or constructively receives them through a controlled corporation. In other words, *P*'s constructive receipt of *T*'s assets through *S* has the same taxfree consequences as if *P* had actually received them. The same reasoning, therefore, which led Congress to correct its oversight in not making forward and reverse mergers with subsidiaries taxfree events because in reality the result is the same, whether accomplished in two or three steps or by using the combinations already sanctioned,¹²⁷ should support a realistic interpretation of the new Texas triangular merger provisions.¹²⁸

Although until resolved in the courts or by amendment some constitutional doubts remain that may cloud the use of forward triangular mergers, not all triangular mergers are affected. Much may depend on the form in which the merger is cast. For example, *P* may have nominees create *S* especially for the merger, beginning it with a nominal capital, then have *T* merge into *S* and immediately thereafter issue its shares to be distributed to the shareholders of the merged corporation (who except for the nominees will be the shareholders of *T*) in exchange for all of *S*'s shares. Since *S*'s shares will be backed by the assets acquired from *T* in the merger, they will have genuine value as property to support the issuance of *P*'s shares. Another possible solution is for *S* to issue additional shares to *P* based on the value of the assets received from *T* in exchange for the shares of *P* which will then be distributed to the share-

¹²⁵ See, e.g., *Consolidated Rock Prods. Co. v. DuBois*, 312 U.S. 510 (1941); *Stone v. Eacho*, 127 F.2d 284 (4th Cir.), cert. denied, 317 U.S. 635 (1942); *Luckenbach S.S. Co. v. W.R. Grace & Co.*, 267 F. 676 (4th Cir. 1920); cf. *Houston-American Life Ins. Co. v. Tate*, 358 S.W.2d 645 (Tex. Civ. App.—Waco 1962). See HENN 268; E. LATTY, *SUBSIDIARIES AND AFFILIATED CORPORATIONS* 42 (1936); Cataldo, *Limited Liability with One-Man Companies and Subsidiary Corporations*, 18 LAW & CONTEMP. PROB. 473, 500 (1953).

¹²⁶ *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950); *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Weiss v. Stearn*, 265 U.S. 242 (1924); *Northern Trust Co. v. United States*, 389 F.2d 731 (7th Cir. 1968); *Foxman v. Commissioner*, 352 F.2d 466 (3d Cir. 1965); see BITTKER & EUSTICE 1-19; HENN 270; Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440, 442 (1968); Eustice, *Tax Problems Arising from Transactions between Affiliated or Controlled Corporations*, 23 TAX L. REV. 451 (1968); Lyon & Eustice, *Federal Income Taxation*, 36 N.Y.L. REV. 642 (1961).

¹²⁷ See notes 80 and 83 *supra*.

¹²⁸ Some of the analysis of the constitutional problem presented in the foregoing discussion was suggested in a letter from Alan R. Bromberg to John T. Kipp, August 24, 1970, distributed to members of the Committee on Revision of Corporation Laws. Of course, Professor Bromberg is not responsible for the manner or form in which his observations are expressed here.

holders of *T*.¹²⁹ Likewise, the reverse merger recognized by section 368(a)(2)-(E) can be used, since to be taxfree *P* must exchange its voting shares for at least eighty percent of the voting and nonvoting shares of *T* at the time of the merger of *S* into *T*. Since *T*'s shares should have some book or market value, they would be considered property received to support the issuance of the *P* shares used to make the exchange. Moreover, *P* would not have to own all the stock in *T*, its new subsidiary, because, unlike the forward merger situation dealt with in amended article 2.16A, the consideration—*i.e.*, the stock of *T* being exchanged for *P*'s stock—is being paid directly to *P*, and not to a wholly owned subsidiary.

Case Law Developments. Three cases were decided during the survey period, including an Arkansas decision applying Texas law, which interpret the merger and sale of assets provisions of the TBCA. In *Hochberg v. Schick Investment Co.*¹³⁰ a shareholder in a Texas corporation who dissented from its merger into a Delaware corporation¹³¹ was held not to have timely filed his petition to have the fair value of his shares determined under the procedures detailed in TBCA article 5.12. He, thus, became bound by the merger, since the dissent action was his exclusive remedy in the absence of fraud in the transaction.¹³² Under article 5.12 a shareholder dissenting to a merger¹³³ and the surviving corporation have a period of sixty days to try to agree on a fair value for his shares; if they do not, then either party may file a petition within another sixty days to have the value judicially determined.¹³⁴ The plaintiff in the instant case mailed his petition from Delaware one day before the expiration of the second sixty-day period, but it was not received by the clerk of the court until several days later. The shareholder argued that because filing the suit was discretionary, he remained under the protection of the TBCA even if he had never filed a suit. The court held, however, that to utilize the dissent remedy the shareholder must file his suit within the time prescribed by the statute or he is forever barred from filing such a suit. It further rejected the contention that the statute should be liberally construed for the protection of the shareholder, stating that even a liberal construction does not call for abandonment of an orderly procedure prescribed by the statute granting the remedy.¹³⁵ Although the result seems somewhat harsh in view of the power given courts under the Texas Rules of Civil Procedure to grant an enlargement,¹³⁶ the holding is consistent with the

¹²⁹ Securities of other corporations are valid consideration for the issuance of stock as property received under the Texas Constitution. *Commonwealth Bonding & Cas. Ins. Co. v. Hollifield*, 220 S.W. 322 (Tex. Comm'n App. 1920), *judgment adopted*.

¹³⁰ 469 S.W.2d 474 (Tex. Civ. App.—Fort Worth 1971).

¹³¹ Effected pursuant to TEX. BUS. CORP. ACT ANN. art. 5.07 (1956), providing for merger or consolidation of domestic and foreign corporations.

¹³² *Id.* art. 5.12G.

¹³³ The right to dissent to a merger is given in *id.* art. 5.11A(2).

¹³⁴ The detailed dissent procedures spelled out in *id.* arts. 5.12 & 5.13 were somewhat simplified and the rights of dissenting shareholders more narrowly limited in a series of amendments adopted in 1967. Ch. 657, §§ 12, 13, [1967] Tex. Laws 1721-23. For a discussion of the amendments see *Amsler*, *supra* note 7, at 62.

¹³⁵ The court followed a Delaware decision, rejecting the same contention. *In re North-eastern Water Co.*, 28 Del. Ch. 139, 38 A.2d 918 (1944).

¹³⁶ TEX. R. CIV. P. 5, as amended effective Jan. 1, 1971, permitting the court to allow an act prescribed to be done within a specified time under the rules to be done after the expiration of the specified period, but only on motion and for good cause shown for the

view sometimes expressed that the rules cannot enlarge the period prescribed by statute in which an action must be brought¹³⁷ and the more specific language within the TBCA making the remedy conditional on timely filing.¹³⁸

In the Arkansas case¹³⁹ a Texas corporation into which its wholly owned Texas subsidiary had been merged was held subject to the jurisdiction of the Arkansas court in an action seeking damages caused by construction carried out by the subsidiary corporation before the merger. The court correctly applied TBCA article 5.06A(5), making the corporation surviving the merger "thenceforth . . . responsible and liable for all liabilities and obligations" of the constituent corporations,¹⁴⁰ noting also that under the TBCA the action could have also been brought against the nonsurviving corporation even after the merger.¹⁴¹

In the third decision,¹⁴² already noted,¹⁴³ the sale of substantially all the assets of a corporation was set aside because, among other reasons, the sale had not been approved by the requisite vote of the holders of at least two-thirds of the outstanding shares.¹⁴⁴ Moreover, the shares held by another corporation holding forty percent of the outstanding stock that had been voted for the sale were cancelled, because they had been issued for a sublease to explore and extract peat moss and sphagnum that was not to become effective until \$600,000 had been paid in cash or its equivalent into the capitalization of the issuing corporation—an event which never occurred.

III. TEXAS SECURITIES ACT

A. *The "Dempsey-Tegeler" Amendment*

When a court hands down an egregiously wrong decision, two recourses are available: (1) appeal to a higher court, if possible; and (2) legislative correction at the next session of the legislature. Usually the former is the relief sought; the second is too often fraught with political pitfalls that await even the most well-meaning efforts to set the law aright. In the wake of a recent

failure to act. *See* 1 R. McDONALD, TEXAS CIVIL PRACTICE 19 (rev. ed. 1965). Apparently no motion for an extension of time was filed in the instant case.

¹³⁷ *See* Fulghum v. Baxley, 219 S.W.2d 1014 (Tex. Civ. App.—Dallas 1949) (statute of limitations).

¹³⁸ *See* TEX. BUS. CORP. ACT ANN. art. 5.13C (Supp. 1972), which provides that if no petition asking for judicial determination of the value of dissenting shares "shall have been filed within the time provided by article 5.12," the shareholder is conclusively presumed to have approved and ratified the action from which he is dissenting; and *id.* art. 5.12G, which states that any shareholder "who fails to comply with the requirements of this Article" is barred from recovering the value of his shares or seeking money damages. *See also* Comment of State Bar Committee, 3A TEX. REV. CIV. STAT. ANN. 96 (Supp. 1972): "Under this Section the right to payment may be terminated . . . if no petition to determine the value of his shares is filed within the prescribed time . . ."

¹³⁹ *Teague v. Home Mortgage & Inv. Co.*, 465 S.W.2d 312 (Ark. 1971).

¹⁴⁰ TEX. BUS. CORP. ACT ANN. art. 5.06A(5) (1956).

¹⁴¹ *Id.* art. 5.06G(5), which permits an action against a constituent corporation to be prosecuted "as if such merger or consolidation had not taken place." *Cf. id.* art. 7.12, which allows survival of a remedy against a dissolved corporation if the action is commenced within three years after dissolution, and art. 2.07C of the Miscellaneous Corporation Laws Act, which allows survival of a remedy not barred by limitations beyond even the three-year period. TEX. REV. CIV. STAT. ANN. art. 1302-2.07C (1962).

¹⁴² Vermilion Parish Peat Co. v. Green Belt Peat Moss Co., 465 S.W.2d 950 (Tex. Civ. App.—Dallas 1971), *error ref. n.r.e.*

¹⁴³ *See* note 116 *supra*.

¹⁴⁴ *See* TEX. BUS. CORP. ACT ANN. art. 5.10 (Supp. 1972).

decision by the Beaumont court of civil appeals which effectively gutted the civil remedy afforded in section 33 of the Texas Securities Act¹⁴⁵ by excluding corporations from its application, both routes were followed. Unfortunately, when too much firepower is brought to bear, an overkill may often result. This seems to be the consequence of the legislative solution adopted, for in the process of attempting to meet the issue by defining "person" wherever used in the Texas Securities Act to include a corporation (with one exception), the legislature may have raised more problems than it solved. The consequence is doubly unfortunate because the Texas Supreme Court quickly restored the civil remedy to full vigor in reversing the Beaumont court without the possible unforeseen side effects implicit in the legislative change.

The "Dempsey-Tegeler" Case. In *Dempsey-Tegeler & Co. v. Flowers*¹⁴⁶ two disgruntled purchasers of securities brought an action in Lubbock under section 33 of the Texas Securities Act to recover their purchase money when the securities plummeted in value against Dempsey-Tegeler, two of its salesmen, and the manager of its Lubbock office, through whom the securities had been purchased. Dempsey-Tegeler filed a plea of privilege to be sued in Harris County where its registered agent resided; plaintiffs countered by asserting that venue could be had in Lubbock County under subdivisions 4, 9, 23, and 30 of article 1995.¹⁴⁷ At the plea of privilege hearing plaintiffs proved they had purchased the shares through Dempsey-Tegeler and introduced a certificate by the Securities Commissioner stating that the securities had never been registered in Texas and that no permit allowing their sale had ever been granted.¹⁴⁸ The trial court overruled the plea of privilege, and Dempsey-Tegeler appealed, contending that no cause of action could be asserted against it because, being a corporation, it was not subject to the provisions of section 33. Agreeing, the court of civil appeals ordered the transfer of the actions against Dempsey-Tegeler to Harris County. One judge dissented.¹⁴⁹

Section 33.A(1) creates a civil cause of action against "any person" who offers or sells a security in violation of certain sections of the Act, including

¹⁴⁵ TEX. REV. CIV. STAT. ANN. art. 581-33 (1964).

¹⁴⁶ *Dempsey-Tegeler & Co. v. Flowers*, 465 S.W.2d 208 (Tex. Civ. App.—Beaumont), *rev'd*, 472 S.W.2d 112 (Tex. 1971).

¹⁴⁷ TEX. REV. CIV. STAT. ANN. art. 1995 (1964). The subdivisions establish exceptions to the general venue rule stated in the article that a defendant is to be sued in the county of his domicile. The subdivisions relied on create exceptions when two or more defendants reside in different counties (subdivision 4); a crime, offense, or trespass has been committed (subdivision 9); a corporation is sued (subdivision 23); and a statute expressly prescribes venue for a particular action (subdivision 30). Under § 16 of the Texas Securities Act non-resident individuals or foreign corporations which register as Texas dealers must file a consent to be sued in any county in which a cause of action against them may arise or in which the plaintiff resides. TEX. REV. CIV. STAT. ANN. art. 581-16 (1964). Dempsey-Tegeler was a Delaware corporation.

¹⁴⁸ Under § 30 of the Act a certificate by the securities commissioner showing compliance or noncompliance with the provisions of the Act by any dealer or salesman is admissible in any action based on or arising out of the Act as prima facie evidence of compliance or noncompliance. TEX. REV. CIV. STAT. ANN. art. 581-30 (1964).

¹⁴⁹ The dissenting opinion by Justice Stephenson relied heavily on a "mischief" or "evil" approach in deciding that the legislature enacted the Securities Act to protect the public interest and, therefore, intended that a civil action should lie against a corporation violating the Act under § 33. His analysis and reasoning are essentially the same as the supreme court's in its reversal.

the registration provisions.¹⁵⁰ As a consequence, a purchaser of unregistered securities may seek rescission or damages for their sale. The majority of the court of civil appeals, after examining the different uses of the terms "person" and "company" in other sections of the Act,¹⁵¹ concluded that the legislature, by using only the word "person" in section 33 and not adding "company," intended that individuals alone, and not corporations or other entities, be held civilly liable under that section. They relied heavily on the fact that section 29,¹⁵² the penal provision of the Act,¹⁵³ which they regarded as basically parallel to section 33, also used "person" exclusively. And since corporations are not generally criminally liable in Texas unless explicitly provided to the contrary,¹⁵⁴ and in light of an administrative interpretation that corporations can-

¹⁵⁰ TEX. REV. CIV. STAT. ANN. art. 581-33.A(1) (1964).

¹⁵¹ A definite deficiency in the Texas Securities Act is the imprecision of its terminology, which was the primary cause of the whole *Dempsey-Tegeler* imbroglio. Although § 4.B of the Act defined "company" to include a "person" before its amendment, "person" and "company" as well as similar terminology are used disjunctively, conjunctively, or singularly throughout the Act when it is evident from the context that a single inclusive term would do. See, e.g., §§ 4.C ("dealer" includes every "person or company"); 4.D ("salesman" includes every "person or company"); 4.G ("issuer" includes every "company or person"); 5 ("company or person" making exempt transaction not deemed a dealer; see also various exemptions in § 5 using singular terms such as "corporation," "company," "issuer," and "vendor" in contexts showing that a multiple meaning was intended); 5.C(1) (isolated sales by "vendor" not to be for benefit of any "company or corporation"; any "person" acting as agent for vendor to be registered); 7 (registration of securities by dealer or "issuer"); 8 (consent to service and certificate of good standing to be filed by "issuer" or dealer); 9.A ("company" offering securities may be required to put proceeds of offering in escrow); 10.C (unlawful for any dealer or "issuer," agent, or salesman to use permit authorizing sale of securities for sales purposes); 12 (no "person, firm, corporation" or dealer to sell securities without being registered); 16 (consent to suit in state by every "company" organized in other states or having its principal office therein and by every non-resident "individual"); 22.A (unlawful for any "person" to use advertising except as Act permits); 22.B(1) (after qualification by notification or coordination, advertising can be used if such "person, company," dealer or firm has been registered); 23.A (commissioner can suspend sales of securities after notice to "the issuer, the registrant, and the person" on whose behalf securities are being sold); 24 (hearing before commissioner by any "person or company" aggrieved by his order); 28 (commissioner may examine records at office of "concern" in lieu of subpoena; commissioner may have access to records of Board of Insurance Commissioners in connection with application for registration of "person or company"); 29 (various acts made crimes when committed by any "person"); 31 (nothing in Act to limit liability or prevent prosecution of any "person or company"); 32 (injunctions authorized against any "person or company" violating Act or engaged in securities fraud); 33 (civil liabilities stated of any "person" making offers or sales in violation of Act or in fraudulent manner); 34 (no "person or company" to bring action for commission unless licensed).

¹⁵² TEX. REV. CIV. STAT. ANN. art. 581-29 (1964).

¹⁵³ By invoking subdivision 9 of the venue statute, the plaintiffs had to allege that a crime or offense had been committed in Lubbock County by the sale of unregistered securities in violation of § 29 of the Securities Act. Since the dissenting opinion in the court of civil appeals and the supreme court's decision indicate that venue could have been sustained under either subdivisions 23 or 30, see note 147 *supra*, resort to subdivision 9 as well as a ground to defeat the plea of privilege may well have been a tactical error in view of the majority opinion's preoccupation with § 29 and the general immunity of corporations from criminal prosecutions in Texas.

¹⁵⁴ See Hamilton, *Corporate Criminal Liability in Texas*, 47 TEXAS L. REV. 60 (1968), for an excellent treatment of the subject. Professor Hamilton concludes that although it sometimes is flatly stated that corporations cannot be indicted or tried under Texas' criminal laws, see 14 TEX. JUR. 2D *Corporations* § 448 (1960), the law on the matter is far from certain; nevertheless, it is probable that a Texas corporation cannot be prosecuted for violation of a criminal statute unless it refers specifically to "corporations" or provides a procedure for their prosecution. The cases generally cited in support of non-criminal liability are *Overt v. State*, 97 Tex. Crim. 202, 260 S.W. 856 (1924); *Judge Lynch Int'l Book & Publishing Co. v. State*, 84 Tex. Crim. 459, 208 S.W. 526 (1919); *Guild v. State*, 79 Tex. Crim. 603, 187 S.W. 215 (1916); *Thompson v. Stauffer Chem. Co.*, 348 S.W.2d 274 (Tex. Civ. App.—Waco 1961), *error ref. n.r.e.*, noted in 40 TEXAS L. REV. 1057 (1962); cf. McCollum

not be indicted or tried for violations of the Securities Act¹⁵⁵ (of which the legislature must have been aware when making later amendments to the Act), it was clear to the majority that "person" in section 29 meant individuals and no others. A contrary interpretation would invalidate section 29, surely something the legislature could not have intended. It followed, therefore, that by using the same word in section 33 in creating a new statutory action just as section 29 was enacted to create a new penal offense, the legislature must have intended that both sections be applied alike to natural persons and not artificial entities.

The Texas Supreme Court reversed in a well-reasoned opinion by Justice McGee.¹⁵⁶ The court found the parallelism to section 29 unpersuasive, noting that in other provisions of the Act, especially section 22.A, where "person" is also used exclusively,¹⁵⁷ it was evident that "person" and "company" were used interchangeably to encompass both individuals and corporations.¹⁵⁸ More importantly, the high court observed that it is a matter of common knowledge that most securities firms in Texas are corporations subject to civil remedies only, and since the purpose of the legislature was to protect the investing public,¹⁵⁹ a narrow interpretation that would permit corporations to sell unregistered securities without fear of civil suits would clearly defeat the legislative intent.¹⁶⁰ Even if penal provisions of section 29 were limited to individuals, an issue the court does not reach,¹⁶¹ this is no reason why section 33, a remedial statute which should be given the widest possible scope,¹⁶² should be

v. State, 165 Tex. Crim. 241, 305 S.W.2d 612 (1957) (dictum indicating corporation can be prosecuted for water pollution, but applicable statute specifically applies to corporations, Act of May 8, 1943, ch. 285, [1943] Tex. Laws 418, repealed 1961, effective Nov. 1, 1962; see, now, TEX. WATER CODE ANN. §§ 21.551-553 (1971)). *And see* Hamilton, *supra* note 13, at 93; Hildebrand, *Corporate Liability for Torts and Crimes*, 13 TEXAS L. REV. 253 (1935).

¹⁵⁵ TEX. ATT'Y GEN. OP. No. C-423 (1965), citing only *Texas Jurisprudence* for that aspect of the opinion. *See* note 154 *supra*.

¹⁵⁶ 472 S.W.2d 112 (Tex. 1971).

¹⁵⁷ As the court noted, § 22.A, the only section other than §§ 29 and 33 to use the word "person" alone, makes it unlawful for any "person" to advertise securities contrary to the provisions of § 22; however, subsection B permits advertising after registration by notification or coordination under sections 7.B and 7.C if "such person, company, dealer, agent, or salesman" has been registered under the Act, clearly indicating "person" is used in the Act in an inclusive sense.

¹⁵⁸ *See* note 151 *supra*.

¹⁵⁹ "[T]he Securities Act must be made current in order to prevent fraud on the Texas public . . ." Ch. 269, § 40, [1957] Tex. Laws 602 (emergency clause for the present Texas Securities Act of 1957). *And see* Kadane v. Clark, 135 Tex. 496, 501, 143 S.W.2d 197, 199 (1940) ("Clearly the outstanding purpose of this Act is for the protection of the public . . . from fraud and imposition by those engaged in selling worthless securities."); *accord*, Fowler v. Hulst, 138 Tex. 636, 161 S.W.2d 478 (1942); Culver v. Cockburn, 127 S.W.2d 328 (Tex. Civ. App.—Galveston 1940), *error dismissed, judgment correct*.

¹⁶⁰ The court applied the general rule of construction found in TEX. REV. CIV. STAT. ANN. art. 10(6) (1969): "In all interpretations, the court shall look diligently for the intention of the Legislature, keeping in view at all times the old law, the evil and the remedy." Thus, in determining legislative intent, the purpose for which a statute is passed must be looked for. Duval Corp. v. Sadler, 407 S.W.2d 493 (Tex. 1966); Calvert v. British-American Oil Producing Co., 397 S.W.2d 839 (Tex. 1965); Board of Ins. Comm'rs v. Great Southern Life Ins. Co., 150 Tex. 258, 239 S.W.2d 803 (1951); City of Mason v. West Tex. Util. Co., 150 Tex. 18, 237 S.W.2d 273 (1951). *See generally* 3 J. SUTHERLAND, STATUTORY CONSTRUCTION 41 (3d ed. 1943). *But see* note 164 *infra*.

¹⁶¹ Because it is "a question not before us." 472 S.W.2d at 115.

¹⁶² Board of Ins. Comm'rs v. Great Southern Life Ins. Co., 150 Tex. 258, 239 S.W.2d 803 (1951); City of Mason v. West Tex. Util. Co., 150 Tex. 18, 237 S.W.2d 273 (1951);

similarly limited.¹⁶³ The court then flatly states: "We hold that section 33 of The Texas Securities Act does apply to corporations as well as individuals."¹⁶⁴ Thus, in a single blast from the judicial barrel of the corrective shotgun the anxieties engendered by *Dempsey-Tegeler* have been effectively resolved.

Amendment to Section 4.B. The legislative reaction to the lower court's decision in *Dempsey-Tegeler*¹⁶⁵ was an amendment to section 4.B, which previously defined only the word "company," adding "person" as a term to be defined as follows:

Bruner v. State, 463 S.W.2d 205 (Tex. Crim. App. 1970), discussed in text at notes 189-207 *infra*.

¹⁶³ The court in explaining the incongruities of language within the Act ascribed the difficulties to the fact that the Act is derived from several sources, noting that § 33 in particular "was lifted almost verbatim" from § 12 of the Federal Securities Act of 1933, which defines "person" to include corporations. 15 U.S.C. §§ 77b(2), 771(2) (1971). In a sense this is correct, although the lifting was a little more roundabout than that. Section 33 was one of a series of amendments to the Act sponsored by the State Bar Committee on Securities and Investment Banking in 1963, see Kerr, *Proposed Amendments to Securities Act of Texas*, 25 TEX. B.J. 1025, 1083 (1962); Meer, *A New Look at the Texas Securities Act*, 43 TEXAS L. REV. 680, 682 (1965); and as originally drafted was substantially the same as § 410 of the Uniform Securities Act, although a number of changes were made during the process of enactment which resulted in the present text. Committee Comment—1963 Amendment, 1B TEX. REV. CIV. STAT. ANN. 69 (1964). However, the Uniform Act provision was derived in turn from § 12(2) of the 1933 Act, 15 U.S.C. § 771(2) (1971); hence, the court's deduction is essentially correct. See UNIFORM SECURITIES ACT § 410, Commissioner's Note subsec. (a) (2); 1 BLUE SKY L. REP. ¶ 4940.01 (1967); 3 L. LOSS, *supra* note 34, at 1632; L. LOSS & E. COWETT, BLUE SKY LAW 390 (1958). On the section 33 civil actions in general see Bordwine, *Civil Remedies Under the Texas Securities Laws*, 8 HOUSTON L. REV. 657 (1971); Meer, *supra*, at 701.

¹⁶⁴ 472 S.W.2d at 115. The court also repudiated an alternative basis for the holding of the court of civil appeals, which had the effect of increasing the plaintiff's burden of proof in a plea of privilege hearing. Following an earlier decision of its own in *Southwestern Transfer Co. v. Slay*, 455 S.W.2d 352 (Tex. Civ. App.—Beaumont 1970), the Beaumont court held that the effect of the commissioner's certificate of nonregistration, which under § 30 of the Securities Act is prima facie evidence of noncompliance, see note 148 *supra*, proved only the existence of a prima facie case, which under the *Slay* holding was insufficient to defeat the defendant's prima facie right to a transfer under the plea of privilege. The supreme court held, however, that all the commissioner's certificate shows is that the securities have not been registered by qualification, notification, or coordination, and that on the record the plaintiff had proved a cause of action that would have supported a judgment on the merits. Since no greater burden is placed on the plaintiff in a venue action than in a trial on the merits, the *Slay* prima facie rule was expressly disapproved.

¹⁶⁵ The impetus for the amendment came from the State Securities Board staff after the Beaumont court's decision in *Dempsey-Tegeler* with the support of the Committee on Securities and Investment Banking of the Section on Corporation, Banking and Business Law of the State Bar of Texas, which reviewed the proposed bill. That the change was generated by *Dempsey-Tegeler* is made evident in the emergency clause of the Act:

The fact that a question has recently been raised in a decision by an Appellate Court in this State as to the applicability of Section 33 of the Securities Act to corporations and other entities other than natural persons; the resulting necessity to confirm that the intent of the Legislature was, and is now, that Section 33 and certain other sections of said Act should apply to corporations and other entities as well as to natural persons; . . . create an emergency . . . Ch. 235, § 2, [1971] Tex. Laws 1086. Interestingly enough, although the supreme court noted the passage of the amendment in its opinion, 472 S.W.2d at 114 n.2, it appeared to have no bearing on its decision. Instead, general expressions of the purpose of the Securities Act and general principles of statutory construction were relied upon in determining legislative intent. See notes 159, 160 *supra*. The specific declaration just quoted, which confirmed that the intent of the legislature was and is that § 33 should apply to corporations, was completely ignored. Perhaps the court felt the need of arriving at its own conclusion as a means of correcting an erroneous interpretation by a lower court. It may have also wanted to correct at the same time the lower court's alternative holding that proof of a prima facie case is not sufficient to defeat a plea of privilege. See note 163 *supra*.

The terms 'person' and 'company' shall include a corporation, person, joint stock company, partnership, limited partnership, association, company, firm, syndicate, trust, incorporated or unincorporated, heretofore or hereafter formed under the laws of this or any other state, country, sovereignty or political subdivision thereof, and shall include a government, or a political subdivision or agency thereof. As used herein, the term 'trust' shall be deemed to include a common law trust, but shall not include a trust created or appointed under or by virtue of a last will and testament or by a court of law or equity. Under the criminal penal provisions of Section 29 of this Act, the word 'person' shall mean a natural person.¹⁶⁶

By affirming that corporations and other business entities are governed by all of the provisions of the Securities Act (except section 29), the amendment, of course, goes further than the supreme court's holding, which necessarily was limited to section 33. In that sense the change is a helpful one that dispels whatever ambiguities future strict constructionism might conjure up as to whom the Act is applicable. Nevertheless, in the process of expanding the former definition new uncertainties may have been caused and some policy decisions appear to have been made that may well necessitate further judicial construction or legislative action.

First, the inclusion of "a government or a political subdivision or agency thereof" as a "person" or "company" infers these governmental entities may not have been subject to the Act before. Yet logically as the issuers of securities that comprise one of the most common forms of investment in this country¹⁶⁷ they should be encompassed within a securities law, and generally are.¹⁶⁸ And although generally exempt from registration procedures,¹⁶⁹ there is no

¹⁶⁶ Ch. 235, § 1, [1971] Tex. Laws 1085, amending TEX. REV. CIV. STAT. ANN. art. 581-4.B (Supp. 1972).

¹⁶⁷ In 1970 a total of \$483 billion in public debt securities were outstanding in the hands of the public, comprising \$301 billion in debt of the federal government, \$38 billion of federal agencies, and \$143 billion of state and local governmental units. U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1971, Table No. 674, at 441 (92d ed. 1971). During 1970 the federal government issued \$14.831 billion in new debt securities, federal agencies \$16.180, and state and local agencies, \$17.762 billion, for a total of \$48.773 billion. See *id.* Table No. 693, at 448.

¹⁶⁸ "Person" is defined in the Securities Act of 1933 to include "a government or political subdivision thereof." 15 U.S.C. § 77b(2) (1971). The term is similarly defined in the UNIFORM SECURITIES ACT § 401(i).

¹⁶⁹ The Texas Securities Act exempts both the sale by the issuer of government securities and the securities themselves. TEX. REV. CIV. STAT. ANN. arts. 581-5.M, -6.A (1964). The more typical pattern is to exempt only the securities. See, e.g., Securities Act of 1933, § 3(a)(2), 15 U.S.C. § 77c(2) (1971); UNIFORM SECURITIES ACT § 402(a)(1).

The federal act seemed to exempt all types of state and municipal bonds from registration, see H. SOWARDS, *supra* note 34, at 3-7; however, in 1968 the Securities Exchange Commission took the position that industrial revenue bonds that are repayable out of funds generated by private enterprise (usually lease payments for the premises built with the proceeds of the bonds) would be deemed separate securities within the meaning of § 2(1) of the Securities Act, 15 U.S.C. § 77b(1) (1971), and would, therefore, require registration after Dec. 31, 1968. SEC Rule 131, 17 C.F.R. § 230.131 (1971); see SEC Securities Act Release Nos. 4896 (1968) (proposed), 4921 (1968) (adopted), 5055 (1970) (clarification of rule with respect to publicly owned and operated airport facilities leased in part to industrial or commercial enterprise); SEC Rule 3b-5, 17 C.F.R. § 240.3b-5 (1971). The SEC's action, as well as the severe limitation on tax-exempt status of such securities enacted by Congress the same year, was undoubtedly engendered by the phenomenal growth in the use and public sale of industrial revenue bonds from 1956, when only \$1.5 million were sold and a few states authorized their issuance, to the end of 1967, when over \$1 billion worth were sold and 43 states permitted their issue, with perhaps twice the amount publicly sold during the interim having been privately placed. By 1968 it appeared that another \$2

reason why their sales should not be subject to antifraud remedies and procedures, especially when the many variegated forms of local governmental units and districts which presently issue bonds for public sale are considered.¹⁷⁰

billion would be sold, thereby seriously threatening the market for all tax-exempt municipal bonds, already under attack as providing tax loopholes for the wealthy, since the prime beneficiaries of sale of these development bonds were the industrial concerns using the facilities built with their proceeds. Moreover, the situation became aggravated when individual bond issues ranging up to \$140 million began to appear, sometimes authorized by very small municipalities; e.g., Wickliffe, Kentucky—\$80 million issue; Middletown, Connecticut—\$82.5 million; Crossett, Arkansas—\$75 million. See Hendricks, *Reconsideration of Industrial Development Bond Income Tax Exemption*, 48 ORE. L. REV. 168, 171 (1969); McDaniel, *Federal Income Taxation of Industrial Bonds: The Public Interest*, 1 URBAN LAWYER 157, 158 (1969); *Battle Brews Over Tax-Exempts*, BUS. WEEK, Dec. 28, 1968, at 66; Wall Street J., Dec. 4, 1967, at 26, cols. 1-3 (Southwestern ed.).

The limitation on tax-exempt status was enacted as part of the Revenue and Expenditure Control Act of 1968 and amended § 103 of the Internal Revenue Code of 1954, which excludes interest on the obligations of a state or any of its political subdivisions from gross income by adding a new subsection (c), which first states the general rule that industrial development bonds will no longer be regarded as tax-exempt state or municipal obligations under § 103(a)(1), but then carves out several exceptions. The amendment applies to all issues after Oct. 24, 1968, or in the instance of certain previously authorized issues, after Jan. 1, 1969. Exempted, however, and consequently still tax-exempt are certain specified bond issues of \$1 million or less, others of \$5 million or less meeting somewhat stricter requirements, and those regardless of size when the proceeds are to be used for residential real property for family units, or for facilities for sports events, conventions or trade shows, various types of transportation, public utility services or pollution abatement, or industrial parks. INT. REV. CODE OF 1954, § 103(c). The exemptions were slightly broadened in the Revenue Act of 1971 by liberalizing one of the conditions on use of the \$5 million exemption and expanding the exemption for financing facilities for furnishing water, if available on reasonable demand to members of the public. *Id.* The Service has proposed new regulations for the industrial development bond provisions, but to date they have not been adopted. Proposed Treas. Reg. §§ 1.103-7 to -12, 36 Fed. Reg. 10953 (1971).

Although small issues and particular types of industrial revenue bonds thus continued to have tax-free status after 1968, the SEC's position as reflected in rules 131 and 3b-10 remained unchanged with registration still being required for any issues in excess of \$300,000 sold publicly on an interstate basis. As a result virtually all new issues after 1968 were either privately placed or sold via an intrastate offering to avoid the expenses of registration. Bell & Hinkle, *A Guide to Industrial Revenue Bond Financing*, 9 WASHBURN L.J. 372, 386 (1970). Perhaps in response to this situation and the incongruity of having a government security that would normally be exempt under both the tax and securities laws recognized by one but not the other, in 1970 Congress amended § 3(a)(2) of the Securities Act and § 3(a)(12) of the Securities Exchange Act to exempt from registration essentially the same categories of industrial development bonds that retained tax-free status under § 103(c) of the Internal Revenue Code. See CONF. REP. 91-1037 TO EMPLOYMENT SECURITY AMENDMENTS OF 1970, 91st Cong., 2d Sess. (1970), reprinted in 2 U.S. CODE CONG. & AD. NEWS 3646, 3648 (1970). The 1970 amendments have a strange legislative history. They apparently were added as a rider by the conference committee to the Employment Security Amendments of 1970, Pub. L. No. 91-373, § 401, 84 Stat. 695 (1970), were deleted (presumably by inadvertence) by unrelated amendments to the same sections of the 1933 and 1934 acts in the Investment Company Amendments Act of 1970, Pub. L. No. 91-547, §§ 27(b), 28(a), 84 Stat. 1413 (1970), and were restored by a rider to the Investor Protection Law of 1970, Pub. L. No. 91-567, § 6, 84 Stat. 1497 (1970). The amendments are explained and the SEC's current position on industrial revenue bonds is set out in SEC Securities Act Release No. 5103 (1970). As to industrial revenue bonds, see generally Abbey, *Municipal Industrial Development Bonds*, 19 VAND. L. REV. 25 (1965); Hendricks, *supra*, at 168; McDaniel, *supra*, at 157; Mumford, *The Past, Present and Future of Industrial Development Bonds*, 1 URBAN LAWYER 147 (1969); Note, *The Proliferation of Industrial Revenue Bond Financing: Ban the Bond?*, 41 TEMP. L.Q. 289 (1968). Securities law aspects are discussed, in addition to the sources just cited, in 1 L. LOSS, *supra* note 34, at 563 (Supp. 1969); H. SOWARDS, *supra* note 34, at 3-8; Bell & Hinkle, *supra*, at 385. The articles previously cited all discuss the tax aspects of these bonds; in addition see 1 MERTENS, §§ 8.21a, 8.21b; Fox, *Industrial Development Bonds*, BNA TAX MANAGEMENT PORTFOLIO NO. 216 (1969).

¹⁷⁰ Just cursory examination of *Moody's Municipal and Government Manual* shows that in Texas alone, in addition to bonds issued by the State of Texas and various state agencies such as river and turnpike authorities and state educational institutions, debt securities are also issued by counties, cities, and a variety of junior college, independent school, water

Yet on this score the Texas Act lacks consistency, assuming the expanded definition was intended to have the effect it apparently has.

For example, since these governmental entities are to be regarded as persons or companies under the Act, does this not mean they become subject to the injunctive relief which may be sought by the attorney general under section 32 to prevent fraud by "any person or company" in the sale of securities?¹⁷¹ Similarly, cannot an aggrieved purchaser maintain a civil action against them based on the civil liability imposed by section 33.A(2) on "any person" who sells securities by fraudulent means?¹⁷² In each instance the remedy applies whether the securities or the transactions in which they are sold are exempt under sections 5 and 6 or not.¹⁷³ Moreover, consider some of the interesting procedural problems that may be encountered in trying to enjoin or sue, for example, an agency of the federal government or of another state, which are not at all resolved by the new definition.

On the other hand, the much more effective remedy of a cease-and-desist order by the commissioner preventing advertising or sales of securities that would work a fraud or not be fair, just, or equitable to purchasers continues to be hamstrung by the specific exclusion of the sale of governmental securities from its application.¹⁷⁴ And while admittedly this administrative remedy might face the same, if not greater, procedural difficulties entailed in proceedings under sections 32 and 33.A(2) against particular governments or agencies, at least the commissioner would have power to prevent dealers, agents, or salesmen from selling any of these securities by false advertising or other fraudulent means.¹⁷⁵

Secondly, in a carryover from the old definition, "trust" is defined not to include a testamentary trust, but presumably covers a private *inter vivos* trust, even though the objectives of the two types of trusts may be essentially the same, unless the latter is excluded by the words referring to a trust created by "a court of law or equity." The wisdom of the exclusion is questionable. Many testamentary trusts own substantial stockholdings or are created to permit trustees to control incorporated businesses.¹⁷⁶ To the extent a trust estate en-

control, water supply, water improvement, county road, navigation, hospital, levee improvement, flood control, drainage, conservation and reclamation, and municipal utility districts. MOODY'S MUNICIPAL & GOVERNMENT MANUAL 1971, at 2713.

¹⁷¹ TEX. REV. CIV. STAT. ANN. art. 581-32 (1964).

¹⁷² *Id.* art. 581-33.A(2).

¹⁷³ *Id.* art. 581-32 (authorizes injunction whenever any security is being fraudulently issued, sold, promoted, negotiated, advertised, or distributed, "including any security embraced in the subsections of Section 6, and including any transaction exempted under the provisions of Section 5"); art. 581-33.A(2) (civil remedy against any person fraudulently offering or selling a security "whether or not the security or transaction is exempt under Section 5 or 6 of this Act").

¹⁷⁴ The commissioner may issue a cease-and-desist order under the circumstances indicated as to the sale or proposed sale of any security whether exempt or not "except the sale of securities as defined in subsection A of Section 6." *Id.* art. 581-23.A. Although regulation of advertising does not apply to exempt securities or transactions, an exception is made when the advertising violates the provisions of section 23. *Id.* art. 581-22.E.

¹⁷⁵ *Id.* art. 581-23.B. For examples of possible fraud by dealers in sales of municipal bonds see articles in Wall Street J., Aug. 13, 1971, at 16, col. 3; Dec. 3, 1971, at 1, col. 1 (Southwestern ed.).

¹⁷⁶ *Cf.* TEX. PROB. CODE ANN. § 238 (1956) (operation of farm, ranch, or other business by personal representative); Connally v. W.H. Lyons & Co., 82 Tex. 664, 18 S.W. 799 (1891); Texas Candy & Nut Co. v. Horton, 235 S.W.2d 518 (Tex. Civ. App.—Dallas

gages in a distribution of its holdings or participates in securities financing for controlled businesses, why should it not be governed by the same law applied to individuals or business entities? Conversely, if the intent is to exclude private trusts altogether, but not business trusts, why not use the language of the Securities Act of 1933 or the Uniform Securities Act, which limit trusts to those in which the interests of the beneficiaries are evidenced by a security?¹⁷⁷

Thirdly, the limitation of "person" in the penal provisions of section 29 to an individual seems particularly unwise. While this may be the result anyway under the present state of the law¹⁷⁸ (although it should be noted the supreme court refused to commit itself on this point in *Dempsey-Tegeler*), there remain the possibilities that the proposed new Texas Penal Code revision,¹⁷⁹ which recognizes corporate criminal liability,¹⁸⁰ may be enacted in the near future, or that the judge-made doctrine, which gives Texas the dubious honor of being the only state which does not hold corporations criminally responsible,¹⁸¹ may be overruled. Why freeze an anachronistic concept into the statutory law, especially in a statute wherein the crimes defined are so frequently committed through use of a corporate vehicle?

In sum, the amendment, although needed to correct an unnecessarily created loophole in the securities law, has some problems of its own.¹⁸² In that sense it is typical of the frequently uncoordinated patchwork that has been done through the years on a statute which Justice McGee aptly described as "one something less than a model of lucidity in legislative drafting."¹⁸³ The

1950), *error ref. n.r.e.*; J.P. Webster & Sons v. Utopia Confectionary, 254 S.W. 123 (Tex. Civ. App.—Fort Worth 1923). See generally 5 G. BOGERT, LAW OF TRUSTS & TRUSTEES §§ 571-79 (2d ed. 1960); 3 A. SCOTT, LAW OF TRUSTS § 230.4 (3d ed. 1967); Keenan, *Business Interests in Trust*, 108 TRUSTS & ESTATES 162 (1969); Krasnowiecki, *Existing Rules of Trust Administration: A Stranglehold on the Trustee-Controlled Business Enterprise* (pts. 1 & 2), 110 U. PA. L. REV. 506, 816 (1962); Ward, *The Texas Trust Act: Discretionary Power of a Trustee*, 40 TEXAS L. REV. 356, 361 (1962); Comment, *Operation of Business by Trustees*, 1967 DUKE L.J. 321.

¹⁷⁷ 15 U.S.C. § 77b(2); UNIFORM SECURITIES ACT § 401(i).

¹⁷⁸ See note 154 *supra*.

¹⁷⁹ H.B. 419, S.B. 250, 62d Tex. Leg., Reg. Sess. (1971); STATE BAR OF TEXAS COMMITTEE ON REVISION OF THE PENAL CODE, TEXAS PENAL CODE: A PROPOSED REVISION (Final Draft Oct. 1970); see Keeton & Searcy, *A New Penal Code for Texas*, 33 TEX. B.J. 980 (1970).

¹⁸⁰ Proposed Texas Penal Code § 7.22, note 179 *supra*; see Bromberg, *Business Aspects of the Revised Penal Code*, 9 BULL. OF THE SECTION ON CORPORATION, BANKING & BUSINESS LAW, May 1971, at 1; Keeton & Searcy, *supra* note 179, at 985.

¹⁸¹ Hamilton, *supra* note 154.

¹⁸² A minor point, perhaps, but there is something circular about a definition that defines a "person" to include a "person" as the present definition in § 4.B does. Although it cannot be done without a major overhaul of the Act in view of the varying terms used, see note 151 *supra*, it would be desirable to use the one word "person" to describe all the possible categories of individuals and entities the Act should govern. This essentially is the pattern of the federal legislation and the Uniform Securities Act. 15 U.S.C. § 77b(2) (1968); UNIFORM SECURITIES ACT § 401(i). Professor Alan Bromberg suggested the following draft in a letter to Howard Wolf, March 10, 1971, circulated to members of the State Bar Committee on Securities and Investment Banking:

(1) The term "person" shall include an individual [a natural person] and a company.

(2) The term "company" shall include any of the following, whether incorporated or unincorporated, whether formed heretofore or hereafter, and whether formed under the laws of this or any other state, country, sovereignty or political subdivision thereof: corporation, person, joint stock company, partnership, limited partnership, association, firm, syndicate or trust [or government or political subdivision or agency thereof].

¹⁸³ 472 S.W.2d at 114.

Texas Securities Act badly needs restructuring, and its terminology cries out for the kind of harmonization that no number of piecemeal, ad hoc amendments can ever provide. But with the proposed Texas Uniform Securities Act apparently suspended in the deepest limbo for the foreseeable future,¹⁸⁴ it can safely be predicted that more *Dempsey-Tegeles* will come along to add another gray hair or two to the collective head of the Texas securities bar.

B. Other Cases

What Is a Security? The perennial quest of some people to separate others from their money by inducing them to invest in various business plans or arrangements glowingly described as sure ways to make money frequently winds up from the investor's standpoint with not only no money being made, but the original investment completely lost. In most instances the losers leave well enough alone—poorer but hopefully wiser about get-rich schemes. Occasionally, however, hard losers attempt to get their money back through civil litigation or complaints to law enforcement officials and agencies. In the absence of specific legislation regulating sales of own-your-own-business schemes promoted under various franchise, distributorship, or marketing plans, the only regulatory statutes that seem to offer some judicial redress are the various securities laws, state and federal. But whenever litigation or prosecutions attacking these plans or schemes are brought under the securities laws, a threshold question always recurs: Does the transaction involve the sale of a "security"?

As noted in last year's *Survey*,¹⁸⁵ the Austin court of civil appeals in *Kosco Interplanetary, Inc. v. King*¹⁸⁶ struggled with the issue of whether a cosmetic manufacturer's sale of distributorships entailed the sale of an investment contract and thus a security as that term is defined in the Texas Securities Act.¹⁸⁷ The court finally decided that under the solely-by-the-efforts-of-others test of

¹⁸⁴ The proposed Texas Uniform Securities Act was drafted by the Committee on Securities and Investment Banking, Section on Corporation, Banking and Business Law of the State Bar of Texas, and was approved by the Council of the Section and the Board of Directors of the State Bar as part of the bar's legislative program for the 1969 session of the legislature. See Bromberg, *Proposed Texas Uniform Securities Act*, 31 TEX. B.J. 1030 (1968) for a statement of the need and a brief summary of the proposal. The act was introduced as S.B. 457 and H.B. 838, 61st Leg., Reg. Sess. (1969), but was opposed by the State Securities Board and the Administrator of the S.E.C.'s Fort Worth Regional Office for Region 5, and failed to gain the support of the Texas Investment Bankers' Association. Not surprisingly, the proposed act failed to pass. Minutes, Meeting of Committee on Securities & Investment Banking, Jan. 31, 1970.

The Committee's defeat was not total, however, because during the session the State Securities Board revised its famous (or infamous, depending on one's point of view) five-fourths rule, in reality a Board interpretation of §§ 7.C(2) and 10.A of the Texas Securities Act limiting the public offering price of new securities to no more than five-fourths of the amount paid by promoters and insiders, by permitting a more flexible pricing policy reflecting market conditions for new securities offerings. For critical discussions of the old five-fourths rule see Bromberg, *supra*; Meer, *supra* note 163, at 688. One of the prime reasons for the proposed Act was to remove the statutory basis for the rule. The new interpretation and pricing policy are found in the recently compiled Board policies and interpretations available for the asking from the Board, *see* note 216 *infra*, and are discussed in Hamilton, *supra* note 13, at 99. In 1970 the Board, with the assistance and advice of the State Bar Committee, adopted additional interpretations and policies which have helped ameliorate some of the objections to the present act. These are discussed *infra* notes 214-71.

¹⁸⁵ Hamilton & Shields, *supra* note 14, at 91.

¹⁸⁶ 452 S.W.2d 531 (Tex. Civ. App.—Austin 1970), *error ref. n.r.e.*

¹⁸⁷ TEX. REV. CIV. STAT. ANN. art. 581-4.A (1964).

SEC v. W.J. Howey Co.,¹⁸⁸ no "security" had been sold. In this past year came the turn of the Texas Court of Criminal Appeals to deal with the problem.

In *Bruner v. State*¹⁸⁹ the transaction in question involved a marketing plan by a soap product distributor under which a participant, pursuant to a contract making him an area director, division manager, district supervisor, or local dealer (depending on the amount of money he paid), would purchase a certain amount of soap to be sold at dinner parties given by the company to persons he invited. Any resulting profit would be shared by the participant with the company as well as profits engendered from sales made by his invitees or their subsequent dinner guests if they should later purchase participations in the marketing plan. Bruner was charged with having solicited one Owens to participate in the plan by a \$1,350 payment to the company, thereby selling Owens an unregistered investment contract and without being a registered dealer. Resolving the conflicting testimony as to what Owens had been told against Bruner,¹⁹⁰ the jury found him guilty of selling an unregistered security. The court of criminal appeals reversed on the ground that the agreement in question did not involve the sale of a "security."

The court's opinion, written by Judge Onion, is a scholarly treatment of the subject that deserves attention. The court first notes that the phrase "investment contract," found in the Texas Securities Act's definition of a security, has no precise meaning; consequently, some test must be employed to determine whether a particular scheme is an investment contract. The test most commonly used,¹⁹¹ both in federal and state decisions,¹⁹² including several in-

¹⁸⁸ 328 U.S. 293 (1946).

¹⁸⁹ 463 S.W.2d 205 (Tex. Crim. App. 1970).

¹⁹⁰ Owens testified that he was assured he would not have to sell the soap door-to-door, but that it could be disposed of through persons he brought to dinner. Two months after paying his money, he received a warehouse receipt for some soap, although he claimed he had purchased no merchandise. When he finally tried to get his money back, he first was given a run-around and on a second visit discovered the company's office was closed and the phone disconnected. Bruner testified that he had not told Owens he would participate in the profits of any guests who later invested in the plan. He stated that he had been hired as a salesman by the company to sell the soap to participants at wholesale in quantities no less than \$300 worth per sale. The participants were then to sell the soap at retail to individuals or could dispose of it through guests invited to the company dinners. Whatever profit was made would depend entirely on the amount of soap sold.

¹⁹¹ The *Howey* case, whose test is referred to here, has more than lived up to the prediction by Professor Loss that it was destined to become the most cited case on the meaning of an "investment contract" under federal and state securities laws. L. LOSS, *supra* note 34, at 483. Virtually every case and commentary in point decided or written since its formulation cites or discusses the *Howey* test, usually at some length. The *Bruner* case discussed herein is a good example. See also authorities cited in notes 192-208 *infra*.

¹⁹² The court cites *Tcherepnin v. Knight*, 389 U.S. 332 (1967) (withdrawable capital share of savings and loan association); *Chapman v. Rudd Paint & Varnish Co.*, 409 F.2d 635 (9th Cir. 1969) (distributorship); *Los Angeles Trust Deed & Mortgage Exchange v. SEC*, 285 F.2d 162 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961) (secondary deeds of trust); *Blackwell v. Bentsen*, 203 F.2d 690 (5th Cir. 1953), *cert. dismissed*, 347 U.S. 925 (1954) (citrus groves); *Brewer v. SEC*, 145 F.2d 233 (9th Cir. 1944) (whiskey sales contracts); *Darwin v. Jess Hickey Oil Corp.*, 153 F. Supp. 667 (N.D. Tex. 1957) (oil lease); *Gallion v. Alabama Market Centers, Inc.*, 282 Ala. 679, 213 So. 2d 841 (1968) (marketing plan); *Georgia Market Centers, Inc. v. Fortson*, 225 Ga. 854, 171 S.E.2d 620 (1969) (marketing plan); *Emery v. So-Soft of Ohio, Inc.*, 94 Ohio L. Abs. 357, 199 N.E.2d 120 (App. Ct. 1964) (marketing plan, soft water conditioners); *Commonwealth ex rel. Pa. Secs. Comm. v. Consumers Research Consultants, Inc.*, 414 Pa. 253, 199 A.2d 428 (1964) (advertising commission agreement). See also *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124 (4th Cir. 1970), *on remand*, 326 F. Supp. 250 (D. Md. 1971) (oil production payments); *Continental Marketing Corp. v. SEC*, 387 F.2d 466 (10th Cir.), *cert. denied*,

volving distributorships or similar merchandising plans,¹⁹³ is that enunciated in *Howey*; i.e., "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."¹⁹⁴ But while *Howey* presents a workable formula,¹⁹⁵ it is not an ultimate determinant, as the *Koscot* holding seems to indicate.¹⁹⁶ It is a starting point, rather, in determining whether a contract, plan, or scheme is an investment contract under the Texas Securities Act and reflects a principle that is flexible rather than static in nature.¹⁹⁷ The agreement alone or the terms used by the parties to characterize their relationship are not decisive,¹⁹⁸ instead, all the circumstances must be considered to determine the true nature of the transaction. Put another way, it is the substance of the transaction, i.e., the terms of the offer, the plan of distribution, and the economic inducements held out to the

391 U.S. 905 (1967) (beavers); *United States v. Herr*, 338 F.2d 607 (7th Cir. 1964), *cert. denied*, 382 U.S. 999 (1965) (inactive distributorship); *Roe v. United States*, 287 F.2d 435 (5th Cir.), *cert. denied*, 368 U.S. 824 (1961) (oil and gas leases); *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640 (D. Colo. 1970) (franchise); *Lennerth v. Mendenhall*, 234 F. Supp. 59 (N.D. Ohio 1964) (franchise).

¹⁹³ See note 191 *supra*, *passim*. See also cases cited in note 201 *infra*.

¹⁹⁴ 328 U.S. at 298.

¹⁹⁵ The *Howey* test has two basic elements: (1) a common enterprise; (2) profits are to result solely from the efforts of others. Sometimes another element is added, i.e., (3) investment of money, this being derived from a somewhat fuller statement by Mr. Justice Murphy in *Howey* defining an investment contract for purposes of the Securities Act as "a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise." 328 U.S. at 298, 299. See Long, *An Attempt To Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 142 (1971). Three years earlier the Court passed up an opportunity to define the term in a similar case, *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), although holding that the sale of assignments in oil and gas leases with the promoter promising to drill test wells came under the investment contract concept in the Securities Act of 1933.

The background and historical development of the *Howey* test are discussed in some detail in Coleman, *A Franchise Agreement: Not a "Security" under the Securities Act of 1933*, 22 BUS. LAW. 493, 498 (1967); Long, *supra*, at 146. As might be expected, considerable gloss on the *Howey* formula has been added by subsequent decisions and the extensive commentary on the securities law aspects of the investment contract, especially in regard to franchising. See discussion in text and authorities cited in notes 197-204 *infra*. Because some courts tend to apply *Howey* literally, the formulation has been criticized as being economically unrealistic in not focusing on the risk of loss of the initial investment in an enterprise with which the investor is not familiar and over which he has no real control, and for overlooking investments made in the form of services, as in the marketing plan involved in the instant *Bruner* decision. For thoughtful criticisms of *Howey* and suggested alternative formulae see Coffey, *The Economic Realities of "Security": Is There a More Meaningful Formula*, 18 W. RES. L. REV. 367 (1967); Long, *supra*, at 159. See also Note, *Regulation of the Franchise as a Security*, 19 J. PUB. L. 105, 124 (1970). Professor Coffey's test was adopted in State *ex rel.* Comm'r of Secs. v. Hawaii Market Center, Inc., 485 P.2d 105 (Hawaii 1971), in preference to *Howey*, which was faulted for its weakness in leading courts to analyze investment projects mechanically and become entrapped in polemics over the meaning of "solely" from the efforts of others. 485 P.2d at 108.

¹⁹⁶ "It is our opinion that the marketing plans of Koscot do not fall within the meaning of 'Security' prescribed by Art. 581-4.A, for the reason that the investors in such plans do not depend solely upon the efforts of others for income and profit." *Koscot Interplanetary, Inc. v. King*, 452 S.W.2d 531, 539 (Tex. Civ. App.—Austin 1970), *error ref. n.r.e.*

¹⁹⁷ The Court so states in *Howey*, describing the definition as one "that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." 328 U.S. at 299. *Accord*, *Tcherepnin v. Knight*, 389 U.S. 332, 338 (1967).

¹⁹⁸ *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 352 (1943); *Chapman v. Rudd Paint & Varnish Co.*, 409 F.2d 635 (9th Cir. 1969); *SEC v. Bailey*, 41 F. Supp. 647, 650 (D.D.C. 1941).

prospect, and not the form of the arrangement that counts.¹⁹⁹ Hence, while under a strict interpretation of the *Howey* test any participation by the investor negates the existence of an investment contract, mere token participation on his part should not prevent a finding that a security has been sold.²⁰⁰ Nevertheless, in the instant case it was clear from the agreement and the facts that Owens was not just a passive investor; whatever profits he made had to come from his actual and continued participation. The arrangement, thus, was not an investment contract, and no security was sold.

While the decision in *Bruner* accords with the probable weight of authority,²⁰¹ the willingness of some courts,²⁰² administrators,²⁰³ and commentators²⁰⁴

¹⁹⁹ SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 352-53 (1943); see *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1127 (4th Cir. 1970); *Continental Marketing Corp. v. SEC*, 387 F.2d 466, 470 (10th Cir.), *cert. denied*, 391 U.S. 805 (1967).

²⁰⁰ The court states that it fully agrees with the position taken by the Georgia Supreme Court in *Georgia Market Centers, Inc. v. Fortson*, 225 Ga. 854, 171 S.E.2d 620, 623 (1969), that the *Howey* definition should not be adhered to "with such strictness that a mere token participation in an enterprise by the person investing capital would prevent the contract from being classed as a security." 463 S.W.2d at 213. The issue turns on whether the phrase "solely from the efforts" of others is to be taken literally. As previously indicated, some courts do. See note 192 *supra*. See also, e.g., *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640 (D. Colo. 1970); *Goldsmith v. American Food Services, Inc.*, 123 Ga. App. 353, 181 S.E.2d 95 (1971); *Gallion v. Alabama Market Centers*, 282 Ala. 679, 213 So. 2d 841 (1968). As an attorney for the Texas Securities Board is reported to have said, all that would be needed to defeat the *Howey* test if applied literally would have been for the promoter to have required the investor to pick a single orange, thereby participating, even if in a minuscule way, in creating the fund from which he would have received his investment. Long, *supra* note 195, at 145. See *Blackwell v. Bentsen*, 203 F.2d 690 (5th Cir.), *cert. dismissed*, 347 U.S. 925 (1953), applying the *Howey* test, but still finding a securities transaction in the sale of citrus groves, even though the contract gave the investor the right to direct the marketing of his crop by the management company.

²⁰¹ See, e.g., *Chapman v. Rudd Paint & Varnish Co.*, 409 F.2d 635 (9th Cir. 1969); *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640 (D. Colo. 1970); *Gallion v. Alabama Market Centers, Inc.*, 282 Ala. 679, 213 So. 2d 841 (1968); *Georgia Market Centers, Inc. v. Fortson*, 225 Ga. 854, 171 S.E.2d 620 (1969); *Goldsmith v. American Food Services, Inc.*, 123 Ga. App. 353, 181 S.E.2d 95 (1971); *Emery v. So-Soft of Ohio, Inc.*, 94 Ohio L. Abs. 357, 199 N.E.2d 120 (App. Ct. 1964); *Commonwealth ex rel. Pa. Secs. Comm. v. Consumers Research Consultants, Inc.*, 414 Pa. 253, 199 A.2d 428 (1964).

²⁰² See, e.g., *Continental Marketing Corp. v. SEC*, 387 F.2d 466 (10th Cir.), *cert. denied*, 391 U.S. 905 (1967) (beavers); *United States v. Herr*, 338 F.2d 607 (7th Cir.), *cert. denied*, 382 U.S. 999 (1964) (inactive distributorship); *Bond v. Koscot Interplanetary, Inc.*, 246 So. 2d 631 (Fla. App. 1971) (marketing plan); *Florida Discount Centers, Inc. v. Antinori*, 226 So. 2d 693 (Fla. App. 1969), *aff'd and opinion adopted*, 232 So. 2d 17 (Fla. 1970) (marketing plan); *State ex rel. Comm'r of Secs. v. Hawaii Market Center, Inc.*, 485 P.2d 105 (Hawaii 1971) (founder-member agreement); *State ex rel. Healy v. Consumer Business Systems, Inc.*, 482 P.2d 549 (Ore. 1971) (advertising franchise); *D.M.C. of Colorado, Inc. v. Hays*, [1961-1971 Transfer Binder] BLUE SKY L. REP. ¶ 70,897 (Colo. Dist. Ct., Denver, 1971) (marketing plan); *People v. Dutch Inns, Inc.*, No. 41199 (N.Y. Sup. Ct., N.Y. County, 1969), and *People v. Buffalo Franchise Corp.*, No. 40939 (N.Y. Sup. Ct., N.Y. County, 1969) (consent orders by New York attorney general in franchise cases) [cited in G. GLICKMAN, FRANCHISING § 8.02[2] n.29 (1971)]; Goodwin, *Regulation of Franchising in Non-Antitrust Fields, Particularly in Application of Securities Laws*, in *PLI, FRANCHISING—TODAY'S LEGAL AND BUSINESS PROBLEMS* 293, 305 (L. Ratner ed. 1970)]; *John Rich Enterprises, SEC Lit. Rel. 4485* (San Francisco Regional Office, Nov. 25, 1969) (franchise) [cited in C. ROSENFELD, THE LAW OF FRANCHISING 286 (1970)]; cf. *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961).

²⁰³ See 49 CAL. ATT'Y GEN. OPS. 124 (1967) (franchise); *In re Discount Mart Corp.*, 3 BLUE SKY L. REP. ¶ 71,003 (Okla. Secs. Dept. 1970) (founder-member contract); Letter from Arthur K. Bolton, Attorney General of Georgia, to Ben W. Fortson, Jr., Corporation Commissioner of Georgia, Nov. 14, 1969 [cited in Note, *supra* note 195, at 121 n.102]. The California Attorney General's opinion posited three hypothetical situations: (1) when the franchisee participates only nominally in the franchised business; (2) when the franchisee participates actively; and (3) when the franchisee participates actively, but the fran-

to expand the concept of an investment contract within the framework of the securities laws indicates a growing concern that a lacuna exists that must be filled. So long as the courts adhere to the general dimensions of the *Howey* formulation, it should not be too difficult for promoters of various franchises and distributorship plans to tailor their agreements and procedures to avoid securities regulation. Yet experience shows that often the same sort of people who were sold the very blue sky itself which led to securities legislation being passed to protect them are likely to be the ones who succumb to the allurements of unlimited riches through pyramiding distributorship and marketing plans, which, as the *Bruner* case illustrates, are difficult to fit into the securities regulation scheme.²⁰⁵ The answer is not a strained construction of the definition of a security,²⁰⁶ but legislation regulating all arrangements whereby inexperienced and uninformed investors are induced to pay for participation in the distribution of products or services as part of general marketing operations over which they have little or no control and yet are largely financed by their own investments.²⁰⁷

chisor needs to secure a substantial portion of his own initial capital from fees from franchisees to provide the goods and services promised. A sale of a security was deemed involved in situations (1) and (3), but not (2). In situation (3) the franchisee's furnishing of the franchisor's risk capital was considered a separate business venture from the one in which he participated. This "risk-capital" test was used by the Oregon Supreme Court to hold that if a substantial portion of the initial capital that a franchisor uses to commence its operations is being provided by franchisees, then a security is being sold. "We believe that the 'risk capital' test is a sound tool to use in analyzing franchising agreements in order to determine whether or not they need to be registered so as to apprise the investing public of the risks involved in an enterprise." *State ex rel. Healy v. Consumer Business System, Inc.*, 482 P.2d 549, 556 (Ore. 1971). The California opinion is further discussed in Augustine & Hrusoff, *Franchising under the Securities Act of 1933 and the California Corporation Code*, 44 LOS ANGELES B. BULL. 555 (1969); Comment, *Franchise Regulation under the California Securities Law*, 5 SAN DIEGO L. REV. 140 (1968).

²⁰⁴ For authorities supporting the view that franchising and similar marketing plans can be subsumed under the securities laws see H. BROWN, *FRANCHISING: TRAP FOR THE TRUSTING* 70-76 (1969); Goodwin, *supra* note 202, at 293; Coffey, *supra* note 195; Goodwin, *Franchising in the Economy: The Franchise Agreement as a Security Under Securities Acts, Including 10b-5 Considerations*, 24 BUS. LAW. 1311 (1969); Long, *supra* note 195; Note, *supra* note 195; Comment, *Franchise Agreement: A Security for Purposes of Regulation*, 1970 U. ILL. L. FORUM 130. The only commentator arguing strongly to the contrary is Coleman, *supra* note 195. See generally G. GLICKMAN, *supra* note 202, at § 14.07[1]; C. ROSENFELD, *supra* note 202, at 283-88; Knauss, *Securities Problems in Franchising*, in INSTITUTE OF CONTINUING LEGAL EDUCATION, *THE FRANCHISING PHENOMENON* 129 (1969); Augustine & Hrusoff, *Franchise Regulation*, 21 HASTINGS L.J. 1347, 1353 (1970); Flynn, *The Regulation of Franchise Sales*, J. KANS. B. ASS'N 121 (1971); Green, *Regulation of Franchising Under the Securities Laws*, 6 GA. STATE B.J. 357 (1970); Comment, *Franchise Sales: Are They Sales of Securities?*, 34 ALBANY L. REV. 383 (1970); Comment, *Franchise as a Security: Application of the Securities Law to Owner-Operated Franchises*, 11 B.C. IND. & COM. L. REV. 228 (1970); Note, *Investment Contracts Under Federal and State Law*, 17 W. RES. L. REV. 1108 (1966).

²⁰⁵ "The language used by franchise companies often bears a startling similarity to the jargon of the securities field. It is not uncommon to read of investments, absentee ownership, yield and promises of security. The life blood of the franchisor is the continuing income generated by the investments and royalty payments of the franchisees." C. ROSENFELD, *supra* note 202, at 283.

²⁰⁶ As the court in *Bruner* observed, quoting the same observation made in *Koscot Interplanetary, Inc. v. King*, "not all 'get rich schemes' are a 'security' If fraud be involved, redress must be found elsewhere than in the penal provisions of the Securities Act." 463 S.W.2d at 215.

²⁰⁷ See, e.g., the California Franchise Investment Law, enacted in 1970. CAL. BUS. & PROF. CODE § 10177 (West 1971); CAL. CORP. CODE §§ 25019, 25212, 31000-31516 (West 1971). The California legislation, which is quite comprehensive, is discussed in G. GLICKMAN, *supra* note 202, § 8.03[1]; Augustine & Hrusoff, *California Franchise Invest-*

"Sale to Registered Dealer" Exemption. The relationship between two of the transaction exemptions in the Texas Securities Act provided the basis for a decision by the United States Court of Appeals for the Tenth Circuit.²⁰⁸ In the diversity action the plaintiff sued a Colorado bank and its president to recover a commission for the sale of stock in a Texas corporation made by the bank as trustee of an *inter vivos* trust. The plaintiff had been promised a commission of \$1 per share to find a buyer for the stock, and ultimately through his efforts the stock was sold through one Texas broker-dealer to another securities dealer firm. To the defendants' assertion that because the plaintiff was not a licensed securities dealer, his claim for commissions was barred under the Texas Securities Act,²⁰⁹ the plaintiff claimed, and was upheld by the trial court and the Tenth Circuit, that the transactions were exempt under section 5.H, which exempts sales made to, among others (mostly institutional investors), "any registered dealer actually engaged in buying and selling securities."²¹⁰

The defendants argued, however, that under section 5.C, permitting isolated sales by individual investors not engaged in the securities business, the

ment Law, 46 J. STATE B. CALIF. 50 (1971); Damon, *Franchise Investment Law*, 2 PAC. L.J. 27 (1971); and is noted briefly in 9 BULL. OF THE SECTION ON CORPORATION, BANKING & BUSINESS LAW, Jan. 1971, at 6. The text of the law and the implementing administrative rules may be found in PLI, FRANCHISE LITIGATION AND LEGISLATION 283 (R. Needham ed. 1971). See also The Franchise Investment Law, California Commissioner of Corporations Release No. 20-C (Oct. 21, 1970); 1 BLUE SKY L. REP. ¶ 8670 (1972).

Legislation in other states has been more limited. Delaware passed a franchise termination law prohibiting unfair termination of franchises, ch. 693, [1970] Del. Laws, amending DEL. CODE ANN. tit. 6, ch. 25 (codified at §§ 2551-57); Florida has enacted a fairly short statute regulating franchising and distributorships, ch. 71-61, [1971] Fla. Laws 187; and Massachusetts has a new law regulating multi-level distributing companies (marketing plans), ch. 1025, [1971] Mass. Laws 640 (codified at MASS. GEN. LAWS ANN. ch. 93, § 69). An effort was made at the 1971 regular session of the Texas Legislature to make franchising a form of business association to permit the rules of mutual agency and fiduciary responsibility applicable to all business associations to govern franchising, but the measure died in conference committee. See Hytken & Pelletier, *Doing Business in Texas: A Legal Briefing for the Incoming Franchisor*, 35 TEX. B.J. 23, 32 (1972); *Proposed Legislation: Franchising*, 9 BULL. OF THE SECTION ON CORPORATION, BANKING & BUSINESS LAW, May 1971, at 12. During 1969-1970 two bills were introduced in Congress by Senators Hart and Williams to regulate franchising, but neither passed. See G. GLICKMAN, *supra* note 202, § 8.04. The Hart bill, to have been known as the Federal Fairness in Franchising Act, is set out in C. ROSENFELD, *supra* note 202, at 313.

²⁰⁸ *Gerchshaimer v. American Heritage Bank & Trust Co.*, 437 F.2d 1332 (10th Cir. 1971).

²⁰⁹ TEX. REV. CIV. STAT. ANN. art. 581-34 (1964). Exempt transactions and sales of exempt securities are expressly excluded from the bar.

²¹⁰ Defendants argued that it had not been shown that the purchasers of the securities were registered dealers "actually engaged in buying and selling securities" so as to exempt the transaction under § 5.H; however, the court found the proof sufficient. The quoted language has been interpreted to mean that to claim the exemption it must be shown that securities transactions are the main course of business of the registered transferee. *Development Inv. Corp. v. Diversa, Inc.*, 393 S.W.2d 653, 657 (Tex. Civ. App.—Texarkana 1965). *But see* § 4.C, which defines a "dealer" to include a person who engages in any transaction involving the disposition of a security or securities on a full or part-time basis. See also cases holding that the definition must be interpreted broadly and will cover one engaging even in a single or isolated transaction. *Breeding v. Anderson*, 152 Tex. 92, 254 S.W.2d 377, 380 (1953); *Dean v. State*, 433 S.W.2d 173, 177 (Tex. Crim. App. 1968); *Flournoy v. Gallagher*, 189 S.W.2d 108, 111 (Tex. Civ. App.—Eastland 1945); *Cosner v. Hancock*, 149 S.W.2d 239, 241 (Tex. Civ. App.—El Paso 1941), *error dismissed*. When the sale has been made to a registered dealer and no question is raised that he was not engaged in the buying and selling of securities, the § 5.H exemption obviously applies. *Dunnam v. Dillingham*, 345 S.W.2d 314, 318 (Tex. Civ. App.—Austin 1961) (sale of options for oil and gas leases to registered dealer).

proviso therein that "in no event shall such sales or offerings be exempt from the provisions of this Act when made or intended by the vendor or his agent, for the benefit, either directly or indirectly, of any company or corporation except the individual vendor,"²¹¹ barred the application of any exemption, including 5.H, under the Act since the bank was selling the stock for the benefit of the beneficiaries, who, though individuals, would come under the Act's definition of "company."²¹² Disagreeing, the Tenth Circuit held that the proviso is limited to the isolated-sales exemption and, therefore, cannot be applied wholesale to preclude reliance on the other exemptions in section 5. The interpretation is sound, for it seems evident the proviso was intended to apply to situations in which a controlling shareholder purports to sell some of his personal holdings, but in reality intends to use the proceeds for the issuer.²¹³ Otherwise, under the defendants' rejected interpretation every sale of stock by a fiduciary for the benefit of others would have to be registered.

C. Administrative Developments

Board Interpretations and Policies. One of the significant administrative deficiencies of the Texas Securities Act is that it fails to give general rule-making power to the State Securities Board.²¹⁴ Nevertheless, the Board has been able to make its views known on some matters through the periodic issuance of Board policies and interpretations.²¹⁵ Recently, the current policies and interpretations still being followed were assembled and indexed by Act section numbers, and presently are available for distribution on request.²¹⁶ Certainly any attorney who does not subscribe to a blue sky law service ought to obtain a copy not only to gain a perspective on the Board's point of view, but also for guidance on the meaning of a number of provisions of the Securities Act that have never been judicially construed.

New Interpretations. In September 1970, several new interpretations of the Act were adopted by the Board,²¹⁷ and since they have not been noted in earlier *Surveys*, a brief summary of their content is given here.

²¹¹ TEX. REV. CIV. STAT. ANN. art. 581-5.C (1964).

²¹² *Id.* art. 581-4.B.

²¹³ See Gilchrist & Hanna, *Secondary Distribution of Corporate Securities*, 13 SW. L.J. 1, 41 (1959).

²¹⁴ See Meer, *supra* note 163, at 705; 3 BLUE SKY L. REP. ¶ 46,601 (1971). The proposed Texas Uniform Securities Act, § 412.A, would have given the State Securities Board general rule-making power. See Bromberg, *Report on Texas Uniform Securities Act*, 7 BULL. OF THE SECTION ON CORPORATION, BANKING & BUSINESS LAW, Apr. 1969, at 6.

²¹⁵ In 1960 the Texas Attorney General ruled the Board could issue an administrative interpretation of certain phrases in § 10.A of the Act. TEX. ATT'Y GEN. OP. No. WW-951 (1960). However, the Board had issued administrative interpretations of the Act prior to that date, see, e.g., 3 BLUE SKY L. REP. ¶¶ 46,631-34 (1971), and has continued the practice since. The Board also issues statements of policy from time to time; presumably these are intended to reflect factors that will influence the Board or the Securities Commissioner in making a specific administrative decision in areas in which because of the range of discretionary action that can be taken adherence to a definitive interpretation is thought too constricting on the administrator.

²¹⁶ Requests should be addressed to the State Securities Board, Post Office Box 13167, Capitol Station, Austin, Texas 78711. The Board's interpretations and policies may also be found in 3 BLUE SKY L. REP. ¶¶ 46,631-52, 46,662-67 (1971).

²¹⁷ The new interpretations are largely the product of a joint study made by the Securities Commissioner, the Deputy Commissioner, and members of the staff of the State Securities

(1) *Excluded Options*. Restricted stock options, qualified stock options, or options granted under an employee stock-purchase plan meeting the requirements of sections 421-25 of the Internal Revenue Code of 1954²¹⁸ will not be regarded as "securities" as defined in section 4.A of the Act,²¹⁹ nor will the

Board, and the Committee on Securities and Investment Banking of the Section on Corporation, Banking and Business Law of the State Bar of Texas, and more particularly by a subcommittee of the Bar group on administrative interpretations of the Act. In the course of the study existing interpretations and policies were reviewed and special consideration was given problem areas encountered in the Act's administration or in practice under it that might be resolved or clarified through additional interpretations or policy statements. Both the staff and the subcommittee (which soon became almost a committee of the whole) prepared proposed new regulations, and these were reviewed at a meeting in Austin on Aug. 12, 1970, between the Securities Commissioner and members of his staff and the full Bar committee. The new interpretations and policies were adopted by the Securities Board on September 18, 1970, substantially in the form agreed upon and recommended as a result of the joint meeting. The Bar committee's proposals are summarized in Report of Committee on Securities and Investment Banking on Administrative Interpretations of the Texas Securities Act, 9 BULL. OF THE SECTION ON CORPORATION, BANKING & BUSINESS LAW, Sept. 1970, at 2 [hereinafter cited as Securities Committee Report on Administrative Interpretations].

²¹⁸ INT. REV. CODE OF 1954, §§ 421-25.

²¹⁹ Despite the interpretation, it is arguable that the stock options specified are covered in § 4.A by such phrases as "subscription or reorganization certificate" (emphasis added) or the catch-all "any other instrument commonly known as a security, whether similar to those herein referred to or not." Admittedly, § 4.A does not explicitly mention a "warrant or right to subscribe to or purchase, any of the foregoing [securities]" as found in the Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) (1971), or in the UNIFORM SECURITIES ACT § 401(1)—language which seemingly covers a stock option. Also, since to attain favorable tax status these options must necessarily be personal to, and nontransferable by, their grantees (except in the event of death), an essential characteristic of a security, *i.e.*, negotiability, is lacking, thus making them something other than the kind of securities which need securities regulation. See 2 G. WASHINGTON & V. ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE 801 (3d ed. 1962). Moreover, there is respectable authority that a nontransferable option, which is an incident to a contract for personal services, may not be a security at all. 1 L. LOSS, *supra* note 34, at 467 (Supp. 1969).

Nevertheless, the very fact that an interpretation is necessary suggests some doubt about the matter. Considering the broad interpretation courts and administrators give statutory definitions of a security, *see, e.g.*, note 197 *supra*, it seems difficult to believe a contractual right to purchase stock is not another "instrument commonly known as security" within § 4.A. The fact that an option's transferability is limited should be no different than the restrictions imposed on transferability of ordinary stock in a close corporation, *see* discussion at notes 354-60 *infra*, and relates more to contractual limits on the exercise of the right rather than determining its classification. Vernava, *Stock Options: Corporate, Regulatory, and Related Tax Aspects*, 30 U. PITT. L. REV. 197, 235-36 (1968). Under the federal securities laws the factor of nontransferability is not conclusive in determining whether a stock option is a security. *See, e.g., In re Middle South Utils., Inc.*, 40 S.E.C. 509 (1961) (nontransferable restricted stock option is a "security" within § 2(a)(16) of Public Utility Holding Company Act of 1935, 15 U.S.C. § 79b(a)(16) (1970), defined to include a "warrant or right to subscribe to or purchase" any security); SEC Securities Act Release No. 33-3210 (1947) (nontransferable warrant may be security under Securities Act of 1933); SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1962), *rev'd on other grounds*, 401 F.2d 833 (2d Cir. 1968) (stock option a security under Securities Exchange Act of 1934); SEC rule 16b-3, 17 C.F.R. § 240.16b-3 (1971) (exempting acquisition of tax-recognized stock options from § 16(b); if options were not securities, no exemption would be needed). *See also* SEC Securities Act Release No. 33-4790 (July 20, 1965), 30 Fed. Reg. 9059 (1965), stating that under specified circumstances, participations in a tax-recognized employee stock purchase plan may become separate securities requiring registration apart from the stock to be purchased. Of course, the stock to be acquired under such options or purchase plans may have to be registered if publicly offered. *See* SEC v. Ralston Purina Co., 346 U.S. 119 (1953). Corporations which report under §§ 13 or 15(d) of the Securities Exchange Act, 15 U.S.C. §§ 78m, 78o(d) (1970), may use a short-form registration under Form S-8 for securities to be offered to employees pursuant to certain plans. 17 C.F.R. § 239.16b (1971).

But even if a stock option is a security, the securities laws need not apply unless there is an actual or attempted disposition of it. This suggests a more logical, and indeed a more accepted securities law basis for the interpretation, namely that the grant of the option involves no sale or acquisition thereof for "value," as that term is used in securities regulation,

holders of any such options be considered "security holders" or "purchasers of securities" as used in sections 5.E and 5.I.²²⁰ Although an argument can be made that the interpretation should be based on a no-sale rather than a no-security concept,²²¹ the reason for the Board's action is understandable. The purpose of the interpretation is to eliminate any need for regarding the holders of such options as persons to whom rights offerings exempted by section 5.E need be made, or having them counted in calculating the extent of the small private offerings exemption in section 5.I. If options are securities, then those to whom they are granted would have to be "security holders"; on the other hand, under either sections 4.A or 4.E, option grantees cannot be "purchasers of securities." Given the unsettled status of option holders under the Texas Securities Act, the interpretation should prove useful, whatever its antecedents should properly be.

(2) *Investment Advisers.* Unlike federal legislation²²² and some state securities laws,²²³ the Texas Securities Act does not directly regulate investment advisers except for an oblique inclusion of one "rendering services as an investment adviser" in the definition of "dealer" in section 4.C. The gap has been filled to some extent by a new interpretation which defines "investment adviser" as including every person or company who for a fee engages in the business of advising the public on the value or advisability of investment in, purchase, or sale of securities, or who for compensation and as part of a regular business issues analyses or reports on securities.²²⁴ Exceptions are made for banks, lawyers, accountants, broker-dealers, and publishers giving investment advice incidental to their main activities. A person or company fitting

since the grantee receives the option as an incident of his employment and not because of an investment decision on his part. See 1 L. LOSS, *supra* note 34, at 673; Bromberg, *Texas Exemptions for Small Offerings of Corporate Securities*, 18 SW. L.J. 537, 544 (1964) [hereinafter cited as Bromberg, *Exemptions for Small Offerings*]; Dean, *Employee Stock Options*, 66 HARV. L. REV. 1403, 1448 (1953); Vernava, *supra*, at 237-39. It would appear more appropriate, therefore, to say that the granting of the options does not involve a sale under § 4.E, especially since that section expressly includes "an option for sale" within the definition of "sale" or "offer for sale" to mean every disposition or attempt to dispose of a security for value. However, while there may not be value in a securities law sense, there must be some assurance of continued service to the corporation to provide adequate consideration for the awarding of such options from a corporate law standpoint, see HENN 493, and, needless to say, such option or purchase plans must be properly authorized in the first place. See, e.g., TEX. BUS. CORP. ACT ANN. art. 2.22D (1956).

For general discussions of various employee compensation plans involving corporate securities, including restricted or qualified stock option or purchase plans, see G. WASHINGTON & V. ROTHSCHILD, *supra*, at 795-847; Dean, *supra*, at 1442; Hyde, *Employee Stock Plans and the Securities Act of 1933*, 16 W. RES. L. REV. 75 (1964); Kelly & Green, *Application of Section 16(b) of the Securities and [sic] Exchange Act of 1934 to Insiders' Transactions Under Employee Stock Option Plans*, 17 BUS. LAW. 402 (1962); Vernava, *supra*, at 231-90 (an excellent treatment of the subject); Wheat, *Securities Regulation Aspects of Employee Stock Options under the 1964 Revenue Act*, U. SO. CAL. 1965 TAX INST. 151.

²²⁰ Texas Securities Board Policies & Interpretations No. 2, at I-A(2) (Sept. 18, 1970), 3 BLUE SKY L. REP. ¶ 46,647 (1970).

²²¹ See note 219 *supra*.

²²² Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (1971).

²²³ See, e.g., CAL. CORP. CODE §§ 25009, 25230-37 (West Supp. 1971); ILL. ANN. STAT. ch. 121½, §§ 137.2-11, 137.8D (Supp. 1972); PA. STAT. ANN. tit. 70, §§ 32(m), 33, 34, 41, 44(b) (1965); cf. UNIFORM SECURITIES ACT § 401(f).

²²⁴ Texas Securities Board Policies & Interpretations No. 3, at I-A(3-4) (Sept. 18, 1970), 3 BLUE SKY L. REP. ¶ 46,648 (1970).

the designation must register under section 12 as "an investment adviser,"²²⁵ and employees and agents of such persons or companies who are employed, appointed, or authorized to give investment advice, *i.e.*, investment analysts, must be registered as salesmen or agents under the Act.²²⁶

(3) *Rights Offerings*. Section 5.E exempts securities offerings made by an issuer to its existing security holders so long as no remuneration or commissions are involved except for a stand-by commitment. Holders of convertible securities and nontransferable warrants are expressly included in the category of existing security holders; under the Board's interpretation this excludes holders of transferable warrants.²²⁷ Moreover, the offering does not have to be made to all the existing security holders of an issuer or to all the holders of a class or series of securities.²²⁸

(4) *Small Offerings*. Among the transaction exemptions recognized by the Texas Securities Act, surely the small offering exemptions spelled out in section 5.I²²⁹ rank among the most important. The 5.I exemptions are somewhat involved and have been exhaustively analyzed by Professor Alan Bromberg in a definitive study²³⁰ written shortly after their substantial amendment in 1963.²³¹ In essence they exempt (a) sales up to thirty-five security holders, (b) sales pursuant to certain employee stock option plans, and (c) sales to no more than fifteen persons per year. In the few years since their adoption several questions concerning their meaning have arisen, some engendered by litigation,²³² changes in federal legislation,²³³ the language of the statute it-

²²⁵ TEX. REV. CIV. STAT. ANN. art. 581-12 (1964) refers only to registration of dealers and others selling securities and makes no mention of registration as an investment adviser. The Board has prescribed a form, however, for application for a license as a general securities dealer or investment adviser for corporations and partnerships. 3 BLUE SKY L. REP. ¶ 42,011 (1971).

²²⁶ The interpretation is intended to remove any doubt that a securities analyst employed by a registered dealer who engages in research or investment advisory activities is a salesman or agent who must register as provided in § 12. Securities Committee Report on Administrative Interpretations 4.

²²⁷ Texas Securities Board Policies & Interpretations No. 5, at I-A(6) (Sept. 18, 1970), 3 BLUE SKY L. REP. ¶ 46,649 (1970). Under the interpretation of § 4.A discussed in note 219 *supra*, grantees of restricted or qualified stock options or options granted under an employee stock purchase plan meeting the requirements of INT. REV. CODE of 1954, §§ 421-25 are also excluded as security holders.

²²⁸ Texas Securities Board Policies & Interpretations No. 5, at I-A(6) (Sept. 18, 1970), 3 BLUE SKY L. REP. ¶ 46,649 (1970). An offering to less than all the holders of a class or series may involve a problem of preemptive rights of shareholders to acquire unissued or treasury shares being offered unless such rights have been limited or denied in the articles of incorporation. TEX. BUS. CORP. ACT ANN. art. 2.22C (1971); see 1 I. HILDEBRAND, *supra* note 117, at 565-75; N. LATTIN, *supra* note 117, at 493-500.

²²⁹ TEX. REV. CIV. STAT. ANN. art. 581-5.I (1964).

²³⁰ Bromberg, *Exemptions for Small Offerings*.

²³¹ Ch. 170, § 4, [1963] Tex. Laws 474. The amendments provided a badly needed exemption for private placements that did not exist under the prior law (except for sales to certain institutional investors and registered dealers) once the corporation reached 35 shareholders. Comment, 1B TEX. REV. STAT. ANN. 17 (1964).

²³² See note 239 *infra*.

²³³ The reference in § 5.I(b) to an "employees' restricted stock option" was quickly outdated by changes made in the Revenue Act of 1964, which virtually limited restricted stock options to those granted before 1964 and recognized two other kinds of options, qualified stock and those granted pursuant to an employees' stock purchase plan. INT. REV. CODE of 1954, §§ 422-24; see note 219 *supra*; Bromberg, *Exemptions for Small Offerings* 543. See also discussion in text accompanying note 265 *infra*. Shortly after adoption of the federal legislation, the Board adopted an interpretation, effective May 22, 1964, construing "restricted stock options" as used in § 5.I(b) to include qualified stock purchase options and em-

self,²³⁴ and administrative procedures; while others have been suggested by commentators²³⁵ and practitioners.²³⁶ The Board has attempted to resolve some of these by informal interpretations or informal practice.²³⁷ Now, most of the questions are answered in a new, comprehensive administrative interpretation of section 5.I,²³⁸ as the following analysis indicates.

(a) *Public Solicitation or Advertisements.* The exemptions granted in section 5.I are all conditioned by an initial proviso that to be exempt the sales thereunder must be made "without any public solicitation or advertisements." In 1965 this language was interpreted by the Beaumont court of civil appeals in *Tumblewood Bowling Corp. v. Matise*²³⁹ to mean that any use of a pamphlet or brochure to aid in the sale of securities would be deemed advertising and defeat the use of the exemption.²⁴⁰ Although criticized for misconstruing the law, misunderstanding the nature of advertising, and ignoring the purpose of the small offering exemption,²⁴¹ the *Tumblewood* case remains the only judicial construction of what constitutes an advertisement and seemingly bars use of any written informational material in connection with a small offering. On the other hand, the statutorily prescribed content of the notice that must be filed under 5.I(c) in conjunction with a fifteen-persons-a-year offering (to which the "advertisements" language also applies) requires that "reasonable information concerning the plan of business and the financial condition of the issuer" be furnished to prospective purchasers. It seems difficult to believe this means only orally communicated information. And by the same token, what does "without any public solicitation" mean? Although sensibly interpreted by the courts,²⁴² does the phrase

ployees' stock purchase plans under the Internal Revenue Code. 3 BLUE SKY L. REP. ¶ 46,637 (1970).

²³⁴ For example, in counting the 35 persons under § 5.I(a) or the 15 persons under § 5.I(c), do husband and wife count as one or two persons if community funds were used to acquire securities in the corporation? See discussion in text accompanying note 260 *infra*. Similarly, in § 5.I(c) purchasers of exempt or registered securities or those who acquired securities in exempt transactions are not counted in the 15-person limitation. Does this also apply to securities sold under § 5.I(a) and (b)? See discussion in text accompanying note 264 *infra*.

²³⁵ See generally Bromberg, *Exemptions for Small Offerings*.

²³⁶ See Securities Committee Report on Administrative Interpretations 3.

²³⁷ See Bromberg, *Exemptions for Small Offerings* 541, 544.

²³⁸ Texas Securities Board Policies & Interpretations No. 7, at I-A(8-11) (Sept. 18, 1970), 3 BLUE SKY L. REP. ¶ 46,650 (1970).

²³⁹ 388 S.W.2d 479 (Tex. Civ. App.—Beaumont 1965), *error ref. n.r.e.*

²⁴⁰ *Id.* at 483.

²⁴¹ See Bromberg, *Texas Exemptions for Small Offerings of Corporate Securities—The Prohibition on Advertisements*, 20 SW. L.J. 239 (1966), for a thorough dissection of the *Tumblewood* case and a thoughtful consideration of its consequences. The case is also critically noted in 4 BULL. OF THE SECTION ON CORPORATION, BANKING & BUSINESS LAW, Oct. 1965, at 1.

²⁴² In the *Tumblewood* case itself the court quite properly held that contacting 250 persons, including a number of strangers, about purchasing stock in a corporation was a "public solicitation" in the sale of securities. 388 S.W.2d at 483. The court quotes the holding in *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953), the leading case on the public offering concept under the Securities Act of 1933, that to be public, an offering need not be open to the whole world. However, it did not take note of the other criteria of a private offering given in *Ralston Purina*, see note 243 *infra*, thus leaving open for the time being the question whether federal private offering concepts were being incorporated into the Texas law. (Had the court stopped with the public solicitation holding and not gone on to use its unfortunate language *supra* concerning advertisements, the opinion would have been a good one; see Bromberg, *supra* note 241, at 242). In *Birchfield v. State*, 401 S.W.2d 825 (Tex. Crim. App. 1966), evidence showing soliciting letters had been sent to prospects listed in the

connote a private offering having the same overtones and characteristics recognized in federal securities law?²⁴³

Houston telephone directory, and that brochures had been shown to each of a number of persons personally contacted by defendant was held ample to prove a public solicitation had occurred. *Cf. Dean v. State*, 433 S.W.2d 173 (Tex. Crim. App. 1968) (holding the defendant, who had not sought out an investor to whom he sold an unregistered "overriding" contract in a seat company, and wherein the investor testified he had already made up his mind to purchase the contract, no advertising was used, and fewer than 35 persons held such contracts, was entitled to have his defense that the sale had been made without public solicitation submitted to the jury). Judge Onion quoted extensively from the *Tumblewood* and *Birchfield* cases, presumably with approval. The *Dean* case is discussed in Hamilton, *supra* note 13, at 106. The reported opinion in *Dean*, handed down after a motion for re-hearing, replaced an earlier opinion that relied extensively on the federal view that a private offering should be limited to sophisticated or informed investors or those in close relationship to the issuer or its principal (in language strikingly similar to that in the Board's current policy statement concerning § 5.1). The original opinion is discussed in Bromberg, *The Texas Small Offering Exemptions: Purchasers Must Have Investment Intent and Be Sophisticated, Informed or Close Associates of the Issuer*, 7 BULL. OF THE SECTION ON CORPORATION, BANKING & BUSINESS LAW, Nov. 1968, at 6. Although based on a withdrawn opinion, Professor Bromberg's comments are still quite helpful in light of the Board's statement of current policy on "public solicitation or advertisements" as used in § 5.1, which, as the discussion in the text accompanying notes 249-51 *infra* indicates, leans heavily on federal private offering criteria and probably was derived in large measure from Judge Onion's first opinion in *Dean*. Some of the analyses of the new policy given herein were suggested by Professor Bromberg's thoughtful commentary.

²⁴³ The federal private offering exemption is found in § 4(2) of the Securities Act of 1933, 15 U.S.C. § 77d(2) (1971), exempting "transactions by an issuer not involving any public offering" from the registration and prospectus requirements of § 5. Over the years these few words have been fleshed out by judicial and administrative interpretations to establish what has been up to quite recently a wholly subjective standard dependent essentially on the circumstances of each case.

Some of the dimensions of the exemption were initially given in an early opinion of the Securities Exchange Commission's General Counsel stating that among factors to be considered were: (1) the number of offerees and their relationship to each other and to the issuer; (2) the number of units offered; (3) the size of the offering; and (4) the manner of the offering, and suggesting, (and thereafter taken as a rule of thumb) that an offering to no more than approximately 25 persons would presumably not involve a public offering. SEC Securities Act Release No. 33-285, 11 Fed. Reg. 10952 (1935), FED. SEC. L. REP. ¶ 2740 (1971). In *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953), however, the Supreme Court expressly rejected any test based on the number of offerees, emphasizing instead that the exemption should depend on whether the class of persons affected needed the protection of the Act unless able to fend for themselves or have access to the kind of information that would have been provided in a registration statement. 346 U.S. at 125, 127. The "fend-for-themselves" criterion has been equated with an inquiry into the sophistication of the investor; whether this alone will suffice if the sophisticated investor does not possess or have access to the proper type of information is not certain. The Commission and some courts regard the access to information test as paramount irrespective of sophistication, *see, e.g.*, *Gilligan, Will & Co.*, SEC Securities Act Release No. 34-5689 (1958), *aff'd sub nom. Gilligan, Will & Co. v. SEC*, 267 F.2d 461 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959); *United States v. Custer Channel Wing Corp.*, 376 F.2d 675 (4th Cir.), *cert. denied*, 389 U.S. 850 (1967). But other opinions indicate sophistication alone, particularly in the instance of institutional investors, may be enough. *Value Line, Inc. v. Marcus*, FED. SEC. L. REP. ¶ 91,523 (S.D.N.Y. Mar. 31, 1965); *cf. Fuller v. Dilbert*, 244 F. Supp. 196, 206 (S.D.N.Y. 1965), *aff'd per curiam sub nom. Righter v. Dilbert*, 358 F.2d 305 (2d Cir. 1966); S. GOLDBERG, PRIVATE PLACEMENTS AND RESTRICTED SECURITIES § 4.2[c] (1971). The most recent statement by the Commission seems to read *Ralston Purina* to require both tests: "The exemption is available for offerings to persons having access to substantially the same information concerning the issuer which registration would provide *and* who are able to fend for themselves." SEC Securities Act Release No. 33-5223, at 4 (Jan. 11, 1972), 37 Fed. Reg. at 592 (1972) (emphasis added).

Another important element is derived from the Commission's view that a public offering is synonymous with a "distribution of a security" as that term is used in § 2(11) of the Act to define an "underwriter." 15 U.S.C. § 77b(11) (1971). Thus, a person who acquires a security which overtly has all the earmarks of a private offering under the standards just set out but who takes it with a view to, or to assist in, its subsequent distribution to the public will become a statutory underwriter. As a consequence, it becomes important to determine the private offeree's intent in acquiring the security as to whether he plans to hold it for

The Securities Board's approach to the problem is to treat "public solicitation" separately from "advertisements" in determining the scope of the 5.I exemption, although choosing to do so by a statement of Board policy rather than an interpretation. The policy statement reflects the Board's support of the view that potential investors in 5.I transactions have a legitimate interest in receiving reasonable information concerning the plan of business and the financial condition of the issuer.²⁴⁴

investment or dispose of it to the public. If the latter proves to be true, the offering becomes a public one and the private offering exemption is lost to the issuer. Moreover, the offeree may well lose his exemption under § 4(1) exempting transactions by persons "other than an issuer, underwriter, or dealer." The need for proving bona fide investment intent leads in turn to questions concerning how long securities must be held or what change of circumstances must occur before a security can be sold consistent with an original investment purpose, and finally to employment of practices such as investment letters and legend stock to protect the private offering exemption.

In short, the federal private offering standard has been aptly summarized as follows:

(1) The group of persons to whom the offering is made available must be limited in number and must have some sort of relationship to the issuer either by prior association or by bargaining ability so as to be able to obtain comprehensive information about the issuer. . . . (2) The persons who have purchased the securities in such non-public offering must acquire the securities as ultimate purchasers, not as conduits to other beneficial owners or subsequent purchasers. Each original purchaser's conduct and state of mind must not make him an "underwriter" as defined in section 2(11) *i.e.*, the exemption will be lost if his purchase was "with a view to . . . distribution [of the] . . . security.

Meer, *The Private Offering Exemption under the Federal Securities Act—A Study in Administrative and Judicial Contradiction*, 20 SW. L.J. 503, 513 (1966).

The Commission's position has been comprehensively restated in a release issued in 1962 on "Non-Public Offering Exemption," SEC Securities Act Release No. 33-4552 (1962), 27 Fed. Reg. 11316 (1962). However, the release must now be read in light of the very recent adoption of the new letter stock rules which will permit limited resales of privately acquired securities under prescribed conditions after two- or five-year holding periods and an accompanying release expressly rejecting the "change in circumstances" factor in determining investment intent for securities acquired after the effective date of the rules, April 15, 1972. SEC Securities Act Release Nos. 5223-26 (Jan. 11, 1972), 37 Fed. Reg. 590-600 (1972); FED. SEC. L. REP. No. 405, Special Report (Jan. 11, 1972); *see* note 252 *infra*. The change in policy of no longer regarding a "change in circumstances" as a viable factor in determining whether a person acquiring a security in a private offering is an underwriter is set out in Release No. 33-5223, *supra*, at 2-3.

The federal private offering exemption is discussed extensively in securities regulation writings. *See generally* S. GOLDBERG, *supra* note 243; R. JENNINGS & H. MARSH, *SECURITIES REGULATION CASES AND MATERIALS* 368-72, 392-400 (2d ed. 1968); L. LOSS, *supra* note 34, at 653-96 (Supp. 1969); PLI, S.E.C. PROBLEMS OF CONTROLLING STOCKHOLDERS AND IN UNDERWRITINGS (C. Israel ed. 1962); H. SOWARDS, *supra* note 34, at §§ 4.01-.02. A helpful statement of the operation and deficiencies of the then current private offering doctrine is given in the famous "Wheat Report." SEC, *DISCLOSURE TO INVESTORS—A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS* 152-247 (1969) (reprinted in S. GOLDBERG, *supra* note 243, appendix at 3-168). Other useful treatments are Bahlman, *Concept of Statutory Underwriter*, in PLI, *CONTROLLING STOCKHOLDERS AND OTHER INSIDERS* 35 (G. Duff ed. 1971); Katz, *Secondary Distributions and Brokers' Transactions*, in PLI, *supra*, at 105; Owen, *The Private Offering and Intra-State Exemptions Under the Securities Act of 1933*, in *SELECTED ARTICLES ON FEDERAL SECURITIES LAW* 165 (H. Wander & W. Grienberger eds. 1968); Gadsby, *Private Placement of Convertible Securities*, 15 BUS. LAW. 470 (1960); Meer, *supra*; Ortick, *Non-Public Offerings of Corporate Securities—Limitations on the Exemption under the Federal Securities Act*, 21 U. PITT. L. REV. 1 (1959); Victor & Bedrick, *Private Offering: Hazard for the Unwary*, 45 VA. L. REV. 869 (1959); Note, *The Investment-Intent Dilemma in Secondary Transactions*, 39 N.Y.U.L. REV. 1043 (1964) (reprinted in *SELECTED ARTICLES ON FEDERAL SECURITIES LAW*, *supra*, at 145). Other articles are listed in S. GOLDBERG, *supra* note 243, appendix at 179; HENN 585-86 n.20.

²⁴⁴ Texas Securities Board Policies & Interpretations No. 7, at I-A(8) (Sept. 18, 1970), 3 BLUE SKY L. REP. § 46,650 (1970).

As to "public solicitation," the 5.I exemption will not be lost if the offers for sale or sales are made to:

sophisticated, well-informed investors or to well-informed investors who have a relationship with the issuer or its principals, executive officers, or directors evincing trust between the parties (namely close business associations, close friendship, or close family ties), and who acquire the securities as ultimate purchasers and not as underwriters or conduits to other beneficial owners or subsequent purchasers.²⁴⁵

Use of a registered dealer should not affect the exemption if all the other requirements of a 5.I transaction are met.

The obvious question posed by the policy statement is when or how a prospective investor attains the requisite state of being "sophisticated" or "well-informed"? The answer given is that in determining sophistication the investor's financial capacity, general knowledge of investing, and practical experience and skill in making investments will be considered. Similarly, he can become "well-informed" when provided printed material that fairly and factually sets out the plan, history, and financial condition of the business, "including material facts necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading."²⁴⁶

As to "advertisements," the term would not include printed material used to make an investor "well-informed," thus repudiating the constricting interpretation in the *Tumblewood* case.²⁴⁷ Emphasis is to be placed on how printed material is used and on efforts made to limit the number of copies and distribution, with the suggestion being made that an appropriate warning of possible violations of the Securities Act if used be placed on the front in large type.²⁴⁸

Aside from dispelling the doubts created by the *Tumblewood* case on the use of printed materials in small offering situations, the most significant aspect of the policy statement is the requirement seemingly laid down that to qualify under any of the three 5.I exemptions, the offeree or purchaser must be (1) well-informed and either (2) sophisticated or (3) in a close relationship to the issuer or its principals or managers, and if the securities are purchased, (4) they must be taken with an investment intent.

Requisites of this sort invite comment. Initially it should be noted that while the information and investment intent requirements can be found in the fifteen-person-a-year exemption of 5.I(c), there is nothing in the language of the other two exemptions to indicate these requisites apply to them unless it can be said they are subsumed under the phrase "without any public solicitation" in the proviso at the start of section 5.I, as is the implication from the policy statement. In that sense the policy expression may be going beyond legislative intent in creating the first two exemptions. The thirty-five-security-

²⁴⁵ *Id.*

²⁴⁶ *Id.* at I-A(9). The Board's policy is not quite the same as the SEC's present view, which indicates every private offeree must be both sophisticated and well-informed. *See* note 243 *supra*.

²⁴⁷ *Tumblewood Bowling Corp. v. Matisse*, 388 S.W.2d 479 (Tex. Civ. App.—Beaumont 1965), *error ref. n.r.e.*; *see* note 241 *supra*.

²⁴⁸ Texas Securities Board Policies & Interpretations No. 7, at I-A(10) (Sept. 18, 1970), 3 BLUE SKY L. REP. ¶ 46,650 (1970).

holder exemption imposes a purely quantitative test, and the employee stock option plan exemption deals with a particular category of purchasers. Neither is conditioned on the sophistication, state of mind, knowledge, or relationship of the security holders or optionees that come under its terms.²⁴⁹

Secondly, by limiting the relationship criteria to those who have a close association evincing trust with the issuer or its principals, executive officers, or directors, persons who come by their information through a close or confidential relationship with a well-informed associate, *i.e.*, by an association two or three steps removed, seem to be eliminated. It is not clear how this can be squared with the result in *Dean v. State*,²⁵⁰ which indicated that an indirect associate can claim the benefit of the thirty-five-man exemption.

Thirdly, the requirement that those acquiring securities under any of the three exemptions must do so as ultimate purchasers may mean that to assure that the exemption will not be lost the whole panoply of protective devices that fetter the disposition of privately acquired shares under the federal law, such as transfer restrictions, investment letters, and the like,²⁵¹ will have to

²⁴⁹ In this regard, Professor Bromberg's admonition, in his article on the Texas small offering exemption, against relying too greatly on the subjective federal private offering tests in interpreting the essentially numerical and objective standards set out in § 5.I are worth repeating:

Specificity in the small offering exemptions has been an overwhelming wish of blue sky lawyers in general and of the members of the State Bar Committee who drafted section 5.I in the form passed by the legislature. In recognition of this deliberate choice of specificity in the face of the federal precedent, it is proper to draw on the federal analogy only to the extent that is consistent with the objective, numerical character of the state provision. There is no reason to import all the nebulous features which complicate and confuse the federal exemption.

Bromberg, *Exemptions for Small Offerings* 558. *But see* J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW PROMOTIONS 27 (1971) contending that from a policy standpoint, the identity of the offerees should be more important than their numbers.

²⁵⁰ 433 S.W.2d 173 (Tex. Crim. App. 1968), discussed in note 242 *supra*. Dean had no control position with the issuer, but was active in securing parts for its product. His contact with the investor was arranged by a "double" first cousin of the investor whom he later married.

²⁵¹ To afford the issuer in a private placement some protection against loss of the federal private offering exemption it has become customary to require private purchasers to give so-called investment letters stating their intention to hold the security purchased for investment and not with a view to distribution (and leading to stock issued under such circumstances to be called "letter stock"). However, the SEC takes a dim view of the efficacy of these letters, regarding them essentially as self-serving and conclusory declarations. Opinion of General Counsel, SEC Securities Act Release No. 33-1862, at 2 (1938), 11 Fed. Reg. 10962 (1946); Crowell-Collier Publishing Co., SEC Securities Act Release No. 33-3825, at 7 (1957); Non-Public Offering Exemption, SEC Securities Act Release No. 4552, at 3 (1962), 27 Fed. Reg. 11316 (1962). Much more effective and consequently more highly regarded by the Commission are restrictive legends placed on certificates (hence the term "legend stock") and adoption of stop-transfer procedures designed to prevent sales of privately-placed securities unless registered subsequently or an opinion of counsel given that an exemption from registration will permit their transfer. S. GOLDBERG, *supra* note 243, §§ 2.6, 2.7; SEC Securities Act Release No. 5223, at 15 (Jan. 11, 1972), 37 Fed. Reg. 591, 596 (1972) (notice of adoption of rule 144); Use of Legends and Stop-Transfer Instructions as Evidence of Non-Public Offerings, SEC Securities Act Release No. 33-5121 (Dec. 30, 1970), 36 Fed. Reg. 1525 (1971). Restrictions on transfer, however, raise problems under the UNIFORM COMMERCIAL CODE § 8-204; TEX. BUS. & COMM. CODE ANN. § 8.204 (1968), and encounter occasional judicial hostility. *See, e.g.*, *Ling & Co. v. Trinity Sav. & Loan Ass'n*, 470 S.W.2d 441 (Tex. Civ. App.—Waco 1971), *error granted* (decided after this survey period, but striking down restrictive legend on stock of a stock brokerage firm).

On the general problems of letter or legend stock see S. GOLDBERG, *supra* note 243, §§ 2.5-7; C. ISRAELS & E. GUTTMAN, MODERN SECURITIES TRANSFERS 404-08 (1967); 1

be employed even in small corporations with only a handful of passive investors. And this at a time when the Securities Exchange Commission seems to be shifting towards more objective criteria for determining investment intent.²⁵³

These reservations aside, the policy statement must still be viewed as a sensible document incorporating reasonable safeguards for the use of 5.I exemptions that may well be read into the law anyway, if the construction of the federal private offering exemption provides any guide.²⁵³ For example, since the statute places no limit on the number of offerees who may be contacted in the thirty-five-security-holder situation,²⁵⁴ it is difficult to see how anyone falling outside the category of investors named in the statement can

L. LOSS, *supra* note 34, at 665-73 (Supp. 1969); Israels, *Current Problems of Securities Underwriters and Dealers*, 18 BUS. LAW. 27, 85-89 (1962); Israels, *Some Commercial Overtones of Private Placement*, 45 VA. L. REV. 851 (1959), reprinted in SELECTED ARTICLES ON FEDERAL SECURITIES LAW, *supra* note 243, at 125; Israels, *Stop-Transfer Procedures and the Securities Act of 1933—Addendum to Uniform Commercial Code—Article 8*, 17 RUTGERS L. REV. 158 (1962), reprinted in SELECTED ARTICLES ON FEDERAL SECURITIES LAW, *supra* note 243, at 231; Kennedy, *Case of the Scarlet Letter or the Easy Way Out on "Private Offerings"*, 23 BUS. LAW. 23 (1967); Shea, *A Practical Look at the Securities Laws, Restrictions on Sales by Owners of Unregistered Stock*, 43 U. DET. L.J. 572 (1966).

²⁵³ As indicated in note 243 *supra*, on Jan. 11, 1972, the SEC adopted its long awaited rules on privately acquired and control securities that grew out of the recommendations of the "Wheat Report." In the process the Commission adopted several new rules and forms, repealed and amended others, and issued several interpretative releases, but the focal point of its action was the promulgation of rule 144, effective Apr. 15, 1972, 17 C.F.R. § 230.144 (1972). SEC Securities Act Release No. 33-5223, Jan. 11, 1972, 37 Fed. Reg. 591 (1972). In brief, rule 144 permits a limited resale of a "restricted security," defined as one acquired directly or indirectly from an issuer or control person in one or a series of private transactions, after a two-year holding period provided adequate public information is available concerning the issuer and proper notice of the sale is filed with the SEC on a prescribed form 144. The availability-of-public-information requirement is satisfied if the issuer is subject to the reporting requirements of §§ 13 or 15(d) of the Securities Exchange Act, 15 U.S.C. §§ 78m, 78o(d) (1971), or information equivalent to that specified in SEC rule 15c2-11(a)(4), clauses (1)-(14) & (16), 17 C.F.R. § 240.15c2-11 (1971), is publicly available. (Rule 15c2-11 became effective Dec. 13, 1971, and is directed at market-making in inactively traded securities and spin-offs of shell corporations. SEC Securities Act Release No. 34-9310 (Sept. 13, 1971), 36 Fed. Reg. 18641 (1971)). Rule 144 is quite detailed and is set out and explained in full in Release No. 5223.

In a companion move the SEC also adopted a new rule 237, 17 C.F.R. § 230.237 (1972), permitting a noncontrolling security holder of an issuer who cannot meet all the conditions of rule 144 to sell a limited amount of his security (up to a maximum of \$50,000), provided he has held the security for 5 years or longer, it is sold through a negotiated transaction and not through a broker or dealer, and an appropriate notice of the sale is filed with an SEC regional office on a prescribed form 237. SEC Securities Act Release No. 33-5224 (Jan. 10, 1972), 37 Fed. Reg. 590 (1972).

Other action taken included: (1) amendments to regulation A, 17 C.F.R. §§ 230.251-230.262 (1971), broadening the availability of that regulation to provide a means for non-controlling investors in small businesses to resell their restricted securities, SEC Securities Act Release No. 33-5225 (Jan. 10, 1972), 37 Fed. Reg. 599 (1972); amendments to forms 10-K, 17 C.F.R. § 249.310 (1971), and 10-Q, 17 C.F.R. § 249.308a (1971), requiring specified information be furnished relating to the issuance of unregistered securities in reliance on exemptions. SEC Securities Act Release Nos. 34-9442 to -9443 (Jan. 10, 1972), 37 Fed. Reg. 600, 601 (1972); (2) rescission of rules 154 and 155, 17 C.F.R. §§ 230.154, 230.155 (1971), SEC Securities Act Release No. 5223 (Jan. 11, 1972), 37 Fed. Reg. 591 (1972); and (3) publication of a release warning that failure to inform a purchaser of a security in a private placement of the circumstances under which he is required to take and hold the security and the limits on its resale may entail a violation of the antifraud provisions of the securities laws, including § 17(a) of the Securities Act, 15 U.S.C. § 77q (1971), and § 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) (1971), and rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 (1971). SEC Securities Act Release Nos. 33-5226, 34-9444 (Jan. 13, 1972), 37 Fed. Reg. 600 (1972).

²⁵³ See note 243 *supra*.

²⁵⁴ TEX. REV. CIV. STAT. ANN. art. 581-5.I(a) (1964).

be approached without some public solicitation or advertising being involved. Even if they can, any written material they are shown ought to meet the standards prescribed. In short, much of what is provided for probably does no more than prudent counsel already require when relying on these exemptions.²⁵⁵ A problem remains, however, whether a sale to one who is neither sophisticated nor related to the issuer or its insiders and yet has been "well-informed" by reading a prospectus or brochure meeting the prescribed standards will defeat the exemption, as the policy statement seems to infer. Arguably, if such a person is not in the prescribed relationship, any solicitation of his purchase would almost have to be public, but then so might the solicitation of a sophisticated investor. The only answer that comes to mind, and perhaps not a very good one, is that the policy statement is simply that, a matter of Board policy, and not a mandatory construction of section 5.I exhausting all the exemptive possibilities.²⁵⁶ The same can probably also be said concerning the application of the sophisticated standard to participants in employee stock option plans, although it is likely that employees who benefit from such plans should be able to meet the relationship test.²⁵⁷ As to the indirect associate problem raised by the *Dean* case,²⁵⁸ that decision may be the exception that proves the rule, or, more traditionally, a case that should be confined to its peculiar facts. The parties in the *Dean* transaction were friends and relatives, yet because Dean was not himself an insider there was not the assurance that what he knew or communicated could be counted on. Despite their close relationship, the investors still testified against him. A line has to be drawn somewhere, and it seems reasonable to limit its application to investors who are in a position to obtain information and rely in confidence on what they are told or given.

Finally, the investment stock requirements should present no real problem to the vast majority of corporations that come under the thirty-five-security-holder exemption since the chances are strong no public market for their securities will exist. If there is a market, as might well be true in the employee stock option and fifteen-person-a-year exemption situations, it then becomes desirable in any event to impose adequate safeguards to prevent the section

²⁵⁵ See Bromberg, *Exemptions for Small Offerings* 548; Securities Committee Report on Administrative Interpretations 3: "It is submitted that this interpretation is consistent with the public interest designed to be protected by the statute and with the practice of reputable and informed persons who engage in transactions in which an exemption under Section 5I is claimed."

²⁵⁶ The Bar committee suggested an interpretation of "public solicitation or advertisements" that would have included the following statement: "The foregoing interpretations are not intended to be exclusive. Other forms of offers do not necessarily constitute public solicitation or advertisements." Securities Committee Report on Administrative Interpretation 3. By adopting a policy statement instead of an interpretation, the Board might well have felt the statement was understood and, therefore, unnecessary.

²⁵⁷ But not necessarily. In the leading case of *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953), which defined the scope of the federal private offering exemption, see note 243 *supra*, an employee stock purchase plan was made available to any of 7,000 employees who on their own initiative inquired into purchasing their employer's stock. Over 400 employees purchased stock in two successive years, including foremen, clerical assistants, and trainees. Despite the argument that all such persons were key employees, the Supreme Court had little difficulty finding a public offering had been made. It is unlikely employees of the sort described in *Ralston Purina* would satisfy the close business association test embodied in the Texas policy statement.

²⁵⁸ See notes 242, 250 *supra*.

5.I exemptions from being utilized as covert means of effecting a public distribution. The exemption will certainly be lost if those acquiring securities form any part of the link in the selling process in transactions that violate the Act.²⁵⁹

(b) *How To Count.* In determining the number of persons to be counted for the 5.I(a) or 5.I(c) exemptions, some uncertainties arise. For example, does a trust estate count as one security holder or must all the beneficiaries be counted? Similarly, what about the husband and wife when community funds have been used to purchase the security? Are they counted as one or two? The interpretation,²⁶⁰ reflecting past administrative practice,²⁶¹ considers the husband and wife as one if the shares are bought from community property or are held by them as joint tenants or tenants by the entirety. Similarly, an express trust, partnership, or corporation counts for one unless organized specifically to hold the issuer's securities, as in the instance of a voting trust.²⁶²

(c) *Sales to Nonresidents.* Again, in counting to thirty-five in section 5.I(a), all security holders of the issuer are counted no matter where they reside or where they acquired the securities. Similarly in counting to fifteen for section 5.I(c), prior sales to nonresidents and sales to Texans outside the state are included.²⁶³

(d) *Exclusion of Other Exemptions.* In counting to fifteen, section 5.I(c) excludes purchasers of securities "exempt under other provisions of this Section 5." Does this also exclude the exemptions in 5.I(a) and 5.I(b) so that if the corporation has just completed sales to say thirty stockholders under 5.I(a) and sold to another five optionees under 5.I(b), it still may sell to another fifteen immediately under 5.I(c)? The interpretation says no; these other exemptions are not excluded.²⁶⁴ Consequently, in the example given twelve months must elapse before 5.I(c) can be used.

(e) *Employee Stock Option Plans.* Section 5.I(b) speaks in terms of "employees' restricted stock options" recognized in the Internal Revenue Code. However, in 1964 the Internal Revenue Code was changed to limit such options to those granted before 1964 and substituted somewhat stricter "qualified stock option plans" and "employee stock purchase plans." In another slight stretching of statutory language, the reference made in 5.I(b) is interpreted

²⁵⁹ *Brown v. Cole*, 155 Tex. 624, 629, 291 S.W.2d 704, 708 (1956); *Dean v. State*, 433 S.W.2d 173, 176 (Tex. Crim. App. 1968); *Smith v. Smith*, 424 S.W.2d 244, 250 (Tex. Civ. App.—Houston 1968).

²⁶⁰ Texas Securities Board Policies & Interpretations No. 7, at I-A(10) (Sept. 18, 1970), 3 BLUE SKY L. REP. ¶ 46,650 (1970).

²⁶¹ See Securities Committee Report on Administrative Interpretations 4; Bromberg, *Exemptions for Small Offerings* 542.

²⁶² *Id.* at 541.

²⁶³ Texas Securities Board Policies & Interpretations No. 7, at I-A(10) (Sept. 18, 1970), 3 BLUE SKY L. REP. ¶ 46,650 (1970). Although the interpretation reflects the position of the Board concerning inclusion of persons outside the state and transactions consummated outside the state in counting for the 15-person exemption, § 5.I(c), some members of the Bar committee felt this part of the interpretation might be invalid because it gives extra-territorial application to the Act in a manner that might be federally unconstitutional. Cf. UNIFORM SECURITIES ACT § 402(b)(9), which exempts offers to no more than 10 persons made within the state.

²⁶⁴ Texas Securities Board Policies & Interpretations No. 7, at I-A(11) (Sept. 18, 1970), 3 BLUE SKY L. REP. ¶ 46,650 (1970). The interpretation incorporates an earlier version to the same effect adopted Aug. 6, 1965. 3 BLUE SKY L. REP. ¶ 46,639 (1970). See Bromberg, *Exemptions for Small Offerings* 550.

to include all three categories of plans which meet the requirements of sections 421-25 of the Internal Revenue Code.²⁶⁵ Also, prospectuses or other materials filed or used under the Securities Act of 1933 for such plans may be employed without constituting public solicitation or advertising.²⁶⁶

(5) *Market Price of Securities in Secondary Trading Transactions.* Section 5.O permits a registered dealer to engage in secondary trading of publicly held securities without registration (unless part of an unsold allotment in his hands as a participant in an underwriting distribution), provided a number of qualifications are met, including the necessity as stated in paragraph (3) that the security be offered for sale "at prices reasonably related to the current market price of such securities at the time of such sale." This is interpreted to mean the market price must be supported by a substantial volume of bona fide sales within or without the state. If there is no going market or only casual sales, then the dealer claiming the 5.O exemption must prove to the Commissioner that the security will have a market price that is fairly determined and can be justified at the inception with reasonable assurance of an after-market. To that end, a number of standards are listed both to determine the basis on which the security's price has been established and to assure that the dealer will make and maintain an orderly market.²⁶⁷

Another requirement of section 5.O is that the security either be registered under the Act or else that specified information concerning the issuer be found in a recognized securities manual. Certain manuals are named in the statute;²⁶⁸ any others have to be approved by the Commissioner. On September 15, 1971, the Commissioner recognized *Moody's OTC Industrial Manual-1971* as a basis for exemption under section 5.O(9),²⁶⁹ an action which should facilitate further normal secondary trading in less widely held securities by Texas dealers.²⁷⁰

(6) *Broker's Transactions.* Section 5.P exempts the execution by dealers of unsolicited orders to buy securities "where the initial offering of such securities has been completed." This is interpreted to mean that any nonexempt public distribution of such securities has been completely sold to the public.²⁷¹

Oil and Gas Drilling Programs Guidelines. On November 22, 1971, the State Securities Board adopted a set of guidelines for the registration of oil and

²⁶⁵ Texas Securities Board Policies & Interpretations No. 7, at I-A(11) (Sept. 18, 1970), 3 BLUE SKY L. REP. ¶ 46,650 (1970). The interpretation replaces and expands on an earlier one similarly construing § 5.I(b) that became effective May 22, 1964. 3 BLUE SKY L. REP. ¶ 46,637 (1970). See also notes 219, 234 *supra*.

²⁶⁶ Reporting companies under the Securities Exchange Act may use form S-8, 17 C.F.R. § 239.16b (1971), to register securities used for tax-favored employee stock option or purchase plans. See note 219 *supra*.

²⁶⁷ Texas Securities Board Policies & Interpretations No. 8, at I-A(12) (Sept. 18, 1970), 3 BLUE SKY L. REP. ¶ 46,651 (1971). The Bar committee's view is that 100,000 shares or units in the hands of 100 persons or more permits the maintenance of a bona fide public market. Securities Committee Report on Administrative Interpretations 5.

²⁶⁸ Manuals published by Moody's Investor Service, Standard & Poor's Corporation, and Best's Life Insurance Reports are specifically named; moreover, the Commissioner may not revoke or suspend their recognition administratively. TEX. REV. CIV. STAT. ANN. art. 581-5 (1964).

²⁶⁹ TEX. MONTHLY SECURITIES BULL., Aug. 1971, at 11; 3 BLUE SKY L. REP. ¶ 46,651.01 (1971).

²⁷⁰ Sales must still comply with other provisions of § 5.O. *Id.*

²⁷¹ Texas Securities Board Policies & Interpretations No. 9, at I-A(14) (Sept. 18, 1970), 3 BLUE SKY L. REP. ¶ 46,652 (1971).

gas drilling programs. The guidelines had been prepared by the Committee on Oil and Gas Securities of the North American Securities Administrators Association, chaired by Truman G. Holladay, the Texas Securities Commissioner, and were adopted in principle by that association in October 1971.²⁷²

Oil and gas drilling funds have increased greatly in recent years,²⁷³ along with the growth in numbers of individuals with sufficient wealth to benefit from the oil and gas tax shelters afforded by such programs²⁷⁴ and still afford to absorb the considerable losses that often occur. Essentially the programs involve the sale of interests of participation, usually on a joint-venture or limited-partnership basis, in programs of oil and gas exploration, development, and acquisition.²⁷⁵ Although sometimes marketed via the same techniques used to sell mutual funds, drilling funds are exempt from the Investment Company Act of 1940.²⁷⁶ But since they normally require large amounts of capital, participation interests are usually publicly sold and, hence, must be registered under the Securities Act of 1933²⁷⁷ and state blue sky laws.²⁷⁸

²⁷² The Board's action in adopting the guidelines has not been officially reported, but they are the same as those adopted in principle by the North American group. The guidelines adopted by the latter are found in 1 BLUE SKY L. REP. ¶¶ 4581-83 (1971).

²⁷³ Prior to 1967 programs filed with the SEC never exceeded \$100 million; by the end of 1969 the dollar value of programs filed almost reached \$1.7 billion. See SEC Securities Act Release No. 33-5001, at 4 (Aug. 27, 1969), 34 Fed. Reg. 14125 (1969); Sullivan, *Oil and Gas Investment Programs; A Brief Survey*, 26 BUS. LAW. 1027, 1028 (1971).

²⁷⁴ There are several tax advantages to participants in the programs, particularly those in high income tax brackets. These include (1) the right to offset a proportionate part of intangible drilling and development costs against ordinary income in the year incurred, see INT. REV. CODE of 1954, § 263(c), and, (2) the utilization of the depletion allowance against income realized from the program, either on the basis of an amount equal to 22% of the gross income from a particular well (but no more than 50% of the net income) or by a portion of the "cost" of the oil in the ground, or "cost" depletion, see INT. REV. CODE of 1954, §§ 612 (cost depletion), 613 (percentage depletion). Many public-investor-financed programs result in investors being able to gain a current deduction equal to 60 to 80% of the investment in the program. Ryan, *Public Financing of Oil and Gas Ventures*, 19 TULANE TAX INST. 466, 468 (1970). On the tax aspects of oil and gas drilling programs see generally Bloomenthal, *Mineral Exploration Funds*, 1968 DUKE L.J. 193, 202-10; Loftin, *Drilling Funds—Seminar: Tax Considerations*, 21ST OIL & GAS INST. 236 (1970); Mosburg, *Mechanics of Registered and Unregistered Investor Drilling Programs*, 18TH OIL & GAS INST. 97, 105-07 (1967); Panel Discussion, *Income Tax and Securities Law Aspects of Investments in Oil and Gas Drilling Programs*, 22 U. SO. CAL. 1970 TAX. INST. 745; Ryan, *supra*, at 467-88, 499-509.

²⁷⁵ Most publicly offered programs are organized as limited partnerships; unregistered funds are more likely to be partnerships or joint ventures. On the organizational aspects of oil and gas funds see Mosburg, *supra* note 274; Ryan, *supra* note 274, at 469-88; White, *Drilling Funds—Seminar: Structure and Documentation*, 21ST OIL & GAS INST. 187, 190, 197 (1970).

²⁷⁶ Investment Company Act of 1940, § 3(c)(11); 15 U.S.C. § 80a-3(c)(11) (1971). A serious move was made in 1969 at the instigation of the SEC with the introduction of H.R. 11995, 91st Cong., 1st Sess. (1969), and S. 2224, 91st Cong., 1st Sess. (1969), to partially eliminate the exemption, but was forestalled on the promise of the SEC and the industry to come up with plans for effective investor protection within 18 months after passage of the Investment Company Amendments Act of 1970, § 806-6a, ch. 686, § 2, 54 Stat. 790 (1940), as amended, 15 U.S.C. § 80a-2 (1971). H.R. REP. NO. 91-1382, 91st Cong., 2d Sess. (1970); CONF. REP. NO. 91-1631, at 1 (1970), reprinted in 3 U.S. CODE CONG. & AD. NEWS 4943 (1970).

²⁷⁷ As most publicly offered programs are limited partnerships, interests in such partnerships are of course securities, and since publicly offered they must be registered unless exempt as intrastate offerings, 15 U.S.C. § 77c(11) (1971), or small enough to qualify under regulations A or B, 17 C.F.R. §§ 230.251-63, 17 C.F.R. §§ 230.300-56 (1971). The form generally used for drilling programs in which the properties are not predesignated is form S-1, 17 C.F.R. § 239.11 (1971). If the program sponsor is offering interests in specific property, then form S-10 would be used, 17 C.F.R. § 239.17 (1971). On Jan. 19, 1970, the Commission issued Guide No. 55 for the preparation of prospectuses relating to interests in

The guidelines adopted by Texas are somewhat detailed and can only be summarized briefly here.²⁷⁹ They appear to be quite tough, and if applied rigorously, should keep a number of marginally operated or promotion-oriented funds participations from being publicly sold in the state. For example, any program with a sponsor lacking substantial experience or qualifications in the oil and gas industry "will be thoroughly scrutinized," and any promotional programs will be held contrary to the public interest.²⁸⁰ The minimum amount of funds to be collected to activate the program must be sufficient to accomplish the objectives of the program, including "spreading the risk," and any amount less than \$250,000 will be presumed inadequate to spread the risk among public investors.²⁸¹

There are several other provisions that regulate fund sponsors. They must be adequately capitalized, must meet the requirements of the Internal Revenue Service, and have a favorable tax ruling assuring flow-through of tax benefits to investors, and are required to either purchase a minimum of \$100,000 in participation interests or else be given the privilege of investing at least ten percent of the amount to be paid in by participants in the program.²⁸² Proceeds from the sale of units in the program are not to be used to prove up adjacent properties belonging to the sponsors or their affiliates; if they are, such must be fully disclosed and justified to the securities commissioner.²⁸³ A maximum of twelve and one-half percent of the amount received from the public offering is allowable to the program sponsor for organizational and offering expenses, and from this any first year management fee must be paid.²⁸⁴ Expenses and compensation of sponsors must be reasonable; as must their retained interests, as well as any other combinations of fees, overriding royalty interests, and working and net profit interests.²⁸⁵ Automatic reinvestment of revenues is considered unfair and contrary to public interest; optional reinvestments are allowed only if full information is given the investor.²⁸⁶ The prospectus must contain a section on conflict of interests, setting out possible areas of conflict and measures taken to protect the public investor as a result. Any properties transferred by a sponsor or its affiliate to the program may be at cost if this is uniformly done with all the sponsor's programs; otherwise, they are to be transferred at fair market value. If the latter greatly exceeds cost, the fair market value must be established by qualified independent petroleum engineers. Moreover,

oil and gas programs. SEC Securities Act Release No. 33-5036 (Jan. 19, 1970), 35 Fed. Reg. 1233 (1970). For discussions of securities regulation aspects of drilling programs see Bloomenthal, *supra* note 274, at 234-39; Mosburg, *supra* note 274, at 144-75; Ryan, *supra* note 274, at 488-98; Shepherd, *Drilling Funds—Seminar: Registration and other Regulatory Considerations*, 21ST OIL & GAS INST. 202 (1970); Sullivan, *supra* note 273, at 1033-38.

²⁷⁸ Knapp, *Blue Sky Laws: State Regulation of Drilling Programs*, OIL DIGEST, Dec. 1970, at 13, 14.

²⁷⁹ The summary given is topical and does not necessarily follow the sequence of the guidelines. When cited *infra* the reference is the Roman numeral and letter assigned a particular guideline.

²⁸⁰ Guidelines for Registration of Oil and Gas Drilling Funds II-A.

²⁸¹ *Id.* IV-D.

²⁸² *Id.* II-B.

²⁸³ *Id.* II-C.

²⁸⁴ *Id.* II-D.

²⁸⁵ *Id.*

²⁸⁶ *Id.* II-G.

any contracts for drilling or other services must be at prices no higher than those normally charged in the same area in arm's-length transactions.²⁸⁷

The minimum purchase in the program may not be less than \$5,000, which is also the minimum investment by a participant that must be paid within twelve months from the date the program commences.²⁸⁸ Assignments of interests are similarly limited. If assessments are allowed, limits must be placed on them, and sales commissions are not allowed thereon.²⁸⁹ No representations are to be made that program interests are readily marketable. If such interests are to be repurchased, the program sponsor or affiliate is unconditionally obligated to repurchase a specific dollar amount each twelve months in cash under a formula to be fully disclosed in the prospectus.²⁹⁰

Brokers and dealers who handle the programs must be paid on a cash commission basis. Broker-dealers must also take steps to be sure that participations are sold only to investors for whom such interests are suitable. The determination of suitability is to be based on the prospective investor's financial capacity, net worth, and income tax bracket, after a reasonable inquiry into his financial condition and other relevant factors.²⁹¹ Finally, all sales are to be made by and through a prospectus that must also accompany or precede any supplementary materials used; in turn, supplementary materials must be approved by the commissioner beforehand.²⁹² The prospectus must contain all material facts necessary for the public investor to make his investment decision and for the commissioner to make a finding after examination.²⁹³

Volume of Registration. During the fiscal year ending August 31, 1971, registrations processed by the State Securities Board totalled 1.237 billion dollars, the fourth consecutive year the billion-dollar mark was exceeded. The total number of registration applications processed was 1,446. Of the dollar amount almost 220 million dollars represented original applications for the sale of securities by Texas companies. In addition, there are now over 10,000 persons licensed to sell securities in the state.²⁹⁴

IV. DISREGARD OF THE CORPORATE ENTITY

During the survey period there were the usual quota of cases raising the fundamental issue whether the corporate entity should be disregarded to hold

²⁸⁷ *Id.* IV-G. Also, sponsors and affiliates cannot be exonerated from liability for losses caused by gross negligence or wilful or wanton misconduct. *Id.* II-I.

²⁸⁸ *Id.* III-A. If the minimum to activate the fund is not attained, there must be a provision for the return of all paid subscriptions. *Id.* IV-D.

²⁸⁹ *Id.* III-B.

²⁹⁰ *Id.* IV-F. If the interests tendered exceed the annual repurchase amount, the interests to be repurchased must be selected by lot. Valuation of the interests are to be made by qualified independent petroleum engineers annually.

²⁹¹ *Id.* III-D.

²⁹² *Id.* III-C.

²⁹³ *Id.* IV-I. The prospectus must contain information concerning the nature of the business organization to be employed, the sponsor's history of operations, maximum and minimum amounts sought, a tabular representation of interests that indicates sharing of costs and expenses as well as sharing in distribution of revenues, provisions for repurchase of participations, statements of conflict of interest, and an account of how the proceeds are to be used.

²⁹⁴ TEX. MONTHLY SECURITIES BULL., Aug. 1971, at 1.

shareholder-owners liable for obligations incurred through their corporate business. From a quantitative standpoint, as past *Surveys* show,²⁹⁵ disregard cases seem to recur more frequently than almost any other kind in corporation law.²⁹⁶ One reason is fairly obvious: Faced with the unpalatable prospect of obtaining judgment against a corporate defendant not able to respond in damages, it is natural that an aggrieved plaintiff seeks to hold accountable those for whose benefit the enterprise was operated, especially when they alone are able to pay. The dilemma that the disregard doctrine poses to a court is equally obvious: Unless businessmen have some assurance their personal wealth can be shielded from the debts and obligations of their incorporated business ventures, the prime attribute of limited liability, which makes the corporation a preferred device for doing business and attracting capital investment, would become meaningless. The solution, as in other areas of law where competing interests and expectations must be reconciled, lies in striking a proper balance on use of the corporate entity. The only difficulty is that judges and lawyers alike obfuscate the needed balancing with colorful rhetoric and conclusory rationalizations which frequently conceal the significant elements that weigh in reaching a just result.

A survey such as this is not the place to examine in depth the seeming pervasiveness and confusing applications of the disregard doctrine, particularly since an excellent and perceptive treatment of the subject by Robert Hamilton has just appeared.²⁹⁷ Professor Hamilton's basic thesis is that the nature of a corporation is not a static concept, but varies from case to case, depending on the issues to be resolved. The traditional terminology Texas courts employ to "pierce the corporate veil" by labeling the corporation the "alter ego" or "instrumentality" of its individual or corporate shareholders states results at best and at worst obscures analysis of the controlling factors which should be articulated, but seldom are. Moreover, many Texas disregard cases could have been resolved by application of conventional tort, contract, or agency theories without invoking postulates based on the conceptual nature of the corporation.²⁹⁸

Yet, granting there may have been noncorporate grounds for decision in some of these cases, one wonders whether a court that uses the artificial personality of the corporation as a premise from which to reason would apply the determinative rule of contract, tort, or agency law any less mechanically. Agency principles in particular are just as obscure in revealing the policy behind their formulation as the disregard doctrine.²⁹⁹ Since that jural relationship we call a corporation is a constant in all these disputes, why cannot the bounds on doing business in corporate form as a means of providing limited liability

²⁹⁵ See Amsler, *supra* note 7, at 100; Amsler, *Corporations, Annual Survey of Texas Law*, 22 SW. L.J. 59, 71 (1968); Hamilton, *supra* note 13, at 108; Hamilton & Shields, *supra* note 14; Pelletier, *supra* note 56.

²⁹⁶ Professor Pelletier noted that from 1960-1967 at least 39 Texas cases involving the question of disregard of the corporate entity had been reported. Pelletier, *supra* note 56, at 141.

²⁹⁷ Hamilton, *supra* note 114.

²⁹⁸ *Id.* at 281-83.

²⁹⁹ See E. LATTY, INTRODUCTION TO BUSINESS ASSOCIATIONS 189 (1951) (Chapter Nine: Policy Choices Behind Linguistics in Agency Law); F. MECHEM, OUTLINES OF THE LAW OF AGENCY 96, 237 (4th ed. by P. Mechem 1952); Seavey, *The Rationale of Agency*, 29 YALE L.J. 859 (1920), reprinted in W. SEAVEY, STUDIES IN AGENCY 65 (1949).

be set within the framework of the same body of law that creates the relationship in the first place, even if it must be done on a case-by-case basis? There then is no necessity to resort to other doctrine. It simply becomes a matter of subjecting the privilege of separate capacity and responsibility to specific equitable limits when needed to prevent abuse of the corporate shield if used illegally, fraudulently, or unfairly under the circumstances of a particular case.

Perhaps this explains why judges and lawyers, although probably aware that use of the corporate fiction has its conceptual limits if they stop to think about the matter, instinctively resort to the time-worn, but resounding, expressions and pejoratives that abound in the disregard cases. Predictably, the whole subject will continue being "enveloped in the mists of metaphor," as Justice Cardozo so aptly expressed it many years ago.³⁰⁰ Still it would be well to also remember his accompanying admonition: "Metaphors in the law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it."³⁰¹

Alter Ego Cases. Several decisions handed down during the survey period exemplify attempts to use the illusory alter ego concept³⁰² as justification for disregard; the results, however, were mixed.

In *Professional Beauty Products, Inc. v. Jay*³⁰³ the alter ego rationale was successfully invoked by an employee to preclude his being enjoined from violating a covenant-not-to-compete with his former beauty supply house employer. The employee had been assigned a territory with the understanding that he was to receive commissions on all sales made to customers of the employer in that area. He claimed the employer had breached the employment contract by setting up a discount beauty supply corporation which through lower prices siphoned off much of his sales volume and reduced his commissions. The discount corporation had officers and shareholders in common with the employer and was managed by the latter pursuant to a management contract. Agreeing with the finding that the discount corporation was the alter ego of the employer, the court held the establishment of the discount operation, insofar as it affected the employee, breached his employment contract and gave the employer unclean hands, thus, barring legal and equitable relief.

The case presents some difficulties because it appears that the discount operation was set up to meet competition and not specifically to diminish the employee's income. Establishing another corporation to engage in a different type

³⁰⁰ *Berkey v. Third Avenue Ry.*, 244 N.Y. 84, 94, 155 N.E. 58, 61 (1926).

³⁰¹ *Id.*

³⁰² The "alter ego" pejorative is frequently employed in situations in which the sole or controlling shareholders ignore corporate formalities and amenities, use the corporation as a vehicle for their own personal ventures, commingle corporate funds or property with their own, or incorporate in an obvious effort to avoid preexisting contractual liabilities, defraud creditors, or statutory policy. *See, e.g.*, *American Petroleum Exch. v. Lord*, 399 S.W.2d 213 (Tex. Civ. App.—Fort Worth 1966), *error ref. n.r.e.*; *Westwood Dev. Co. v. Esponge*, 342 S.W.2d 623 (Tex. Civ. App.—San Antonio 1961), *error ref. n.r.e.*; *Five Star Transfer & Terminal Warehouse Corp. v. Flusche*, 339 S.W.2d 384 (Tex. Civ. App.—Texarkana 1960), *error ref. n.r.e.*; *Irish v. Bahner*, 109 S.W.2d 1023 (Tex. Civ. App.—Dallas 1937), *error dismissed*; *Bond-Reed Hardware Co. v. Walsh*, 193 S.W. 1148 (Tex. Civ. App.—San Antonio 1917), *error ref. See generally* N. LATTIN, *supra* note 117, at 86.

³⁰³ 463 S.W.2d 288 (Tex. Civ. App.—Amarillo 1970), *discussed in* Hamilton, *supra* note 114, at 1003.

of business activity or to segregate a specific operation is quite common. Certainly the fact that two corporations have officers and shareholders in common does not in itself justify treating one as the alter ego of the other.³⁰⁴ Whether the management contract was a critical factor is difficult to assess. It is likely the result would have been the same had the discount operation been conducted by essentially the same people in unincorporated form or without the management contract. This suggests that the court simply regarded the two businesses as part of a single enterprise whose acts harmed the employee.³⁰⁵ On that basis the case was easily resolved by applying elementary principles of contracts and equity. Yet because another corporation was used as the instrumentality, the disregard doctrine provided a useful peg on which to hang the result.

On the other hand, in *Paine v. Carter*³⁰⁶ a somewhat reverse twist on the alter ego formulation was encountered because of a jury finding that the sole shareholder was the alter ego of the corporation rather than vice versa.³⁰⁷ The reversal of roles turned out not to matter because estoppel precluded the issue being raised in the first place.

The action was brought by Paine who had cosigned and ultimately had to pay the \$20,000 balance of a \$30,000 note given by Bartlett to a Houston bank to purchase shares in the corporation. Bartlett had formed the corporation, Artex Construction Company, along with Carter and two others to engage in road construction in Argentina. Carter apparently furnished most of the financing for Artex. Because of poor progress on the Argentine road projects the shareholders began to quarrel, culminating in litigation between Bartlett and Carter. Their suit was settled by a contract signed by Carter, Bartlett, Artex,

³⁰⁴ *Bell Oil & Gas Co. v. Allied Chem. Corp.*, 431 S.W.2d 336, 337 (Tex. 1968); *Hubbard v. Capital Southwest Corp.*, 448 S.W.2d 571, 573 (Tex. Civ. App.—Waco 1969); *Thompson v. Sinkler*, 295 S.W.2d 508, 513 (Tex. Civ. App.—Beaumont 1956), *error ref. n.r.e.*, *rev'd on other grounds sub nom. Sinkler v. Missouri Pac. R.R.*, 365 U.S. 758 (1958); *State v. Swift & Co.*, 187 S.W.2d 127, 131 (Tex. Civ. App.—Austin 1945), *error ref.*; *Texas Pac. Coal & Oil Co. v. Smith*, 130 S.W.2d 425, 429 (Tex. Civ. App.—Eastland 1939), *error dismissed, judgment correct.*

³⁰⁵ "The fact that separate corporate entities were formed which represent different departments of the integrated but single business enterprise does not affect the question, because the court must look beyond the corporate form to the purpose of the unified organization, and to the officials who are identified with that purpose." *State v. Lone Star Gas Co.*, 86 S.W.2d 484, 492 (Tex. Civ. App.—Austin 1935), *rev'd on other grounds*, 304 U.S. 484 (1938). *See also* note 314 *infra*.

³⁰⁶ 469 S.W.2d 822 (Tex. Civ. App.—Houston [14th Dist.] 1971), *error ref. n.r.e.*

³⁰⁷ Defendants contended that there is no law in Texas holding that an individual can be the alter ego of the corporation instead of the reverse. The court's response was that while it made little difference in the outcome, some cases have so held, citing *Gill v. Smith*, 233 S.W.2d 223 (Tex. Civ. App.—Galveston 1950), *error ref. n.r.e.*; *Texas Elec. Serv. Co. v. Moxley*, 157 S.W.2d 726 (Tex. Civ. App.—Fort Worth 1941). *See also* *Gulf Reduction Corp. v. Boyles Galvanizing & Plating Co.*, 456 S.W.2d 476, 480 (Tex. Civ. App.—Fort Worth 1970) (*see text at note 313 infra*); *Lybrand v. Miller-Lybrand Co.*, 75 S.W.2d 286, 287 (Tex. Civ. App.—Amarillo 1934): "[T]he stockholders are but the alter ego of the corporation and its fictional existence cannot be made the excuse for bringing a suit or asserting a right which all the stockholders are estopped from asserting." If logically applied, the reverse alter ego doctrine would make the corporation accountable or responsible for, or possibly in some instances the beneficiary of, any act of a shareholder performed in his individual capacity. But if the corporation is to be bound, surely ordinary agency principles of authority, apparent authority, or ratification should suffice to make it liable. If it is a matter of satisfying individual creditors, the shares in the corporation can always be levied upon. Nevertheless, the reverse doctrine illustrates the willingness of courts to restructure a fact situation and recast the parties to accomplish a desired result whether in the process the corporate entity is allowed to play its intended role or is removed instead from the stage.

and others whereby Bartlett severed all his connections with Artex, Carter became the sole shareholder, paid \$10,000 on Bartlett's note to the bank, and agreed to pay on the balance of the note \$1 for every \$6 from moneys Artex made available to Carter from the Argentine contracts whether by way of repayment of advances and loans, dividends, dissolution, salary, or otherwise. Artex was ultimately dissolved without anything more being paid on the \$20,000 balance on the note. Having paid the balance, Paine sued to enforce the contract as the assignee of Bartlett's rights therein.

The evidence showed that Artex had not only lost a great deal of money on the Argentine projects, but lost all of its construction equipment as well when converted in Bolivia by a fellow joint adventurer in Artex's Argentine venture. Carter alone lost over 2 million dollars in advances and loans, and Artex on dissolution owed another \$1,750,000. The jury found that all that Artex had received from the Argentine government after the contract was signed was \$2.01. Relying on another finding that Carter was the alter ego of Artex, Paine argued that Carter should have paid Artex's debt from whatever moneys Artex received regardless of expenses owed or incurred. The court regarded the jury's alter ego finding as immaterial, because having chosen to contract with Artex and Carter in their separate capacities with full knowledge of the corporate structure and with the contract itself calling on Carter to assume full ownership of the corporation, Bartlett, and consequently the plaintiff, would be estopped to claim Carter was the alter ego of Artex.

The holding is eminently sound and demonstrates again the reluctance of the Texas courts to allow a person who elects to contract with a corporation fully aware of its financing and shareholder ownership to avoid the consequences and risks of his voluntary choice of obligors and contractual arrangements by incantation of alter ego or the other litany of the disregard doctrine.³⁰⁸ Surely if anyone is to be bound by his selection of parties with whom to contract, as between the corporation and its sole shareholder, it ought to be the president of the corporation who has full knowledge of its affairs.

The alter ego argument was raised in two other cases, but in somewhat different contexts. In *Sargent v. Highline Broadcasting Co.*³⁰⁹ the Austin court of civil appeals refused to allow a corporation, which it characterized as a sham, to avoid a contract for its sale on grounds that proper corporate formalities had not been observed in authorizing the sale.³¹⁰ Although neglect to follow the prescribed procedures for corporate governance is sometimes a factor in dis-

³⁰⁸ See *Bell Oil & Gas Co. v. Allied Chem. Corp.*, 431 S.W.2d 336 (Tex. 1968) (by implication); *Pace Corp. v. Jackson*, 155 Tex. 179, 195, 284 S.W.2d 340, 351 (1955); *Minchen v. Van Trease*, 425 S.W.2d 435, 438 (Tex. Civ. App.—Houston [14th Dist.] 1968), error ref. n.r.e.; *George v. Houston Boxing Club, Inc.*, 423 S.W.2d 128, 132 (Tex. Civ. App.—Houston [14th Dist.] 1967), error ref. n.r.e.; *Blond Lighting Fixture Supply Co. v. Funk*, 392 S.W.2d 586, 591 (Tex. Civ. App.—San Antonio 1965); *Associates Dev. Corp. v. Air Control Prods., Inc.*, 392 S.W.2d 542, 547 (Tex. Civ. App.—Austin 1965), error ref. n.r.e.; *Radio KBUY, Inc. v. Lieurance*, 390 S.W.2d 16, 19 (Tex. Civ. App.—Amarillo 1965); *Atomic Fuel Extraction Corp. v. Estate of Slick*, 386 S.W.2d 180, 190 (Tex. Civ. App.—San Antonio 1964), error ref. n.r.e.

³⁰⁹ 466 S.W.2d 866 (Tex. Civ. App.—Austin 1971).

³¹⁰ The facts were not fully developed because no brief was filed for the corporation. 466 S.W.2d at 867.

regard cases,³¹¹ there is ample authority to bind a corporation, whether sham or real, to informally approved transactions³¹² without having to talk, as the court did, in alter ego terms. In the other case,³¹³ a creditor who recovered judgment against an insolvent corporation, but was denied recovery against its shareholder for conversion, was barred by *res judicata* from suing the shareholder again on an alter ego theory. Even if the corporation were the alter ego of the defendant shareholder, which the court found it not to be, that fact alone does not create a cause of action against the shareholder; it is simply a basis for holding the individual for a cause of action that would otherwise exist only against the corporation.

Parent-Subsidiary Cases. The disregard doctrine is often raised in cases involving the parent-subsidiary relationship with occasional success. At times elementary justice seems to demand that a business as a whole be held responsible for obligations incurred in carrying on part of its enterprise,³¹⁴ rather than to allow various layers of limited liability to be interposed through use of multiple corporations and, thus, thwart creditors of one of the segments of the business. Nevertheless, dividing a business into separate corporate units con-

³¹¹ This factor is seldom articulated, but is obviously present in cases that talk of the sole or controlling shareholder treating the corporation as his alter ego. *See, e.g.,* *Manney v. Texas Reserve Life Ins. Co.*, 407 S.W.2d 345, 350 (Tex. Civ. App.—Dallas 1966) (by implication); *American Petroleum Exch. Inc. v. Lord*, 399 S.W.2d 213, 217 (Tex. Civ. App.—Fort Worth 1966), *error ref. n.r.e.*; *Evans v. General Ins. Co. of America*, 390 S.W.2d 818, 822 (Tex. Civ. App.—Dallas 1965) (dictum); *Westwood Dev. Co. v. Esponge*, 342 S.W.2d 623, 626 (Tex. Civ. App.—San Antonio 1961), *error ref. n.r.e.*; *Bayou Drilling Co. v. Baillo*, 312 S.W.2d 705 (Tex. Civ. App.—Houston 1958), *error ref. n.r.e.* (by implication); *Fruth v. Gaston*, 187 S.W.2d 581 (Tex. Civ. App.—Austin 1945), *error ref. w.o.m.* (by implication). *See also* Hamilton, *supra* note 114, at 990 n.41, commenting on the difficulty of listing such cases even though the informality factor is a most significant consideration in alter ego or other disregard cases.

Professor Hamilton is critical of the use of the alter ego rationale when corporate informalities or confusion of personal and corporate funds have occurred, since neither may relate to the real issue of liability in tort or in contract. True, the shareholders may justly complain of such actions, but to allow creditors to take advantage of such deficiencies is to give them a windfall. For a recent, well-reasoned decision refusing to disregard the entity for the benefit of creditors when these elements were present, see *Sutton v. Reagan & Gee*, 405 S.W.2d 828 (Tex. Civ. App.—San Antonio 1966), *error ref. n.r.e., discussed critically in Pelletier, supra* note 56, at 144; *cf. Texlite, Inc. v. Wineburgh*, 373 S.W.2d 325 (Tex. Civ. App.—Dallas 1963), *error ref. n.r.e. See generally* N. LATTIN, *supra* note 117, at 69.

³¹² *See* *Camp v. Shannon*, 162 Tex. 515, 519-20, 348 S.W.2d 517, 519-20 (1961); *Aranas Pass Harbor Co. v. Manning*, 94 Tex. 558, 562-63, 63 S.W. 627, 629-30 (1901); *Sutton v. Reagan & Gee*, 405 S.W.2d 828 (Tex. Civ. App.—San Antonio 1966), *error ref. n.r.e.*; *cf. Caldwell v. Kingsberry*, 451 S.W.2d 247, 251 (Tex. Civ. App.—Austin 1970), *error ref. n.r.e. But see* *Curtis v. Pipelife Corp.*, 370 S.W.2d 764, 767 (Tex. Civ. App.—Eastland 1963) (applying Delaware law).

³¹³ *Gulf Reduction Corp. v. Boyles Galvanizing & Plating Co.*, 456 S.W.2d 476 (Tex. Civ. App.—Fort Worth 1970).

³¹⁴ The notion of using the disregard doctrine to construct a single entity responsible for the acts of its incorporated parts was developed in Berle, *supra* note 34, although suggested earlier in E. LATTY, *supra* note 125, at 212-20. *See, e.g.,* *NLRB v. Deena Artware, Inc.*, 361 U.S. 398 (1960); *Mull v. Colt Co.*, 31 F.R.D. 154, 166 (S.D.N.Y. 1962); *Hartford Steam Serv. Co. v. Sullivan*, 26 Conn. Super. 277, 220 A.2d 772 (1966); *Walkovszky v. Carlton*, 18 N.Y.2d 414, 223 N.E.2d 6 (1966). *See also* Hamilton, *supra* note 114, at 985. Texas cases illustrating the enterprise approach include *Beneficial Fin. Co. v. Miskell*, 424 S.W.2d 482 (Tex. Civ. App.—Austin 1968), *error ref. n.r.e.*; *Houston-American Life Ins. Co. v. Tate*, 358 S.W.2d 645 (Tex. Civ. App.—Waco 1962); *State v. Lone Star Gas Co.*, 86 S.W.2d 484 (Tex. Civ. App.—Austin 1935), *rev'd on other grounds*, 304 U.S. 224 (1938); *Atchison, T. & S.F. Ry. v. Texas R.R. Comm'n*, 77 S.W.2d 773 (Tex. Civ. App.—Austin 1934).

trolled either through a holding company or common ownership is part of our economic way of life, so that here too disregard is the exception and not the rule.³¹⁵ So long as proper formalities are observed and a genuine effort is made to avoid commingling the affairs of the constituent corporations, their separate entities (and responsibilities) will be respected.³¹⁶

For example, in a federal district court decision applying Texas law³¹⁷ the lessor of a truck terminal successfully sued the lessee truck company, a truck system which later acquired all the truck company's stock and guaranteed performance of the lease, and a freight company to whom the terminal was subleased, for damages to the terminal during the lease period. The case turned on the respective liabilities of the three defendants. Among its arguments the truck company contended that its erstwhile parent had exercised such domination and control over it that it was just a tool or instrumentality of the parent which was, therefore, the real party in interest. Although finding for the truck company on other grounds, the court rejected the disregard argument. The parent company would not be held liable as the primary obligor on the lease, it said, inasmuch as the truck company had been maintained, operated, and managed as a separate entity. Undoubtedly a significant factor, of which the court took note, was the fact the truck company had operated in the terminal independently for eight years before its acquisition by the truck system.

On the other hand, when the intercorporate relationship is used to defraud creditors, work an inequity, or evade statutory or public policy, the courts will not hesitate to consider the interrelated corporations as one or hold the parent liable.³¹⁸ As has been suggested, the results are frequently cloaked behind terms branding the subsidiary the instrumentality, dummy, puppet, tool, or agent of the parent, without revealing the primary reasons for invoking the doctrine, although the agency analogy may be appropriate if the subsidiary actually represented the parent in the transaction.

Two cases decided during the survey period dealing with the Sunday closing

³¹⁵ See *Bell Oil & Gas Co. v. Allied Chem. Corp.*, 431 S.W.2d 336 (Tex. 1968); *Hubbard v. Capital Southwest Corp.*, 448 S.W.2d 571 (Tex. Civ. App.—Waco 1969); *Thompson v. Sinkler*, 295 S.W.2d 508 (Tex. Civ. App.—Beaumont 1956), *error ref. n.r.e., rev'd on other grounds sub nom. Sinkler v. Missouri Pac. R.R.*, 365 U.S. 758 (1958); *State v. Swift & Co.*, 187 S.W.2d 127 (Tex. Civ. App.—Austin 1945), *error ref.*; *Texas Pac. Coal & Oil Co. v. Smith*, 130 S.W.2d 425 (Tex. Civ. App.—Eastland 1939), *error dismissed, judgment correct*; *State v. Humble Oil & Ref. Co.*, 263 S.W. 319 (Tex. Civ. App.—Austin 1924), *error ref. See generally HENN 258; N. LATTIN, supra note 117, at 100; E. LATTY, supra note 125; Ballantine, Separate Entity of Parent and Subsidiary Corporations*, 14 CALIF. L. REV. 12 (1925); Cataldo, *Limited Liability with One-Man Companies and Subsidiary Corporations*, 18 LAW & CONTEMP. PROB. 473, 487 (1953); Annot., 38 A.L.R.3d 1102 (1971) (liability of corporation for contracts of subsidiary).

³¹⁶ Both the Texas Supreme Court in *Bell Oil* and the Austin court of civil appeals in the leading *State v. Swift & Co.* cases, note 315 *supra*, quote approvingly from Douglas & Shanks, *Insulation From Liability Through Subsidiary Corporations*, 39 YALE L.J. 193, 196-97 (1929), setting out four standards for keeping business units from being assimilated. See *Hamilton, supra note 114, at 992; Note, Corporations—Piercing the Corporate Veil*, 23 Sw. L.J. 384 (1969).

³¹⁷ *Freight Terminals, Inc. v. Ryder System, Inc.*, 326 F. Supp. 881 (S.D. Tex. 1971).

³¹⁸ *E.g., Beneficial Fin. Co. v. Miskell*, 424 S.W.2d 482, 484 (Tex. Civ. App.—Austin 1968), *error ref. n.r.e.*; *Houston-American Life Ins. Co. v. Tate*, 358 S.W.2d 645, 656 (Tex. Civ. App.—Waco 1962); *Hamblen v. Horwitz-Texan Theaters Co.*, 162 S.W.2d 455, 457 (Tex. Civ. App.—Galveston 1942); *Continental Supply Co. v. Forrest E. Gilmore Co.*, 55 S.W.2d 622, 628 (Tex. Civ. App.—Amarillo 1932), *error dismissed*.

laws illustrate the refusal of the Texas courts to allow the corporate device to be employed to circumvent prohibitory legislation.³¹⁹ Both concerned the same multicorporation discount chain and its efforts to avoid the impact of the Texas statute prohibiting sales of certain merchandise on consecutive Saturdays and Sundays³²⁰ by setting up a separate corporation to nominally operate the discount stores on Sunday.³²¹ The corporation was named, appropriately enough, Sundaco, Inc. It had been organized a few days before a restrictive amendment to the blue law became effective,³²² shared officers and shareholders in common with the parent of the discount chain, and utilized the same employees of various stores in the chain. Under the arrangements between Sundaco and some of the individual stores, each week Sundaco would lease the retail premises from one minute before Saturday midnight to Sunday midnight, and at the same time purchase all the merchandise on hand at the beginning of the period with the option to the lessor to repurchase the goods on hand at midnight Sunday, an option always exercised. The goods sold or repurchased were never inventoried, and the retail sales were made by employees who worked for the chain the remainder of the week. Despite the argument that Sundaco was a separate entity distinct from its lessors and suppliers, both the Waco and Eastland courts of civil appeals had no difficulty affirming injunctions issued against all the corporations concerned from violating the Sunday closing law on the ground that the defendants in essence were operating the same business at the same place by the same employees. The arrangement was deemed a subterfuge, and Sundaco itself was found, in the usual opprobrious terms, to be the alter ego, agent, conduit, and tool of the chain, because, as the Eastland court typically put it: "[C]ourts will look through the form to the substance of the relations between corporations and will disregard the fiction of corporate identity if it is used to circumvent the statute or as a mere tool or business conduit."³²³ Without arguing the wisdom of the Sunday closing laws and with the issue of their unconstitutionality seemingly foreclosed,³²⁴ it is difficult to conceive of any court permitting the underlying

³¹⁹ *Clark's Texas, Inc. v. Stewart*, 466 S.W.2d 354 (Tex. Civ. App.—Waco 1971), *error ref. n.r.e.*; *Sundaco, Inc. v. State*, 463 S.W.2d 528 (Tex. Civ. App.—Eastland 1970), *error ref. n.r.e.*

³²⁰ TEX. PEN. CODE ANN. art. 286a (Supp. 1972).

³²¹ The chain's efforts to stay open on Sundays have led to considerable litigation in addition to the cases cited in note 319 *supra*. See *State v. Cook United, Inc.*, 469 S.W.2d 709 (Tex.), *modifying* 463 S.W.2d 509 (Tex. Civ. App.—Fort Worth 1971); *State v. Cook United, Inc.*, 464 S.W.2d 105 (Tex. 1971), *rev'g* 455 S.W.2d 332 (Tex. Civ. App.—Fort Worth 1970); *Suttle v. State*, 457 S.W.2d 344 (Tex. Civ. App.—Waco 1970); *State v. Sundaco, Inc.*, 445 S.W.2d 606 (Tex. Civ. App.—Eastland 1969), *error ref. n.r.e., appeal dismissed*, 397 U.S. 591 (1970).

³²² Ch. 39, § 1, [1967] Tex. Laws 79, *repealing* ch. 15, § 4(a), [1961] Tex. Laws 38. The repealed section allowed the purchase of any of the items forbidden to be sold on a consecutive Saturday or Sunday if the purchaser would certify in writing that the purchase was for an emergency to protect health, welfare, or safety of human or animal life or limb. Some discount stores opening on Sunday prepared certificate-of-necessity forms, which their Sunday customers would almost invariably sign. The practice was upheld by the Texas Supreme Court in *State v. Shoppers World, Inc.*, 380 S.W.2d 107 (Tex. 1964), which held that the seller was not obligated to determine if the purchasers signed such certificates in good faith. With the repeal the Sundaco device seemed to be the only alternative left to try (short of repeal of the closing law itself).

³²³ 463 S.W.2d at 532.

³²⁴ The constitutionality of the Texas Sunday (and Saturday) closing law, TEX. PEN. CODE ANN. art. 286a (Supp. 1972), has been specifically upheld. *State v. Spartan's Indus-*

policies which support such legislation to be flaunted by a legalism as patent as the one employed here.³²⁵

Even so, not every prohibition mandated by public policy is necessarily free from erosion, even when found in constitutional form. This is suggested by another of the disregard cases, this time in the field of banking. In *Bank of North America v. State Banking Board*³²⁶ a Houston bank attempted to enjoin the issuance of a state bank charter to a new competitor on several grounds, including an assertion that the new bank was in reality a branch of a much larger downtown Houston bank in contravention of the Texas Constitution, which bans branch banking.³²⁷ The plaintiff alleged that of the 30,000 shares in the new bank, 11,740 were being taken by the law firm that represented the downtown bank with another 2,800 shares subscribed to by some of the downtown bank's officers and employees, showing that as a matter of law the new bank was being organized "as an adjunct, instrumentality, or agency" of the larger bank.

Affirming the trial court's refusal to grant a temporary injunction, the Austin court of civil appeals rejected the plaintiff's inferences and conclusory arguments. As to the law firm, the court observed that the bank was also represented by two other firms, and to explain the large stock purchase took notice of the fact that law firms sometimes invest in stock of their corporate clients. Of the 2,800 other shares, 1,000 were being taken by the officer of the larger bank who was to become president of the new bank. Although a member of the law firm was a director of the big bank and solicited subscriptions to the new bank, this in itself did not prove that he was acting in behalf of his firm's client. Nor were the facts that the new president might consult his former employer or that it would become the main correspondent of the new bank deemed conclusive.

tries, Inc., 447 S.W.2d 407 (Tex. 1969), *appeal dismissed*, 397 U.S. 590 (1970); Ralph Williams Gulfgate Chrysler Plymouth Inc. v. State, 466 S.W.2d 639 (Tex. Civ. App.—Houston [14th Dist.] 1971), *error ref. n.r.e.*; Levitz Furniture Co. v. State, 450 S.W.2d 96 (Tex. Civ. App.—Eastland 1969), *error ref. n.r.e.*; State v. Sundaco, Inc., 445 S.W.2d 606 (Tex. Civ. App.—Eastland 1969), *error ref. n.r.e.*, *appeal dismissed*, 397 U.S. 591 (1970). In general such legislation has been held constitutional. *See, e.g.*, Gallagher v. Crown Kosher Super Market, 366 U.S. 617 (1961); Braunfeld v. Brown, 366 U.S. 599 (1961); Two Guys from Harrison-Allentown, Inc. v. McGinley, 366 U.S. 582 (1961); McGowan v. Maryland, 366 U.S. 420 (1961).

³²⁵ For other Texas cases supporting the disregard doctrine when statutory regulation or policy is being evaded through use of the corporate fiction see *Sapphire Homes, Inc. v. Gilbert*, 426 S.W.2d 278 (Tex. Civ. App.—Dallas 1968), *error ref. n.r.e.* (usury laws); *Beneficial Fin. Co. v. Miskell*, 424 S.W.2d 482 (Tex. Civ. App.—Austin 1968), *error ref. n.r.e.* (loan company regulation); *Manning v. State*, 423 S.W.2d 406 (Tex. Civ. App.—Austin 1967), *error ref. n.r.e.* (insurance regulation); *Houston-American Life Ins. Co. v. Tate*, 358 S.W.2d 645 (Tex. Civ. App.—Waco 1962) (usury and insurance regulation); *State v. Lone Star Gas Co.*, 86 S.W.2d 484 (Tex. Civ. App.—Austin 1935), *error ref., rev'd on other grounds*, 304 U.S. 224 (1938) (utility company regulation); *Atchison, T. & S.F. Ry. v. Texas R.R. Comm'n*, 77 S.W.2d 773 (Tex. Civ. App.—Austin 1934) (transportation regulation); *Williams v. Freeport Sulphur Co.*, 40 S.W.2d 817 (Tex. Civ. App.—Galveston 1930) (shareholder's inspection rights); *Lee v. Galena-Signal Oil Co.*, 8 S.W.2d 1051 (Tex. Civ. App.—Galveston 1928) (receivership statutes). *See generally* N. LATTIN, *supra* note 117, at 79-83.

³²⁶ 468 S.W.2d 529 (Tex. Civ. App.—Austin 1971).

³²⁷ TEX. CONST. art. XVI, § 16. The constitution says simply: "Such [bank] shall not be authorized to engage in business at more than one place which shall be designated in its charter." The prohibition is reiterated, but in much more expansive terms in TEX. REV. CIV. STAT. ANN. art. 342-903 (Supp. 1972).

Although the court's opinion was undoubtedly correct on the basis of the record before it, the result hardly squares with the realities of banking in Texas. Overtly, the prohibition against branch banking has led to a proliferation of unit banks in Texas, more so than in any other state.³²⁸ Nevertheless, there is considerable informal affiliation through the strong correspondent banking system by which the very largest banks in the state have established networks of correspondent banks from which they derive large deposits.³²⁹ Another phenomenon is the prevalence of chain banking based either on control of two or more banks by an individual or group of individuals through common stock ownership or on direct ownership by a usually large, metropolitan bank of no more than 24.9 percent of the stock of each of several, usually smaller, suburban banks.³³⁰ Thus, at the end of December 1971 there were at least 124 bank chains in Texas containing 434 banks, accounting for thirty-six percent of the total banks in the state and fifty percent of the deposits.³³¹ Other Texas banks are more formally controlled by one-bank holding companies that grew in number from forty in 1968 to ninety-one in late 1971 and hold roughly a third of the deposits in metropolitan areas.³³² The most recent development, and the likely wave of the future, has been the growth of multibank holding companies, spurred by the Bank Holding Company Amendments of 1970.³³³ By the end of 1971 seven such companies had

³²⁸ 1971 STATISTICAL ABSTRACT OF U.S., Table No. 663, at 435; *Finance: Texas Banks Make a Bid for the Big Time*, BUS. WEEK, Dec. 4, 1971, at 60 [hereinafter cited as BUS. WEEK]. There are more than 1,200 unit banks in Texas. Of these, 530 are national banks, again the largest number in the country. 1970 COMPTROLLER OF CURRENCY ANN. REP. 186.

³²⁹ BUS. WEEK 62.

³³⁰ *Id.* See also Kelly, *Bank Structure—Consolidation of Banks Reshaping Texas Markets*, FEDERAL RESERVE BANK OF DALLAS BUS. REV., Jan. 1, 1972, at 3 [hereinafter cited as Kelly]. Prior to the adoption of the Bank Holding Company Act Amendments of 1970, see note 333 *infra*, companies owning 25% or more of the stock of two or more banks had to register as bank holding companies; hence, many large banks kept their direct ownership in smaller banks to less than 25%, resulting in chains composed of a large metropolitan bank and so-called "24.9 percent" affiliates. *Id.* at 3.

³³¹ *Id.* See also BUS. WEEK 62.

³³² Kelly 5.

³³³ Pub. L. No. 91-607, §§ 101-06, 84 Stat. 1760 (1970), amending 12 U.S.C. §§ 1841-49 (1970). The 1970 amendments made several significant changes in the bank holding company law. Among the more important were: (1) Inclusion of one-bank holding companies and partnerships within the coverage of the 1956 Act so as to make them subject to the jurisdiction of the Board of Governors of the Federal Reserve System; under the former law two or more banks had to be controlled; (2) expansion of the control concept under the old law from the power to vote 25% or more of the voting shares, or ability to control the election of a majority of the board of directors, to giving the Board of Governors authority to determine that an organization is a bank holding company if it directly or indirectly exercises a controlling influence over the policies and management of a bank. There is presumption of noncontrol if less than 5% of the voting securities can be voted; (3) limiting the permitted scope of nonbanking activities to those closely related to the business of banking. As a result of the amendments, many large Texas banks that formerly held 24.9% or less interests in other banks, see note 330 *supra*, are now applying to become multibank holding companies to formalize their preexisting relationship, since they undoubtedly exercise the requisite controlling influence over their affiliates. See Kelly 3.

On federal bank holding company legislation see generally PLI, *THE NEW BANK HOLDING COMPANY ACT OF 1970* (R. Needham ed. 1971); Blaine, *Registered Bank Holding Companies and the One-Bank Holding Company*, 26 BUS. LAW. 9 (1970); Edwards, *The One Bank Holding Company Conglomerate: Analysis and Evaluation*, 22 VAND. L. REV. 1275 (1959); Panel Discussion, *Banks and Bank Holding Companies*, 39 ABA ANTITRUST L.J. 432 (1970); Comment, *Approaches to Regulation of One-Bank Holding Companies*, 55 VA. L. REV. 952 (1969); Legislation Note, *Bank Holding Company Act Amendment of*

been formed or approved and another sixteen applications were pending before the Board of Governors of the Federal Reserve System.³³⁴ If approved, a total of seventy-one Texas banks representing a twenty-two percent share of all deposits in the state would become part of multibank holding company systems.³³⁵

The legal dimensions of these patterns of banking organization and affiliation remain to be fully measured. As the Austin court pointed out in the *Bank of North America* case, the no-branch-banking provision had not been judicially construed before, the only rulings on the subject being several attorney general's opinions.³³⁶ In its decision the court set out the substance of the most comprehensive of these³³⁷ without deciding that it necessarily stated the law. The attorney general's report extrapolated a state policy from the constitutional provision that prohibits one bank organizing another and then dominating it to such an extent that it becomes a branch operation. On the other hand, the constitution does not preclude common stock ownership, and that fact alone shows no violation unless the shareholders of one bank acquire a controlling interest in another for the purpose of so operating the controlled bank as an instrumentality or agency of their other bank.³³⁸ The attorney general's opinion reflects, of course, the basic elements of the disregard doctrine. And while the absence of judicial construction until *Bank of North America* suggests general satisfaction with the status quo, the advent of, and reactions to, the holding company movement as well as recent bank scandals may yet prove that that decision marked the end of the lull before the storm, both legislatively³³⁹ and judicially.

Other Disregard Cases. The remaining two disregard cases reflect some of the variety of circumstances in which the doctrine can be involved. In *Knebel v.*

1970, 39 GEO. WASH. L. REV. 1200 (1971); Note, *Banking—Recent Enactment of Federal Legislation Regulating One Bank Holding Companies*, 7 WAKE FOREST L. REV. 473 (1971).

³³⁴ Kelly 5.

³³⁵ *Id.* at 4; see BUS. WEEK 60.

³³⁶ See TEX. ATT'Y GEN. OP. Nos. M-273 (1968), M-82 (1967), WW-41 (1958), WW-159 (1957), V-1046 (1950).

³³⁷ The opinion referred to was really a 38-page study submitted by the attorney general to the State Banking Board on Aug. 18, 1952, as a background report, not a formal opinion. As a consequence it is not found in the Attorney General's Opinions nor is it indexed in C. MARTIN, TWENTY-FOUR YEAR INDEX AND TABLES TO THE OPINIONS OF THE ATTORNEY GENERAL OF TEXAS 1947-1970 (1971). However, the report can be obtained from the office of the attorney general in Austin upon request.

³³⁸ The language is taken from the attorney general's report referred to in note 337 *supra*. Most of the study is devoted to a consideration of the authorities on disregard of the corporate entity especially in instances in which the corporate entity is used to evade public policy. See note 325 *supra*.

³³⁹ The Bank Holding Company Act expressly reserves power to the states to regulate banks and bank holding companies as they see fit, 12 U.S.C. § 1846 (1971), and this would seem to include the power to prohibit the formation of bank holding companies. See *Whitney Nat'l Bank v. Bank of New Orleans & Trust Co.*, 379 U.S. 411 (1965). However, § 1846 does not necessarily mean that state imposed restrictions on branch banking automatically become applicable to bank holding companies. *Commercial Nat'l Bank v. Board of Governors*, 451 F.2d 86 (8th Cir. 1971) (holding that the Federal Reserve Board did not err in determining formation of multibank holding company in Arkansas was valid despite that state's prohibition against branch banking). Arkansas has now passed specific legislation prohibiting the creation or expansion of multibank holding companies. No. 47, §§ 1-9, [1971] Ark. Acts 188.

*Capital National Bank*³⁴⁰ the court ignored the incorporation of a one-man business to carry out the testamentary intention of the owner. Knebel executed a will at a time when he was the sole proprietor of a soft drink bottling company, leaving fifty-two percent of his residual estate to ten individuals, one of whom was designated as "my general manager," and each of the other nine as "my employee." Three years before his death Knebel incorporated the business both for tax reasons and to give four of his employees an interest in the business. However, he continued to operate the business as before and directed the new employee-shareholders in their work as he always had. After his death his coexecutor brought a declaratory judgment action to construe the will, contending that since the business had been incorporated when Knebel died, he had no employees and, hence, the bequest failed. The court wisely held that while it would not hold the corporation was not bona fide, it would not permit the technicality of its existence to defeat Knebel's obvious intention to benefit "his" long-term employees.

In the other case,³⁴¹ this time involving the sole shareholder of two corporations who was sued as a guarantor along with one of his corporations on an account, the defendants were unsuccessful in an argument that a payment that the defendant corporation had made for goods supplied to the other corporation should be credited to the defendant corporation's account because it was paid by mistake. The court refused to allow a set-off or find unjust enrichment in view of the fact that the payment had been made by the bookkeeper for both corporations pursuant to general instructions given by the sole shareholder. The latter's ownership of substantially all the shares of both corporations provided consideration for the payment, even if the bookkeeper did mistakenly pay a draft drawn on one corporation out of the funds of another.

V. SHAREHOLDERS' AGREEMENTS

The great bulk of corporations organized in Texas each year are closely held enterprises, which are for all practical purposes incorporated proprietorships or partnerships. In the instance of the latter it is understandable that the several persons associated together in corporate form would like the same protection against outsiders being admitted into the business that partnership law affords.³⁴² The *delectus personae*³⁴³ safeguard cannot be attained in the corporation, however, without some concrete action being taken. Frequently this takes the form of restrictions on transferability of shares that the corporation imposes in its articles or bylaws, or that arise from agreements among some or all the shareholders, and sometimes the corporation, that give the contracting parties the right or option to acquire stock that might otherwise be disposed of to others. But not all agreements among shareholders need

³⁴⁰ 469 S.W.2d 458 (Tex. Civ. App.—Austin 1971), *error ref. n.r.e.*

³⁴¹ *Pacific Molasses Co. v. Graves*, 451 S.W.2d 294 (Tex. Civ. App.—San Antonio 1970), *error ref. n.r.e.*

³⁴² "No person can become a member of a partnership without the consent of all the partners." Texas Uniform Partnership Act § 18(g), TEX. REV. CIV. STAT. ANN. art. 6132b (1962).

³⁴³ See J. CRANE & A. BROMBERG, *PARTNERSHIP* 43 (A. Bromberg ed. 1968) on *delectus personae* concept.

be for this purpose. Some may seek to establish or assure control; others to provide buy-out arrangements in the event of disagreement or deadlock. All, of course, are contracts, and when disputes arise concerning their meaning or application, the issues can often be resolved in the same manner as any other contracts case, despite their corporate context. This was largely true of the rather large number of cases dealing with shareholder's agreements decided during the survey period, only one of which raised any significant question concerning the validity of such arrangements under corporate law.

Buy-Out Arrangements. A potential hazard in the close corporation, and one that should be anticipated and provided for, is the possibility of dissension among the shareholder-associates. The operation of any partnership type of business is necessarily based on a close working relationship among the participants in the enterprise, and, given the frailties of human nature, such relationships can be easily soured for a variety of reasons ranging from petty annoyances to incomparability to outright knavery. If the business is a prosperous one, the resulting discord can wreck everyone's investment. One solution is to provide a buy-out arrangement whereby the dissatisfied party can require his shares be purchased by the others or be given an option to purchase theirs. Such arrangements are quite common when the shareholdings are evenly divided.³⁴⁴

In a case³⁴⁵ involving a buy-out agreement between two owners of all the stock of a poultry packing company, the issue turned on whether the dissatisfied shareholder's notification to the other of his desire to buy out the latter's shares was an unconditional offer. Under the shareholder's agreement a party not satisfied with the manner in which the business of the corporation was being conducted was to notify the other in writing of such fact and state the cash price he was willing to sell his stock for or buy the stock of the other. The defendant wrote the plaintiff that to accomplish business objectives he needed full ownership and offered to buy the plaintiff's stock, indicating, however, that certain matters would have to be negotiated. The negotiations were not successful, but thereafter the plaintiff wrote the defendant saying that it exercised its option to buy the defendant's stock. The defendant answered withdrawing his offer, and the plaintiff sued seeking transfer of the shares. The Tyler court of civil appeals reversed a summary judgment for the plaintiff, holding that the series of letters did not establish a concluded contract. The defendant's offer was conditional and was not prohibited by the buy-sell agreement.

³⁴⁴ See 2 F. O'NEAL, *supra* note 11, at § 9.05; W. PAINTER, CORPORATE AND TAX ASPECTS OF CLOSELY HELD CORPORATIONS 260 (1971) [hereinafter cited as PAINTER] on use of buy-out arrangements when deadlock and dissension occur. See also Bradley, *Stock Transfer Restrictions and Buy-Sell Agreements*, 1969 U. ILL. L.F. 139, 175; Israels, *The Sacred Cow of Corporate Existence: Problems of Deadlock and Dissolution*, 19 U. CHI. L. REV. 778 (1952); cf. TEX. BUS. CORP. ACT ANN. arts. 7.05.A(1)(b), (3) (1956) (receivership when directors or shareholders become deadlocked); Note, *Arbitration as a Means of Settling Disputes Within Close Corporations*, 63 COLUM. L. REV. 267 (1963); Note, *Mandatory Arbitration as a Remedy for Intra-Close Corporation Disputes*, 56 VA. L. REV. 271 (1970).

³⁴⁵ Roy Herider Feed Co. v. Modern Feeds of Nacogdoches, Inc., 468 S.W.2d 554 (Tex. Civ. App.—Tyler 1971), *error ref. n.r.e.*

Sometimes buy-out arrangements are made to acquire the interest of a minority shareholder who would rather have his shares purchased than go along with an impending change in the corporate set-up. This seems to have been the situation in a decision construing the provisions of a contract for the sale of a minority block of stock in a drug store chain.³⁴⁶ Alkire, a minority shareholder in Dugan Drug Stores, Inc., entered into an agreement with Dugan, the majority shareholder, and the corporation to sell his shares to the corporation for \$3 per share to be paid by the corporation's \$96,000 note, payable \$1,000 per month. The agreement was then supplemented by another which provided that "in the event all of the outstanding shares of corporate stock of Dugan Drug Store, Inc. should be sold by J. S. Dugan" for less than \$3 per share, Alkire agreed to a proportionate reduction of the sales price of his shares "to correspond with the sales price per share received by J. S. Dugan from a bona fide sale of his controlling interest," provided the consideration was paid in cash.

Three years later Dugan sold all 275,000 shares of his stock to Mading Drug Stores. Although nominally paid \$390,000 in cash, of that amount \$206,000 was paid immediately to a creditor pharmaceutical manufacturer, and \$184,000 was credited on the corporation's books against Dugan's drawing account to cover his withdrawals from the corporation. Even though \$54,000 remained to be paid on Alkire's note, the corporation, now under Mading's control, tendered a check for \$1,760 in final payment of his note, claiming that under the proportionate reduction provision no more was owed. Not surprisingly, Alkire sued.

At the trial the jury found that the provision that "[i]n the event all of the outstanding shares" in the corporation's stock should be sold by Dugan was intended by the parties to mean a sale of "all the outstanding shares of stock owned by J. S. Dugan." Reversing a judgment based on the verdict for the corporation, the court held that the price-reduction clause would not apply unless Dugan had sold all the outstanding shares in the corporation. Since the parties chose their words with care, there was no indication that Alkire agreed to reduce the consideration he was to receive if all Dugan sold was his controlling interest in the corporation.

Perhaps so, but at the time the documents were executed, 31,600 shares were owned by persons other than Dugan and Alkire. Since there was likewise no indication that Dugan planned to acquire these shares, it is just as plausible the parties intended to deal only with a possible disposition of Dugan's controlling shares, especially since negotiations for a sale or merger of the corporation had been going on at the time. But no doubt the reduction in consideration was so great that it seemed fairer to give Alkire the benefit of the questioned construction, even though discrepancy in price is seldom critical in shareholders' agreements.³⁴⁷

³⁴⁶ Alkire v. Dugan Drug Stores, Inc., 468 S.W.2d 492 (Tex. Civ. App.—Houston [1st Dist.] 1971), *error ref. n.r.e.*

³⁴⁷ See, e.g., Helms v. Duckworth, 249 F.2d 482 (D.C. Cir. 1957) (\$80,000 interest bought for \$10,000); Cutter Labs., Inc. v. Twining, 221 Cal. App. 2d 302, 34 Cal. Rptr. 317 (1963) (\$800,000 worth of stock redeemed for \$36,000); *In re Estate of Mather*, 410 Pa. 361, 189 A.2d 586 (1963) (\$1 share paid under agreement for stock having value of

Control Agreement. Two cases dealt with agreements among holders of controlling shares in banks and subsequent dispositions or attempts to dispose of control shares. In *Woodrum v. Cowan*³⁴⁸ Woodrum, the president of an Abilene bank, entered into an agreement with Cowan and Jacobsen, who had just purchased a substantial block of stock in the bank, to pool their holdings and vote the block as a unit so long as the shares remained pledged to a Fort Worth bank from whom the parties had borrowed the purchase money for the stock. After four months the parties disagreed and, according to Woodrum, he was forced to sell his shares to Cowan and Jacobsen, but under a contract providing that if the latter sold their controlling interest in the bank or enough stock to amount to fifty-one percent of the outstanding shares to "any one person, firm or corporation" within the next two years, Woodrum would receive one-third of their profit.

Five months later Cowan and Johnson sold more than fifty-one percent of the bank's stock to a group of five Abilene businessmen at a substantial profit. Woodrum sued to recover his one-third of the profit. The defendants claimed they were not obligated under their contract with Woodrum because the sale had not been to "one person, firm or corporation." In response the court noted that the Abilene group obligated themselves to retain control of the bank among themselves so long as the funds they jointly borrowed to finance the purchase remained unpaid. Because they acted as a group in buying the stock as a block, financing it, and agreeing to maintain control through the shares acquired, the Abilene group were joint adventurers. Since the Texas courts regard joint ventures as a species of partnership,³⁴⁹ and the purpose of the agreement with Woodrum was to assure sale of the stock in a single transaction to realize the enhanced value of control stock,³⁵⁰ the sale to the Abilene group was quite properly held to be tantamount to the sale to a firm within the meaning and intent of the contract.

The other case also concerned a pooling agreement among majority shareholders of a bank that had been entered into to forestall a takeover by an outsider, but the facts stated must be read in light of those given by the Texas

\$1,060); *Jones v. Harris*, 63 Wash. 2d 559, 388 P.2d 539 (1964) (\$325,000 interest purchased for \$25,000); see HENN 561; 2 F. O'NEAL, *supra* note 11, at § 7.06.

³⁴⁸ 468 S.W.2d 592 (Tex. Civ. App.—Austin), *rev'd and remanded per curiam*, 472 S.W.2d 749 (Tex. 1971). The supreme court based its action on the fact that Woodrum had not moved for summary judgment, but the court of civil appeals had, nevertheless, rendered judgment in his behalf. The only issue the court could consider was whether the trial court erred in granting summary judgment to Cowan and Jacobsen. The case was remanded for a trial on all the issues, the supreme court indicating it would not decide whether the court of civil appeals was correct in any of the holdings discussed herein other than that summary judgment against Woodrum was improvidently granted.

³⁴⁹ *E.g.*, *Colonial Refrigerated Transp. Inc. v. Mitchell*, 403 F.2d 541, 546 (5th Cir. 1968) (applying Texas law); *Brown v. Cole*, 155 Tex. 624, 631, 291 S.W.2d 704, 709 (1956). See generally J. CRANE & A. BROMBERG, *supra* note 343; Jaeger, *Partnership or Joint Venture?*, 37 NOTRE DAME LAW. 138 (1961); Taubman, *What Constitutes a Joint Venture?*, 41 CORNELL L.Q. 640 (1956).

³⁵⁰ Although not raised as an issue, the legitimacy of the premium price a control block of stock commands in light of the fiduciary duties that may be owed by those selling control to the corporation and the remaining shareholders has been a topic of continuing interest among the commentators. See, *e.g.*, Bayne, *The Sale-of-Control Premium: The Intrinsic Illegitimacy*, 47 TEXAS L. REV. 215 (1969); Berle, *The Price of Controlling Shares*, 70 HARV. L. REV. 986 (1957); Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956); Newman & Pickering, *Premium for Control*, 28 TEX. B.J. 735 (1965). See also HENN 479 n.5 collecting other authorities.

Supreme Court in reversing the decision at the close of the year.³⁵¹ As stated by the court of civil appeals, the agreement in question required any withdrawing party to give a ninety-day option to the other shareholders during which time his shares could be purchased at their fair market value.³⁵² Later the president and another director of the bank sold part of their shares to another outsider who wanted control on the assurance that the president would be kept in office, and both aided in buying stock for the outsider from other stockholders. Despite the primary objective of keeping the first outsider from getting control, the agreement had no termination date. Hence, the court was of the opinion that the plaintiff was entitled to a temporary injunction to protect his option rights to the stock against what it viewed as an obvious breach of contract by the president and director.³⁵³

Stock Transfer Restrictions. Only one case during the survey period dealt with stock transfer restrictions,³⁵⁴ and it raised the interesting question of whether such restrictions retain any validity after the corporation is dissolved. In *Mischer v. Burke*³⁵⁵ the bylaws of the corporation had a first option provision requiring a stockholder desiring to sell his shares to give written notice to the other stockholders of his intent and his asking price. The other stockholders or whatever number chose to exercise the option would then have five days to decide. If the options were not exercised, the stockholder was free to sell to third parties, but at a price no lower than that stated in the notice. The stock certificates were duly indorsed with notice of the restriction.

In 1958 Peachey, one of the original directors and officers of the corpora-

³⁵¹ *Wieser v. Manning*, 469 S.W.2d 805 (Tex. Civ. App.—Waco), *rev'd*, 474 S.W.2d 448 (Tex. 1971).

³⁵² In the supreme court's view there was a serious question whether a presently enforceable contract existed at all, if the testimony of the president was accurate. The president testified that the only document the shareholders signed was a statement: "I hereby subscribe to the pooling of shares owned in Perry National Bank and will sign the formal instrument when it is ready for my signature." 474 S.W.2d at 450. The other terms, including the 90-day option, came from two sheets of paper kept in the bank files which he had gotten from another banker in the event a formal contract was ever prepared.

³⁵³ As stated by the supreme court, the president and director had already sold all but their qualifying shares to the outsider when plaintiff brought his suit and by the time the temporary injunction hearing was held, the outsider, who had no knowledge of the agreements, was in control. The trial court's decision that there was no need for the restraint was well within the exercise of its discretion. *Id.* at 450.

³⁵⁴ A troublesome case dealing with stock transfer restrictions was decided after the close of the survey period, but while this Article was being written. It is *Ling & Co. v. Trinity Sav. & Loan Ass'n*, 470 S.W.2d 441 (Tex. Civ. App.—Waco 1971), *error granted*, and has drawn such adverse reaction from the corporate bar that it is briefly noted here. In the case the Waco court invalidated what appears to have been a fairly standard first option restriction (except for a then-required consent restraint because of Ling's membership in the New York Stock Exchange) on several grounds, all of them dubious. The restriction was held to be too cumbersome, not conspicuously noted on the stock certificate despite adherence to the incorporation-by-reference procedure permitted in TEX. BUS. CORP. ACT ANN. art. 2.19(F) (1956) (which the court failed to mention), and most importantly, not applicable when a corporation has more than 20 shareholders. The last ruling, in particular, is a patent misreading of *id.* art. 2.22, which permits reasonable restraints on transfer in several circumstances beyond the 20-shareholder, buy-sell agreement category the Waco court used to limit all of art. 2.22. Because corrective action may be forthcoming either in the supreme court or the legislature further comment is deferred until next year's *Survey*.

³⁵⁵ 456 S.W.2d 550 (Tex. Civ. App.—Houston [1st Dist.] 1970), *error ref. n.r.e.*, discussed in Comment, *Vitality of Restrictions on Transferability of Shares—Extinction on Dissolution or Life Everlasting*, 23 BAYLOR L. REV. 97, 99 (1971).

tion, but who had been removed from office two years earlier, gave Mischer a note in payment of a prior debt accompanied by an assignment of his stock.³⁵⁶ In February 1960 after Peachey defaulted on the note, Mischer asked that the stock be transferred to his name on the corporation's books. In August 1960 the corporation dissolved. The final accounting showed a credit to Peachey's account of \$27,000, which Mischer sought to recover as the assignee of Peachey's stock interest.

Because the restrictions had been imposed prior to passage of the Texas Business Corporation Act and the corporation had not adopted the Act before its dissolution,³⁵⁷ the court applied the pre-TBCA law although the result would likely have been the same under the present law. The restriction itself was held to be reasonable,³⁵⁸ but once the corporation had been dissolved there was no longer any need to protect the shares against transferability. On dissolution the stockholder acquires an equitable interest to receive his distributive share of the net corporate estate, and in this instance Mischer properly succeeded to Peachey's distributive rights. While it was true Mischer obtained his shares during the life of the corporation, no action was taken to set aside his acquisition. Moreover, a transfer in violation of the restriction is not void, but simply susceptible to being set aside by the corporation or other shareholders for whose benefit the restriction was imposed.³⁵⁹ Insofar as the selling shareholder is concerned, his rights in the stock are effectively transferred.

The decision is sound. Transfer restrictions of the type involved here are designed to preserve a closeness of association in an ongoing enterprise.³⁶⁰

³⁵⁶ Mischer argued that the transaction was a pledge and, therefore, not covered by the restriction which applied only to sales. However, the court read the assignment to be a sale or transfer instead of a pledge since Peachey retained no rights in the stock.

³⁵⁷ When passed in 1955, the TBCA was not immediately applicable to all business corporations, but only those formed after it became effective or which adopted the Act by following the procedure prescribed in art. 9.14(F). Because the Act made such drastic changes in the old corporate law, the Bar committee thought it desirable to have a five-year trial period before the Act became applicable to all corporations in 1961. See Comment of Bar Committee, 3A TEX. BUS. CORP. ACT ANN. 421 (1956); Carrington, *The Texas Business Corporation Act as Enacted and Ten Years Later*, 43 TEXAS L. REV. 609, 616 (1965); Carrington, *Experience in Texas with the Model Business Corporation Act*, 5 UTAH L. REV. 292, 304 (1957).

³⁵⁸ The court quoted here the famous remark by Holmes that "there seems to be no greater objection to retaining the right of choosing one's associates in a corporation than in a firm." *Barrett v. King*, 181 Mass. 476, 479, 63 N.E. 934, 935 (1902). On the need for reasonable restrictions on transfer see generally 2 F. O'NEAL, *supra* note 11, § 7.06; PAINTER 86; Castle, *Restrictions on Transferability of Securities*, 7 BULL. OF THE SECTION ON CORPORATION, BANKING & BUSINESS LAW, Jan. 1969, at 7; Pelletier & Marsh, *Incorporation Planning in Texas*, 23 SW. L.J. 820, 841-43 (1969); 14 SW. L.J. 106 (1960); 38 TEXAS L. REV. 499 (1960).

³⁵⁹ Cf. *Irwin v. Prestressed Structures, Inc.*, 420 S.W.2d 491 (Tex. Civ. App.—Amarillo 1967), *error ref. n.r.e.* (corporation can waive restriction); Comment, *supra* note 355, at 98 (Texas courts will hold transfer in violation of reasonable restriction voidable unless expressly made void in the restriction).

³⁶⁰ The author of the Comment, *supra* note 355, argues that a restriction on transfer may need to remain viable even after dissolution to keep outsiders from participating in the liquidation process, particularly in view of the limited three-year existence given the dissolved corporation in art. 2.07 of the Miscellaneous Act, TEX. REV. CIV. STAT. ANN. art. 1302-2.07 (1962), and the right granted a corporation whose period of duration has expired to revive its corporate existence. Although none of these considerations appears relevant in the instant case or would justify a different result, they do suggest the need for considering the impact and consequences of dissolution when drafting transfer restrictions.

Surely if the remaining shareholders took no steps to preserve their close corporation during its existence, they can hardly complain when a selling shareholder's transferee asserts his proprietary rights after the desired association has ended.

VI. OTHER DECISIONS

Problems of Formation. Two of the decided cases seem to fit in this category, although one was concerned with an ingenious argument that a nonprofit corporation had been transformed into a business corporation without incorporation under the TBCA.

In the first case³⁶¹ two promoters opened a checking account with the defendant bank in the name of their proposed corporation with the signature of both required. Later in the day the plaintiff promoter was asked by his copromoter to execute two checks to pay for property to be acquired by the corporation. The plaintiff gave him postdated checks, but wrote only the name of the corporation at the bottom of the checks. The copromoter alone signed the checks, gave them to the owner of the property, who immediately cashed them. The plaintiff sued the bank for wrongful disbursement of his funds, contending, among other arguments, the checks required the signatures of both promoters and that a corporate resolution authorizing checking had not been filed. The court held, however, that the two were joint adventurers, each being responsible for and being bound by the acts of the other, including the withdrawal of funds. Moreover, because the plaintiff asserted that he alone could withdraw the money, his fellow venturer should necessarily have the same right. As to the corporate resolution, the corporation was never formed, and the deposit remained the property of the joint venturers. And if it had been formed, then only the corporation would have had standing to complain of the unauthorized withdrawal.

In the other case³⁶² shareholders of a country club by a two-thirds vote of those present voted to sell its property in Houston and move the club elsewhere. The vote met the requirements of the Texas Non-Profit Corporation Act.³⁶³ The plaintiffs, who were members opposed to the move, contended the club was a business corporation and that under the TBCA, a sale of all the assets required approval by the holders of at least two-thirds of the outstanding shares,³⁶⁴ not just those present at the meeting. They theorized that because the president and secretary of the club filed a statement in 1960 pursuant to article 9.14(F) of the TBCA requiring corporations not yet subject to the Business Act to designate a registered agent and office, the country club became converted into a profit corporation. As the court of civil appeals noted, the statement in question was required to be filed with the annual report for the state franchise tax, but no such reports had been filed by the club. Nor would have adoption of the Business Act by following the procedure prescribed in article

³⁶¹ *Roland v. Republic Nat'l Bank*, 463 S.W.2d 747 (Tex. Civ. App.—Waco 1971), error ref. n.r.e.

³⁶² *Argue v. Golfcrest Country Club*, 461 S.W.2d 248 (Tex. Civ. App.—Houston [1st Dist.] 1970).

³⁶³ TEX. REV. CIV. STAT. ANN. art. 1396-5.09 (1962).

³⁶⁴ TEX. BUS. CORP. ACT ANN. art. 5.10 (Supp. 1972).

9.14(C) for business corporations to come under the Act have been effective,³⁶⁵ since the TBCA expressly prohibits nonprofit corporations from adopting or organizing under its provisions.³⁶⁶ The only way a nonprofit corporation can convert into a business corporation is by dissolving and reincorporating under the TBCA.

Corporate Officers: The President. The role of the president in corporate affairs has progressed considerably from the days when he was considered just another director with very limited authority whose primary duty was to preside over meetings of the board.³⁶⁷ Today in most corporations, both large and small, the president is the chief executive officer both in fact and in title and possesses a wide range of implied authority to take action that will bind the corporation, although the full dimensions of how far he can speak and act in its behalf remain to be determined.³⁶⁸ It should be kept in mind, however, that no matter how mighty, the president, like other officers, is a fiduciary who must adhere to the standards of care and loyalty expected of all those who represent others. If he does not, he may be brought to account either by his corporation or the shareholders for whose general benefit and profit he is supposed to be working. And while his conduct even if unauthorized may bind the corporation to third parties under principles of apparent authority, estoppel, or inherent power of his position,³⁶⁹ he may at the same time have to make good the ultimate loss his corporate employer suffers because of his carelessness or misconduct. Some of these overtones are reflected in three cases decided during the survey period dealing with activities of corporation presidents.

In the simplest case³⁷⁰ the president's misrepresentations resulted in liability of his corporation to subcontractors whose claim against the corporation was asserted after the statute of limitations had run. Although the subcontractors had filed a mechanic's and materialman's lien against the corporation for work and materials furnished in reconstructing a drive-in theater, when sued by the president and contractor to cancel their lien, their cross-action was brought against the president and their contractor and not the corporation because the president in his pleadings asserted that the theater property belonged to him.

³⁶⁵ See note 357 *supra*.

³⁶⁶ TEX. BUS. CORP. ACT ANN. arts. 2.01(A), 9.14(A) (1956). See also TEX. REV. CIV. STAT. ANN. art. 1302-1.03 (1962).

³⁶⁷ E.g., *Black v. Harrison Home Co.*, 155 Cal. 121, 99 P. 494 (1909); *Wainwright-West Oils, Ltd. v. Cooke*, 103 S.W.2d 847 (Tex. Civ. App.—Texarkana 1937), *error dismissed*; *El Fresnal Irrigated Land Co. v. Bank of Washington*, 182 S.W. 701 (Tex. Civ. App.—San Antonio 1916); see W. CARY, *CASES & MATERIALS ON CORPORATIONS* 204 (4th ed. 1969); HENN 439; 2 I. HILDEBRAND, *supra* note 154, at 598; N. LATTIN, *supra* note 117, at 257.

³⁶⁸ Cf. *San Antonio Joint Stock Land Bank v. Taylor*, 129 Tex. 335, 105 S.W.2d 650 (1937); *Mr. Eddie, Inc. v. Ginsberg*, 430 S.W.2d 5 (Tex. Civ. App.—Eastland 1968), *error ref. n.r.e.* See also commentators cited in note 369 *infra, passim*.

³⁶⁹ See Myers, *The Inherent Powers of Corporation Presidents*, 23 WASH. U.L.Q. 117 (1937); Note, *Inherent Power as a Basis of a Corporate Officer's Authority To Contract*, 57 COLUM. L. REV. 868 (1957); Note, *Inherent Powers of Corporate Officers: Need for a Statutory Definition*, 61 HARV. L. REV. 867 (1948); Note, *Authority of a Corporate President To Bind the Corporation by Virtue of His Office*, 50 YALE L.J. 348 (1940). The meaning of apparent authority, estoppel, and inherent agency power in agency law is discussed in W. SEAVEY, *HANDBOOK OF LAW OF AGENCY* 13-17 (1964).

³⁷⁰ *Long v. Smith*, 466 S.W.2d 32 (Tex. Civ. App.—Corpus Christi 1971), *error ref. n.r.e.*

Just before the trial, but over two years after the work was performed, the subcontractors learned for the first time that the theater company owned the property and filed an amended cross-action. The court ruled that because of the president's knowledge of the true state of affairs, the corporation would be estopped to plead limitations, and he would be held personally liable for his fraudulent misrepresentations.

The second decision concerned a bank president who executed a \$100,000 "take-out" letter or guaranty for the benefit of a long-time customer of the bank, which the bank later had to make good, but not without being sued first.³⁷¹ In the action the bank claimed that the president lacked authority to execute the letter and brought a third party claim against him for his dishonest and fraudulent act in entering into the guaranty. The evidence showed that the president had no prior experience with "take-out" letters, but arranged the deal to accommodate a customer to whom the bank could not make a requested loan because its loan ratio was too high at the time. The customer's financial statement showed him worth in excess of one million dollars, and he secured the transaction by an assignment to the bank of property worth \$300,000. The bank's bylaws gave the president authority to perform the duties generally performed by bank presidents, and he felt he had authority to handle the transaction, even though he failed to get approval from the board or loan committee and indeed kept the transaction secret except from the cashier. Part of the proceeds of the guaranteed loan was used to pay off the customer's \$28,000 debt to the bank, and the president received no personal benefit from the arrangement. The trial court held the bank liable on the "take-out" letter and found for the president in the bank's third party claim against him.

The Dallas court of civil appeals affirmed, stating that the findings of the trial court were sufficiently supported by the evidence. More specifically, it held that the president had not violated article 342-411 of the Banking Code³⁷² in creating a "bill payable" without authorization from the board because the "take-out" letter was not a bill payable. Moreover, the bank had failed to prove that the statute was violated; thus, inferring that the president had ample authority from the bylaws to execute the guaranty. Whether the president had been guilty of a dishonest or fraudulent act was a matter best left to the factfinder. Reading between the lines, it seems evident that the court felt the transaction involved no more than the exercise of honest business judgment on the president's part even though it may have turned out badly for the bank. No doubt the testimony by one of the bank's attorneys that the president was an honorable and honest man who was upright in his dealings with him did little to hurt the president's cause.

The third case is from the Fifth Circuit, applying Texas law, and forms part of the ever-continuing Westec story.³⁷³ As Judge Wisdom aptly put it, the facts

³⁷¹ Guaranty Bond State Bank v. Tucker, 462 S.W.2d 398 (Tex. Civ. App.—Dallas 1970), *error ref. n.r.e.*

³⁷² TEX. REV. CIV. STAT. ANN. art. 342-411 (1959).

³⁷³ *In re Westec Corp.*, 434 F.2d 195 (5th Cir. 1970). Westec was a conglomerate concern whose stock shot up in market value from 4¼ in 1961 to a high of 67½ in April 1966, before trading in the stock was suspended and the business collapsed in August 1966. See *The Economist*, Oct. 8, 1966, at 195; *NEWSWEEK*, Sept. 12, 1966, at 78; *id.*, Oct. 10, 1966, at

out of which the action arose "constitute a prescription for corporate collapse: loose stock transactions, a corporate acquisition made to placate and benefit a subsidiary's principal officer, and, allegedly, double payments for an officer's activities."³⁷⁴

The case concerned a claim filed in the Westec chapter X reorganization proceedings by Walker, who was the chief executive officer of Seismic, a wholly owned Australian subsidiary of Westec, for \$383,000 based on breach of a contract with Westec. The trial court disallowed the claim, finding that no binding contract had been made, and its judgment was affirmed. The Fifth Circuit held that Walker had not shown that Hall, the president of Westec, with whom he dealt, had authority to make the alleged contract or that the contract was consistent with Walker's fiduciary obligations as a corporate officer.

The contract in question arose from an investment Walker had made in Continental, another Australian corporation, to whom he eventually loaned \$43,000 of his own funds to keep it from going under. In order to recoup he felt he had to get Westec to take over Continental and told Hall that unless Westec acquired the company and otherwise made it worthwhile for him to stay he would resign and go into competition with Seismic. He assured Hall that Continental was a good investment even though it was insolvent. Continental was acquired, but by Seismic, the Westec subsidiary that Walker headed. Although Walker's loan to Continental was repaid as a result, he remained unhappy because he anticipated getting Westec stock in the exchange and profiting in the rapidly rising market for Westec stock.³⁷⁵ He wrote Hall asking in effect that his minority interest in Continental be bought out and Hall responded by promising to issue 7,000 shares of Westec for Walker's Continental holdings. However, the board did not authorize the issue, but did authorize that an option be given Walker for the same number of shares that he ultimately accepted,³⁷⁶ although demanding his 7,000 shares from time to time and finally suing for their market value of \$383,000 as of March 15, 1971.

In his effort to show that Hall had authority to contract and to issue the 7,000 shares to him, Walker contended that a president's actions are presumed to be within the scope of his authority unless otherwise shown.³⁷⁷ The Fifth

95; TIME, Sept. 9, 1966, at 96. The corporation went into bankruptcy reorganization under chapter X of the Bankruptcy Act, 11 U.S.C. §§ 501-676 (1970), and some of its executives were convicted of stock fraud for market manipulation and dissemination of false information. SEC Litigation Release No. 4125 (Oct. 2, 1968). Some details concerning the reorganization are given in *In Re Westec Corp.*, 313 F. Supp. 1296 (S.D. Tex. 1970) (trustee awarded \$400,000 for 33-months service; general counsel for trustee awarded fee of \$600,000). The trustee in reorganization has brought a 10b-5 action against 93 defendants, including a number of banks, securities firms, and an accounting firm for the stock manipulation which ultimately led to Westec's collapse. See *Ernst & Ernst v. United States District Court*, 439 F.2d 1288 (5th Cir. 1971).

³⁷⁴ 434 F.2d at 197.

³⁷⁵ Between Oct. 15, 1965, and Mar. 15, 1966, the market price of Westec's stock sextupled in value. *Id.* at 199.

³⁷⁶ The trial court found in an alternative holding that Walker's acceptance of the option constituted a novation, even if a valid contract to pay Walker 7,000 shares had been made. The finding was upheld as amply supported by the evidence. *Id.* at 201.

³⁷⁷ Despite the Fifth Circuit's rejection of the presumption argument, some authority supports the view that there is a presumption the president has authority to act within the ordinary course of the corporation's business. The few Texas cases so suggesting, however, are

Circuit rejected the argument, saying that under Texas law one who wants to hold a corporation on a contract made by an agent must prove his authority to act.³⁷⁸ Furthermore, the president normally does not have the power to issue stock. As to apparent authority, because Walker was an insider, he knew better than to rely on Hall's statement to him since he knew only the board could issue stock. Nor could Walker claim Westec was unjustly enriched by the Continental acquisition at his expense. He himself gained by having his personal debt paid back, and it fell within his duties anyway as manager of Seismic, for which he was amply compensated, to arrange the acquisition.

The court also found that Walker was breaching his fiduciary duties by seeking to in effect be paid twice for services he should have been rendering to his corporation and indirectly to all the shareholders of the Westec enterprise. Because of his own interest in the transaction he would have the burden of showing that the transaction was fair and made in good faith.³⁷⁹ Hence, even if the contract had been made with the board it would have been voidable unless Walker could have shown that the transaction was a good business move for his corporation—something he failed to do. On the contrary, he was guilty of bad faith in promoting an acquisition that would benefit himself.

Receiverships. The TBCA has detailed provisions outlining the manner in which corporations subject to the Act can be placed in receivership.³⁸⁰ The statutory scheme is an amalgam of the old corporate receivership law³⁸¹ and the involuntary dissolution provisions of the Model Business Corporation Act,³⁸² and contemplates that less drastic procedures must be utilized first unless shown to be inadequate. Thus, a receiver can be appointed for specific corporate assets³⁸³ to rehabilitate the corporation, but only if all other remedies, including

ones upholding the validity of a mortgage signed by a corporate officer. See *Ballard v. Carmichael*, 83 Tex. 355, 18 S.W. 734 (1892); *Hufstедler v. Sides*, 165 S.W.2d 1006 (Tex. Civ. App.—Amarillo 1942), *error ref.*; *Peyton v. Sturgis*, 202 S.W. 205 (Tex. Civ. App.—Dallas 1918); *Brownwood Ice Co. v. York Mfg. Co.*, 37 S.W. 339 (Tex. Civ. App. 1896). Dean Hildebrand strongly supported use of the inherent power and presumed authority concepts as bases to hold the corporation liable to third persons who innocently dealt with the president or other officers. 2 I. HILDEBRAND, *supra* note 154, at 610-15. See generally *Schwartz v. United Merchants & Mfrs., Inc.*, 72 F.2d 256 (2d Cir. 1934); Note, *Inherent Powers of Corporate Officers: Need for a Statutory Definition*, 61 HARV. L. REV. 867, 870 (1948).

³⁷⁸ Citing *Adkins-Polk Co. v. Pate*, 11 S.W.2d 654 (Tex. Civ. App.—Texarkana 1928); *cf. Burns v. Gonzalez*, 439 S.W.2d 128 (Tex. Civ. App.—San Antonio 1969), *error ref. n.r.e.* (partnership law).

³⁷⁹ Citing *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963); *Popperman v. Rest Haven Cemetery, Inc.*, 162 Tex. 255, 345 S.W.2d 715 (1961). The fairness test used by the court is the standard now generally adhered to by Texas courts when examining contracts or other transactions with interested or interlocking directors. See *Hamilton & Shields*, *supra* note 14, at 93; *Lebowitz*, *supra* note 57, at 17; *Lebowitz, Recent Decisions on Fiduciary Duties to Corporations*, BULL. OF THE SECTION ON CORPORATION, BANKING & BUSINESS LAW, May 1963, at 1; Comment, *The Interested Director in Texas*, 21 SW. L.J. 794, 801 (1967).

³⁸⁰ TEX. BUS. CORP. ACT ANN. arts. 7.04-.09 (1956); see *Leeds, Merger, Consolidation, Reorganization, and Receivership Under the Texas Business Corporation Act*, 3A TEX. REV. CIV. STAT. ANN. 490 (1956); *Slover, Receivership Provisions of the Proposed Texas Business Corporation Act*, 4 BAYLOR L. REV. 489 (1952).

³⁸¹ TEX. REV. CIV. STAT. ANN. arts. 2293-2318 (1971).

³⁸² ABA MODEL BUS. CORP. ACT §§ 94-99 (1969); see *Slover, supra* note 380, setting out the sources used in drafting the TBCA's receivership provisions.

³⁸³ TEX. BUS. CORP. ACT ANN. art. 7.04 (1956).

the receivership for specific assets, are found inadequate,³⁸⁴ and to liquidate the corporation, but again only if the first two receiverships as well as any other legal or equitable remedies are not adequate.³⁸⁵

Two cases decided during the survey period had occasion to apply the TBCA receivership provisions with differing results. In *Robinson v. Thompson*³⁸⁶ shareholders and directors of AUstralite Corporation sought appointment of a corporate receiver under subdivisions 3 and 4 of article 2293³⁸⁷ and TBCA article 7.05. The plaintiffs claimed that the corporation was insolvent, that its assets were being wasted by advance payments of unnecessary salaries in that no work was being done for the corporation, and that to continue the salary payments would completely deplete the few remaining assets in a few months since the corporation had no income. On the facts found, the court had no difficulty determining that the appointment of a receiver to rehabilitate the corporation was necessary and that no other remedy could furnish relief.

In *Associated Bankers Credit Co. v. Meis*³⁸⁸ a corporate receivership obtained without notice by a plaintiff who was neither a shareholder nor creditor of a sign company (although apparently a shareholder of the corporation's parent company) was ordered dissolved, since either a temporary restraining order or temporary injunction would have provided the plaintiff adequate relief. The receivership arose as an incident to a suit against the parent corporation that was alleged to have impaired plaintiff's financial standing and encumbered large amounts of his assets. The controversy seems to have been the aftermath of an acquisition of plaintiff's sign company by the defendant parent in a stock-for-stock exchange. The trial court granted a sweeping injunction, again without notice, and appointed a receiver to take charge of certain assets of the sign company. However, the sign company had not been made a party to the action at the time the receivership was sought, and this too was held to be error. A corporation whose property is being placed in receivership is a necessary and indispensable party under rule 39(a).³⁸⁹

Miscellaneous. Finally, a few other cases dealing with diverse aspects of corporate law are worth mentioning. In *Danielson v. Ling-Temco-Vought, Inc.*³⁹⁰ a stock subscriber's heirs attempted to specifically enforce a stock subscription agreement, but were held barred by limitations. The subscription contract was entered into in November 1955, with the only installment payment being made then. It expired by its own terms in November 1957, and suit was not brought until May 1968. The Waco court of civil appeals held that in the absence of a statute, a stock subscription is governed by the same statute of limitations that applies to contracts in general,³⁹¹ and that the statute begins to run when the cause of action on the stock subscription accrues.

³⁸⁴ *Id.* art. 7.05 (Supp. 1972).

³⁸⁵ *Id.* art. 7.06.

³⁸⁶ 466 S.W.2d 626 (Tex. Civ. App.—Eastland 1971).

³⁸⁷ TEX. REV. CIV. STAT. ANN. art. 2293 (1971).

³⁸⁸ 456 S.W.2d 744 (Tex. Civ. App.—Corpus Christi 1970).

³⁸⁹ TEX. R. CIV. P. 39(a).

³⁹⁰ 461 S.W.2d 641 (Tex. Civ. App.—Waco 1970).

³⁹¹ TEX. REV. CIV. STAT. ANN. art. 5527 (1958).

In *W. A. Green Co. v. Cope*³⁹² the issue concerned the validity of a default judgment against a dissolved corporation obtained after service on the Secretary of State. The action was timely brought under TBCA article 7.12, which permits the survival of a remedy against a dissolved corporation if brought within three years of its dissolution. Following the Bar committee's comment on article 7.12, that the statute is cumulative of the procedures set out in rules of civil procedure 29 and 160, the court held that rule 29 should have been followed. Rule 29 expressly provides that a dissolved corporation can be served by service of process on the president, directors, general manager, trustee, assignee, or other person in charge of the corporation's affairs at the time of dissolution. Also, under the TBCA a domestic corporation cannot be served through the secretary of state unless a registered agent has not been appointed or maintained or cannot be found.³⁹³ There likewise were no allegations showing these circumstances had occurred.

The final case³⁹⁴ arose out of the Sunday closing law litigation previously discussed.³⁹⁵ In response to several actions brought by the state to enjoin Sunday openings by a discount chain, the several corporate defendants counterclaimed for injunctive relief against harassment by the multiplicity of such suits being filed against them. The trial court granted the defendants their injunction. On appeal the state contended that because two of the defendants were foreign corporations not qualified to do business in Texas, they could not maintain their cross-action. Under TBCA article 8.18 a nonadmitted foreign corporation transacting a business in the state cannot sue on a cause of action arising out of such business until it qualifies, but is permitted to defend any action brought against it.³⁹⁶ The court held, following New York precedent,³⁹⁷ that defendants could maintain their cross-action since the relief they sought was essentially defensive in nature. In a somewhat more questionable aspect of the holding the subject matter of the cross-action was thought not to arise out of business being transacted in the state and, therefore, would not have been barred by article 8.18(A) in the first place.

³⁹² 466 S.W.2d 860 (Tex. Civ. App.—Dallas 1971).

³⁹³ TEX. BUS. CORP. ACT ANN. art. 2.11(B) (1956).

³⁹⁴ *State v. Cook United, Inc.*, 463 S.W.2d 509 (Tex. Civ. App.—Fort Worth), *aff'd and modified on other grounds*, 469 S.W.2d 709 (Tex. 1971).

³⁹⁵ See note 321 *supra*.

³⁹⁶ TEX. BUS. CORP. ACT ANN. art. 8.18(B) (1956).

³⁹⁷ The court cites *Warren Trading Corp. v. Kraglan Bldg. Corp.*, 220 App. Div. 3, 220 N.Y.S. 455 (1927); *James Howden & Co. v. American Condenser & Eng'r Corp.*, 194 App. Div. 164, 185 N.Y.S. 159 (1920), *aff'd*, 231 N.Y. 627, 132 N.E. 915 (1921).