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George Slover

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ENFORCEABILITY OF GUARANTIES MADE BY TEXAS CORPORATIONS

by

*George Slover**

ONE of the most common problems confronting attorneys practicing corporation law in Texas is determining whether, in a given set of circumstances, a Texas corporation may make an enforceable guaranty of the obligations of another person. Frequently, when a borrower is met by a requirement of additional security, he will suggest that he can persuade some corporation to offer to guaranty his obligations, either because he is an officer or a major stockholder, or a good customer, or for some other reason is able to exert sufficient influence on the corporation. The attorneys for the corporation and for the lender must then determine whether a guaranty made by the corporation will be valid and enforceable. The question can arise, of course, not only in connection with guaranties of indebtedness but in connection with guaranties of leases, contracts, and other obligations.

There have been a number of Texas decisions bearing on this problem. The general rule evolved by this authority is that a guaranty by a corporation of the obligations of another person will be enforceable only if it directly benefits the corporation in the pursuit of the purposes for which it was created; a benefit which is merely indirect or incidental is not sufficient. There are two theories on which a corporate guaranty might be enforced. It may be enforced because the benefits anticipated from the guaranty bring it within the implied powers of the corporation; or it may be ultra vires but none the less enforceable because the corporation is estopped to assert ultra vires by reason of the benefits actually received. Both bases of enforceability depend on the benefits derived or to be derived by the corporation from the guaranty, but it would seem that different results might be reached in certain circumstances depending on whether the guaranty was within the implied powers of the corporation or merely enforce-

*A.B., University of Tennessee, 1945; LL.B., Harvard School of Law, 1949; practicing with the firm of Carrington, Gowan, Johnson, Bromberg & Leads.

able by reason of some sort of estoppel. For instance, the fact that a contract of guaranty was still completely executory would have no effect if the contract was within the implied powers of a corporation; however, it might preclude enforcement if the contract is ultra vires and must depend for enforceability on estoppel. The distinctions between these two bases of enforcement have not been explicitly developed by the courts.

STATUTORY PROVISIONS

The old corporation statutes antedating the Texas Business Corporation Act¹ contained certain provisions sometimes cited by the Texas courts when considering corporate guaranties. These were found in Articles 1348 and 1349² and read as follows:

Art. 1348. No corporation, domestic or foreign, doing business in this State shall create any indebtedness whatever except for money paid, labor done which is reasonably worth at least the sum at which it was taken by the corporation, or property actually received reasonably worth at least the sum at which it was taken by the corporation.

Art. 1349. No corporation, domestic or foreign, doing business in this State, shall employ or use its stock, means, assets or other property, directly or indirectly for any purpose whatever other than to accomplish the legitimate business of its creation, or those purposes otherwise permitted by law; . . .

Actually these statutes probably added little if anything to the common law as to corporate guaranties, and often the opinions have not referred to these statutes at all. They are worded so generally that in the usual situation they have been of limited utility in determining whether a particular guaranty was enforceable, and recourse to the court decisions has been necessary.

The Texas Business Corporation Act provides no direct solution to the problem of the enforceability of corporate guaranties, although it should reduce the problem in certain respects for those corporations governed by the new Act. The new Act contains no provisions expressly dealing with corporate guaranties. The provisions most closely in point are found in Article 2.02A among the general corporate powers set forth in that Article. These include the following:

¹ Tex. Acts 1955, c. 64.

² TEX. REV. CIV. STAT. (1925)

Art. 2.02. General Powers

A. Subject to the provisions of Section B and C of this Article. each corporation shall have power:

.....

(7) To purchase, receive, subscribe for, or otherwise acquire, own, hold, vote, use, employ, mortgage, lend, pledge, sell or otherwise dispose of, and otherwise use and deal in and with, shares or other interests in, or obligations of, other domestic or foreign corporations, associations, partnerships, or individuals, or direct or indirect obligations of the United States or of any other government, state, territory, government district, or municipality, or of any instrumentality thereof.

.....

(9) To make contracts and incur liabilities, borrow money at such rates of interest as the corporation may determine, issues its notes, bonds, and other obligations, and secure any of its obligations by mortgage or pledge of all or any of its property, franchises, and income.

(10) To lend money for its corporate purposes, invest and reinvest its funds, and take and hold real and personal property as security for the payment of funds so loaned or invested.

While some of the transactions authorized by those provisions may be the economic equivalent of a guaranty, none of the provisions expressly authorize guaranties in so many words. Moreover, the grant of powers contained in Article 2.02A must be considered in context with the restrictions contained within Article 2.02B which provides as follows:

B. Nothing in this Article grants any authority to officers or directors of a corporation for the exercise of any of the foregoing powers, inconsistent with limitations on any of the same which may be expressly set forth in this Act or in the articles of incorporation or in any other laws of this State. Authority of officers and directors to act beyond the scope of the purpose or purposes of a corporation is not granted by any provisions of this Article.

Admittedly, there is nothing in the Act so inconsistent with the direct benefit rule as to evidence a legislative intent to change the rule by statute. And since authority to exercise the powers granted by Section A of Article 2.02 is expressly limited through Section B of that Article by the scope of the corporate purposes, one might well ask how the Texas Business Corporation Act can have effected any change at all from the old direct benefit rule evolved by the courts. Nevertheless, in at least two respects the new Act should

have an effect on the problem of corporate guaranties. In the first place, the new Act permits incorporation for multiple purposes. Formerly, for a guaranty to be enforceable, it was necessary to establish that it was calculated to produce a direct benefit to the corporation in the pursuit of its single limited purpose drawn from old Article 1302. Corporations incorporated under the new Act will generally have much broader purpose clauses and accordingly the chances will be much better that the guaranty falls within the scope of the corporate purposes. In the second place, Article 2.04 of the Act places new restrictions on the assertion of ultra vires by or against corporations, although it by no means abolishes the old doctrine. Consequently, even under the new Act it will still be profitable to advert to the cases decided prior to its enactment for guidance in determining whether there exists in the particular situation the type of direct benefit to the corporation in the pursuit of its corporate purposes which will make a guaranty enforceable.

GUARANTIES FOR THE PRIMARY BENEFIT OF THE CORPORATION AND ACCOMMODATION GUARANTIES

Sometimes there is a situation in which a contract is entered into for the primary benefit of the corporation, but for some reason the corporation appears in the capacity of guarantor rather than as the primary obligor. Such a case in *Gaston & Ayres v. J. I. Campbell Company*.³ In that case, the vice-president of a corporation personally executed a note as maker and then endorsed it on behalf of the corporation. Part of the proceeds of the note were used to pay an existing indebtedness of the corporation. The remainder of the proceeds appear to have been held as a credit to the account of the corporation. The court held that the corporation was liable for the full amount of the note to a holder in due course, emphasizing that the transaction was in reality by the corporation and for the corporation. Situations of this type where the corporation is to receive the primary benefit from the transaction, of course, present the clearest case for enforcement of corporate guaranties.⁴

³ 104 Tex. 576, 140 S.W. 770 (1911), *modified on rehearing*, 104 Tex. 585, 141 S.W. 515 (1911).

⁴ *Waller v. Gorman Mercantile Co.*, 141 S.W. 833 (Tex. Civ. App. 1911). *Cf.* *North Texas State Bank v. Crowley-Southerland Commission Co.*, 145 S.W. 1027 (Tex. Civ. App. 1912); *Malone v. Republic National Bank & Trust Co.*, 70 S.W. 2d 809 (Tex. Civ. App. 1934) *error disp.*

The converse type of situation is where the guaranty is made solely as an accommodation to the other person without prospect of benefit to the corporation. In line with the rule in other states, Texas decisions have definitely established that this sort of non-charitable gift of corporate credit and property is invalid, and the guaranty will not be binding on the corporation in the absence of a further showing of facts sufficient to establish liability.⁵ In the usual situation, however, the facts do not present a black and white picture of a guaranty made for the primary benefit of the corporation or for the sole benefit of another person. Instead the transaction is usually admittedly for the primary benefit of another, and the question is whether the corporation, too, receives such benefits as will support the guaranty.

GUARANTIES FOR AFFILIATED CORPORATIONS

In the old case of *Northside Railway Company v. Worthington*,⁶ the Texas Supreme Court established the rule that the fact that corporations had common ownership and were otherwise economically related would not of itself support a guaranty by one of indebtedness of the other. In that case, two corporations were organized by substantially the same people and had the same officers and directors. The purpose of one was the purchase, subdivision, and sale of land. The purpose of the other was the construction and maintenance of street railways. They were intended to be correlated enterprises, one depending largely for its success upon the success of the other, since the street railway was to serve the area being developed by the land company. The land company needed money to pay off an existing indebtedness, and the street railway company needed money for construction work. The two companies jointly floated an issue of bonds, each company executing each bond, in order to obtain this needed capital. The court held that this action was ultra vires, insofar as it represented an extension of credit by one of the companies in aid of the other, and that each

⁵ *Brand v. Eastland County Lumber Co.*, 77 S.W. 2d 600 (Tex. Civ. App. 1934); *McCaleb v. Boerne Electric Power & Mfg. Co.*, 173 S.W. 1191 (Tex. Civ. App. 1915) *error dismissed*; *South Texas National Bank v. LaGrange Oil Mill Co.*, 40 S.W. 328 (Tex. Civ. App. 1897) *error ref.*

⁶ 88 Tex. 562, 30 S.W. 1055 (1895).

corporation was liable only proportionately to the amount of the proceeds of the bonds received by it.

That the success of the one enterprise tended to promote the success of the other was not itself sufficient to authorize the one corporation to aid the other, for the reason that the benefit which was to accrue was not the direct result of the means employed.⁷

Where the corporate guarantor and the primary obligor are related only because of interlocking directors and officers or common ownership, and do not have other common interests, then the rationale of the *Worthington* case applies even more strongly and the guaranty is clearly unenforceable.⁸

GUARANTIES FOR SUBSIDIARY CORPORATIONS

Corporations which possess a parent-subsidary relationship present a situation distinguishable from the case of corporations which merely have common ownership. In the case of common ownership, if one corporation prospers, this will not directly benefit the other corporation as such and only by disregarding the corporate entities of the two corporations can we say that the other corporation also benefits since the common stockholders benefit. On the other hand, in the case of parent and subsidiary corporations, if the subsidiary prospers the parent also prospers through the increase in the value of the stock of the subsidiary. This distinction was observed in *Baker v. Edson Hotel Operating Co.*⁹ The involved fact situation in that case may be summarized as follows. Two corporations sold lots to a third corporation in exchange for capital stock of the third corporation. The first two corporations also purchased bonds issued by the first corporation to finance construction by it of a hotel which was then leased to a fourth corporation which was to operate the hotel. The third corporation owned 25 percent of the stock of the fourth corporation, and subsequently, the first two corporations purchased the remaining 75 percent of the stock of the fourth corporation, one taking 50 percent and the

⁷ 88 Tex. 562, 570, 30 S.W. 1055, 1057 (1895). Also See *Rio Grande Valley Gas Co. v. Grand Rapids Store Equipment Corporation*, 57 S.W. 2d 348 (Tex. Civ. App. 1933).

⁸ *McCaleb v. Boerne Electric Power & Mfg. Co.*, 173 S.W. 1191 (Tex. Civ. App. 1915) *error dismissed*; *Kaplan Dry Goods Co. v. Sanger Bros.*, 214 S.W. 485 (Tex. Civ. App. 1919). *Cf.* *Taylor Feed Pen Co. v. Taylor National Bank*, 215 S.W. 850 (Tex. Comm. App. 1919).

⁹ 99 S.W. 2d 998 (Tex. Civ. App. 1936).

other taking 25 percent. By the same resolutions authorizing the purchase of this stock, the first two corporations also authorized loans to the fourth corporation and authorized endorsement of certain notes of the fourth corporation. This suit was brought on those notes. The court held that the endorsement of the notes of the fourth corporation was not *ultra vires*, stating:

If these corporations had the corporate right to purchase and hold the stock of the Baker-Beaumont Hotel Company—and, as just stated, that right is not denied by any party to this suit—then these holding corporations had the right to protect their investment. It would be a strange rule of law to give these holding companies the right to purchase and hold stock in the Baker-Beaumont Hotel Company, and then to deny them the right to protect the solvency of their investment.¹⁰

A similar case is *Ingram v. Texas Christian University*.¹¹ It appeared that the medical school of Texas Christian University was a separate corporation with its own board of directors. As an auxiliary and correlated school of the University, however, it occupied a position analogous to that of a subsidiary corporation. In order to obtain facilities for the establishment of a hospital to be used by the Medical School, the University leased certain property and then sublet it to the College Hospital Association, a separate corporation formed to operate the hospital. For the purposes of its opinion, the court treated the transaction as if the University had guaranteed performance of the lease by the hospital corporation, and held that this was not *ultra vires*.

GUARANTIES FOR EMPLOYEES

The leading Texas case on guaranties made for employees is *L. G. Balfour Co. v. Gossett*.¹² It was alleged that the company had guaranteed the indebtedness of its regional manager. In answer to a defense of *ultra vires*, it was contended that the corporation should be estopped to plead the defense of *ultra vires*, because the corporation received benefits from its contract in that if the manager's business should prosper and be properly financed, he might sell more of the goods of the corporation. The court held that this was

¹⁰ 99 S.W. 2d 998, 1003 (Tex. Civ. App. 1936).

¹¹ 196 S.W. 608 (Tex. Civ. App. 1917) *error ref.*

¹² 131 Tex. 348, 115 S.W. 2d 594 (1938).

not the sort of direct benefit which would justify the application of an estoppel.

A similar case is *Al & Lloyd Parker, Inc., v. Cameron County Lumber Co.*¹³ The Al Parker Securities Company, a corporation, sold a tract of land to J. A. Schulgen retaining a vendor's lien for the balance due on the purchase price. Schulgen built a house on the lot with materials furnished by plaintiff, giving therefor a note for \$1,500.00 endorsed by his employer, Al & Lloyd Parker, Inc., which it was alleged was indebted to him in the sum of \$1,800.00 and, therefore, additionally interested in helping him get the improvements. Moreover, it appeared that the two corporations were closely related and that the two Parker Brothers owned most of the stock of each, and it was contended that the guarantor corporation would benefit in that the security for the vendor's lien note of the other corporation would be enhanced by the improvements. The court held that all of these alleged benefits were insufficient to estop Al & Lloyd Parker, Inc., from asserting the defense of ultra vires.

GUARANTIES FOR CUSTOMERS

Other than cases involving mere gratuitous accomodation guaranties, probably more decisions deal with guaranties for customers than for any other type of guaranty. The leading case is *W. C. Bowman Lumber Company v. Pierson*.¹⁴ In that case a lumber company executed the bond of a contractor covering a certain building for which he had bought the necessary lumber and other materials from the lumber company. Pointing out that no issue of estoppel had been raised by the pleadings, the supreme court held the pledge of credit by the lumber company was ultra vires and stated broadly,

It is not a fostering of the business of a corporation to pledge its capital as security for the debts of prospective customers for the purpose of enabling them to buy its wares. It is inviting its destruction.¹⁵

Another type of guaranty for the benefit of a customer was involved in *Deaton Grocery Co. v. International Harvester Co. of*

¹³ 56 S.W. 2d 256 (Tex. Civ. App. 1932), *aff'd*, 122 Tex. 487, 62 S.W. 2d 63 (1933).

¹⁴ 110 Tex. 543, 221 S.W. 930 (1920).

¹⁵ 110 Tex. 543, 545, 221 S.W. 930, 931 (1920).

America.¹⁶ In that case, a customer of the guarantor corporation was indebted to the Harvester Company. There was testimony that the customer was also heavily indebted to the guarantor corporation and that the guaranty was made to obtain an extension of time on the Harvester Company debt in order to prevent a collapse of the customer's business. The court held that even assuming that the customer had been insolvent at the time the guaranty was made and that by reason of the extension of time on the indebtedness, the guarantor corporation collected more from the customer than it would have otherwise, still the guaranty was ultra vires and not binding on the corporation. A similar case in which the benefits received by the corporation were more direct and ascertainable and in which a different result was reached is *H. Seay & Co. v. Moore*.¹⁷ In that case, a customer of a bank was indebted to it for loans made to finance the purchase of cotton. The bank guaranteed the plaintiff against any loss on account of the purchase on consignment from the customer of 300 bales of cotton. The bank received all sums advanced under the contract by plaintiff and applied these to the customer's indebtedness. The court held that the guaranty was enforceable.¹⁸

CONCLUSION

A review of the Texas cases shows that the Texas courts have been most diligent in protecting those interested in the corporate assets from dissipation of those assets by the officers and directors of the corporation through improvident guaranties. Perhaps they have been too diligent, and the overall interests of Texas corporations have accordingly suffered. To hold unenforceable a guaranty made by a corporation purely for the accommodation of a third person without prospect of benefit to the corporation would necessarily be favorable to the corporation. On the other hand, there are many occasions on which sound business judgment would call for the execution of a guaranty, even though it did not fall within the restrictive interpretation of the "direct-benefit" test heretofore

¹⁶ 105 S.W. 556 (Tex. Civ. App. 1907).

¹⁷ 265 S.W. 376 (Tex. Comm. App. 1924).

¹⁸ Other cases involving guaranties for customers are *Parlin & Orendorff Implement Co. v. Frey*, 200 S.W. 1143 (Tex. Civ. App. 1918) *error ref., certiorari denied*, 250 U.S. 640 (1919); *Munoz v. Brassel*, 108 S.W. 417 (Tex. Civ. App. 1908), *error ref.* *Cf. Long Bell Lumber Company v. Hampton*, 20 S.W. 2d 1081 (Tex. Civ. App. 1929).

adopted by the courts. Guaranties executed for customers, employees, or others having a special relationship to the corporation might, in the long run, produce profits for the corporation far outweighing the risk of loss attendant upon the guaranty. It would seem to be to the advantage of the corporation to be able to make an enforceable guaranty in such circumstances, or the corporation may be handicapped in competing with unincorporated competitors.

As a practical matter, many guaranties are undoubtedly made and honored by Texas corporations in such circumstances, even though they would not be enforceable in the courts. And the courts may consider that it is sufficient for them to enforce liability in the clear cases in which an undisputable direct benefit to the corporation can be shown, leaving enforcement of guaranties where there is only an indirect benefit to trade practices and customs.

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