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Corporations and Partnerships

by

Robert F. Gray, Jr.,* Katie-Pat Vletas,** and Steven A. Waters***

A. Corporation Case Law Developments

1. Corporate Disregard

Similar to the treatment of corporate disregard during last year's Survey period, Texas courts have, for the most part, solidified the sorcerer's apprentice role played by the Texas Supreme Court in Castleberry v. Branscum.1 Pan Eastern Exploration Co. v. Hufo Oils2 represents one of the cases in this area that attempts to make sense of Castleberry. The plaintiffs in Pan Eastern, Anadarko Petroleum Corporation (Anadarko), and its wholly owned subsidiary, Pan Eastern Exploration Company (Pan Eastern Exploration), composed part of a related group of corporations operating in the oil and gas industry. The plaintiffs brought suit against Panhandle Eastern Pipeline Company (Panhandle Eastern) and others3 claiming that the defendant owners of oil and casinghead gas rights had unjustly produced the plaintiffs' dry gas while other defendants had purchased and transported the converted dry gas. The defendants asserted that they did not wrongfully convert the plaintiffs' dry gas, and, alternatively, even if they did take the plaintiffs' gas, it was with the consent of the plaintiffs or Panhandle Eastern, an affiliated corporation, whose acts were binding on the plaintiffs. The defendants successfully argued that the plaintiffs' sister corporations had consented to the defendants' taking their gas and that this consent estopped plaintiffs from complaining that their gas had been wrongfully converted. The jury rejected the plaintiffs' claim and the defendants' cross-claims, and the court granted a take-nothing judgment. The Fifth Circuit Court of Appeals affirmed in part, but held that any consent to the defendants' actions

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1. 721 S.W.2d 270 (Tex. 1986).
2. 855 F.2d 1106 (5th Cir. 1988).
3. For a discussion of the relations and classification of the different defendants, see infra text following note 4.
would have ended at the time the plaintiffs filed the lawsuit and that the plaintiffs should be entitled to recover damages sustained thereafter.\textsuperscript{4}

An understanding of the case requires a detailed discussion of the parties involved. Originally, Panhandle Eastern, the parent of Anadarko, held the gas leases in dispute. Panhandle Eastern later assigned the leases to Pan Eastern Exploration, a subsidiary of Anadarko, and conveyed the stock of Anadarko to Panhandle Eastern's corporate parent, Panhandle Eastern Corporation (PEC). Thus, Panhandle Eastern became an affiliate of Anadarko and Pan Eastern Exploration rather than their parent. Anadarko operated as a fully functioning exploration and production company; Pan Eastern Exploration existed merely as a shell corporation, with only one employee. Anadarko managed Pan Eastern Exploration's day-to-day business affairs, while Panhandle Eastern operated Pan Eastern Exploration's gas wells as an independent contractor. The officers and directors of Panhandle Eastern, Anadarko, and Pan Eastern Exploration overlapped, but did not mirror each other. In preparing the financial statements and the required periodic reports filed with the Securities and Exchange Commission, the companies consolidated their profits and losses. The corporate formalities of each of these companies, however, were strictly observed at all times.

The defendants may be categorized as: (i) the "operator defendants," who produced the oil from the properties in dispute (which category includes Hufo Oils and Ted True, Inc., two of the well operators); (ii) the "processing defendants," who installed gas plants on the properties and processed the gas produced by the operator defendants; and (iii) the "pipeline defendants," who, along with Panhandle Eastern, purchased gas from the operator and processing defendants.

At the heart of the plaintiffs' claim lies the controversy surrounding the casinghead gas wells drilled during the early 1980s, when demand for natural gas soared. The Fifth Circuit Court of Appeals explained the mechanism by which the holders of oil rights on "split leases" (properties where the right to produce gas has been severed from the right to produce oil and casinghead gas) would convert what would otherwise be a statutory gas well into a statutory oil well, thereby entitling them to produce casinghead gas.\textsuperscript{5} The operator defendants had used this mechanism to produce casinghead gas from the properties in dispute, thus giving the plaintiffs a potential cause of action for the conversion of their dry gas.

In the early 1980s, Hufo Oils acquired the oil and casinghead gas rights in the properties. Then, in late 1981, Hufo Oils approached Panhandle Eastern's gas purchasing agent, John Gurche, to see if Panhandle Eastern would purchase the casinghead gas that Hufo planned to produce. Despite Panhandle Eastern's need for additional gas supplies, Richard Dixon, Gurche's supervisor, ordered Panhandle Eastern to cease all casinghead gas purchases while it attempted to assess the risks involved in purchasing gas from the

\textsuperscript{4} Pan Eastern, 855 F.2d at 1129.

\textsuperscript{5} See id. at 1111-13.
"white oil" operators. Panhandle Eastern later decided that it would accept the offer from Hufo. In reaching its decision, Panhandle Eastern reasoned that if Panhandle Eastern didn't purchase the gas, someone else would likely purchase it, and, if rumors proved true that some companies commingled dry gas with casinghead gas, then Pan Eastern Exploration's wells could well be drained and the group of affiliated companies would lose the dry gas entirely. The Hufo Oils contract required Hufo Oils to steadily increase its casinghead gas production. The contract also called for Panhandle Eastern to honor a three-phase obligation to expand and improve its gathering facilities and to take or pay for the growing quantities of gas made available as a result of this increased operation. Concern that Hufo Oils' wells might drain Pan Eastern Exploration's and Anadarko's gas reserves prompted Panhandle Eastern officials to include in the contract a special definition for casinghead gas\textsuperscript{7} intended to protect them from possible claims by Panhandle Eastern's affiliates based on Hufo Oils' production practices.

Panhandle Eastern began purchasing gas from Hufo Oils' wells in February 1982. Defendant Ted True, Inc. succeeded Hufo Oils as operator in November 1982, and began to prepare for increased gas production. Then, in late 1982 and early 1983, the demand for gas suddenly and sharply decreased, and Dixon ordered his buyers to cease all new gas purchases. He also sent telegrams to Panhandle Eastern's producers instructing them to defer any new drilling. When Gurche met with Ted True in early 1983, True reported that he still intended to develop gas at a fast pace and would hold Panhandle Eastern to its obligation under the contract to take or pay for up to 60,000 mcf of gas per day. Panhandle Eastern attempted to terminate the Hufo Oils contract to induce True to seek other gas purchasers. True ultimately entered into an agreement to sell his gas to defendant Liquid Energy Corporation, but only after a vice president of Panhandle Eastern confirmed to Liquid Energy that Panhandle Eastern had no objections to Liquid Energy's proposed contract with True.

The defendants argued that plaintiffs' managers were aware that the drilling and production practices of Hufo and True might be producing gas that belonged to the plaintiffs, yet Panhandle Eastern's desperate need for more gas induced them to continue the Hufo Oils contract. The Fifth Circuit focused specifically on the behavior of three key persons: Dixon, a Senior Vice President of gas supply at Panhandle Eastern, the chief executive officer of Pan Eastern Exploration, and a director of Anadarko; Robert Allison, the chief executive officer of Anadarko, a director of Anadarko, Pan Eastern Exploration and Panhandle Eastern, and a group vice president of Panhandle Eastern; and Richard O'Shields, the Chairman of the Board of Panhan-

\textsuperscript{6} "White oil" operators refers to those owners and operators of oil wells that produced casinghead gas from dry gas formations. \textit{Id.} at 1112.

\textsuperscript{7} The contract defined casinghead gas as "all of Seller's interest in gas which is produced from a reservoir in association with crude oil or is dispersed in and in intimate contact with crude oil and may be legally produced from a well classified as an oil well by the Texas Railroad Commission." \textit{Id.} at 1113 n.13.
die Eastern and Anadarko and a director of Pan Eastern Exploration. At the time Panhandle Eastern imposed its moratorium on casinghead gas purchases in early 1982, Allison became concerned that the independent gas producers might unlawfully take Anadarko’s and Pan Eastern Exploration’s dry gas and suggested to Dixon and O’Shields that Panhandle Eastern stop buying casinghead gas from the independents. Both Dixon and O’Shields generally responded that there would be no changes in Panhandle Eastern’s buying practices.

When Pan Eastern Exploration and Anadarko brought suit in 1985 they did not name their sister corporation, Panhandle Eastern, as a party to the suit. The defendants joined Panhandle Eastern as a third-party defendant, however, and urged that Panhandle Eastern merely constituted an alter ego of plaintiffs Pan Eastern Exploration and Anadarko. The jury found in favor of the defendants on their affirmative defenses. On appeal, the Fifth Circuit identified four central issues: (i) whether the plaintiffs consented to the taking of their gas; (ii) whether their affiliate, Panhandle Eastern, consented to the taking of the gas, and, if it did, whether its consent would bind the plaintiffs; (iii) whether sufficient reasons existed for disregarding the corporate distinctions between the plaintiffs and their parent and sister companies; and (iv) whether the plaintiffs should be estopped from claiming conversion because of their own behavior or the behavior of their agents or alter egos.

The defendants argued that the plaintiffs’ affiliate, Panhandle Eastern, represented the plaintiffs’ alter ego or, in the alternative, that Panhandle Eastern acted as an agent of the plaintiffs so that Panhandle Eastern’s acts were binding on the plaintiffs. The defendants also asserted that the plaintiffs, through their corporate management, consented to the taking. The Fifth Circuit noted, in reviewing the latter argument, that Dixon, Allison, and O’Shields, as the chief executive officers of Pan Eastern Exploration, its parent Anadarko, and Anadarko’s parent, respectively, had the power and the duty to maximize profits for the entire family of corporations. The three men had the power to risk gas losses by the plaintiffs to help Panhandle Eastern in its time of gas shortage. Whether or not, as a matter of their duties of care and loyalty to the plaintiffs, they should have so decided, they had the power and authority to act for the plaintiffs and they did so, to plaintiffs’ detriment. To find for the defendants, the jury had only to conclude that the plaintiffs’ management knowingly accepted the loss of gas to further other corporate goals. The Fifth Circuit found evidence to support that conclusion.

The plaintiffs argued that their corporate management’s knowledge of or acquiescence in the defendants’ taking should not be imputed to the plaintiffs because the acts of an agent should not bind a principal unless the agent

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8. *Pan Eastern*, 855 F.2d at 1113.
9. *Id.* at 1122.
10. *Id.* at 1126.
11. *Id.* at 1128.
acted within the course and scope of its authority and in the best interests of the principal. The court concluded that by virtue of the Texas Supreme Court's holding in *Fireman's Fund Indemnity Co. v. Boyle General Tire Co.*, Texas follows the Restatement (First) of Agency rule, which imputes all knowledge of an agent (except that acquired in confidence) to his current principal. The plaintiffs also argued that their management's consent was not in their best interests and thus should not be imputed to them. The Fifth Circuit rejected this argument as well.

It reasoned that the corporate fiction should be disregarded where a manager's decision to help the sole shareholder at the expense of the corporation would violate some "surrealistic" duty of care or loyalty to the corporation. The court further found that the plaintiffs' analogy to self-dealing was misplaced because even if the plaintiffs' managers did something so harmful to plaintiffs as to violate their duty of care or loyalty, that violation would only give rise to a cause of action by the plaintiff corporations against their managers and would not absolve the plaintiffs of their responsibility to third parties.

The trial court instructed the jury on four affirmative defenses raised by the defendants (waiver, ratification, estoppel, and laches), each of which required an implicit finding that Panhandle Eastern was the agent of the plaintiffs or that the corporate distinction between them should be disregarded. Before addressing the issue of defendants' affirmative defenses, the Fifth Circuit attempted to decipher the reasoning of the *Castleberry* court concerning corporate disregard as applied to Texas corporations. From the *Castleberry* opinion, the court discerned three distinct theories under Texas law for disregarding the corporate entity.

The court defined the first theory of corporate disregard under Texas law, the "alter ego" doctrine, as "when a corporation is organized and operated as a mere tool or business conduit of another corporation." The focus of this theory is the relationship between the corporation and its controlling shareholder, as opposed to the relationship between the corporation and the third-party claimant. The second theory identified in *Castleberry*, the "illegal purpose" theory, relates to the use of the corporate form to avoid legal limitations on natural persons or corporations. As with the alter ego doctrine, the focus of this theory is on the relationship between the corporation, its owners, and the laws of the state, rather than the relationship between the third-party claimant and the corporation. Illegal purpose, as defined in *Castleberry*, differs from the alter ego doctrine in that a party may allege the former even when all corporate formalities have been adequately observed.
The third theory of corporate disregard recognized by Castleberry is "sham to perpetrate a fraud," which requires neither actual fraud nor an intent to defraud.\textsuperscript{22} If recognition of the separate corporate entity would bring about an inequitable result, then such a finding of fact by the jury sufficiently establishes a claim of sham to perpetrate a fraud.\textsuperscript{23} The Fifth Circuit recognized the need to limit the application of this theory, stating, "[t]he only limitation on this broad strand of corporate disregard is that the focus is on injustice or unfairness to the claimant caused by the corporation and its owners. The unfairness must be something greater than the mere failure to recover a full measure of damages . . . ."\textsuperscript{24}

Recognizing that in a contractual corporate disregard case based upon the sham to perpetrate a fraud theory, "reasonable reliance" upon the financial backing of the corporation's shareholders is required before the corporate entity may be disregarded,\textsuperscript{25} the Fifth Circuit went on to note that under Texas law "[i]n contract cases (or in any case based on deliberate acts), the inequity frequently comes from reasonable reliance on the financial backing of the owners. Without reliance, the contract claimant cannot avoid the risk of insolvency that it originally accepted as part of the bargain."\textsuperscript{26}

The trial court submitted questions to the jury on all three theories of corporate disregard. In reviewing the jury instructions, the Fifth Circuit found that the defendants produced no evidence indicating any improprieties in the manner in which the plaintiffs, their parent, or any affiliate were operated.\textsuperscript{27} Thus, the alter ego issue should never have been submitted to the jury.\textsuperscript{28} Additionally, the Fifth Circuit held that a persuasive circumvention of law argument for the defendants never existed.\textsuperscript{29} The court noted the inconsistency in the defendants' argument; the defendants claimed that Panhandle Eastern's great need for more gas forced Hufo Oils to drill more wells per section than was permitted by the Texas Railroad Commission, yet the defendants consistently maintained that they never violated any statute or Texas Railroad Commission rules.\textsuperscript{30} Through these arguments the defendants refuted their own defense!\textsuperscript{31} As a result, the illegal purpose theory was not applicable to the plaintiffs' conduct.\textsuperscript{32} The Fifth Circuit, however, did find that the jury properly addressed the issue of sham to perpetrate a fraud.\textsuperscript{33} Because the management of the various Panhandle entities decided to distribute unequally the costs and benefits of acquiring casinghead gas among the various corporations, thus shifting the costs to the plaintiffs but

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\textsuperscript{22} Id. at 1133.  \\
\textsuperscript{23} Id.  \\
\textsuperscript{24} Id. (emphasis in original) (citing Lucas v. Texas Indus., 696 S.W.2d 372 (Tex. 1984)).  \\
\textsuperscript{25} Id.  \\
\textsuperscript{26} Id. (citing Edwards Co. v. Monogram Indus., 730 F.2d 977 (5th Cir. 1984) (en banc); Bell Oil & Gas Co. v. Allied Chemical Corp., 431 S.W.2d 336 (Tex. 1968)).  \\
\textsuperscript{27} Id. at 1134.  \\
\textsuperscript{28} Id.  \\
\textsuperscript{29} Id.  \\
\textsuperscript{30} Id.  \\
\textsuperscript{31} Id.  \\
\textsuperscript{32} Id.  \\
\textsuperscript{33} Id.
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allowing Panhandle Eastern to reap all the benefits, the jury could reason-
ably conclude that, if their findings accorded distinct rights and corporate
separateness to the corporations, an inequitable result would follow.\textsuperscript{34} Fi-
nally, the court rejected the plaintiffs’ argument that corporate disregard
could only be used offensively (such as where creditors or victims seek to
satisfy unpaid debts of a corporate defendant by finding a deeper pocket) and
concluded that the \textit{Castleberry} court did not intend to so limit the applica-
tion of the sham to perpetrate a fraud theory.\textsuperscript{35}

Another corporate disregard case decided during the Survey period, \textit{Speed
v. Eluma International, Inc.},\textsuperscript{36} involved an award of exemplary damages
against the officers and sole shareholder of a corporation pursuant to the
jury’s finding of constructive fraud.

Joe Speed, the sole shareholder, an officer, and a director of Josef Manu-
facturing, Inc. (Josef), owned the real property on which Josef’s offices were
located. Thus, Joe also acted in the capacity of Josef’s landlord. Keith
Speed, Joe’s son, was also an officer and director of Josef. In October of
1984 Josef negotiated a bulk sale of its assets to Ft. Worth Avenue Manufac-
turing, Inc. (Ft. Worth) in exchange for $250,000, $150,000 of which Ft.
Worth would pay in the form of a two-year promissory note. When two of
Josef’s general creditors, Eluma International, Inc. (Eluma) and Common-
wealth Metals Corporation (Commonwealth), discovered the proposed
transfer and obtained an order restraining the sale, Joe foreclosed his land-
lord’s lien on the assets of Josef. Joe then held a private sale and sold the
assets to Ft. Worth at the price agreed upon in the aborted bulk sale transac-
tion. The trial court disregarded the corporate identity of Josef and entered
judgment against the Speeds in accordance with the jury’s findings, which
were based on the sham to perpetrate a fraud and alter ego theories of corpo-
rate disregard set forth in \textit{Castleberry}. The jury awarded Eluma and Com-
monwealth actual damages of $92,000 and $59,000, respectively, as well as
exemplary damages aggregating $160,000.

On appeal, the Speeds set forth two arguments. First, they argued that
they did not breach any legal duty that would give rise to a constructive
fraud action. Second, the Speeds claimed that the trial court should not
have disregarded the corporate entity because the plaintiffs produced insuffi-
cient evidence to support a finding of alter ego. In response to the Speeds’
first argument, the court stated that constructive fraud may also arise when
an equitable duty is violated.\textsuperscript{37} The trial court submitted to the jury a spe-
cial issue asking whether the Speeds committed fraud. In its instruction, the
court defined fraud as “any act, omission, or concealment that involves a
breach of legal duty, trust, or confidence and that is injurious to or misleads
another person or by which an undue and unconscionable advantage is
taken.”\textsuperscript{38} The court determined that, if the jury believed that the foreclosure

\begin{itemize}
  \item 34. \textit{Id.} at 1135.
  \item 35. \textit{Id.}
  \item 36. 757 S.W.2d 794 (Tex. App.—Dallas 1988, writ requested).
  \item 37. \textit{Id.} at 797.
  \item 38. \textit{Id.} at 796.
\end{itemize}
of the landlord's lien represented a sham perpetrated in order to circumvent the temporary restraining order, such a finding would support a claim of constructive fraud and a corresponding judgment to disregard the corporate fiction and hold the Speeds personally liable. In a loosely worded opinion, however, the appellate court ultimately concluded that the jury need only affirmatively answer the special constructive fraud issue to support a judgment disregarding the corporate fiction and that no special finding on sham to perpetrate a fraud need be obtained.

The appellate court next, and perhaps more importantly, reviewed the award of exemplary damages. The jury found that the Speeds acted with malice in breaching the equitable duty they owed to the plaintiffs. Reviewing the evidence, the court concluded that the jury could have believed that the Speeds attempted to consummate the sale prohibited by the temporary restraining order by creating a nonexistent back rent claim, and that the Speeds committed such acts intentionally and without just cause or excuse. Based upon this presumption, the court upheld an award of exemplary damages on a finding of corporate disregard in connection with the breach of an equitable duty to general trade creditors.

In a Texas court of appeals case dealing with the alter ego doctrine, *Gensco, Inc. v. Canco Equipment, Inc.* Gensco, Inc. (Gensco) sued Canco Equipment, Inc. (Canco) on a debt and attempted to pierce its corporate veil and thereby recover from Canco's two shareholders, Nolan H. Brunson, III and Jerry Fowler. Following the opinion of the Dallas Court of Appeals in *Branscum v. Castleberry*, the trial court held that it was a matter of law whether Canco constituted the alter ego of Brunson and Fowler. Based on jury findings (i) that neither Brunson nor Fowler "primarily used the corporate form of Canco as a conduit for the conduct of their own personal business," and (ii) that upon incorporation Canco did not have inadequate capitalization, the trial court concluded as a matter of law that Gensco could not prevail on its alter ego theory.

The court of appeals noted that the Texas Supreme Court, in its subsequent review of *Branscum v. Castleberry*, disapproved of the lower court's method of submitting an alter ego case to the jury, endorsing instead a procedure whereby the court asks the jury the ultimate question, "[d]o you find from a preponderance of the evidence that the corporation was the alter ego of the individual?" The *Gensco* court, interpreting *Castleberry v. Branscum*, stated that for the jury to be able to answer this ultimate question,
instructions must be given as to the different fact situations that may justify a decision to disregard the corporate identity. The appellate court concluded that the trial court incorrectly submitted the case to the jury, reversed the holding, and remanded the case for retrial.

Another point illuminated by the *Gensco* court involved the estoppel theory advanced by the shareholders, Brunson and Fowler. The court noted that Texas courts have acknowledged that if the party acts with full knowledge of the relationship between the corporation and the stockholder, he may be estopped from attempting to disregard the corporate entity. The court pointed out, however, that estoppel only arises if a party seeking to disregard the corporate entity has all the "essential facts" relevant in a situation and nevertheless continues to do business with the corporation without implementing any safeguards. Notwithstanding the fact that the jury found Gensco had adequate opportunity to investigate the financial ability and creditworthiness of Canco, and Gensco knew of Canco's corporate nature and voluntarily did business with it, the court of appeals determined that to establish a successful defense, Brunson and Fowler should have secured a specific finding that Gensco in fact knew the "essential facts" of the relationship between Canco, Brunson, and Fowler and continued to do business with Canco despite that knowledge.

The plaintiff in *Hideca Petroleum Corp. v. Tampimex Oil International, Ltd.*, Tampimex, successfully applied the alter ego theory to its breach of contract action. Robert Sessions, an employee of Tampimex (the seller), and Vincente Scippa, an employee of Hideca Petroleum (the buyer), negotiated by telex the sale of Dubai crude oil. The signature on all telexes read "Vincente Scippa Hideca Petroleum Corp. on behalf of and as instructed only by Hideca Trading, Inc." As a consequence of that evidence and, in addition, the fact that Tampimex sent Hideca Petroleum a telex confirming an oral agreement between Scippa and Tampimex naming Hideca Trading as the buyer, the trial court found that both Hideca Trading and Hideca Petroleum entered into a contract with Tampimex for the purchase of oil. The Tudela brothers of Caracas, Venezuela, owned a majority of the stock in the corporations that owned Hideca Petroleum, a Delaware corporation, and Hideca Trading, a Cayman Islands corporation. Hideca Petroleum operated in the domestic crude oil markets and had offices in Houston, Texas. Hideca Trading operated in the international markets and had offices in Caracas, Venezuela.

The Hideca entities alleged that Scippa worked only for Hideca Petroleum and not Hideca Trading. Scippa learned of the opportunity for Hideca Trading to sell 800,000 barrels of Dubai crude oil to Amerada Hess Company through I.T.I., a broker. Scippa began searching for a source from

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49. *Id.*
50. *Id.*
51. *Id.* at 348.
52. *Id.*
53. *Id.*
54. 740 S.W.2d 838 (Tex. App.—Houston [1st Dist.] 1987, no writ).
which to obtain the crude and happened to contact Robert Sessions of Tampimex. The transaction ultimately failed. Scippa, allegedly representing only Hideca Trading, could not acquire the required letters of credit from I.T.I. At the same time, Scippa also found out that I.T.I. did not really have a buyer for the Dubai crude oil. Sessions testified that, by that time, the third party that was to provide the oil for resale to Hideca expected Sessions to honor his commitment that Tampimex purchase the crude. The trial court concluded that both Hideca Petroleum and Hideca Trading had entered into and subsequently breached a contract with Tampimex. The court also found that Scippa had agency authority to act for Hideca Petroleum and, in turn, that Hideca Petroleum had actual authority to act as an agent for Hideca Trading.

On appeal, the Hideca companies argued that the trial court erred in ruling that Hideca Petroleum represented the alter ego of Hideca Trading and, therefore, was liable to Tampimex. The court of appeals reviewed the factors generally necessary for applying the doctrine of alter ego as set forth in Castleberry. The court concluded that the rationale for the doctrine follows from one presumption: "[i]f the shareholders themselves, or the corporations disregard themselves, the legal separation, distinct properties, or proper formalities of the different corporate enterprises, then the law will likewise disregard them so far as is necessary to protect individual and corporate creditors." 55 In reviewing the facts of the case, the court noted that the Hideca entities presented no evidence that Hideca Petroleum ever actually informed Tampimex of Hideca Petroleum's alleged role as agent for Hideca Trading or ever received any directions or instructions from Hideca Trading regarding the proposed Dubai crude transactions. 56 Consequently, the court stated that because the corporations themselves made no identifiable effort to separate the two entities, as evidenced by the foregoing facts, the law should not view them separately, but instead as one enterprise. 57 In light of the above and other testimony to the effect that, in the petroleum business, corporations often use various forms of a corporate name in referring to the same company, and Hideca Petroleum told Tampimex that Hideca Trading used the same Houston address as Hideca Petroleum, never hinting that two separate corporate entities might exist, the court reaffirmed the "single business enterprise" theory of the alter ego doctrine. 58 The court defined the single business enterprise theory as follows: "[w]hen corporations are not operated as separate entities, but rather integrate their resources to achieve a common business purpose, each constituent corporation may be held liable for the debts incurred by the other component entities in pursuit of that business purpose." 59 Given the compelling facts of the Hideca case, one can easily understand the court of appeals' reasoning. Nevertheless, the maintenance of corporate formalities, the existence or nonexis-

55. Id. at 843.
56. Id. at 844.
57. Id.
58. Id.
59. Id.
tence of which may not be known by a third party, should not be a factor in applying the alter ego doctrine in a contract-based corporate disregard case. To do so would allow contract-based claimants a windfall.

In *Gallagher v. Bintliff* 60 the court of appeals held that when a plaintiff sues the shareholders of a corporation on a theory of corporate disregard, the event that commences the running of the statute of limitations on the underlying cause of action against the corporation also commences the running of the statute of limitations with respect to the claim against the corporation's shareholders.61 The court based its holding on the principle that the assertion by a plaintiff of a theory of corporate disregard is not, in and of itself, a cause of action, but rather a means of imposing liability upon the responsible party for a tort or breach of contract cause of action.62

In February 1982 Sabrina Gallagher worked at the Sea Gun Sports Inn, Inc. (Sea Gun) as a waitress, during which time she suffered a work-related injury. Gallagher filed a tort claim against the corporation, citing Sea Gun's failure to maintain a safe workplace, and a contract claim, alleging breach of contract as a result of Sea Gun's failure to maintain workers' compensation insurance. The jury awarded Gallagher a judgment in the amount of $414,000.

On June 19, 1986, Gallagher instituted a collection proceeding63 against McClure Bintliff and others as the shareholders of Sea Gun, asserting their personal liability on the judgment under the alter ego doctrine. Bintliff moved for summary judgment, alleging estoppel, res judicata, and the statute of limitations. The court of appeals affirmed the trial court's grant of summary judgment on the basis that the statute of limitations barred Gallagher's claim.64 Bintliff's evidence showed the following sequence of events: February 1982, Gallagher sustained her injury; October 1982, Gallagher filed suit against Sea Gun; November 1983, the district court entered a judgment in favor of Gallagher; and June 1986, Gallagher filed a collection suit. In response, Gallagher pointed out that sections 16.001 and 16.051 of the Texas Civil Practice and Remedies Code state the limitation period to collect a judgment is not less than four years.65 Gallagher also argued that, under the statute, the cause of action accrued on the date of the entry of judgment, November 14, 1983. Citing *Gulf Reduction Corp. v. Boyles Galvanizing & Plating Co.*,66 the court of appeals found that the determination as to which statute of limitations should apply depends upon the basic substance of the pleadings rather than the form of the cause of action.67 Although Gallagher brought suit against Bintliff pursuant to a collections statute, she wanted the court to base the liability of Sea Gun's shareholders

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60. 740 S.W.2d 118 (Tex. App.—Austin 1987, writ denied).
61. *Id.* at 119.
62. *Id.*
64. *Gallagher*, 740 S.W.2d at 119.
on a theory of alter ego.\textsuperscript{68} The court noted that an attempt to disregard a corporate entity does not constitute a separate cause of action; thus, the cause of action pleaded by Gallagher could only be the underlying tort claim relating to failure to keep a safe workplace or the breach of contract action.\textsuperscript{69} Accordingly, the applicable period of limitations would run for two years, under the tort cause of action, or four years, under the contract cause of action, but, in either case, the cause of action that would commence the running of the limitations period accrued when Gallagher sustained her injury.\textsuperscript{70}

2. Fiduciary Duties of Officers, Directors, and Shareholders

The Dallas court of appeals case, \textit{Kaspar v. Thorne},\textsuperscript{71} addresses the question whether shareholders in a close corporation owe a fiduciary duty to each other. In \textit{Kaspar Lansing Thorne}, a fifty percent shareholder of F.F.P., Inc. (F.F.P.), sued Henry Kaspar, the other fifty percent shareholder of F.F.P. F.F.P., a corporation engaged primarily in the business of real estate development, purchased several lots on which it constructed six houses and arranged for Mercantile Bank (Mercantile) to provide financing for such construction. Kaspar testified that, because Mercantile wanted F.F.P. to decrease its indebtedness, Kaspar and Thorne each purchased one of the homes so that the purchase money could be used by F.F.P. to repay the indebtedness owed Mercantile. Kaspar executed a promissory note in favor of F.F.P. for $32,000, which contained a provision stating "[t]his note is to become null and void upon payment in full of all indebtedness owed to Mercantile . . . by F.F.P."\textsuperscript{72} Thorne testified that he did not know about this language until after the execution of the note. Kaspar, on the other hand, testified that he and Thorne had an understanding that he purchased the home only to accommodate the bank's request. Thorne brought suit because (i) he felt Kaspar should be held liable under the promissory note issued to F.F.P. and wanted a declaratory judgment so stating, (ii) he wanted monetary damages for Kaspar's breach of a fiduciary duty owed him, and (iii) he wanted the court to appoint a receiver with the authority to dissolve F.F.P. The trial court granted both the declaratory judgment and money damages and appointed Thorne as receiver to liquidate F.F.P. The court of appeals, however, reversed, holding that Thorne, as an individual shareholder, had no right to sue to enforce a corporate obligation.\textsuperscript{73} The court of appeals also held that, because the question whether one shareholder owes a fiduciary duty to another usually constitutes a question of fact, the trial court erred in failing to submit that question to the jury.\textsuperscript{74}

On review, the court of appeals first noted that article 7.06\textsuperscript{(A)} of the

\textsuperscript{68} \textit{Id.} at 119.
\textsuperscript{69} \textit{Id.}
\textsuperscript{70} \textit{Id.}
\textsuperscript{71} 755 S.W.2d 151 (Tex. App.—Dallas 1988, no writ).
\textsuperscript{72} \textit{Id.} at 153.
\textsuperscript{73} \textit{Id.} at 155.
\textsuperscript{74} \textit{Id.} at 156.
Texas Business Corporation Act (the TBCA), when read in conjunction with article 6.04(A)(4) of the TBCA, requires that a corporation make an affirmative decision to dissolve as a condition precedent to the appointment of a receiver pursuant to article 7.06(A). Because, in this case, dissolution had not been authorized by unanimous written consent of the shareholders or by a resolution of the board of directors and the affirmative vote of the holders of two-thirds of the corporation's outstanding shares, the court held that under article 7.06 the trial court did not have authority to appoint a receiver to liquidate F.F.P.

The court then addressed Thorne's right to seek a declaration that F.F.P.'s note was enforceable against Kaspar. The court concluded that Thorne had no right to seek a declaration of the corporation's rights as an individual, but only as a representative of F.F.P. Thorne did not bring suit as a representative of the corporation and, therefore, had no legal right to seek a declaratory judgment. The court also noted that an individual shareholder has no private cause of action for personal damages caused solely by a wrong to the corporation, nor may an individual shareholder sue to enforce a corporate obligation. The only method by which an individual shareholder may sue to enforce a corporate obligation is by way of a derivative action. In a derivative action, the shareholder's pleading must state with particularity the effort made by the shareholder to encourage the board of directors to bring suit on behalf of the corporation. Finding that Thorne made no such allegation, the court concluded that he had no right to seek a declaratory judgment establishing F.F.P.'s rights under the note.

The court in Kaspar then addressed whether Kaspar was liable to Thorne, rather than to F.F.P. itself, for any breach of fiduciary duty. The trial court had submitted a special issue to the jury whether Kaspar had breached his fiduciary duty to Thorne, and the jury found that he had. The jury, however, did not receive a question whether Kaspar owed a fiduciary duty to Thorne. Instead, the trial court instructed that Thorne and Kaspar had a

75. **TEX. BUS. CORP. ACT. ANN. art. 7.06(A)** (Vernon 1988).
76. **Id. art. 6.04(A)(4).**
77. **Kaspar, 755 S.W.2d at 153.**
78. Article 6.02 of the TBCA provides that “[a] corporation may be voluntarily dissolved by the written consent of all of its shareholders.” **TEX. BUS. CORP. ACT. ANN. art. 6.02** (Vernon 1988).
79. **Id.**
80. **Kaspar, 755 S.W.2d at 153-54.**
81. **Id.** The court also noted that even if Thorne were president of the corporation, absent a specific provision in the bylaws allowing the president to bring or defend litigation on behalf of the corporation or a special board resolution regarding such action, Thorne would still be unable to seek a declaratory judgment on behalf of the corporation. **Id.** Thorne neither alleged nor attempted to present any evidence of such a provision or resolution.
82. **Id.**
83. **Id.**
84. **Id.**
85. In light of **Eye Site, Inc. v. Blackburn, 750 S.W.2d 274 (Tex. App.—Houston [14th Dist.] 1988),** which was decided by the court of appeals in Houston six weeks earlier than **Kaspar,** Thorne presumably would not have been able to bring such a derivative action. **See discussion infra at notes 109-15 and accompanying text.**
86. **Kaspar, 755 S.W.2d at 155.**
fiduciary relationship as a matter of law. The court of appeals then reiterated a principle set forth in its decision in Schoellkopf v. Pledger. There the court specifically repudiated the principle that shareholders in a closely held corporation owed an implied duty of good faith to each other as a matter of law. Whether a fiduciary relationship may exist in a particular fact situation presents a question of fact for the jury. In light of the erroneous jury instructions, the Kaspar court reversed the decision of the trial court because the verdict would not support a recovery for Thorne.

In Davis v. Sheerin the court of appeals affirmed the trial court's order that a majority shareholder purchase a minority shareholder's interest in a corporation, thus approving an ordered buy-out as an appropriate remedy for a jury's findings of breach of fiduciary duty and oppressive conduct by a majority shareholder. In 1955, William H. Davis and James L. Sheerin incorporated a business. Davis owned fifty-five percent of the corporation's outstanding capital stock and Sheerin owned the remaining forty-five percent. While both men served as directors and officers, Davis served as the corporation's president and managed the day-to-day operations of the business; Sherin was not an employee of the corporation. In 1960, Sheerin and Davis formed a partnership for the purpose of acquiring real estate.

In 1985, Davis and his wife, Catherine, a named defendant in the suit, denied Sheerin his right to inspect the corporate books unless he presented a stock certificate evidencing his ownership in the company. Sheerin brought suit against the Davises claiming breach of fiduciary duty and oppressive conduct by the Davises as majority shareholders. The Davises alleged that, in the late 1960s, Sheerin gave them his forty-five percent interest in the corporation's stock. The Davises also alleged that Sheerin had no interest in the partnership's property, namely a forty-five percent interest in certain tracts of land. To further their argument, the Davises claimed that, because Mr. Davis purchased the first tract of land before the formation of the partnership and because the Davises appeared as the grantees in each of the deeds, the properties did not constitute partnership assets.

Based upon the jury's finding that the Davises had conspired to deprive Sheerin of his stock and the trial court's conclusion that, as a matter of law, the Davises acted oppressively against Sheerin, the trial court declared that Sheerin owned a forty-five percent interest in the corporation, the partnership, and the tracts of land. The trial court ordered, among other things, that: (i) the Davises purchase Sheerin's stock in the corporation for the stock's fair value as determined by the jury; (ii) an injunction issue prohibiting the Davises from contributing to a profit-sharing plan for their benefit unless Sheerin received a proportionate sum; (iii) the Davises pay damages in the amount of $21,000 as compensation for their willful breach of fiduci-

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87. 739 S.W.2d 914 (Tex. App.—Dallas 1987), rev'd, 762 S.W.2d 145 (Tex. 1988).
88. Kaspar, 755 S.W.2d at 155.
89. Id. at 155-56.
90. Id. at 375 (Tex. App.—Houston [1st Dist.] 1988, writ denied).
91. Id. at 381.
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ary duty by making contributions to such profit-sharing plan to the exclusion of Sheerin; and (iv) a receiver be appointed for the corporation. The Davises presented a two-fold argument on appeal. First, they claimed that under Texas law a court-ordered purchase of a minority shareholder's interest is not an available remedy for a minority shareholder. Second, the Davises argued that even if minority shareholders could obtain such a remedy, the specific facts of this case did not support the jury's findings or the court's determination of oppressive conduct.

The court of appeals first noted that the TBCA\textsuperscript{93} does not specifically grant an aggrieved minority shareholder a buy-out remedy, but does provide for the appointment of a receiver in certain instances, including situations of illegal, oppressive, or fraudulent conduct by majority shareholders or those in control.\textsuperscript{94} Further, the court was unable to find any support in Texas case law for ordering a buy-out remedy absent a specific provision in the contract between the parties.\textsuperscript{95} The court ultimately based its holding upon the decision in \textit{Patton v. Nicholas},\textsuperscript{96} which stated that Texas courts, in the absence of statutory authority, may order liquidation under their general equity powers.\textsuperscript{97} The \textit{Davis} court held that courts may order less harsh remedies under those same equity powers, and that a buy-out may be decreed in appropriate cases if any less harsh remedy would be inadequate to protect the rights of the parties.\textsuperscript{98}

The court then questioned whether an ordered buy-out was an appropriate remedy for Sheerin in his action against the Davises. The court found, after reviewing several cases from other jurisdictions, that oppressive conduct was the most common violation for which other courts found a buy-out to be an appropriate remedy.\textsuperscript{99} The court of appeals pointed out that although the TBCA authorizes a cause of action based on oppressive conduct,\textsuperscript{100} neither the TBCA nor any Texas court has specified what constitutes "oppressive conduct."\textsuperscript{101} The court cited a New York case that found that oppressive conduct occurs only when a minority shareholder's expectations, objectively viewed as reasonable and important in the minority shareholder's decision to invest in the business, ultimately failed to materialize solely because of the majority shareholder's oppressive conduct.\textsuperscript{102} Relying upon the definition of "oppressive conduct" set by the New York court, the court held that whether a majority shareholder's acts constitute oppressive conduct usually presents a question of law for the court,\textsuperscript{103} and that the evidence supported the trial court's conclusion that the Davises engaged in

\textsuperscript{93} TEX. BUS. CORP. ACT ANN. art. 7.05 (Vernon 1986).
\textsuperscript{94} Davis, 754 S.W.2d at 378.
\textsuperscript{95} See id.
\textsuperscript{96} 154 Tex. 385, 279 S.W.2d 848 (1955).
\textsuperscript{97} Davis, 754 S.W.2d at 379 (citing Patton v. Nicholas).
\textsuperscript{98} Id. at 379.
\textsuperscript{99} Id. at 379-81.
\textsuperscript{100} TEX. BUS. CORP. ACT ANN. art. 7.05 (Vernon 1988).
\textsuperscript{101} Davis, 754 S.W.2d at 381.
\textsuperscript{102} Id. (interpreting In re Wiedy's Furniture Clearance Center Co., 108 A.2d 81, 487 N.Y.S.2d 901 (1985)).
\textsuperscript{103} Id.
oppressive conduct and would have likely continued to do so in the future.\textsuperscript{104} The court specifically mentioned the jury’s findings of conspiracy to deprive Sheerin of his interest in the business, willful breach of fiduciary duty, and the probability that Sheerin would be denied any future voice in the corporation.\textsuperscript{105}

Finally, the \textit{Davis} court reviewed the question whether a less harsh remedy than an ordered buy-out could adequately protect Sheerin’s interest. The court noted that decisions of courts in states with statutes that contain provisions similar to article 7.05 of the TBCA have held that an action for oppressive conduct affords an independent ground for relief that does not require a showing of fraud, illegality, mismanagement, wasting of assets, or deadlock.\textsuperscript{106} The court concluded that the Davises’ oppressive conduct in attempting to acquire Sheerin’s stock indicated their desire to gain total control of the business and that a judgment consisting merely of certain injunctions against the Davises and an award of damages would be inadequate to fully protect Sheerin’s rights and interest in the corporation.\textsuperscript{107} The court held that given the facts of the case, an ordered buy-out represented the only appropriate remedy.\textsuperscript{108}

3. Derivative Actions

In \textit{Eye Site, Inc. v. Blackburn}\textsuperscript{109} a Texas court of appeals reviewed a shareholder’s ability to maintain a derivative action in a situation where no other shareholders are “similarly situated.” In \textit{Eye Site} Joseph Blackburn and Stephen Smolins, licensed optometrists, developed a new method for servicing their patients in a retail optical store. To test the concept, Blackburn and Smolins formed a limited partnership and opened one store. Blackburn, Smolins, and Orville Cox (who had become involved in the business by raising money for the store) then formed a Texas corporation, Eye Site, Inc., and Cox received twenty-five percent of the shares of common stock. Subsequently, Blackburn and Smolins had a falling out with Cox and formed a new entity, Eye Optics, Inc., for the purpose of raising funds for future stores.

The Gillette Company, interested in the Eye Optics concept, made a loan of $36,000,000 to Eye Optics and also purchased forty percent of the shares of Eye Optics common stock. Shortly thereafter, Cox filed a shareholders’ derivative suit on behalf of Eye Site accusing Blackburn and Smolins of diverting corporate opportunities properly belonging to Eye Site to Eye Optics. When it later became obvious that Eye Optics would be unable to meet its debt obligation, Gillette offered to purchase the remainder of the out-

\textsuperscript{104} Id. at 383.
\textsuperscript{105} Id.
\textsuperscript{106} Id. at 381-82 (referring to Fix v. Fix Material Co., 538 S.W.2d 351, 358 (Mo. Ct. App. 1976) (citing Gidwitz v. Lanzit Corrugated Box Co., 20 Ill. 2d 208, 170 N.E.2d 131, 135 (1960)).
\textsuperscript{107} Id. at 383.
\textsuperscript{108} Id.
\textsuperscript{109} 750 S.W.2d 274 (Tex. App.—Houston [14th Dist.] 1988, writ denied).
standing stock. Cox promptly filed a temporary restraining order on behalf of Eye Site to enjoin the sale of the stock or the company assets. At the temporary injunction hearing, the defendants challenged Cox's legal standing to bring a derivative action on behalf of Eye Site, and the court dismissed the lawsuit.

On appeal, Cox argued two points of error. First, Cox claimed the trial court should not have dismissed the derivative suit since no other shareholder existed who was willing to enforce the corporation's rights against the remaining shareholders, Blackburn and Smolins. Second, Cox alleged that the trial court mistakenly dismissed the case based on its determination that one shareholder lacked standing to sue under article 5.14 of the TBCA and that Cox failed to comply with rule 42(a) of the Texas Rules of Civil Procedure governing derivative actions. Rule 42(a) essentially provides that a derivative suit may only be maintained if the plaintiff "fairly and adequately" represents the interests of the other shareholders "similarly situated" in enforcing the rights of the corporation.

The appellate court addressed the single issue whether one minority shareholder, opposed by all other shareholders, could fairly and adequately represent the interests of other similarly situated shareholders. Although no Texas court had specifically ruled on this issue, the court pointed out that rule 23.1 of the Federal Rules of Civil Procedure represented the derivative action. Cox argued that one shareholder could fairly and adequately represent the interests of other shareholders in bringing a derivative suit.

The court cited rule 23.1 of the Federal Rules of Civil Procedure, which states that a derivative suit may only be maintained if the plaintiff "fairly and adequately" represents the interests of the other shareholders "similarly situated." The court ruled that Cox could fairly and adequately represent the interests of other shareholders similar to Eye Site.

110. Article 5.14 of the TBCA provides:
A derivative suit may be brought in this State only if: (1) The plaintiff was a record or beneficial owner of shares, or of an interest in a voting trust for shares, at the time of the transaction of which he complains, or his shares or interest thereafter devolved upon him by operation of law from a person who was such an owner at that time . . . .
TEX. BUS. CORP. ACT ANN. art. 5.14 (Vernon 1988).

111. TEX. R. CIV. P. 42(a) provides:
(a) Prerequisites to a Class Action. One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law, or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

Derivative Suit. In a derivative suit brought pursuant to Article 5.14 of the Texas Business Corporation Act, the petition shall contain the allegations (1) that the plaintiff was a record or beneficial owner of shares, or of an interest in a voting trust for shares at the time of the transaction of which he complains, or his shares or interest thereafter devolved upon him by operation of law from a person who was the owner at that time, and (2) with particularity, the efforts of the plaintiff to have suit brought for the corporation by the board of directors, or the reasons for not making such efforts. The derivative suit may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders similarly situated in enforcing the right of the corporation. The suit shall not be dismissed or compromised without the approval of the court, and notice in the manner directed by the court of the proposed dismissal or compromise shall be given to shareholders.

112. Id.; Eye Site, 750 S.W.2d at 276.

113. FED. R. CIV. P. 23.1 states:
Derivative Actions by Shareholders. In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and
tive source of rule 42(a) and that federal courts had steadfastly dismissed derivative suits arising under comparable circumstances. The court of appeals concluded that a single shareholder cannot satisfy the requirements of rule 42(a) and maintain a derivative action for a corporation when all remaining shareholders stand opposed.

Eye Site represents the first Texas case to construe the rule 42(a) prerequisite that a shareholder plaintiff in a derivative action must "fairly and adequately represent the interests of the shareholders similarly situated." The court, however, did not address the full scope of this requirement. The court failed to consider how many plaintiff shareholders in a derivative suit would satisfy the requirement of rule 42(a). In addition, the court did not define how close the "interests" of the plaintiff shareholder must be to the interests of other shareholders "similarly situated." The court has now opened the door for litigants to raise these issues in future derivative actions.


In Sealock v. Texas Federal Savings & Loan Association the Texas Supreme Court held that a corporate reorganization, effected by a reverse triangular merger, that resulted in an employer's stock being exchanged for the stock of a newly formed holding company triggered the golden parachute provisions of an employment contract.

Glenn Sealock and Texas Federal Savings & Loan Association (Texas Federal) entered into an employment contract that contained an ambiguous golden parachute provision purporting to guarantee Sealock certain severance benefits if he were fired after a specified change in corporate ownership or control. The vesting of ownership of ten percent or more of the outstanding voting securities of Texas Federal in any person or group of persons acting in concert triggered the golden parachute. Texas Federal subsequently formed a holding company, Texas Federal Financial Corporation (Texas Federal Financial), as a Delaware corporation, and a second savings and loan association, New Texas Federal Savings and Loan Association

shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff's failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

114. Eye Site, 750 S.W.2d at 276.
115. Id.
116. 755 S.W.2d 69 (Tex. 1988).
117. Id. at 71.
(New Texas), as a wholly owned subsidiary of Texas Federal Financial. Texas Federal then merged with and into New Texas and, by way of the reverse triangular merger, became a wholly owned subsidiary of Texas Federal Financial. The merger agreement provided that the outstanding shares of Texas Federal be exchanged for shares of Texas Federal Financial stock on a one-for-one basis. The liabilities, assets, directors, and officers, even the articles of incorporation and the bylaws of Texas Federal, remained as part of New Texas. The sole purpose of the merger was to establish a Delaware savings and loan holding company for Texas Federal. Texas Federal fired Sealock eleven days after the merger. Sealock then filed a breach of contract action when Texas Federal refused to pay his severance benefits. The trial court, finding as a matter of law that the reverse triangular merger triggered the golden parachute provision, awarded Sealock monetary damages in the amount of $790,000.

The court of appeals reversed and rendered a take-nothing judgment against Sealock.\textsuperscript{118} The appeals court stated that because the Texas Federal stock “disappeared” as a result of the merger, such stock never vested in any other person or entity as required by the employment contract’s golden parachute provision.\textsuperscript{119} The court held that no breach of contract occurred because the golden parachute provision never came into effect.\textsuperscript{120}

The Texas Supreme Court began its analysis by reviewing golden parachute provisions and noted that they are generally designed to protect key executives in the event of a change in control or ownership of a company.\textsuperscript{121} Surprisingly, the supreme court then rejected Texas Federal’s contention that no change in ownership occurred, even though all of the owners of Texas Federal stock were also owners of Texas Federal Financial stock, which, in turn, owned all of the stock of New Texas. The court held that the terms of this particular golden parachute provision would be satisfied if the Texas Federal stock became vested “in any person or group of persons acting in concert.”\textsuperscript{122}

5. Survival of Actions Upon Dissolution

The Austin Court of Appeals, in Reveille Tool & Supply, Inc. v. State,\textsuperscript{123} reviewed article 7.12 of the TBCA prior to the 1987 amendments.\textsuperscript{124} Former article 7.12 provided:

The dissolution of a corporation . . . shall not take away or impair any remedy available to or against such corporation . . . for any right or claim existing, or any liability incurred, prior to such dissolution if action or other proceeding thereon is commenced within three years after

\textsuperscript{118} Texas Fed. Sav. & Loan v. Sealock, 737 S.W.2d 870, 877 (Tex. App.—Dallas 1987), rev’d, 755 S.W.2d 69 (Tex. 1988).
\textsuperscript{119} 737 S.W.2d at 875.
\textsuperscript{120} 755 S.W.2d at 70-71.
\textsuperscript{121} Id. at 71 (emphasis by the court).
\textsuperscript{122} 756 S.W.2d 102 (Tex. App.—Austin 1988, no writ).
\textsuperscript{123} TEX. BUS. CORP. ACT ANN. art. 7.12 (Vernon 1986).
the date of such dissolution.\textsuperscript{125}

In Reveille, the State of Texas, certain municipalities, and the Houston Metropolitan Rapid Transit Authority sued Reveille Tool & Supply, Inc. (Reveille) to recover taxes and penalties pursuant to various tax statutes. The Texas Comptroller of Public Accounts delivered a "Notice of Jeopardy Determination" for sales tax liability against Reveille in November 1982. Reveille promptly requested a redetermination of the tax deficiency calculation. One month later, Reveille filed articles of dissolution. In late 1984, the Comptroller modified the original determination; the modifying order became final on September 5, 1984, with the deficiency tax ordered due and payable twenty days later. Because Reveille failed to pay the deficiency, on January 31, 1986, more than three years following Reveille's filing of its articles of dissolution, the state filed suit to recover the tax due.

Reveille argued to the trial court that because the state filed suit more than three years after the date of dissolution, TBCA article 7.12 barred the suit. The state, referring to the exact language of the statute, claimed that the phrase "action or other proceeding" includes an administrative proceeding, such as a request for redetermination.

The court of appeals affirmed the trial court's judgment and concluded that the phrase "action or other proceeding" should be broadly interpreted to illustrate that more than one method exists for claiming corporate liability that will survive dissolution.\textsuperscript{126} The court noted that the phrase "action or other proceeding" clearly includes administrative proceedings and does not require that liability be asserted by a lawsuit to a court.\textsuperscript{127} Although the court's language in Reveille seems to imply that its decision might have been different had the current article 7.12 been in effect, given the substantially similar language of amended article 7.12, there is no reason to conclude that the court would have reached a different result had the current version of article 7.12 been in effect at the time of dissolution.\textsuperscript{128}

\begin{itemize}
\item \textsuperscript{125} Id.
\item \textsuperscript{126} Id.; Reveille, 756 S.W.2d at 103.
\item \textsuperscript{127} Reveille, 756 S.W.2d at 103.
\item \textsuperscript{128} Amended article 7.12 now reads, in relevant part, as follows:
\begin{enumerate}
\item A. A corporation dissolved (1) by the issuance of a certificate of dissolution or other action by the Secretary of State, (2) by a decree of a court when the court has not liquidated all the assets and business of the corporation as provided in this Act, or (3) by expiration of its period of duration, shall continue its corporate existence for a period of three (3) years from the date of dissolution, for the following purposes:
\begin{itemize}
\item (2) permitting the survival of any remedy not otherwise barred by limitations available to or against the corporation, its officers, directors, shareholders, or creditors, for any right or claim existing, or any liability incurred, \textit{before the dissolution};
\end{itemize}
\item C. If after the expiration of the three-year period there still remains unresolved any action or proceeding not otherwise barred by limitations \textit{begun by or against the corporation before its dissolution or within three (3) years after the date of its dissolution}, the corporation shall continue to survive \textit{only} for the purpose of that action or proceeding, until any judgment, order, or decree, in the action or proceeding is fully executed.
\end{enumerate}
\end{itemize}
6. Failure to Disclose Acquisition Negotiations to Shareholders

In Voskamp v. Arnoldy¹²⁹ minority shareholders of a closely held corporation successfully brought an action against the chairman and an officer of the corporation for fraud in connection with the corporation's purchase of their shares. At trial the jury found that the chairman and executive vice president had misrepresented and failed to disclose material facts concerning the corporation to the minority shareholders who, in reliance thereon, sold their shares back to the corporation and suffered damages in the amount of approximately $150 per share. On motion by the corporation and its officers, the trial court granted the corporation and its officers judgment notwithstanding the verdict. The plaintiff shareholders appealed. The court of appeals reversed, holding that sufficient evidence existed to support a finding of common law fraud and that the rule that preliminary merger discussions need not be disclosed in connection with the purchase or sale of a corporation's securities did not apply to negotiations to sell the corporation's assets.¹³⁰

The parties in Voskamp included: Roman Arnoldy, the majority shareholder, president, and chairman of Tapco International (Tapco); his son, John Arnoldy, the executive vice president, a director, and a shareholder of Tapco; and Peter Voskamp, C.W. Bair, and Jerry Amussen, employees and part of the management of Tapco. In 1972, Roman persuaded Voskamp and Bair to purchase all of the shares of Tapco stock then held by a retiring Tapco officer. Then, in 1977, after a significant increase in Tapco's sales, Roman allegedly demanded that Voskamp and Bair sell a large portion of that stock to him at the same price per share they paid in 1972. Bair sold Roman approximately 425 shares, but Voskamp refused to comply with Roman's demand. After Bair's sale, Voskamp and Bair together owned 6,000 of the 33,000 outstanding shares and Jerry Amussen owned 445 shares. Tapco terminated all three employees between early 1978 and early 1979.

In late 1978, the Arnoldys hired a business broker to help them find a potential buyer for either Tapco or one of its divisions. The broker arranged a meeting with General Signal in December of 1978. At some point thereafter, but prior to April 1979, General Signal offered to purchase Tapco's valve division. The Arnoldys rejected this offer, but never disclosed either the meeting or the offer to Voskamp, Bair, or Amussen. Voskamp and Bair filed separate suits in early 1979 against Roman alleging, on behalf of Tapco shareholders, that Roman had mismanaged the corporation's affairs, neglected to arrange promised pension benefits, and inflated his salary so as to

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¹²⁹. 749 S.W.2d 113 (Tex. App.—Houston [1st Dist.] 1987, writ denied).
¹³⁰. Id. at 119-20.
unduly enrich himself. Allegedly, Voskamp and Bair filed the suits to coerce Tapco into buying back their stock. Between February 1978 and April 1979, Voskamp and Bair's attorney met with Arnoldy to determine the value of their stock. Voskamp, Bair, and Arnoldy negotiated a settlement that provided for Tapco to purchase Bair's and Voskamp's stock at a price of $100 per share. At no time during the pending suits or the settlement negotiations did the Arnoldys disclose that they intended to sell a portion of Tapco. Voskamp and Bair neither knew that a prospective buyer had been located nor that an offer to buy Tapco had been made. Voskamp, Bair, and Amussen all sold their stock back to Tapco at $100 per share, completely unaware of the corporation's negotiations with General Signal.

The final agreement between General Signal and Tapco, signed in November 1980, provided for a purchase price of $8.8 million for Tapco's valve division. Approximately eighteen months later, Voskamp, Bair, and Amussen filed suit against the Arnoldys and Tapco claiming common law fraud, stock fraud under section 27.01 of the Texas Business & Commerce Code, and breach of fiduciary duty. The jury found in favor of Voskamp, Bair, and Amussen and awarded them actual and punitive damages, but the trial court granted judgment for the defendants notwithstanding the verdict.

In an effort to convince the court of appeals to uphold the trial court's judgment, the Arnoldys argued that they had no duty to communicate to any of the other shareholders their "preliminary discussions" with General Signal and that "all official knowledge" had been disclosed. In support of their argument, they cited Greenfield v. Heublein, Inc. and Staffin v. Greenberg, which discussed the duties imposed on officers of a corporation under the Securities Exchange Act of 1934. Both of these courts held that inquiries, preliminary discussions, or other communications preparatory to a possible acquisition of one company by another do not mandate disclosure. The court, however, found the principle of Greenfield and Staffin inapplicable to the instant case and reversed the trial court by making a puzzling distinction; the court simply stated that Tapco's situation involved negotiations regarding the sale of assets, while Greenfield and Staffin dealt with merger negotiations. The existence or nonexistence of a duty to disclose pending negotiations that may lead to a transaction that would materially affect per share values should not turn on the structure of the transaction.

The Arnoldys and Tapco further argued that insufficient evidence existed to support the excessive jury award of punitive damages, which were such as would force Tapco into bankruptcy. The appellate court noted that the

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131. TEX. BUS. & COM. CODE ANN. § 27.01 (Vernon 1987).
132. 742 F.2d 751 (3d Cir. 1984).
134. Greenfield, 742 F.2d at 756; Staffin, 509 F. Supp. at 826; see also Voskamp, 749 S.W.2d at 119 (discussing the Greenfield and Staffin holdings). Query whether the court's holding with respect to this matter would have been the same had the court had the opportunity to review Basic, Inc. v. Levinson, 108 S. Ct. 978 (1988). See infra discussion at notes 180-208 and accompanying text.
135. Voskamp, 749 S.W.2d at 119.
amount of punitive damages turns upon the unique facts of each case and rests largely within the discretion of the jury.\textsuperscript{136} Given that the largest ratio between punitive damages and actual damages awarded to Voskamp, Bair, or Amussen equalled six to one, and considering the Arnoldys' purposeful concealment of material information that was intended to induce Voskamp, Bair, and Amussen to sell their shares at less than fair value, the court of appeals concluded that the jury's award of punitive damages was reasonable.\textsuperscript{137} The court dismissed the Arnoldys' contention that the business judgment rule justified their actions.\textsuperscript{138} The court noted that the business judgment rule may not be employed as a defense to suits alleging fraud.\textsuperscript{139}

Finally, the court of appeals rejected the Arnoldys' argument that Voskamp, Bair, and Amussen knowingly and intelligently waived any right to later demand a higher price for their stock when they sold it pursuant to a prior settlement.\textsuperscript{140} Waiver, noted the court, constitutes an intentional relinquishment or abandonment of a known right or privilege, "but fraud vitiates whatever it touches and cannot be waived."\textsuperscript{141}

7. Noncompetition Agreements and Conflicts of Law and the Texas Free Enterprise and Antitrust Act

In 1987 the Texas Supreme Court severely restricted the use of noncompetition agreements when, in \textit{Hill v. Mobile Auto Trim, Inc.}\textsuperscript{142} and \textit{Bergman v. Norris of Houston},\textsuperscript{143} the court reformulated the criteria to be applied in determining whether such agreements are enforceable. In those cases, the court held unenforceable covenants designed to limit competition or restrain the right to engage in a "common calling." In July 1988 the Texas Supreme Court dealt another blow to the enforceability of noncompetition agreements. In \textit{DeSantis v. Wackenhut Corporation}\textsuperscript{144} the court held that Texas' interest in promoting the free movement of workers in the job market constitutes a fundamental public policy so that Texas courts will not honor an otherwise valid choice of foreign law to govern a noncompetition agreement if the chosen state's law would enforce the noncompetition agreement and Texas law would not.\textsuperscript{145}

Edward DeSantis worked as the area manager for Wackenhut Corporation (Wackenhut) in its Houston office. In connection with his employment, DeSantis negotiated and entered into a noncompetition agreement while at Wackenhut's corporate headquarters in Florida. Wackenhut specialized in furnishing various business enterprises with security personnel. Having pre-

\textsuperscript{136} Id. at 121.
\textsuperscript{137} Id.
\textsuperscript{138} Id.
\textsuperscript{139} Id.
\textsuperscript{140} Id. at 124.
\textsuperscript{141} Id. (citing Stonecipher v. Butts, 591 S.W.2d 806, 809 (Tex. 1979)).
\textsuperscript{142} 725 S.W.2d 168 (Tex. 1987).
\textsuperscript{143} 734 S.W.2d 673 (Tex. 1987).
\textsuperscript{144} 31 Tex. Sup. Ct. J. 616 (July 13, 1988). The Texas Supreme Court has granted a request for rehearing.
\textsuperscript{145} Id. at 620.
viously been employed by the United States’ Central Intelligence Agency and in the private sector, DeSantis had several years of experience in the security area. After three years, DeSantis resigned from Wackenhut under threat of termination and formed a new company, Risk Deterrence, Inc. (RDI). RDI provided security consulting and guard services to a limited clientele, including certain former clients of Wackenhut. Wackenhut sued DeSantis and RDI for breach of the noncompetition agreement and sought injunctive relief as well as monetary damages. The trial court enjoined DeSantis from competing with Wackenhut for two years in a thirteen-county area and from releasing client lists or revealing confidential information. The court also enjoined RDI from ever divulging or using any confidential or proprietary information acquired through DeSantis by reason of his employment with Wackenhut. Both the trial court and the court of appeals honored the choice of law specified in the agreement, stating that Florida law should govern all questions concerning interpretation or enforcement of the contract. On appeal, DeSantis argued that the lower courts erred by giving effect to the Florida choice of law provisions because Florida law on covenants not to compete contradicted Texas fundamental public policy.

The Texas Supreme Court first analyzed the Texas contractual choice of law rule, stated by the court in First Commerce Realty Investors v. K-F Land Co.146 that “an express agreement among the parties that a contract is to be governed by the laws of a particular state will be given effect if the contract bears a reasonable relation to the chosen state and no countervailing public policy of the forum demands otherwise.”147 The supreme court, acknowledging the need for certainty and predictability in multi-state contract transactions, expressly adopted section 187 of the Restatement (Second) of Conflict of Laws.148 This provision states that a contractual choice of foreign law will be enforced if (i) a reasonable relationship exists between the parties and the jurisdiction whose law is chosen and (ii) the chosen law is not contrary to a fundamental public policy of the forum state.149

In applying the Restatement rule to the choice of Florida law in the Wackenhut noncompetition agreement, the Texas Supreme Court noted that Wackenhut’s Florida corporate offices were the place in which Wackenhut interviewed and hired DeSantis and that persons from the Florida headquarters closely supervised the management of the Houston office.150 The court thus found a reasonable relationship between the parties and the State of Florida.151 The court also found, however, that the law of Florida differed dramatically from Texas law in the area of covenants not to compete, so that the application of Florida law would adversely affect personal rights created in support of a fundamental policy of the State of Texas.152 The court noted

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146. 617 S.W.2d 806 (Tex. Civ. App.—Houston [14th Dist.] 1981, writ ref’d n.r.e.).
147. DeSantis, 31 Tex. Sup. Ct. J. at 618 (citing First Commerce Realty Investors, 617 S.W.2d at 808-09).
148. Id.
151. Id.
152. Id. at 618-20.
that a Florida statute mandated the enforceability of covenants not to compete, and that Florida courts had freely granted injunctive relief for breach of noncompetition agreements by recognizing a presumption of irreparable harm to the promisee. Finally, as the court noted, Florida had no counterpart to Texas' restriction in areas of "common calling," but rather had specifically enforced covenants not to compete against hairstylists, telephone salespersons, and secretaries.

The Texas Supreme Court contrasted Florida's approach to noncompetition agreements to the four-part test set out in *Hill v. Mobile Auto Trim, Inc.*, which requires that the covenant:

(i) be necessary for the protection of the promisee,
(ii) not be oppressive to the promisor [including reasonable limitations as to time, territory, and activity],
(iii) not be injurious to the public through prevention of competition or by depriving the community of needed goods, and
(iv) be enforced only if the promisee gives consideration.

The court further noted that Texas courts steadfastly enforce their strict rules for granting injunctive relief (the showing of a probable right of the promisee to prevail on the merits and probable irreparable injury to the promisee) when considering possible remedies for breach of covenants not to compete. Based on the significant differences between Florida law and Texas law regarding enforcement of covenants not to compete, the court held that the application of Florida law would be contrary to a newly defined fundamental public policy of Texas, promoting free movement of workers in the job market. Therefore, the court refused to enforce the parties' choice of law in the agreement.

Having determined that Florida law should not apply, the court proceeded to review the facts of the case and the findings of the jury in light of Texas law as established in *Hill*. The court stated that the jury's failure to find that Wackenhut would suffer irreparable harm as a result of DeSantis's breach when determining the appropriateness of equitable relief was somehow tantamount to a finding that the covenant was not necessary for Wackenhut's protection. The covenant, therefore, did not satisfy the first criterion set forth in *Hill*. Curiously, the failure of the covenant to satisfy this criterion was found to render the covenant "unreasonable."

**Footnotes**

153. *Id.* at 619 (citing FLA. STAT. § 542.33 (1988)).
154. *Id.* at 619. The Texas Supreme Court specifically held in *Hill v. Mobile Auto Trim, Inc.*, 725 S.W.2d 168, 172 (Tex. 1987), that covenants not to compete may not be enforced if such covenants impair or restrict the right to engage in a "common calling."
155. *Id.*
156. 725 S.W.2d 168 (Tex. 1987).
159. *Id.* at 620.
160. *Id.*
161. *Id.*
162. *Id.*
163. *Id.*
edge in the security area prior to his employment by Wackenhut. In the opinion of the court, this showed an absence of consideration on the part of the promisee, notwithstanding Wackenhut's agreement to employ and pay DeSantis during his employment. Again, however, the failure of the covenant to satisfy the fourth criterion set forth in Hill was said to make the covenant "unreasonable." Based upon these two findings the court held the covenant not to compete unenforceable under Texas law.

A disturbing aspect of the supreme court's opinion in Wackenhut is the court's confusion of the standards for granting the equitable relief of injunction and the standards for enforceability of noncompetition agreements on the one hand with the criteria for determining whether such covenants are reasonable on the other. As previously mentioned, the court equated a finding of no irreparable harm to Wackenhut with a failure to demonstrate that the covenant was necessary for the protection of Wackenhut. This equation was then used to support the conclusion that the covenant was unreasonable. Presumably, even if there were no threat of irreparable harm to support injunctive relief, the remedy of money damages would be available to Wackenhut for DeSantis's breach of his employment agreement. In addition, by equating unenforceability for lack of consideration with unreasonableness, the court implied a cause of action against Wackenhut under the Texas Free Enterprise and Antitrust Act (Antitrust Act). This implication is entirely inconsistent with federal judicial interpretations of section 1 of the Sherman Act because the court failed to recognize the necessary element of a cause of action under the Antitrust Act of evaluating the effect of the DeSantis covenant not to compete upon competition for security services in the Houston market. Such an evaluation is mandated by section 15.04 of the Antitrust Act, which requires the courts to construe the Antitrust Act in "harmony with federal judicial interpretations of comparable federal antitrust statutes."

By contrast, the supreme court's opinion in DeSantis is instructive in the area of conflict of laws. In this case, the supreme court adopted section 187 of the Restatement (Second) of Conflict of Laws as the Texas courts' rule with respect to contractual choices of law. As earlier noted, section 187 states in effect that if the parties to a contract provide in the contract that another state's law will govern their rights and duties under the contract, that provision will be effective so long as (i) there is a substantial relationship between the state whose law is chosen and either the transaction or the par-

164. Id.
165. Id.
166. Id.
167. Id.
168. TEX. BUS. & COM. CODE ANN. §§ 15.01-.40 (Vernon 1987).
170. TEX. BUS. & COM. CODE ANN. § 15.04 (Vernon 1987). In fact, as noted in Bradford v. New York Times Co., 501 F.2d 51, 59 (2d Cir. 1974), no court applying the rule of reason doctrine had yet found an employee covenant not to compete to be in violation of § 1 of the Sherman Act.
171. See supra note 149 and accompanying text.
ties and (ii) the application of the chosen law would not be contrary to a fundamental policy of the forum state, the forum state has a materially greater interest in the issue than the state whose law is chosen, and the law of the forum state would apply in the absence of the parties' choice of law.\textsuperscript{172}

The first feature of this rule, the so called "reasonable relationship" test, is a feature of previously existing Texas choice of law rules.\textsuperscript{173} Further, the second feature of this rule, the so called "fundamental policy" exception, has been previously recognized by the Texas courts and does not represent a new development in Texas choice of law rules.\textsuperscript{174} However, the adoption by the supreme court of section 187 of the Restatement raises the question what criteria the Texas courts will apply to determine the fundamental policies of the state.\textsuperscript{175}

Questions of enforceability of contractual choices of law frequently have arisen in the case of contracts that provide for the payment of interest at rates that would be usurious under the law of the forum state.\textsuperscript{176} The Fifth Circuit Court of Appeals has correctly observed that a number of reported decisions of Texas courts have applied foreign law to determine the maximum rate of interest that a foreign lender may take, charge, collect, or receive from a Texas borrower,\textsuperscript{177} with the clear implication that Texas's usury laws do not embody fundamental policy. Therefore, despite the reference to "public policy" in a Texas usury statute,\textsuperscript{178} the federal courts have concluded that honoring the parties' choice of foreign law to determine the maximum lawful rate of interest that may be charged to a Texas borrower "does not offend fundamental public policy of the State of Texas."\textsuperscript{179} This conclusion is instructive because it demonstrates that a legislative pronouncement of "public policy" should not necessarily be read as a statement of "fundamental policy," within the meaning of section 187 of the Restatement. It is the authors' view that every statute that refers to "public policy" should not be regarded as a legislative instruction to the courts that the statute embodies "fundamental policy," as that term is used in Texas, choice of law rules.

\begin{itemize}
\item \textsuperscript{172} Restatement (Second) of Conflict of Laws § 187 (1969).
\item \textsuperscript{174} See, e.g., First Commerce Realty Investors v. K-F Land Co., 617 S.W.2d 806 (Tex. Civ. App.—Houston [14th Dist.] 1981, writ ref'd n.r.e.).
\item \textsuperscript{175} Wackenhut does not provide bright lines for determining those contractual obligations the enforcement of which would be contrary to fundamental policy. Enforcement of a contractual obligation will offend fundamental policy if the provision's enforcement would be against good morals or natural justice or, for some other reason, would be prejudicial to the general interests of Texas citizens. See Castilleja v. Camero, 414 S.W.2d 424, 427 (Tex. 1967).
\item \textsuperscript{176} See Pederson & Cox, Choice of Law and Usury Limits Under Texas Law and the National Bank Act, 34 Sw. L.J. 755 (1980).
\item \textsuperscript{177} Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Dev. Co., 642 F.2d 744, 751 (5th Cir. 1981).
\item \textsuperscript{179} Woods-Tucker, 642 F.2d at 753. In addition, there is a sound economic basis for this conclusion. The characterization of the usury laws of Texas as part of the state's fundamental policy would elevate parochial issues over the economic benefit to Texas borrowers of free access to out-of-state sources of capital, with the result that non-Texas institutional lending markets would be less available to Texas businesses.
\end{itemize}
B. Securities Law Development

In Basic, Inc. v. Levinson\(^{180}\) the United States Supreme Court expressly adopted the standard of materiality set forth in TSC Industries, Inc. v. Northway\(^{181}\) for claims brought under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 promulgated thereunder, which states that an omitted fact is material if a substantial likelihood exists that its disclosure would have been considered significant by a reasonable investor.\(^{182}\) The facts in Basic involved the timing of the disclosure of a potential business combination. The Court rejected use of the "agreement-in-principle" test for establishing the point at which preliminary merger discussions become material.\(^{183}\) Instead, the Court embraced the probability magnitude approach applied in SEC v. Texas Gulf Sulphur Co.\(^{184}\) In addition, the Court found that persons who traded their stock on impersonal, well-developed markets for securities could, for purposes of claims under section 10(b) and rule 10b-5, use the fraud-on-the-market theory to establish a rebuttable presumption of reliance.\(^{185}\)

Basic, Inc. (Basic), a publicly held company, manufactured chemical refractories for the steel industry. Combustion Engineering, Inc. (Combustion), which also engaged in the refractory production business, had, for a number of years, expressed an interest in acquiring Basic. Beginning in September 1976, representatives of Combustion met with officers and directors of Basic to discuss a possible merger of their companies. On December 18, 1978, Basic asked the New York Stock Exchange to suspend trading in its shares and released a statement that it had been approached concerning the possible acquisition of Basic. The following day, Basic's board of directors approved a tender offer by Combustion, and Basic publicly announced the approval one day later.

During 1977 and 1978, prior to the tender offer, Basic made three public statements denying any merger negotiations. The respondents, former Basic shareholders, sold their shares during the period beginning after the first of such announcements and ending on December 8, 1978. They subsequently brought a class action against Basic and its directors under section 10(b) and rule 10b-5, asserting that the three announcements were false and misleading and had caused the respondents injury because they sold their shares at artificially depressed prices.

The trial court held that any misstatements were immaterial as a matter of law because the negotiations in process at the time of the announcements were "not destined, with reasonable clarity" to become an agreement-in-principle. The Court of Appeals for the Sixth Circuit rejected that view and held that any statement the company voluntarily released could not be so

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183. Id. at 986.
incomplete as to mislead.\textsuperscript{186} It found that Basic's statement that it knew of no negotiations or corporate developments that might account for the heavy trading in its shares did indeed mislead investors, and, although such discussions may not have been material in the absence of denial, they became material because of the denial.\textsuperscript{187}

The Supreme Court's analysis began with an acknowledgment that Congress designed the 1934 Act to protect investors against manipulation of stock prices through a system requiring full disclosure.\textsuperscript{188} The Court cited its earlier decision in \textit{TSC Industries} in which the Court addressed the question of whether certain misstatements in a proxy statement should be deemed material.\textsuperscript{189} Recognizing that an overabundance of data burying shareholders in a large quantity of insignificant information would be self defeating, the Court in \textit{TSC Industries} adopted the standard that "an omitted fact is material if a reasonable investor would consider it important in deciding how to vote; the fact would have to significantly alter the total mix of information available."\textsuperscript{190} The Court in \textit{Basic} expressly adopted this standard of materiality as applying to section 10(b) and rule 10b-5 actions.\textsuperscript{191}

In adopting the \textit{TSC Industries} standard, the Supreme Court admitted that such a standard, in the context of preliminary merger negotiations, would be difficult to apply because of the inherent speculative nature of such negotiations.\textsuperscript{192} The Court, however, rejected the rule-of-thumb test relied upon by management that such negotiations become material only when an agreement-in-principle has been reached, finding unpersuasive each of the rationales supporting such a rule.\textsuperscript{193} First, the Court dismissed the rationale that preliminary discussions are simply too tentative prior to an agreement-in-principle for an investor to be able to discern the importance of any disclosures that are made.\textsuperscript{194} The Court distinguished this paternalistic approach to disclosure from the need to filter out insignificant and essentially useless information.\textsuperscript{195} The Court dismissed as irrelevant the second rationale, relating to the importance of secrecy during preliminary negotiations.\textsuperscript{196} Interestingly, the Court stated that, in its opinion, the issues raised in \textit{Basic} did not go to the timing of disclosure, but rather only to the accuracy and completeness of disclosure.\textsuperscript{197} The Court quickly disposed of the final rationale, established as essentially a bright-line rule for management's ease of application, as an improper excuse for ignoring the purpose of the securities acts.\textsuperscript{198}

\begin{itemize}
\item \textsuperscript{186} 786 F.2d 741, 746 (6th Cir. 1986).
\item \textsuperscript{187} Id. at 749.
\item \textsuperscript{188} \textit{Basic}, 108 S. Ct. at 982.
\item \textsuperscript{189} Id. at 983 (citing \textit{TSC Industries}, 426 U.S. at 438).
\item \textsuperscript{190} \textit{TSC Industries}, 426 U.S. at 449.
\item \textsuperscript{191} \textit{Basic}, 108 S. Ct. at 983.
\item \textsuperscript{192} Id.
\item \textsuperscript{193} Id.
\item \textsuperscript{194} Id. at 984.
\item \textsuperscript{195} Id.
\item \textsuperscript{196} Id.
\item \textsuperscript{197} Id.
\item \textsuperscript{198} Id. at 985.
\end{itemize}
The Court further explained that the court of appeal's position, which made material any statement denying the existence of preliminary merger negotiations, proved "equally insensitive" to the distinction between materiality and the other elements of a cause of action under rule 10b-5.²⁰⁹ Rather, the Supreme Court stated that a claimant under rule 10b-5 must show that a statement or omission is both misleading and material.²⁰² The materiality approach adopted by the Court, and set forth in Texas Gulf Sulphur, requires an evaluation of both an event's probability of occurrence and its significance to the company.²⁰¹ The Court noted that, to assess the probability of a merger transaction, the fact finder should look for indicia of interest at the highest corporate levels, as evidenced by board resolutions and instructions to investment bankers.²⁰² A determination of the magnitude of the transaction to the issuer would require an examination of the size of the combining entities and the potential premiums over market value to be realized by shareholders.²⁰³

The Supreme Court next considered the use of the fraud-on-the-market theory²⁰⁴ to establish reliance on the part of the respondents in their sale of stock, which reliance would be necessary to support a class action under rule 10b-5.²⁰⁵ The Court noted that requiring each member of the class to prove his reliance would have effectively prevented the respondents from bringing a class action because the individual issues would have overwhelmed the common ones.²⁰⁶ The Court then found that requiring a rule 10b-5 claimant to demonstrate how he would have acted had there not been a material omission or misstatement would place on him an unrealistic evidentiary burden.²⁰⁷ In a four to two decision, the Supreme Court upheld the appellate court's acceptance of a rebuttable presumption, supported by the fraud-on-the-market theory, that the respondents had traded their shares in reliance on the integrity of a developed market, and that this reliance, though subject

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199. Id.
200. Id.
201. Id. at 986.
202. Id.
203. Id. at 987.
204. In discussing reliance one commentator states:

The purpose of the reliance requirement in face-to-face transactions is to ensure that plaintiffs who would not have acted differently if the true information were known cannot recover. It guarantees that information that does not affect a buyer's or seller's view of the merits of a transaction cannot form the basis of a cause of action.


The fraud-on-the-market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. . . . Misleading statements will therefore defraud purchasers of stock even if they do not directly rely on the misstatements. . . .

Basic, 108 S. Ct. at 988-89.
206. Id.
207. Id.
to rebuttal, would support a claim under rule 10b-5.\textsuperscript{208}

II. PARTNERSHIPS

During the Survey period, there were few Texas partnership case law developments. There were even fewer significant partnership developments. In fact, some of the cases this Article reviews are more significant for their non-partnership law aspects.

1. Ability of Partnership to Benefit from Fraudulent or Illegal Act of Co-Partner

a. Ward v. Dallas Texas National Title Company.\textsuperscript{209} Judge Hecht introduced this case with an ominous note: "This is another in the host of lawsuits spawned by the notoriously ill-fortuned condominium development along Interstate 30 in the Lake Ray Hubbard area."\textsuperscript{210} The partnership issue in this case was whether a person is entitled to recover from his partner a share of profits generated by the partner's fraudulent scheme. The court held that one could not recover profits from the fraudulent actions of a partner because the effect would be to allow the recovering party to also benefit from the fraud.\textsuperscript{211} The court, however, did find that an allegation of a civil conspiracy to defraud third parties does not, as a matter of law, preclude an action for damages for loss of the value of property.\textsuperscript{212} The court reversed the summary judgment of the trial court in favor of the defendants and remanded the case for further proceedings.\textsuperscript{213}

The plaintiffs in this case owned 60% of the J.A.D.A. Partnership. J.A.D.A. contracted to buy a tract of property for approximately $245,000. Two of the other partners, Todd and Wilson, allegedly misrepresented to the plaintiffs that there were no buyers for the property and that the earnest money deposit made pursuant to the contract should be forfeited.\textsuperscript{214} The plaintiffs further alleged that Todd and Wilson, without the plaintiff's knowledge, acquired the property in the name of J.A.D.A. and then re-sold it to a third party for approximately $535,000. They also alleged that two additional conveyances, which took place in the same day, for a total price of $1,706,000 were part of a civil conspiracy to defraud Empire Savings and Loan Association.

The dissent agreed with the majority that a partner cannot profit from his

\textsuperscript{208} Id. at 992.
\textsuperscript{209} 735 S.W.2d 919 (Tex. App.—Dallas 1987, writ ref'd n.r.e.).
\textsuperscript{210} Id. at 920.
\textsuperscript{211} Id. at 921.
\textsuperscript{212} Id. at 921-22. The court distinguished this claim for loss of damages from the claim to recover profits from the fraudulent transactions. "Although appellants can have no moiety in any fraud-forged fund, they may have the right to recover damages for any real loss of value of the property." Id. at 922.
\textsuperscript{213} Id. at 922.
\textsuperscript{214} Plaintiffs claimed that they followed Todd's advice not to pay an additional deposit to extend the closing until buyers could be found, not knowing that Todd's intention was secretly to purchase the property for resale.
partner's fraudulent actions. They differed, however, on whether, independently of that fraud, the claimant partner can show that he was deprived of his share of profits from the partnership property. The dissent held that the partner should not have the right to make that showing.

b. *Darnell v. Martin.* The issue in this case was whether a partner convicted of theft and ordered to make restitution to a defrauded buyer could obtain contribution from his co-partner for profits paid to the co-partner that resulted from the original fraudulent sale. The lower court decision awarding the partner claiming contribution $11,200 was reversed and rendered. The court found that the "criminal conviction and its consequences are personal to the defendant [the plaintiff in this case] and not chargeable to co-partner unless he had knowledge." Interestingly, the court's holding in *Ward v. Dallas Texas National Title Co.*, discussed above, would have precluded the innocent partner from suing to collect his share of profits from the partner who defrauded the buyer if those profits had not been distributed before the fraud was discovered. The lesson here must be for the nonfraudulent partner to know as little as possible and get the money in advance.

2. *Construction of Partnership Dissolution Agreement: Baldwin v. New* This case is really not a partnership law case. Although it involves a partnership dissolution agreement, it is simply a contract construction case. Because it has some interesting issues, however, it will be covered here.

The case turned on the meaning of the term "offer" in a partnership dissolution agreement under which Baldwin would be paid his share of the sales price for a building if his co-partner, New, received an "offer to purchase" the building within a certain period of time. Baldwin presented three "offers" to New within the prescribed time, but New rejected each as not being an "offer to purchase" the building.

The Dallas Court of Appeals affirmed the summary judgment granted to New by the trial court on the basis that the "offers" submitted by Baldwin were not contracts of sale but, rather, were options. The two proposals that satisfied the monetary prerequisites of the dissolution agreement contained "free look" provisions giving the prospective buyer the unfettered right to terminate the contract during the sixty days after the contract was

215. *Id.* at 923.
216. *Id.* at 923-24.
217. *Id.* (Whitham, J., dissenting). “I conclude that the [plaintiff's] complain... that a conspiracy by the [defendants] denied the [plaintiffs] an opportunity to participate in a scheme to defraud Empire Savings and Loan of the amount of $1,706,158 by inflating the value of the... land. Surely, we have not reached the point where a person may recover damages for being denied the right to defraud.” *Id.*
219. *Id.* at 16.
220. *Id.*
221. 735 S.W.2d at 921.
222. 736 S.W.2d 148 (Tex. App.—Dallas 1987, writ denied).
223. *Id.*
executed, and limited the seller's remedies on a buyer's default to a retention of the earnest money deposit. No right to bring an action for specific performance or damages existed, even after the free look period in the contract expired. The sole remedy was to retain the earnest money. The court, therefore, held that under settled Texas case law the proposals at issue were no more than option contracts. Furthermore, under Texas law the word "offer" means a proposal that produces a binding contract on its acceptance, enforceable by any party to it. The court found that the offers in this case, even if accepted, would produce buyer's option contracts, not bilateral contracts enforceable by either party.

Because the proposals described in Baldwin are typical of what would be termed "contracts of sale" in the Texas real estate industry, the proposals probably satisfied the parties' intent for purposes of the dissolution agreement. The court, however, found the terms of the dissolution agreement to be unambiguous and, therefore, disallowed any parol evidence of the parties' intent. On the other hand, there exists a somewhat more compelling argument in support of the court's holding, which the court failed to make. Under the dissolution agreement, Baldwin was entitled to be paid even if the property was not sold pursuant to the "offer to purchase." Therefore, requiring New to pay Baldwin full value on Baldwin's production of an option contract under which New's sole recourse against the prospective buyer in the event of the latter's default was to retain the earnest money, is arguably unfair.

3. Forfeiture of Partnership Interest: Brewer v. Tehuacana Venture, Ltd.

Brewer involved a suit by a limited partner against the limited partnership and the general partner for an accounting and for damages equal to the limited partner's share of profits resulting from the sale of partnership property. The court of appeals affirmed the trial court's holding in favor of the general partner and the partnership. In this case, the limited partner refused to fund a mandatory "cash call" made by the general partner on behalf of the partnership. The limited partnership agreement contained a procedure to deal with such a default. The agreement permitted the general partner to purchase the defaulting partner's

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224. Id. at 151 (citing Hott v. Pearce/Christon, Inc., 663 S.W.2d 851, 853 (Tex. App.—Dallas 1983, writ ref'd n.r.e.)).
225. Id. at 150 (citing Lede v. Aycock, 630 S.W.2d 669, 674 (Tex. App.—Houston [14th Dist.] 1981, writ ref'd n.r.e.)).
226. Id. at 151.
227. Id. at 153.
228. New had the right either to (i) sell the property pursuant to the contract produced by Baldwin, or (ii) pay Baldwin the amount Baldwin would have received under the agreement had the sale occurred.
229. In other words, the court might have said that the only type of contract for which Baldwin was entitled to full payment on New's election not to sell was one under which New has a right to sue the buyer for the full sales price if the buyer defaulted.
230. 737 S.W.2d 349 (Tex. App.—Houston [14th Dist.] 1987, no writ).
231. Id. at 350.
interest by paying the amount of the cash call within ten days after the default. If the general partner failed to timely exercise that option, it had an additional thirty-day period during which it could substitute another person for the defaulting partner. If that substitution did not occur, the general partner could then dissolve the limited partnership and wind up its affairs. Alternatively, the general partner could waive the default and avoid dissolution and winding up.

Shortly after the limited partner refused to comply with the cash call, the partnership contracted to sell its property. The property was later sold pursuant to that contract. Apparently feeling that the timing of the loss of his interest and the sale of the property were not entirely coincidental, the limited partner sued for his share of the sale proceeds, claiming that had he known of the sale he would have paid his contribution. The limited partner makes a rational argument. Most people would pay $2,050 for the right to shortly thereafter receive $21,764.23. The jury, however, found that the initial contract regarding the sale occurred almost two months after the cash call was made and more than two weeks after the limited partner’s final default.232

The court of appeals concluded that the general partner’s failure to strictly observe the limited partnership agreement’s default procedure was immaterial.233 The court found that the general partner purchased the limited partner’s interest shortly after the time period prescribed by the agreement and that the delay was principally caused by the general partner’s allowance of additional time for the limited partner to make the cash call.234

Two of the court’s findings are significant. First, the court found irrelevant the general partner’s failure to amend the certificate of limited partnership to reflect the general partner’s acquisition of the interest of the limited partner.235 The limited partner apparently offered that failure as further evidence that the general partner had not acquired the limited partner’s interest before the sale of the partnership property.236 The court reasoned that because the Texas Uniform Limited Partnership Act237 does not require strict compliance in the formation of a limited partnership, an amendment to the certificate of limited partnership to indicate that the general partner purchased the limited partner’s interest was not required for the acquisition to be effective.238 This result may be correct considering that the limited partner did not technically lose his status as a limited partner, but the court’s stated rationale seems a little strained.

Second, the court rejected the limited partner’s argument that the court should refuse to enforce a forfeiture if language allowing the forfeiture can be

232. Id. at 352.  
233. Id. at 351.  
234. Id.  
235. Id.  
236. Id. at 352.  
238. 737 S.W.2d at 352.
construed to provide a different result.\(^{239}\) Although the court referred elsewhere in the opinion to a *purchase* of the limited partner's interest\(^{240}\) (which is more consistent with the language of the partnership agreement than the concept of forfeiture), the court implicitly acknowledged that a forfeiture resulted here by finding that a forfeiture occurring in compliance with the clear language of an agreement approved by all the partners was enforceable.\(^{241}\)


*Anderson* is more interesting to lenders who have taken an equity or partnership interest in their borrower's business or in the borrower itself, than to those interested in partnership law issues. In connection with an interim construction loan to build a motel, the borrower in *Anderson* formed a limited partnership with an affiliate of the lender giving that affiliate a 50% limited partnership interest. The partnership agreement provided that the property could be sold only by the affirmative vote of partners holding a 51% interest in the partnership. The borrower contended that after the completion of the motel he found a number of willing buyers, several of whom would have paid enough to repay the lender's loan and provide a profit to the partners, but that the limited partner refused to vote in favor of any of those sales. A successor to the original lender later foreclosed on the property for failure to pay the construction loan.

The borrower claimed that the lender had charged usury by requiring the formation of the limited partnership and then refusing to consent to a sale of the property. As to this claim the jury found that (i) the 50% limited partnership interest did not have ascertainable value at the time the loan was made, (ii) the limited partner was the alter ego of the lender, (iii) the lender and the lender's affiliate (the limited partner) unreasonably prevented the borrower from performing his obligation to repay the loan, (iv) the plaintiff was not damaged by being prevented from repaying the loan, and (v) the lender and the limited partner did not intentionally violate a duty of good faith and fair dealing.\(^{243}\)

The court rejected the plaintiff's apparent argument that the alter ego finding was, itself, a sufficient basis for liability, stating that alter ego corporations were not themselves illegal.\(^{244}\) The court found that either entity, or both, were exercising a right to approve or disapprove of a sale of the prop-

\(^{239}\) *Id.*

\(^{240}\) *Id.* at 351.

\(^{241}\) *Id.* at 352. The forfeiture occurred when Brewer failed to meet the cash call with regard to the property in question. In accordance with the partnership agreement, Brewer's default resulted in his loss of his partnership interest to the partner who covered Brewer's cash call. Because that occurred before the property was sold, it effectively resulted in a forfeiture of Brewer's interest in the sale of the property.

\(^{242}\) 738 S.W.2d 768 (Tex. App.—Beaumont 1987, writ denied).

\(^{243}\) *Id.* at 770.

\(^{244}\) *Id.* at 771 (citing Long Falls Realty Co. v. Anchor Elec. Co., 405 S.W.2d 170 (Tex. Civ. App.—Dallas 1966, no writ).
The court offered this same rationale to reject the plaintiff's argument that the lender's unreasonable prevention of the plaintiff's performance of his part of the obligation to repay the note excused the plaintiff from that obligation. It is hard to find sympathy for the plaintiff when the lender did not seek a deficiency and, partly because of the advances he had previously taken, the plaintiff suffered no damages.

The dissent is, perhaps, better reasoned, but would produce a result that would cause lenders to lose sleep at night. The dissent would hold that because the jury found that the lender and its affiliate, the partner of the borrower, unreasonably prevented the plaintiff from repaying the loan, Texas law would excuse payment of the $587,000 loan. Furthermore, the dissent would give to the plaintiff one-half ($212,500) of the amount the lender received on a subsequent sale of the property ($425,000), plus attorney's fees. In this author's judgment, that is a completely unjustifiable windfall for the borrower. The loan was fully repaid through a sale (albeit a foreclosure sale), there was no action for a deficiency (the lender bid $160,000 more than the property was worth), and the jury effectively found that the borrower suffered no damages because he realized his "profit" in advance by taking numerous draws of funds from the partnership.

One interesting note is that the majority opinion was written by Chief Justice Dies, the same judge who wrote the opinion in Halter v. Allied Merchants Bank, which is decidedly a non-lender decision.

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245. Id. at 770.
246. Id. at 771.
247. Apparently the lender bid the full amount of the loan ($587,710.95) at the foreclosure sale when the property was only valued at $425,000. Additionally, the borrower had used the loan proceeds to pay his salary, as well as incidental personal items.
248. 738 S.W.2d at 772 (Burgess, J., dissenting).
249. Id.
250. 751 S.W.2d 286 (Tex. App.—Beaumont 1988, writ denied).
251. In Halter, although the court held for the lender, it did so purely on procedural grounds. Instead of reserving the issue for a later date when it was properly before the court, the Halter court went out of its way to reject the bank's argument that it was entitled to summary judgment on its lawsuit for a deficiency against the borrower based on established case law that even gross inadequacy of consideration paid at a foreclosure sale is not enough, by itself, to justify setting a foreclosure sale aside. The court found the bank's reliance on the Texas Supreme Court case of American Sav. & Loan Ass'n v. Musick, 531 S.W.2d 581 (Tex. 1975), to be misguided because that case did not involve the issue of a suit for a deficiency but, rather, only an action to set aside a foreclosure sale. 751 S.W.2d at 287.