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COMMENTS

THE GUARANTY: A DILEMMA FOR CORPORATE MANAGERS

by J. Christopher Bird

The corporate guaranty utilized by management as a financing device is a valuable tool. Although the main benefit is to the debtor whose obligation is guarantied, the corporate guaranty can be used effectively to confer benefits upon a guarantying corporation in facilitating the sale of bond issues for subsidiaries, negotiating a lease of property, and by arranging lines of credit for a dependent corporation. Guaranties executed for suppliers, customers, employees or others having a special relationship to the corporation may produce benefits for the guarantor corporation far outweighing the risk of loss attendant upon the guaranty.

The utility of the guaranty is clearest in the increasingly widespread use of related corporate entities. In the past it was more common for a business entity to be embodied in one corporation which owned its business quarters, purchased the raw materials, manufactured them into the finished product, and sold them through its own sales office. However, tax and other advantages have motivated corporate managers to break up a manufacturing enterprise into separate corporations, each handling a distinct function of the entire enterprise. For example, one corporation is formed to own the real estate and manufacturing equipment and to purchase the raw materials, a second company is created to perform all the manufacturing processes, and a third is formed as a distributing outlet to purchase the finished products and resell them. Often similar functions in different geographical areas are separately incorporated, each under local law, to minimize local taxes. Also, related ventures may be separately incorporated to protect their liabilities from one another. Obviously the financial standings of these “family corporations” are not always equal. Frequently one corporation seeking credit has very limited financial means, but another corporation in the group is willing to guarantee the proposed financial obligations of the weaker company. In Texas, if the relationship between the two corporations were that of parent and one hundred per

1 The term “guaranty” is frequently indistinguishable from the closely related concepts of “surety” and “accommodation.” Compare, e.g., Tex. Bus. & Comm. Code Ann. § 3.415 (1968), with id. §§ 3.416, 34.01. Both “guaranty” and “guarantee” are used interchangeably to mean a promise to answer for the payment of some debt in case of the failure of another person, who, in the first instance, is liable for such payment. Black’s Law Dictionary 833 (4th ed. 1951).

2 Within this Comment the scope of a corporate guaranty is limited to those circumstances in which a corporation, through the actions of its officers and directors, guarantees the obligations of persons or entities other than itself.

3 The guaranty’s necessity has been recognized and corrective legislation called for to solve the chronic problems concerning the authorization and enforceability of the corporate guaranty. Report of the Subcommittee on Factors Liens and Accounts Receivable, 11 Bus. Law. 59, 69 (1956).

4 For the purposes of convenience “corporate managers” will be used in the Comment in lieu of “corporate officers and directors.”

5 Another mode of enterprise fracturing exists where several corporations are formed, each marketing a limited product line and all companies using the same manufacturing and distribution facilities.
cent wholly-owned subsidiary, severe legal problems would not exist. However, if the relationship between the two companies rests merely on mutual stockholdings of less than one hundred per cent and the anticipated benefits from the symbiotic arrangement, the validity of the guaranty depends upon the willingness of the courts to recognize such benefits as justifying the issuance of the guaranty.

The Texas legislature and courts have been "diligent in protecting stockholders from dissipation of a corporation's assets by its managers through improvident guaranties." Similarly the legislature and courts have been ready to afford utmost protection against potential injury to any creditor who has relied upon the execution of a guaranty in extending credit. But the corporate manager has not been shown the same protection; the dissident shareholder or damaged creditor can seek recourse against him.

Sound business judgment occasionally calls for the execution of a corporate guaranty although the particular circumstance may not support the manager's action as intra vires. While the guaranty is not the most necessary tool of corporate finance, its recurring unavailability to corporate managers and lending institutions reportedly has caused the bouleversement of many proposed business transactions. Unable to use the guaranty device, the corporate managers are forced to utilize other prevalent techniques of financial aid used between related corporations, such as subleasing, subcontracting, sublending, advance orders for goods, and security deposits. While these forms of financial aid between businesses create an immediate liability for the financing corporation, the guaranty creates only a liability contingent upon the default of the individual or corporation whose obligation is guarantied. A comprehensive statute is needed to eliminate the hazards which presently exist in utilizing the guaranty. Legislative recognition should be given to the sound business motivations of creditors, primary obligors and corporate guarantors in using the guaranty as a financing device.

Until such legislative action, the corporate manager's dilemma is: Should he utilize the guaranty as a credit device and risk personal liability or should he pursue alternatives, even though less desirable to the corporation, and thereby avoid any consequence of personal liability? This Comment will attempt to examine the situations in which a corporation could be

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6 Tex. Rev. Civ. Stat. Ann. art. 1302-2.06(B) (Supp. 1968) grants a corporation the authority to guarantee obligations for its 100% wholly owned and operated subsidiaries.
7 Slover, Enforceability of Guaranties Made by Texas Corporations, 10 Sw. L.J. 134, 142 (1956).
8 See text accompanying notes 61-70 infra.
9 See text accompanying notes 92-97 infra.
10 Officers of several Dallas banks report that they believe approximately 2% to 5% of their banks' loan portfolios are secured by corporate guaranties. Depending upon the loan capacity of the particular bank, these percentages are equivalent to amounts between $2 million and $80 million.
11 Both bankers and corporate managers are aware that the guaranty can be properly authorized today in only two situations: (1) where a direct benefit accrues to the guarantor corporation, or (2) where the parties to the guaranty transaction are a parent corporation and its wholly-owned subsidiary, or two subsidiaries wholly owned by the same parent.
benefited by the use of guaranties, the dilemma of corporate managers contemplating authorization of a guaranty and appropriate legislation to empower Texas corporations to act as guarantors.

I. UTILIZING THE CORPORATE GUARANTY

The guaranty’s usefulness is limited only by the imagination of corporate managers. In some situations the benefits conferred on the guarantor resulting from the guaranty are obvious. In other situations the guaranty effects the desired results, but these results are not easily categorized as directly beneficial to the corporation.

Guaranties Between Parent and Subsidiary Corporations. The use of a corporate guaranty may be advantageous for a parent corporation in instances where: (a) the success of the parent corporation is largely dependent upon the success of the subsidiary; (b) the failure of the subsidiary would impair the parent’s credit standing; (c) the subsidiary needs the time and opportunity to develop a credit of its own; and (d) the added credit of the parent will materially lower the cost of a commercial loan to the subsidiary.

The corporate guaranty is utilized in several ways by a parent seeking to benefit its subsidiary. The parent can guarantee the payment of rentals to the owner of property leased by the subsidiary. Similarly, the parent corporation can enable a subsidiary to make needed purchases of equipment and property by guarantying to the seller the subsidiary’s installment payments. Bank and commercial financing for the subsidiary is possible through the lines of credit provided by the parent company’s guaranty.

The purpose of guarantying the subsidiary’s bond is to improve the investment character of the bond issue. The guarantied bond is one on

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14 See text accompanying notes 48-51 infra.

15 See notes 10-11 infra. These bankers point out that the majority of corporate guaranties are "downstream" guaranties issued by the parent on obligations of the subsidiary. "Upstream" guaranties are feasible when the enterprise fracturing results in the subsidiary appearing financially stronger than the parent, or when the bank simply wants any additional security.


18 See Bogen 14:26; Dewing 125.


20 Guaranties on bond issues may be direct, as in a guaranty by endorsement upon the bond at the time of issue, or indirect, as in a special covenant, lease or operating agreement with the debtor corporation. A direct guaranty usually arises at the time of issue in the case of a parent company desiring to aid the sale of bonds by its subsidiary when the credit of the parent permits the subsidiary to issue lower interest bonds. Such a guaranty assures the bond purchaser that the parent
which the payment of interest or principal, or usually both, are guarantied by the parent. A lease of a subsidiary’s property by the parent can include consideration provisions whereby the parent guaranties to pay to the subsidiary a certain sum of money each year for a definite period of time. The sum closely approximates amounts owed by the subsidiary on bond obligations. A guaranty of dividends on the preferred stock of a subsidiary by a parent can be utilized to provide capital for a subsidiary before the smaller company has had the time and opportunity to develop a reputation or credit rating of its own. Many times the only means by which a subsidiary can secure a loan is by having its parent guarantee to the creditor that the subsidiary will maintain a prescribed working capital.

Guaranties for Common-Control Companies. Common-control companies utilize the guaranty to supplement the credit of one another. Investors frequently consider the purchase of a corporation’s securities where the investment is attractive only because of the availability of recourse against one or more corporations under common control. The most obvious of these situations is represented where two commonly controlled subsidiaries of the same parent are obligors jointly and severally on issues of long-term notes and bonds. Since it is liable for the full amount of the obligation, each subsidiary then guaranties repayment of any portion of the financing proceeds which it did not receive.

1. See Dewing 127. Dewing explains that the guaranty may take various forms, of which two are more common: (1) guaranty of both principal and interest, and (2) guaranty of only a portion of principal and of interest. Id. at 221 n.f.t.

2. See Dewing 220.

3. Guarantied stocks came into existence as a by-product of leases and consolidations among railroads and other rolling stock concerns. See Dewing 125-26. One corporation may lease property of another company by providing rental in the form of a guarantied dividend on the stock of the lessor corporation. See Guthmann & Dougall 95. Similarly, consideration by a larger corporation for securing the operating control of smaller companies may be in the form of an agreement whereby specified dividends on the stock of the smaller companies were guarantied by the larger corporation. See Dewing 126.

4. See Dewing 126. The guaranty contract runs between the guarantor and the equity security holder. In no way can the stock issuer be forced to meet the payment of dividends if the guaranty is repudiated by the guarantor or if the guaranty cannot be enforced. Id. at 127.

5. See notes 10, 11, 15 supra. The bankers report that this arrangement is similar to those loan contracts conditioning the payments of any dividends upon a prescribed level or ratio of net assets to liabilities.

6. See notes 10, 11, 15 supra. The bankers report that this arrangement is similar to those loan contracts conditioning the payments of any dividends upon a prescribed level or ratio of net assets to liabilities.


9. See Bogen 14:27; Guthmann & Dougall 210; Everdell & Longstreth, supra note 28, at 501-03.

10. If one of two joint and several obligors receives one-third of the proceeds of the sale of securities and the other receives two-thirds, then in legal theory the first is a guarantor for the payment of two-thirds and the second is a guarantor for the payment of one-third. If the proceeds are
Guaranties for Customers: Increasing Sales. A corporation may attempt to increase its sales by guarantying the contracts of its customers with third parties. By stabilizing the business of its customers, a guarantor corporation can thereby stimulate its own business.\textsuperscript{81} The corporate guaranty as a credit device is useful in allowing the corporation to: (a) assist its customers (usually retail dealers) by guarantying their rent to lessors;\textsuperscript{82} (b) guarantee a dealer’s contract with a third person in which the guarantor corporation intends to supply the merchandise;\textsuperscript{83} and (c) assist a lessee of corporation property to remain a going concern by guarantying its obligations.\textsuperscript{84}

Guaranties To Insure Component Supplies and Services. A corporation needing raw materials, components or other products for assembly and finishing can utilize a guaranty to enable the vendor manufacturer to furnish the goods. By guarantying the future purchase\textsuperscript{85} or existing obligations\textsuperscript{86} of the manufacturer, the guarantor enables the supplier to produce goods to be manufactured for the guarantor corporation’s account. In a similar manner, a corporation can utilize the guaranty to benefit a company which can provide needed services for the guarantor.\textsuperscript{87}

Guaranties For Employees or Franchisees. If a corporation considers the

to go entirely to one of the two corporations, the other is acting as a mere accommodation guarantor for the other. If the proceeds are to be divided equally between the two corporations and there is no security involved, it is at least arguable that each guaranty given is supported by the guaranty received and that the benefit to each corporation is mutual and equivalent.


\textsuperscript{83} See also cases cited notes 35, 36 supra.


\textsuperscript{86} See also cases cited notes 35, 36 supra.

\textsuperscript{87} See also cases cited notes 35, 36 supra.
services of an employee valuable, it may execute a guaranty of his personal obligations for the purpose of retaining him. This added confidence in the corporate employee would bolster the corporation’s opportunity to function efficiently and allow the company to pursue prospective customers initially solicited by the employee. A similar application of the guaranty can be found in the franchisor-franchisee relationship. The franchisor corporation may guarantee the debt obligations of a franchisee to strengthen or increase the growth of the franchise operation. To furnish financial assistance when needed by the franchisee has been considered an “obvious responsibility of the franchisor.” However, to avoid incurring an immediate liability themselves, some franchisors will aid a franchisee in obtaining credit by guarantying the franchisee’s debt obligations.

II. THE CORPORATE MANAGER’S DILEMMA

Prior to the adoption of the Texas Business Corporation Act in 1955, Texas corporations were limited to the pursuit of a single purpose and all acts of a corporation were required to be directed toward the effectuation of that purpose. The impositions of such restrictions on corporate actions fostered strict judicial application of the ultra vires doctrine. Courts consistently held that it was not generally necessary in the proper conduct of a business that a corporation lend its credit to another. However, two exceptions to this general rule developed: (1) a guaranty could be authorized and enforced because the direct benefits to the corporation anticipated from the guaranty brought it within the implied

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28 M. Burg & Sons v. Twin City Four Wheel Drive Co., 140 Minn. 101, 167 N.W. 300 (1918); L.G. Balfour Co. v. Gossett, 131 Tex. 348, 115 S.W.2d 194 (1938); Al & Lloyd Parker, Inc. v. Cameron County Lumber Co., 56 S.W.2d 256 (Tex. Civ. App. 1932), aff’d, 122 Tex. 487, 62 S.W.2d 63 (1933); see Slover, supra note 7, at 141-42.

29 C. VAUGHN, FRANCHISING TODAY 59 (1969).

30 J. RICE, supra note 12, at 11.

31 TEX. REV. CIV. STAT. ANN. art. 1302 (repealed by Tex. Laws 1961, ch. 229, § 1, ch. 205, § 2; Tex. Laws 1953, ch. 64, art. 9.16).


33 Ramsey v. Tod, 95 Tex. 614, 69 S.W. 133 (1902), held that a corporation is limited to the pursuit of only one enumerated statutory purpose. Thus, a corporation could be incorporated under only one subdivision of the purpose article and could not combine two purposes set out in the same subdivision unless one was necessary or incidental to the other. In some situations the corporation’s purpose did not quite correspond to an enumerated statutory purpose. Thus, recourse to the courts was necessary to determine whether the corporate purpose was valid. Similarly, the scope of the corporation’s powers was gauged by the courts. The judicial resolution took one of two forms: (1) the particular power was properly implied from the charter power as limited by the statute, or (2) the particular power was actually set out in a separately enumerated statutory provision, and was, therefore, ultra vires. See Baker, supra note 42, at 846-47.

powers of the corporation," or (2) a guaranty was enforceable because the corporation was estopped to assert ultra vires since benefits to the corporation were actually received.\footnote{See, e.g., North Tex. State Bank v. Crowley-Southland Comm'n Co., 145 S.W. 1027 (Tex. Civ. App. 1912) (corporate guaranty was used as partial purchase price for cattle).}

In application of the first exception, authorization of the guaranty was deemed intra vires not by the corporate manager's characterization and anticipation of a "direct benefit" from the guaranty, but rather by judicial hindsight of the results of the guaranty transaction.\footnote{See, e.g., Gaston & Ayres v. J.I. Campbell Co., 130 S.W. 222 (Tex. Civ. App. 1910), rev'd, 104 Tex. 576, 140 S.W. 770, modified, 104 Tex. 585, 141 S.W. 515 (1911).} \textit{North Side Railway v. Worthington}\footnote{But generally a court does not substitute its judgment for that of a corporate board of directors. See Galler v. Galler, 95 Ill. App. 340, 238 N.E.2d 274 (1968); Bates v. Texas Elec. Ry., 220 S.W.2d 707 (Tex. Civ. App. 1949).} provided the "direct benefit" guideline upon which later decisions construed\footnote{88 Tex. 562, 10 S.W. 1055 (1895).} the authorization and enforceability of corporate guaranties. Noting that it was not easy to lay down a rule by which to determine whether or not a guarantor derived "direct benefit" from the guaranty transaction, the court cited a "well-known text writer" as having announced a rule not only reasonable but also in accord with the great weight of authority:

Whatever be a company's legitimate business, the company may foster it by all the usual means. But it may not go beyond this; it may not, under the pretext of fostering, entangle itself in proceedings with which it has no legitimate concern. In the next place, the courts have, however, determined that such means shall be direct, not indirect,—i.e. that a company shall not enter into engagements, as the rendering of assistance to other undertakings, from which it anticipates a benefit to itself, not immediately, but mediately by reaction, as it were, from the success of the operations thus encouraged; all such proceedings inevitably tending to breaches of duty on part of the directors, to abandonment of its peculiar objects on part of the corporation. Green's Brice, Ultra Viros, 88. In short, if the means be such as are usually resorted to, and a direct method of accomplishing the purpose of the incorporation, they are within its powers. If they be unusual, and tend in an indirect manner only to promote its interests, they are held to be ultra vires.\footnote{See cases cited note 44 supra.}

The Texas Business Corporation Act (hereinafter referred to as the TBCA) and the Texas Miscellaneous Corporation Laws Act contained several provisions bearing on the corporate guaranty question. These provisions afford considerable protection for shareholders and creditors relying on a guaranty and place the corporate managers in a serious dilemma regarding its authorization.

\textbf{TBCA: Purpose Clauses.} The TBCA introduced the multi-purpose approach by permitting a corporation to be organized for any lawful purpose, provided that the purpose was fully stated in the articles of incorporation.\footnote{Tex. Bus. Corp. Act Ann. art. 2.01A (1956).} The language of article 2.01A would seem to permit the corporate draftsman to include the guaranty function as one of the corpora-
tion's stated purposes, but the Secretary of State will not issue a charter if a guaranty purpose is explicitly stated in the articles of incorporation. Some observers argue that even if the courts were still to adhere to the "direct benefit" test, the broadened scope of permitted purposes would make it far more likely that a guaranty would directly benefit one or more of the purposes for which a particular corporation was organized. Others, however, conclude that listing page after page of purpose clauses inherently promotes restrictions through inferred exclusions, and therefore prefer a short purpose clause upon which hosts of direct benefits may be founded. Thus, the purpose clause provisions of the TBCA provide no relief for the managers of a business who remain in the same precarious position as before TBCA enactment when contemplating the authorization of a corporate guaranty.

TBCA: Powers. The right of a corporation to guarantee indebtedness more properly should be analyzed in terms of the corporation's powers than in terms of its corporate purposes. Article 2.02A provides that each corporation organized under the Act shall have enumerated powers, without requiring that these powers be set out in the articles of incorporation. Some of the listed statutory powers, such as the power to "deal in and with . . . obligations of other . . . corporations," and the power to "make contracts and incur liabilities" are arguably very close to the power to guarantee. Further, subsection 19 of article 2.02A confers all powers, whether listed or not, which are "necessary or appropriate" to carry out the purposes for which the corporation is organized. However, determination by the courts of the necessity or appropriateness of a corporate guaranty would be not only by resort to the "direct benefit" test, but also by consideration of the Attorney General's opinion on this matter. Provisions of the TBCA providing for corporate powers offer no sure solution to the corporate manager's dilemma.

TBCA: Ultra Vires. Article 2.04 of the TBCA purports "to limit materially, not abolish, the doctrine of ultra vires." Section A does away with the concept that a corporate act is invalid for want of capacity by the corporation to perform it. This Texas provision goes further in

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53 Tex. Att'y Gen. Op. No. WW-440 (1958) concluded that a corporation, whose articles of incorporation contain a purpose clause concerning the execution of guaranties, would be authorized to engage in the business of insurance—a business for which a corporation may not be organized under the TBCA.


57 Id. art. 2.02A(7).

58 Id. art. 2.02A(9); cf. text accompanying note 100 infra.

59 Id. art. 2.02A(19).

60 See note 53 supra.


abrogating the defense of ultra vires than does its counterpart in the Model Business Corporation Act. Whereas the latter uses "lack of capacity" throughout to indicate ultra vires transactions, the TBCA characterizes acts beyond the corporate purposes as "wanting authority."64 Section B provides that no act or conveyance is invalid because such act is beyond the scope of the purpose(s) of the corporation expressed in the articles of incorporation.64 Corporate acts likewise may not be held invalid by reason of a limitation expressed in the articles on the authority of corporate officers and directors to exercise any statutory power of the corporation.68 However, section B sets forth three instances in which ultra vires may be asserted to support a cause of action:66 (1) in a proceeding by a shareholder against the corporation to enjoin the commission of an act or transfer of property by or to the corporation;67 (2) in a proceeding by the corporation, directly or derivatively, against incumbent or former officers or directors for exceeding their authority; and (3) in a proceeding by the Attorney General to dissolve the corporation, to enjoin the corporation from transacting unauthorized business, or to divest the corporation of real property acquired or held contrary to law.

The broad terms of the provisions of article 2.04B(1) authorize shareholder intervention in a suit against the corporation. Therefore, if a corporation is involved in a suit on a guaranty that it has issued, a shareholder could intervene in the suit and seek to have the performance of the guaranty enjoined. In resolving this issue, the courts will undoubtedly utilize the tests formulated in cases decided prior to the adoption of the TBCA; thus, the old case law of "direct benefit" qualification may retain its vitality.68 If the shareholder is successful, the court may still allow recovery against the corporation to the recipient of the guaranty for actual damages69 sustained as a result of reliance on the guaranty. The

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64 The statutory language and the comments of the bar committee draftsmen indicate that the corporation should be viewed as a collection of individuals for whom the articles serve as a limiting source of authority for the corporate managers. But since the "agency" approach for the solution of ultra vires transactions is not clearly established, the corporate managers' resort to shareholder ratification for the execution of a guaranty does not eliminate their dilemma. See text accompanying notes 74-75 infra.
65 Id. at §§ 2598-2599.
66 The court may enjoin or set aside performance of the (authorized) contract only if all the parties to the contract are made parties to the action and only if the court deems it equitable. Compare Intercontinental Corp. v. Moody, 411 S.W.2d 378 (Tex. Civ. App. 1967), error ref. n.r.e., with remarks made in Brimble, "Ultra Vires Under the Texas Business Corporation Act," 40 Texas L. Rev. 677, 691, 696 (1962).
67 See text accompanying note 51 supra.
corporation then has a cause of action against the corporate managers for indemnification.  

Article 2.04B(2) similarly spotlights the potential liability of corporate managers by providing for corporate suits against them to recover losses suffered as a result of actions exceeding their authority. A determination of exceeded authority in executing a guaranty is hinged upon the corporation's implied and incidental powers and ultimately turns upon the litmus reaction in the "direct benefit" medium. Thus again, a manager who issues an "unauthorizable" corporate guaranty may be personally liable for any resulting losses. 

One avenue of escape may exist for corporate managers. They can substantially decrease the possibility of article 2.04B(1) and (2) actions by seeking shareholder ratification of a proposed guaranty. While formal shareholder ratification is not required, the affirmation by all shareholders is, since a single shareholder can initiate article 2.04B(1) or (2) proceedings.

Texas Miscellaneous Corporation Laws Act. In 1961 the Texas legislature attempted to tidy up the remnants of the general corporation statutes still having validity after enactment of the TBCA. They enacted the Texas Miscellaneous Corporation Laws Act, and, in separate enactments, repealed most of the old statutes duplicating or conflicting with the TBCA. Articles 1349 and 1351 were not repealed, and the deliberate omission of these articles from the repealing statute emphasizes their continuing vitality. Article 1349 provides that no corporation shall employ or use its stock, means, assets or other property, directly or indirectly for any purpose whatever other than to accomplish the legitimate business

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70 Id. art. 2.04B(2).
71 Id. art. 2.02A(19).
72 See text accompanying note 51 supra.
74 E.g., permitting the corporate managers repeatedly to authorize and execute guaranties over a long period of time would be adequate evidence of shareholder ratification. See Petroleum Anchor Equip., Inc. v. Tyra, 419 S.W.2d 829 (Tex. 1967); I. Hildebrand, Texas Corporations § 144 (1942). In a publicly held corporation, however, this argument would carry little weight.
75 Robinson v. Bradley, 141 S.W.2d 425 (Tex. Civ. App. 1940). See Lebowitz, Director Misconduct and Shareholder Ratification in Texas, 6 Baylor L. Rev. 1 (1953). Should a shareholder consenting to the guaranty subsequently sell his stock, his purchaser might seek an injunction against enforcement of the guaranty. If the purchaser knew of the selling shareholder's consent, he would be estopped to complain. 7 Fletcher § 3445. Even without such notice the purchaser may be estopped. Id. at § 3456. Moreover, usually a shareholder may only complain of corporate wrongs which occurred after he acquired stock in the corporation. Although the concept of a "continuing wrong" permits anyone becoming a shareholder after the wrong complained of had commenced to sue for its discontinuance, a guaranty contract would probably not fit within this concept even in the case where the corporation was called upon to fulfill its obligations as guarantor after consenting shareholders had transferred their stock to outside purchasers. See Henis v. Compania Agricola de Guatemala, 116 F. Supp. 223, 229 (D. Del. 1953), aff'd, 210 F.2d 950 (3d Cir. 1954).
80 Id. art. 1351.
81 The repeal of article 1348 in 1963 adds emphasis to the continuing validity of articles 1349 and 1351. Tex. Laws 1963, ch. 469, § 1, at 1184.
of the corporation's creation or those purposes permitted by law.83 These general prohibitions on activity beyond the corporate purposes and powers do not render such activity illegal, but rather ultra vires and voidable.84 Article 1351,85 on the other hand, makes a violation of any provision of article 1349 grounds for forfeiture of the corporation charter, upon proof of such violation. The statute does mitigate the harshness of forfeiture if the corporation within one year of the violation disavows the wrong and permanently dismisses from its service all persons directly or indirectly connected with such violation.86 Although Attorney General action seeking the forfeiture of a corporation charter because of the execution of a corporate guaranty seems inconceivable,87 the consequence to the corporate manager for utilizing a corporate guaranty may be either no charter with which to continue the business or dismissal from employment or directorship.

Article 1302-2.06(B) of the Miscellaneous Act88 expressly provides for upstream, downstream and cross-stream guaranties among parent corporations and one hundred per cent wholly-owned subsidiaries.89 This provision most likely would be argued as limiting the authority for corporate guaranties to the defined situations,90 and emphasizing that corporate managers cannot authorize an ultra vires guaranty without taking the risk that the guaranty may not meet the rigid "direct benefit" requirements.

**TBCA: The Guaranty Cases.** Since adoption of the TBCA in 1955 the

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86 Id. The only logical motive in retaining art. 1351 is to provide a means for forfeiture for violating art. 1359. But see note 83 supra.


88 See Vol. 7, No. 1 Bulletin of the Section on Corporation, Banking & Business Law 2 (Tex. State Bar, Sept. 1968). The Committee on Revision of Corporation Law drafted a bill for the 1967 Texas legislature to amend Tex. Rev. Civ. Stat. Ann. art. 1302-2.06 (Supp. 1968) so as to reduce from 100% to 10% the minimum stock ownership required to support corporate guaranties. Id. The legislative liaison Committee of the Texas State Bar entertained doubt as to the constitutionality of the bill in view of Tex. Const. art. XII, § 6, and the bill was withdrawn pending further study. Tex. Const. art. XII, § 6 provides that "No corporation shall issue stock or bonds except for money paid, labor done or property actually received, and all fictitious increase of stock or indebtedness shall be void." If this constitutional provision has any bearing on the guaranty's employment, and it is suspected that it does not, the constitutionality must rest on the scope and interpretation of "fictitious increase of . . . indebtedness." If the judgment of the board of directors as to the value of consideration received for shares is conclusive, Tex. Bus. Corp. Act Ann. art. 2.16C (1956), why shouldn't the same statutory treatment be constitutional regarding authorization and expectations of the corporate guaranty?


90 But see id. art. 1302-2.06B (6): "Nothing in this section B is intended or shall be construed to limit or deny to any corporation . . . the right or power to do . . . any action which it is . . . empowered or authorized to do . . . under any other laws of the State of Texas now in force . . . ."
question of corporate guaranties has arisen in two Texas cases. In Empire Steel Corp. v. Omni Steel Corp., the court held that TBCA article 2.04 prohibits corporate assertion of the defense of ultra vires in a suit brought by a non-shareholder to enforce a corporate guaranty executed by Empire. The direct benefit test was not applied to determine the validity of Empire’s guaranty; rather, Empire’s guaranty was enforced because the TBCA inhibits presentation of the defense of ultra vires. The Empire case left no clue concerning whether the direct benefit test would be utilized in a suit to challenge the authorization, rather than the enforceability, of the corporate guaranty. In Cooper Petroleum Co. v. LaGloria Oil & Gas Co., the contention was made that Cooper’s letter of guaranty was illegal, void and unenforceable. The court held that although the guaranty contract violated the terms of articles 1349 and 1302-2.06, the guaranty was not void but ultra vires. Because ultra vires, TBCA article 2.04B operated to make the guaranty enforceable. As in the Empire decision, Cooper provides no touchstone regarding the guaranty’s authorization by a corporate manager. Empire and Cooper illustrate the effect that the TBCA has had upon the status of corporate guaranties. The recipient of a corporate guaranty is accorded maximum protection against damages incurred as a result of reliance on the guaranty, while the corporate manager stands on tenuous ground in calculating the feasibility of a corporate guaranty and his personal risk.

III. The Desirability of Legislative Action

The utility of the guaranty has been demonstrated and the dilemma of corporate managers contemplating the guaranty is evident. If the officers and directors of a corporation are acting lawfully in transacting its business, they must necessarily have a right to perform all the usual commercial acts which the conduct of the business may demand. An examination of the statutory forms of a corporation’s guaranty power in other jurisdictions will underscore the desirability of legislative action in Texas. Only eight states appear to have no statutes relating to the corporate guaranty. The

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81 Despite the date of decision in Rio Refrigeration Co. v. Thermal Supply, 368 S.W.2d 128 (Tex. Civ. App. 1963), the TBCA did not apply to Rio Refrigeration Co. because it had been incorporated prior to the adoption of the TBCA. The civil appeals court held that Rio Refrigeration’s guaranty as consideration for another company’s accounts payable was of direct and material benefit to Rio and thus the guaranty was within the implied powers of the corporation.

82 378 S.W.2d 901 (Tex. Civ. App. 1964), error ref. n.r.e. (corporation had adopted TBCA prior to executing guaranty of its subsidiary’s obligation to pay fifty per cent of losses, if any, up to $50,000 resulting from a joint venture; guarantor corporation could not avoid enforcement of the guaranty by claiming it was an ultra vires transaction). See, Note, Corporations—Ultra Vires—Texas Corporation May Not Assert Ultra Vires Defense in a Suit by a Nonshareholder To Compel Performance of a Corporate Guaranty, 43 Texas L. Rev. 792 (1965).

83 378 S.W.2d at 910.


85 See notes 79-83 supra.

86 See notes 88-89 supra.

87 Subject to the situation arising in Intercontinental Corp. v. Moody, 411 S.W.2d 578 (Tex. Civ. App. 1967), error ref. n.r.e.

remaining forty-two states have statutes which vary the scope, purpose and manner in which the corporate managers can utilize the guaranty.

Model Business Corporation Act. The present Model Business Corporation Act (hereinafter referred to as MBCA), upon which the TBCA is based, specifically gives corporations the broad power to guarantee. The guaranty provision, "to make contracts and guarantees," currently found in section 4(h) of the Model Act, was not added to the MBCA until 1957, two years after the adoption of the TBCA. But TBCA article 2.02A(9) is identical with section 4(h) of the MBCA as it existed in 1955, thus negating any deliberate legislative omission of the guaranty power. Further, as the draftsmen of the MBCA point out in their comments to section 4(h): "The addition of the word 'guarantees' to section 4(h) of the Model Act in 1957 merely makes expressed a power already possessed both at common law and under the general language of section 4(h)."

Express Grants of Extensive Guaranty Powers. In twenty-three states the statutory grant of power to execute corporate guaranties is apparently extremely broad. Hawaii, Indiana, Iowa, Maryland, Mississippi, Missouri, Montana, New Mexico, Oregon, Utah, Washington,

"Each corporation shall have power: . . . (h) to make contracts and guarantees and incur liabilities, borrow money at such rates of interest as the corporation may determine, issue its notes, bonds and other obligations, and secure any of its obligations by mortgage or pledge of all or any of its property, franchises and income." MODEL BUS. CORP. ACT ANN. § 4(h) (1960).

Id. § 4(h) (1960). Whether the drafters were entirely correct in assuming that the common law afforded corporations the guaranty power is questionable. See, e.g., text accompanying notes 44, 51 infra.

An attempt is made here to classify forty-two states within four categories on the basis of bald statutory language. The classification headings are not designed to serve as conclusive observations of particular state legislation. For example, the MODEL BUS. CORP. ACT ANN. § 4(h) (1960) provision apparently connotes an express grant of an extensive guaranty power; but a state such as Iowa, although adopting the MBCA provision, is unsure of the continuing vitality of the "direct benefit" theory. See note 104 infra.

HAWAI REV. LAWS § 416-26(9) (1968).


IOWA CODE § 496A.4(8) (1962) includes "and to guarantee the obligations of other persons." Comments succeeding the statute include: While Section 4(h) of the Model Act gives corporations power to make guaranties, the committee had in mind that a corporation might at some time for its own benefit wish to guarantee the obligations of its employees or customers, for example . . . Accordingly, the committee added to Section 469A.4(8) the specific power to guarantee the obligations of other persons, intending thereby to broaden corporate powers in this respect. The committee felt the Iowa Business Corporation Act thereby indicates a public policy that corporate powers as to the making of guaranties shall be broader than they were under the old law, but of course many details are not covered. There is, for example, no statement of what degree of benefit, if any, the corporation must be shown to receive if the contract of guaranty is to be valid.


MISS. CODE ANN. § 5109-04(h) (Supp. 1968).

Mo. Rev. Stat. § 351.385(7) (1966). The comments succeeding the statute state that the guaranty amendment allowed corporations to guarantee the obligations of other corporations, thus permitting financial aid to affiliated or subsidiary corporations or others with whom it is doing business.


ORE. REV. STAT. § 57.030(8) (1968).

UTAH CODE ANN. § 16-10-4(h) (1962).

Wisconsin,\textsuperscript{113} and Wyoming\textsuperscript{114} have adopted the Model Business Corporation Act provision empowering the corporation “to make contracts and guarantees.”\textsuperscript{115} Connecticut,\textsuperscript{116} Delaware,\textsuperscript{117} Georgia,\textsuperscript{118} New Hampshire,\textsuperscript{119} Pennsylvania,\textsuperscript{120} South Carolina,\textsuperscript{121} and Tennessee\textsuperscript{122} have language in their corporation statutes comparable to the MBCA’s broad grant. Idaho\textsuperscript{123} and Louisiana\textsuperscript{124} provide a corporation the power of guaranty on the obligations of a corporation, partnership, association, individual or government.

**Less Extensive Grants of Power.** Oklahoma\textsuperscript{125} and Virginia\textsuperscript{126} extend the Idaho-Louisiana-type guaranty power to corporations, with the exception of the express provision authorizing the guaranty of governmental obligations. The Virginia statute adds the proviso that the corporate guaranty extends to the obligations of “any corporation organized for any purpose.”\textsuperscript{127} Maine provides for the extension of corporate guaranties to the obligations of another corporation, firm or individual.\textsuperscript{128} Florida\textsuperscript{129} and Nevada\textsuperscript{130} both restrict the corporate guaranty’s use to the obligations of other respective intrastate corporations, but both extend the guaranty use to any other state or governmental obligations. Michigan expressly validates the corporate guaranty of the obligations of other corporations, banking corporations or trust companies.\textsuperscript{131} Kansas\textsuperscript{132} and West Virginia\textsuperscript{133} limit the corporate guaranty to only the obligations of other corporations. Conversely, Ohio limits the guaranty only to the obligations of any “persons.”\textsuperscript{134} Rhode Island provides the power to guarantee the obligations on “a certain amount per share in liquidation of the capital stock of any other corporation.”\textsuperscript{135} Arkansas specifically empowers corporate guaranties “to

\[\text{113 WIS. STAT. § 180.04(7) (Supp. 1969).}\]
\[\text{114 WYO. STAT. ANN. § 17-36.4(h) (1961).}\]
\[\text{115 Other states have adopted the MBCA § 4(h) provision, but because of other statutory provisions which effectively mitigate the extensive grant of power, they are mentioned in other subsections infra. See text accompanying notes 140, 149 infra.}\]
\[\text{116 CONN. GEN. STAT. REV. § 33-291(c)(3) (1961).}\]
\[\text{117 DEL. CODE ANN. tit. 8, § 122(13) (Supp. 1968).}\]
\[\text{118 GA. CODE ANN. § 22-202(a)(11) (Supp. 1969).}\]
\[\text{120 PA. STAT. tit. 11, § 1302(6) (Supp. 1969).}\]
\[\text{121 S.C. CODE ANN. § 12-12.2(a)(11) (Supp. 1968).}\]
\[\text{122 TENN. CODE ANN. § 48-403 (Supp. 1964).}\]
\[\text{123 IDAHO CODE ANN. § 30-114(2)(d) (1967).}\]
\[\text{124 LA. REV. STAT. § 12:41B(6) (1969).}\]
\[\text{125 OKLA. STAT. tit. 18, § 1.19 (1913).}\]
\[\text{126 VA. CODE ANN. § 13.1-3(g) (Supp. 1968).}\]
\[\text{127 Id.}\]
\[\text{128 Id.}\]
\[\text{129 ME. REV. STAT. ANN. tit. 13, § 141 (1965), was recently amended by adding the following to the end of the statute: “A Corporation, unless its certificate of organization or bylaws specifically provide otherwise, may by vote of its board of directors guarantee without charge or payment the obligations of another corporation, firm or individual.” Me. Leg. Serv., ch. 227, H.P. 192—L.D. 773 (1969).}\]
\[\text{130 FLA. STAT. ANN. § 608.13(9a) (1956).}\]
\[\text{131 NEV. REV. STAT. § 78.070 (1967).}\]
\[\text{132 Mich. Comp. Laws § 450.10(i) (1967).}\]
\[\text{133 KAN. STAT. ANN. § 17-3001E (1964).}\]
\[\text{134 IDAHO COMP. CODE ANN. § 31-1-65 (1966).}\]
\[\text{135 OHIO REV. CODE ANN. § 1701.13(F)(6) (1964). Id. § 1701.01(G) defines “persons” as including, without limitation, a corporation (whether nonprofit or for profit), a partnership, an unincorporated society or association, and two or more persons having a joint or common interest.}\]
\[\text{136 R.I. GEN. LAWS ANN. § 7-2-10(i) (1917).}\]
customers, suppliers and employees, where, in the opinion of the directors such action should be taken to promote good employer-employee relationships. North Carolina permits a corporation to enter into contracts of guaranty for the benefit of any person, firm or corporation.

"Benefit" or "Corporate Purpose" Requirements. Delaware authorizes financial assistance via guaranties by the parent corporation to officers and employees of the parent or subsidiary "whenever, in the judgment of the directors, such . . . guaranty . . . may reasonably be expected to benefit the corporation." Nebraska, in addition to an MBCA section 4(h) provision, authorizes a guaranty of the obligations of "others" for the guarantor's "corporate purposes." Colorado likewise validates the guaranty upon the obligations of "others" for its corporate purposes. Massachusetts empowers the corporation to "give guaranties" in furtherance of its corporate purposes. Minnesota permits the corporate guaranty, where not authorized in the articles of incorporation, upon the obligations of other corporations when "reasonably necessary or incidental to accomplish the purposes stated in its articles."

Voting Requirements. California denies a corporation the power to guarantee the obligations of (1) any directors or officers of the corporation, its holding corporations or any of its subsidiary corporations, directly or indirectly, or (2) any person, upon the security of the shares of the corporation, its holding corporation or subsidiary corporations, except by vote or written consent of the non-benefitted holders of two-thirds of the shares of all classes. Colorado provides that upon the affirmative vote of the holders of at least two-thirds of the outstanding shares of the corporation which are entitled to vote for directors, the corporation can guarantee the obligations of its directors and officers. Montana's counterpart to Colorado's statute requires only a majority vote. New York provides that a guaranty not in furtherance of a corporate purpose must be authorized at a meeting of shareholders by the holders of two-thirds of all outstanding shares entitled to vote thereon. New Jersey adopted the

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137 N.C. Gen. Stat. § 55-17 (b) (3) (Supp. 1965).
143 Cal. Corp. Code § 823 (a) (West 1955). Comments to Cal. Corp. Code § 823 (West 1968) indicate the drafter's intent to remove any doubt that a corporation may guarantee the loan of an affiliate.
146 The "meeting" requirement becomes more stringent as the number of shareholders increases, but can probably be handled with proxy voting.
MBCA section 4(h) provision and, through a slight twist of the New York provision, required that a corporation could give a guaranty not in furtherance of its corporate purposes only when authorized by affirmative vote of two-thirds of the votes cast by the holders of each class and series of shares entitled to vote.\textsuperscript{140} Tennessee provides the corporate guaranty of the obligations of any other entity by vote of a majority of the entire board of directors, unless such power is reserved to the shareholders in the charter.\textsuperscript{140} North Carolina requires the consent of the holders of a majority of all the "disinterested" shares outstanding before the corporation can guarantee the obligations of (1) any directors or officers of the corporation, (2) any corporation of which the officers and directors of the lending or securing corporation own more than fifty per cent of the outstanding securities of any class, or (3) any dominant shareholder or any other corporation of which the shareholder is a dominant shareholder, unless that corporation is a subsidiary of the lending or securing corporation.\textsuperscript{115}

\textbf{Suggested Texas Amendment.} States adopting the MBCA section 4(h) provision but further defining the guaranty's scope indicate the uncertainty of the boundaries of utilizing the MBCA guaranty power.\textsuperscript{152} Hence, mere legislative adoption of a statement that "each corporation shall have power to make guaranties" will neither expunge resort to the "direct benefit" test nor the corporate managers' dilemma. Rejection of the simplistic approach constrains the acceptance of more cumbersome verbiage in attempting to formulate an amendment to TBCA article 2.02.\textsuperscript{153} By selecting the most advantageous provisions from the foregoing statutory potpourri, and by repealing article 1302-2.06,\textsuperscript{154} the following amendment to the Texas Business Corporation Act is tendered:

\textbf{Art. 2.02-1. Guaranties.}
A. Each corporation shall have (subject to Section B below) power to make guaranties respecting contracts, securities and other obligations of any person (including, but not limited to any domestic or foreign corporation, partnership, association, joint venture, trust or individual),\textsuperscript{155} any government, state, territory, government district, or municipality, or any instrumentality

\textsuperscript{140} N.J. REV. STAT. §§ 14A:3-1 (1) (g), 14A:3-3 (1969): "The section will prove useful, in the opinion of the Commission, where the transaction is entered into in good faith and with the thought of indirect or long-run corporate benefit but where there is also doubt as to whether the transaction would be adjudicated to be not in furtherance of the corporate purposes."
\textsuperscript{142} TENN. CODE ANN. § 48-403 (Supp. 1964).
\textsuperscript{155} N.C. GEN. STAT. § 55-22 (Supp. 1965).
\textsuperscript{152} Iowa, Montana, Nebraska, and New Jersey are states in which additional expletives were added to the MBAC provision. Compare MONT. REV. CODES ANN. §§ 15-2004, 15-2204 (f) (1967), where the scope of the guaranty was not altered, but rather the voting requirement for using it, with Neb. REV. STAT. § 21-2004 (8), (9) (Supp. 1968), wherein the MBCA grant was limited for the guarantor's corporate purposes.
\textsuperscript{154} TEX. BUS. CORP. ACT ANN. art. 2.02 (1956).
\textsuperscript{155} TEX. REV. CIV. STAT. ANN. art. 1302-2.06 (Supp. 1968). Since most of the situations calling for a corporate guaranty involve the parent-subsidiary relationship where the parent owns less than 100% of the subsidiary, the present 100% ownership requirement must be eliminated in order to establish an effective guaranty statute.
\textsuperscript{156} Subject to the (B) provisions, employees, customers, suppliers and others with whom the corporation transacts business are included.
if such guaranties may reasonably be expected to benefit, directly or indirectly, the guarantor corporation. In the absence of fraud, the decision of a majority of the board of directors not deriving any personal benefit from the guaranty, within the meaning of Section B of this Article, that the guaranty may reasonably be expected to benefit, directly or indirectly, the guarantor corporation shall be conclusive.

B. Each corporation shall have power to make guaranties conferring a personal benefit upon any of its officers or directors or any holder (including but not limited to any domestic or foreign corporation, partnership, association, joint venture, trust, or individual) of ten (10) per cent or more of any class or series of the corporation’s outstanding shares only if authorized by an affirmative vote of two-thirds of all shares of each class entitled to vote thereon. A guaranty shall be deemed to confer a personal benefit upon such a person, if it is a guaranty of the contracts, securities, or other obligations (a) of that person or (b) of another person in whom that person has a financial interest of ten (10) per cent or more as a shareholder of any class or series of shares, partner, member, venturer, beneficiary or otherwise, or (c) of another person with which that person has the position of officer, director, general partner, or similar relationship.

IV. Conclusion

The traditional protective attitude of the legislature that shareholders' investments should not be exposed to uncontrolled risks by corporate managers will be an important factor in the future success of guaranty proposals. From the standpoint of business realities the corporate guarantor’s risk should be viewed not as uncontrolled, but rather as calculated. Likewise, the anachronistic rule perpetuated in Texas that the guaranty is not within the ordinary scope of a corporation’s business has been fostered under a misapprehension of the nature of a guaranty contract. A guaranty is not “corporate business” in a general sense of the expression, but rather takes its color entirely from the business transaction of which it happens to be a part.

Legislative action is required to ameliorate the guaranty’s use in Texas. The corporate manager is presently empowered to utilize absolute instruments in leasing and dealing with personal property, assisting employees, and in making contracts and incurring liabilities. But the cor-

157 Without having to explain the demarcation between a “direct” and “indirect” benefit, the dilemma of corporate managers vanishes.
158 The two-thirds voting requirement is consistent with the other voting requirements within the TBCA. However, there is some question of the advisability of allowing corporate guaranties to directors and officers since the corporation can’t make loans to such individuals. Tex. Bus. Corp. Act Ann. art. 2.41(4) (1956) states “The directors of a corporation who vote for or assent to the making of a loan to an officer or director of the corporation, or the making of any loan secured by shares of the corporation, shall be jointly and severally liable to the corporation for the amount of such loan until the repayment thereof.” However, in Whitten v. Republic Nat’l Bank, 397 S.W.2d 415 (Tex. 1965), it was made clear that a loan to an officer or director by the corporation was simply ultra vires and not illegal. Thus, regarding the proposed statute, corporate managers, in order to be fully protected from liability, should obtain 100% ratification of the guaranty transaction by the shareholders. Of course, the 100% voting requirement is available to the legislators, in lieu of the two-thirds provision, should they desire no future uncertainty.
159 Id. art. 2.02A(4) (1956).
160 Id. art. 2.02A(6).
161 Id. art. 2.02A(9).
Corporate manager is pinched by a seventy-five-year-old restriction upon his authorization of a guaranty. It would seem that there is a contradiction in extending approval to the corporate manager's execution of an *absolute* instrument of indebtedness when his authorization of a *conditional* credit device is abnegated.