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Choice of State of Incorporation - Texas versus Delaware: Is It Now Time to Rethink Traditional Notions

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CHOICE OF STATE OF INCORPORATION— TEXAS VERSUS DELAWARE: IS IT NOW TIME TO RETHINK TRADITIONAL NOTIONS?

*Byron F. Egan**
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TABLE OF CONTENTS

I.	INTRODUCTION	250
II.	RELATIVE TAX BURDENS	252
	A. IMPORTANCE OF WHERE OPERATIONS ARE CONDUCTED	252
	B. TAX IF OPERATIONS ARE IN TEXAS.....	254
	C. TAX IF OPERATIONS ARE IN DELAWARE	254
	D. INTERNAL PARTNERSHIPS STILL WORK	255
	E. CONCLUSIONS	256
III.	JUDICIARY.....	256
	A. DELAWARE	256
	B. TEXAS	259
IV.	FIDUCIARY DUTIES GENERALLY	259
	A. GENERAL PRINCIPLES	259
	B. APPLICABLE LAW	259
	C. FIDUCIARY DUTIES IN TEXAS CASES	260
	D. FIDUCIARY DUTIES IN DELAWARE CASES	263
	E. FIDUCIARY DUTIES/LIABILITIES OF OFFICERS	270
	F. CONSEQUENCES OF BREACH	270
V.	STATUTORY COMPARISON	271
	A. DIRECTOR DUTIES AND LIABILITIES.....	272
	B. MERGERS, SHARE EXCHANGES, CONVERSIONS AND OTHER BUSINESS COMBINATIONS AND ASSET SALES ..	280
	C. STOCKHOLDER VOTING RIGHTS AND ACTIONS; LIABILITIES AND PREEMPTIVE RIGHTS	295
	D. STOCK ISSUANCES	303

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E. DIVIDENDS AND DISTRIBUTIONS.....	306
F. SHAREHOLDER AGREEMENTS	310
G. DISSOLUTIONS.....	312
H. MISCELLANEOUS	321
VI. PROPOSED TEXAS BUSINESS ORGANIZATIONS	
CODE	322
VII. CONCLUSION	323

I. INTRODUCTION

ONE of the fundamental decisions a corporate practitioner must make when organizing a corporation is that of the jurisdiction of incorporation. The ramifications of this decision will have far-reaching implications for both the client and the corporation as transactions are considered and carried out over the life of the corporation. The decision on the jurisdiction of incorporation, however, is often given little thought. Many practitioners choose Delaware on instinct, based on non-quantifiable concepts such as the existence of a wider body of case law interpreting corporation law and a judiciary that is perceived to be more sophisticated in corporation law matters. Others choose Delaware due to inertia, based on prior experience in Delaware or investment banker advice that everybody does it.

The Texas Legislature over the past fifteen years has sought to address the Delaware bias by improving the corporation laws of the State and establishing clear statutory answers to questions that have historically been addressed in Delaware by case law. Although Delaware has attempted to follow suit in certain areas by providing corporations with greater flexibility in structuring business combinations and establishing their capital structures, many areas continue to be left to the Delaware courts. The Delaware courts have in turn tended to establish legal principles that often create more questions than they resolve. Often this leaves counsel unable to give clear advice as to how transactions may be structured and allows Delaware judges to second guess the business judgment of Texas-based corporations. Accordingly, it is now time for practitioners to shed their historical notions of Delaware as the most desirable jurisdiction for incorporation and to seriously consider the differences between Texas and Delaware law on corporation law issues. The results of such an inquiry may be surprising.

The resurgence of Texas as a desirable jurisdiction in which to incorporate was not merely an accident of nature. Rather, it was the product of a concerted effort by the Texas Legislature and the corporate bar to revise the Texas Business Corporation Act¹ (the "TBCA") to better operate in an ever-expanding global economy where the ability of corporations to react quickly, innovatively, and with certainty is necessary to effectively

1. TEX. BUS. CORP. ACT ANN. art. 1.01(A) (Vernon 2001).

compete and survive.²

Among the changes that have been enacted to the TBCA in recent years are:

- (i) an expansion of the director and officer indemnification provisions of the TBCA to permit and accommodate alternative and unique forms of indemnification arrangements;
- (ii) the adoption of a statute that allows for the limitation of liability of directors for actions that do not constitute violations of law or breaches of the duty of loyalty;
- (iii) an expansion of the type of information directors and officers may rely upon in performing their duties;
- (iv) a complete revision of the merger provisions of the TBCA to permit corporations a nearly unlimited range of choices and means for effecting acquisitive, divestitive, and restructuring transactions;
- (v) the authorization of broad forms of shareholder agreements that allow for modification to traditional statutory management and shareholder matters;
- (vi) the creation of a clear procedure for the handling of derivative lawsuits;
- (vii) an update and clarification of the rights and obligations of shareholders; and
- (viii) a simplification of the distribution provisions.³

The common thread running through these and other changes made to the TBCA has been a fundamental desire by the drafters to create a more practical statute. The changes seek to provide certainty as well as flexibility for corporations in arranging their capital structures, effecting transactions, attracting qualified management, and other decisions. Many of the statutory concepts adopted in Texas do not exist in Delaware or are materially more restrictive in Delaware than in Texas.

The road to the current TBCA has not always been smooth and has been paved with battles over issues such as the scope and nature of director liability and when shareholders should and should not be held liable for the obligations of their corporations.⁴ Texas has also had to overcome the adverse publicity and misimpressions that were created in the wake of the *Texaco/Pennzoil* case,⁵ which, other than having been filed in a Texas court, had very little to do with the corporation or other laws of the State of Texas. In fact, both Texaco and Pennzoil were Delaware corporations,

2. See Alan Bromberg et al., *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 31 BULLETIN OF BUS. L. SECTION OF THE STATE BAR OF TEX. 1 (June 1994).

3. See Byron F. Egan & Amanda M. French, *1987 Amendments to the Texas Business Corporation Act and Other Texas Corporation Laws*, 25 BULLETIN OF BUS. LAW SECTION OF THE STATE BAR OF TEX. 1 (Sept. 1987); see also Bromberg, *supra* note 2, at 1; Curtis W. Huff, *Choice of State of Incorporation—Texas Versus Delaware: Is it Now Time To Rethink Traditional Notions*, 31 BULLETIN OF BUS. LAW SECTION OF THE STATE BAR OF TEX. 9 (Dec. 1994).

4. See, generally, Robert W. Hamilton, *A New Turn in Texas Law of "Piercing the Corporate Veil"*, 8 CORP. COUNS. REV. 2, 16-22 (1989).

5. *Texaco, Inc. v. Pennzoil Co.*, 729 S.W.2d 768 (Tex. Civ. App.—Houston [1st Dist.] 1987, writ ref'd n.r.e.).

and the case turned on New York law. The result could have occurred in any jurisdiction where a jury system exists.

The Texas Legislature has offset these effects by striving to resolve various corporate legal issues by statute rather than in the courts. For example, Texas has adopted a viable and successful tort reform system while the Delaware courts tend to create legal theories that are dependent on relatively uncertain and fact-specific standards of conduct. Thus, the historical Delaware approach of relying on judicial interpretation to resolve many issues has in recent years created more uncertainties than it has resolved.

Although the process of molding the TBCA into a modern and flexible statute is an ongoing process, the efforts of Texas to create a friendly environment for businesses has been successful. Today, while Texas may not have as expansive a body of case law on corporation law issues as Delaware's nor, arguably, as sophisticated a judiciary on such issues, Texas corporations enjoy many advantages over their Delaware counterparts. Those advantages are provided through a combination of a statutory philosophy of providing corporations with maximum flexibility and a clearer and more precise statute that obviates the need for case law to interpret the ambiguities existing under the Delaware General Corporation Law ("DGCL").⁶ Whether the changes to the TBCA will result in any increase in the number of incorporations in Texas is yet to be seen. However, the TBCA has come of age and become a model for other jurisdictions in how to provide a flexible statute for our changing economy as we move forward in the 21st Century.

The TBCA, however, cannot be viewed as a corporate panacea. Offsetting the benefits of the changes that have been made to the Texas corporation laws is the impact of Texas' franchise tax laws that in effect impose an income tax on businesses incorporated in Texas. There are, however, tax strategies that can be used to minimize the franchise tax impact.

II. RELATIVE TAX BURDENS

A. IMPORTANCE OF WHERE OPERATIONS ARE CONDUCTED

To compare the relative tax burdens associated with being incorporated in Texas and Delaware, assumptions must be made about where the corporation's business operations will be conducted and sales will be made. If operations are physically located in the state of incorporation, the comparative tax burdens will be different than if the operations are located in other states. The comparisons below only address franchise and income taxes. They do not include sales, property, severance, fuel, or other similar taxes.

6. See generally Huff, *Choice of State of Incorporation* *supra* note 3; see also, Bromberg, *supra* note 2.

1. Texas Franchise Tax

Texas has a franchise tax that applies to corporations that are either incorporated under the TBCA or qualified to do business in Texas as a foreign corporation. The Texas franchise tax is the greater of a 4.5% income tax or a .25% tax on net worth, with both calculations apportioned to Texas based on a ratio of gross receipts in Texas divided by total gross receipts.⁷ Dividends received by Texas corporations from corporations incorporated under the laws of other states are not Texas-sourced income for franchise taxes even if the payor is qualified to do business in Texas and pays Texas franchise taxes.⁸

2. Delaware Income and Franchise Taxes

Delaware has (i) an 8.7% income tax apportioned to Delaware using a three-factor apportionment formula (equally weighted payroll, property, and sales tax),⁹ and (ii) a franchise tax based on authorized shares or assets, whichever is less.¹⁰ The Delaware income tax exempts corporations that have a statutory office in the state but do not conduct any business in Delaware.

The Delaware franchise tax calculation is based on either the number of authorized shares or adjusted gross assets, and is quite complex. *The tax is the lesser of:*

7. The Texas franchise tax for both domestic and foreign corporations is equal to the greater of (i) 0.25% of its "taxable capital" (generally owners' equity or net worth) or (ii) 4.5% of its "net taxable earned surplus." TEX. TAX CODE ANN. § 171.002 (Vernon 1992). "Net taxable earned surplus" is computed by determining the entity's reportable federal taxable income, adding to that amount the compensation of officers and directors (unless the corporation has not more than 35 shareholders or is an S corporation for federal tax purposes, in which case the add-back is not required), making certain other adjustments, and then apportioning the adjusted amount to Texas based on the percentage of its gross receipts from Texas sources. Any sales shipped from Texas into other states where such corporation is not subject to state income tax will be "thrown back" into Texas gross receipts for purposes of the Texas apportionment formula. See TEX. TAX CODE ANN. § 171.1032(a)(1) (West 2000); 34 TEX. ADMIN. CODE § 3.557(e)(37)(I) (West 2000). Although labeled a "franchise tax," the tax on "net taxable earned surplus" is really a 4.5% income tax levied at the entity level.

Limited and general partnerships (including registered limited liability partnerships) are not presently subject to the Texas franchise tax, but there were legislative proposals to subject them to the franchise tax or some other measure of tax on their income during the 75th Session of the Texas Legislature in 1997. See H.B. 4 introduced in January 1997, which ultimately did not pass. The Texas Comptroller of Public Accounts has issued private letter rulings stating that it will honor the state law classification of an entity as a partnership, despite any "check-the-box" election by the partnership to be treated as a corporation for federal income tax purposes. See Comptroller Taxpayer Response Letter Accession No. 9811328L (Nov. 30, 1998).

8. 34 TEX. ADMIN. CODE § 3.557(e)(13)(C) (West 2000). There is no consolidation for Texas franchise taxes as there is for federal income taxes. *Id.* § 3.544(c).

9. DEL. CODE ANN. tit. 30, § 1902 (1994). The Delaware income tax apportionment formula is [.33 x Delaware sales/aggregate sales + .33 x Delaware property/aggregate property + .33 x Delaware payroll/aggregate payroll]. Delaware does not have a "throwback" rule applicable to sales shipped into other states.

10. DEL. CODE ANN. tit. 30, § 503 (1994 & Supp. 1998).

(a) approximately \$50 for each 10,000 authorized shares (regardless of par value). For example, if there are 1,000,000 shares authorized, this calculation would result in a tax of \$5,000 (.005 per authorized share); *or*

(b) a tax on "assumed par value capital" calculated as follows:

gross assets¹¹ divided by issued shares equals assumed par value

(i) if assumed par value is greater than stated par value, then assumed par value times total authorized shares equals assumed par value capital. In this scenario, the tax would equal assumed par value capital divided by 1,000,000 (rounded up to next whole number) times \$200

(ii) if assumed par value is less than stated par value, then actual par value times total authorized shares equals par value capital, and the tax would equal par value capital divided by 1,000,000 (rounded up to the next whole number) times \$200.

B. TAX IF OPERATIONS ARE IN TEXAS

If the corporation will have its physical operations in Texas, then the following comparison of tax burdens applies.

1. Texas Corporations

If the corporation is *incorporated in Texas*, its annual tax burden will include Texas franchise tax at 4.5% of net income or .25% of net worth, whichever is greater, apportioned to Texas based on gross receipts.

2. Delaware Corporations

If the corporation is *incorporated in Delaware* (again with its physical operations in Texas), it will have to qualify to do business in Texas as a foreign corporation (\$750 one-time fee),¹² and its annual tax burden will include:

(a) Texas franchise tax at 4.5% of net income or .25% of net worth, whichever is greater, apportioned to Texas based on gross receipts.¹³

(b) Assuming the corporation does not conduct any business in Delaware, it will be exempt from the Delaware income tax.

(c) Delaware franchise tax, which generally results in a tax of .02% of "assumed par value capital."

C. TAX IF OPERATIONS ARE IN DELAWARE

If *the corporation will have its physical operations in Delaware*, then the following comparison of tax burdens applies.

11. The total gross assets means all assets of the corporation net only of allowances for bad debts, accumulated depreciation, accumulated depreciation, accumulated amortization of land and accumulated amortization of land and accumulated amortization of intangible assets. See also Schedule L of the federal Form 1120.

12. TEX. BUS. CORP. ACT ANN. art. 10.01(A)(4) (West 2001).

13. TEX. TAX CODE ANN. § 172.001 (West 2000).

1. Delaware Corporations

If the corporation is *incorporated in Delaware* (and has its physical operations in Delaware), its tax burden will include:

(a) The Delaware income tax will be 8.7% of federal taxable income apportioned to Delaware. Delaware does not have a “throwback” rule applicable to sales shipped into other states.

(b) Delaware franchise tax, which generally results in a tax of .02% of “assumed par value capital.”

2. Texas Corporations

If the corporation is *incorporated in Texas*, its tax burden will include:

(a) If there is no activity in Texas other than holding the Texas charter, a Texas franchise tax of .25% of net worth will be apportioned to Texas based on gross receipts.¹⁴

(b) The Delaware income tax will be 8.7% of federal taxable income apportioned to Delaware.

(c) Delaware franchise tax, which generally results in a tax of .02% of “assumed par value capital.”

D. INTERNAL PARTNERSHIPS STILL WORK

Many Texas-based corporations (whether or not incorporated in Texas) have utilized internal limited partnerships to isolate liabilities and reduce franchise taxes. Because the Texas franchise/income tax is based upon federal taxable income (computed on a separate company basis, for there is no consolidation for Texas franchise tax purposes), the corporate partner would be subject to franchise taxes to the extent that its distributive share of the partnership’s income (whether or not distributed) is Texas sourced.¹⁵

If the limited partnership is structured such that the Texas parent is a 1% general partner and the 99% limited partner is incorporated in a state without an income tax (assume Nevada) and does not otherwise do business or pay franchise taxes in Texas (the ownership of a limited partner interest in a limited partnership doing business in Texas does not alone require the Nevada corporate limited partner to qualify in Texas as a foreign corporation or to pay Texas franchise taxes on its distributive share of the partnership’s income),¹⁶ the income attributable to the 99% limited partnership interest will not be subject to the Texas franchise/income

14. See 34 TEX. ADMIN. CODE § 3.554 (b) (result forced by federal Public Law 86-272); *but cf.* Rylander v. Bandag Licensing Corp., 18 S.W.3d 296 (Tex. App.—Austin 2000, writ granted).

15. 34 TEX. ADMIN. CODE § 3.544(c) (West 2000).

16. 34 TEX. ADMIN. CODE § 3.546(c)(12)(B) (West 2000); *see also* Priv. Ltr. Rul. 9911323L (Nov. 2, 1999); Priv. Ltr. Rul. 9904593L (Apr. 22, 1999); Priv. Ltr. Rul. 9903584L (Mar. 24, 1999); Priv. Ltr. Rul. 9903710L (Mar. 24, 1999); Priv. Ltr. Rul. 9812313L (Dec. 1, 1998); Priv. Ltr. Rul. 9710257L (Oct. 7, 1997); Priv. Ltr. Rul. 9610805L (Oct. 1, 1996); Priv. Ltr. Rul. 9412302L (Dec. 22, 1994); Priv. Ltr. Rul. 9503L140SG09 (Mar. 20, 1995).

tax.¹⁷ If the Nevada subsidiary subsequently dividends the income from the limited partnership to its Texas parent, that dividend income will not be subject to the Texas franchise/income tax, either because the dividend is deducted in arriving at federal taxable income or it is a non-Texas receipt for franchise tax purposes.¹⁸ The foregoing is a simplification of a common internal limited partnership structure. The actual analysis, of course, becomes very fact specific and there are a number of structural variations available depending upon the objectives and the source of the income.

E. CONCLUSIONS

The tax burdens are dependent on the substantive nature and circumstances of the new corporation to be formed. The generalizations that can be drawn include:

(1) If the physical operations and sales will be in Texas, there is no tax advantage to forming the corporation in Delaware.

(2) If the physical operations and sales will be in Delaware, there is no tax advantage to forming the corporation in Texas.

(3) If the corporation will have substantial sales of products throughout the United States or abroad, the foregoing conclusions will have to be tested in the numerical/geographical profile of the particular corporation, particularly where the corporation is subject to the tax laws of multiple jurisdictions.

Further, the use of internal partnerships and foreign subsidiaries can reduce the Texas franchise tax burden such that there is no tax advantage for the parent company to be incorporated in Delaware.

III. JUDICIARY

A. DELAWARE

The Delaware Court of Chancery is the forum for resolution of internal corporate governance disputes, contests for corporate control, and similar matters in Delaware. The expertise of the Court of Chancery and the body of Delaware case law are frequently cited as reasons for Delaware being a preferred state for incorporation.¹⁹ This judicial sword has two edges.

The Court of Chancery is a court of general equity jurisdiction and does not have jurisdiction over criminal cases or tort actions seeking damages, which tend to crowd the dockets of law courts. As a result, the Court of Chancery often can deal with cases expeditiously when the circumstances so require, which may not be an advantage depending upon

17. *Id.*

18. 34 TEX. ADMIN. CODE § 3.549(e)(13)(A) (West 2000).

19. See Demetrios G. Kaouris, Note, *Is Delaware Still a Haven For Incorporation?* 20 DEL. J. CORP. L. 965 (1995); LEWIS S. BLACK, JR., *WHY CORPORATIONS CHOOSE DELAWARE* (1993).

one's posture in a case.²⁰

The Delaware Court of Chancery presently consists of one chancellor and four vice chancellors, each appointed by the Governor and subject to Senate confirmation, for a twelve-year term.²¹ These judges see a volume of cases and have developed specialized expertise, a willingness to become judicially involved in corporate disputes, and some distinct ideas as to how corporations should be governed, which often proves discomforting to management and the attorneys who represent the management perspective. Delaware also has a developed corporate plaintiffs' bar, which is comfortable with the Court of Chancery.

Because it is a court of equity, trials in the Court of Chancery are to the court rather than a jury. So long as a matter is properly within the equitable subject matter jurisdiction of the Court of Chancery, equity may proceed to determine all facts essential to a decree, and there is no right, constitutional or otherwise, to have factual issues tried before a jury.²²

The Delaware Legislature has enacted legislation giving the Court of Chancery statutory authority over a broad spectrum of intracorporate issues, including actions relating to director and officer indemnification,²³ suits concerning the replacement of lost stock certificates,²⁴ actions to compel the holding of annual stockholders meetings,²⁵ proceedings to require the production of corporate records for stockholder inspection,²⁶ judicial review of elections of directors and other stockholder actions,²⁷ cases seeking a court appraisal of the fair value of corporate stock,²⁸ and a variety of proceedings relating to corporate dissolution and insolvency.²⁹

The concepts of fiduciary rights and duties arose as creation of equity in response to perceived inadequacies in the common law, and the construction and enforcement thereof now lie within the exclusive province of the Court of Chancery.³⁰ The existence of a fiduciary relationship confers upon the Court of Chancery jurisdiction to hear and determine all relevant controversies existing between the parties, although there may exist some other cause of action at law. Equitable jurisdiction exists even if the remedy sought is an award of money damages, since the source of

20. See generally DONALD J. WOLFE & MICHAEL A. PITTENGER, *CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY* (1998).

21. See DEL. CONST. art. IV, §§ 2, 3 (1999); DEL. CODE ANN. tit. 10, § 307 (1999) (adding three vice chancellors by statute to the chancellor and vice chancellor required by the state's constitution).

22. See WOLFE & PITTENGER, *supra* note 20.

23. DEL. CODE ANN. tit. 8 (1994 & Supp. 1998).

24. See *id.* § 168.

25. See *id.* § 211.

26. See *id.* § 220.

27. See *id.* § 225.

28. DEL. CODE ANN. tit. 8 § 262.

29. See *id.* §§ 273, 280, 284, 291.

30. See *McMahon v. New Castle Assocs.*, 532 A.2d 601, 604 (Del. Ch. 1987).

jurisdiction is the substantive equitable right itself.³¹

Cases within the subject matter jurisdiction of the Court of Chancery may involve both legal and equitable claims.³² The Court of Chancery generally lacks the power to impose penalties or forfeitures, including punitive or exemplary damages.³³

Under Delaware law, nonresident directors of Delaware corporations are subject to personal jurisdiction in Delaware courts based on their activities as directors. Under DGCL § 325,³⁴ actions may be brought against officers, directors, or stockholders of Delaware corporations when they are "liable by the provisions of this chapter to pay the debts of the corporation." However, an action under DGCL § 325 may not be brought against any officer, director or stockholder for any such debt "until judgment be obtained therefor against the corporation."

Under Delaware's director consent statute,³⁵ a court may exercise jurisdiction over a director or former director of a Delaware corporation for claims of breach of directors' duties, based upon his implied consent to substituted service of process.³⁶ The statute does not apply to nonresident directors who die before suit or service of process is commenced.³⁷

If § 3114 does not apply, Delaware's long-arm statute³⁸ would confer personal jurisdiction over a nonresident defendant as long as the defendant has engaged in any one of a list of enumerated acts, including: engaging in contracts, causing tortious injury, having or possessing real property in Delaware, and transacting business or performing work in Delaware.³⁹ This provision also confers jurisdiction over a nonresident defendant for claims relating to the act of incorporation, provided there is some nexus between the act giving rise to jurisdiction (the act of incorporating) and the plaintiff's claim.⁴⁰ The Delaware statute confers jurisdiction as of the time the alleged wrongful action occurred and does not require that the defendant be in office at the time process is served.⁴¹

31. See *Harman v. Masoneilan Int'l, Inc.*, 442 A.2d 487, 500 (Del. 1982); *Bird v. Lida, Inc.*, 681 A.2d 399, 402 (Del. Ch. 1996); *McMahon*, 532 A.2d at 604.

32. See *Wilmington Homes, Inc. v. Weiler*, 202 A.2d 576, 580 (Del. Ch. 1964).

33. See *Beals v. Wash. Int'l, Inc.*, 386 A.2d 1156, 1159 (Del. Ch. 1978).

34. DEL. CODE ANN. tit. 10, § 3114 (1999).

35. *Id.*

36. See *id.* tit. 10, § 3114(a); *Carlton Inv. v. TLC Beatrice Int'l Holdings, Inc.*, Civ. A. No. 13950, 1995 WL 694397, at *7 (Del. Ch. Nov. 21, 1995); *Tabas v. Crosby*, 444 A.2d 250, 252-53 (Del. Ch. 1982) (a director, by accepting election or appointment as a director of a Delaware corporation, is deemed to have consented to personal jurisdiction being obtained in suits which relate to acts as a director).

37. See *Tabas*, 444 A.2d at 252-53 (Section 3114 does not provide for substituted service upon the decedent's personal representative).

38. DEL. CODE ANN. tit. 10, § 3104 (1999).

39. See *id.*

40. See *Mobilificio San Giacomo S.P.A. v. Stoffi*, No. 96-415-LON, 1996 WL 924508, at *3, *10 (D. Del. Oct. 29, 1996) (citations omitted) (holding that because there was no allegation that the act of incorporating in any way harmed the plaintiff, the nexus was insufficient to confer jurisdiction over the nonresident defendant).

41. WOLFE & PITTENGER, *supra* note 20, at 134.

B. TEXAS

Corporate disputes in Texas are handled in law courts of general jurisdiction just as other civil cases. Judges are elected. Questions of fact are subject to trial by jury.

IV. FIDUCIARY DUTIES GENERALLY

A. GENERAL PRINCIPLES

The concepts that underlie the fiduciary duties of corporate directors have their origins in English common law of trusts and agency from over two hundred years ago.⁴² The current concepts of those duties in both Texas and Delaware are still largely matters of evolving common law.

Both the TBCA and the DGCL provide that the business and affairs of a corporation are to be managed under the direction of its board of directors.⁴³ While the TBCA and the DGCL provide statutory guidance as to matters such as the issuance of securities, the payment of dividends, the conduct of meetings of directors and shareholders, and the ability of directors to rely on specified persons and information, the nature of a director's "fiduciary" duty to the corporation and the shareholders has been largely defined by the courts through damage and injunctive actions. In Texas, the fiduciary duty of a director has been characterized as including duties of loyalty, care and obedience.⁴⁴ In Delaware, the fiduciary duties include those loyalty, care, and candor.⁴⁵ Both Texas and Delaware have adopted a judicial rule of review for the business decisions, known as the "business judgment rule," that is intended to protect disinterested directors from liability for decisions made by them when exercising their business judgment, but there are substantial differences between the Delaware and Texas judicial approaches to the business judgment rule.

B. APPLICABLE LAW

Under the internal affairs doctrine, courts in Texas apply the law of a corporation's state of incorporation in adjudications regarding director fiduciary duties.⁴⁶ Delaware also subscribes to the internal affairs doctrine. However, Delaware has enacted a choice of law statute under which the parties can agree that internal matters ordinarily governed by the law of the state of incorporation will be resolved under the laws of

42. Henry R. Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 973 (1994).

43. TEX. BUS. CORP. ACT ANN. art. 2.31 (Vernon 1980 & Supp. 2000), DEL. CODE ANN. tit. 8, § 141(a) (1991).

44. *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984).

45. *See Smith v. Van Gorkom*, 488 A.2d 858, 873-73 (Del. 1985).

46. TEX. BUS. CORP. ACT ANN. art. 8.02; (Vernon Supp. 2001); MISC. CORP. LAWS ACT ("TMCLA") art. 1302-1.03 (Vernon Supp. 2001); *Hollis v. Hill*, 232 F.3d 460 (5th Cir. 2000); *see also Gearhart*, 741 F.2d at 719; *A. Copeland Enter., Inc. v. Guste*, 706 F. Supp. 1283, 1288 (W.D. Tex. 1989); *Texaco, Inc. v. Pennzoil Co.*, 729 S.W.2d 768 (Tex. App.—Houston [1st Dist.] 1987, writ ref'd n.r.e.).

Delaware in Delaware courts.⁴⁷

C. FIDUCIARY DUTIES IN TEXAS CASES

The Fifth Circuit stated in *Gearhart* that under Texas law “[t]hree broad duties stem from the fiduciary status of corporate directors; namely, the duties of obedience, loyalty, and due care,”⁴⁸ and commented that (i) the duty of obedience requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the authority of the corporation as defined by its articles of incorporation or the laws of the state of incorporation, (ii) the duty of loyalty dictates that a director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation, and (iii) the duty of due care requires that a director must handle his corporate duties with such care as an ordinarily prudent man would use under similar circumstances.⁴⁹ *Gearhart* remains the seminal case for defining the fiduciary duties of directors in Texas, although there are subsequent cases which amplify *Gearhart* as they apply it in particular situations, such as lawsuits by the Federal Deposit Insurance Corporation (“FDIC”) and the Resolution Trust Company (“RTC”) arising out of failed financial institutions.⁵⁰

1. Loyalty

The duty of loyalty in Texas is a duty that dictates that the director act in good faith and not allow his personal interest to prevail over that of the corporation.⁵¹ The good faith of a director will be determined on whether the director acted with an intent to confer a benefit to the corporation.⁵² Whether there exists a personal interest by the director will be a question of fact.⁵³ In general, a director will not be permitted to derive a personal profit or advantage at the expense of the corporation and must act solely with an eye to the best interest of the corporation, unhampered by any pecuniary interest of his own.⁵⁴

The court in *Gearhart* summarized Texas law with respect to the question of whether a director is interested:

A director is considered ‘interested’ if he or she (1) makes a personal profit from a transaction by dealing with the corporation or usurps a corporate opportunity . . . (2) buys or sells assets of the corporation . . . (3) transacts business in his director’s capacity with a second

47. See DEL. CODE ANN. tit. 6, § 2708; see also Larry E. Ribstein, *Delaware, Lawyers, and Contractual Choice of Law*, 19 DEL. J. CORP. L. 999 (1994).

48. *Gearhart*, 741 F.2d at 719.

49. See *id.* at 712-20; see also *McCollum v. Dollar*, 213 S.W. 259 (Tex. Comm’n App. 1919, holding approved).

50. See, e.g., *FDIC v. Harrington*, 844 F. Supp. 300 (N.D. Tex. 1994).

51. See *Gearhart*, 741 F.2d at 719.

52. See *Int’l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963).

53. See *id.* at 578.

54. See *Copeland Enters., Inc. v. Guste*, 706 F. Supp. 1283, 1291; *Milam v. Cooper Co.*, 258 S.W.2d 953, 956 (Tex. Civ. App.—Waco 1953, writ ref’d n.r.e.). See generally John T. Kendrick, Jr., *The Interested Director in Texas*, 21 Sw. L.J. 794 (1967).

corporation of which he is also a director or significantly financially associated . . . or (4) transacts business in his director's capacity with a family member.⁵⁵

2. Care

The duty of care in Texas requires the director to handle his duties with such care as an ordinarily prudent man would use under similar circumstances. In performing this obligation, the director must be diligent and informed and exercise honest and unbiased business judgment in pursuit of corporate interests.⁵⁶

In general, the duty of care will be satisfied if the directors' actions are covered by the business judgment rule. The Fifth Circuit stated in *Gearhart* that, in spite of the requirement that a corporate director handle his duties with such care as an ordinarily prudent man would use under similar circumstances, Texas courts will not impose liability upon a *noninterested* corporate director unless the challenged action is *ultra vires* or is tainted by fraud. In a footnote in the *Gearhart* decision, the Fifth Circuit stated:

The business judgment rule is a defense to the duty of care. As such, the Texas business judgment rule precludes judicial interference with the business judgment of directors absent a showing of fraud or an *ultra vires* act. If such a showing is not made, then the good or bad faith of the directors is irrelevant.⁵⁷

In applying the business judgment rule in Texas, the courts have quoted from the early Texas decision of *Cates v. Sparkman*,⁵⁸ as setting the standard for judicial intervention in cases involving duty of care issues:

[I]f the acts or things are or may be that which the majority of the company have a right to do, or if they have been done irregularly, negligently, or imprudently, or are within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved, these would not constitute such a breach of duty, however unwise or inexpedient such acts might be, as would authorize interference by the courts at the suit of a stockholder.⁵⁹

In *Gearhart* the Court commented that “[e]ven though *Cates* was decided in 1889, and despite the ordinary care standard announced in *McCullum v. Dollar*, Texas courts to this day will not impose liability upon a noninterested corporate director unless the challenged action is *ultra vires* or is tainted by fraud.”⁶⁰

Neither *Gearhart* nor the earlier Texas cases on which it relied referred to “gross negligence” as a standard for director liability. If read literally,

55. *Gearhart*, 741 F.2d at 719-20 (citations omitted).

56. *See id.* at 719; *see also McCullum*, 213 S.W. at 261.

57. *Gearhart*, 741 F.2d at 723 n.9.

58. 11 S.W. 846 (1889).

59. *Id.* at 849.

60. *Gearhart*, 741 F.2d at 721.

the business judgment rule articulated in *Gearhart* would protect even grossly negligent conduct. Recent federal district court decisions in FDIC and RTC initiated cases, however, have declined to interpret Texas law this broadly and have held that the Texas business judgment rule does not protect "any breach of the duty of care that amounts to gross negligence" or "directors who abdicate their responsibilities and fail to exercise any judgment."⁶¹

In response to RTC and FDIC claims that ordinary negligence was the standard for duty of care cases against failed Texas financial institutions, the Texas legislature in 1993 passed House Bill 1076⁶² which, purporting not to change existing law, provided that a disinterested director of a failed institution may not be held personally liable unless the director was grossly negligent or committed willful or negligent misconduct.⁶³ While House Bill 1076 is inapplicable beyond FDIC and RTC cases, its legislative imprimatur "gave added weight to the *Gearhart* standard of liability" because the "statute explicitly provides that officers and directors may be held liable only for acts of gross negligence" and "was not intended to change, but merely clarify, existing law regarding the proper standard of care for directors and officers of insured financial institutions."⁶⁴ The RTC challenged the constitutionality of House Bill 1076 in *Harrington*, but the court resolved the issues before it without reaching the constitutional question.

Gross negligence in Texas is defined as "that entire want of care which would raise the belief that the act or omission complained of was the result of a conscious indifference to the right or welfare of the person or persons to be affected by it."⁶⁵ In *Harrington*,⁶⁶ the Court concluded "that a director's total abdication of duties falls within this definition of gross negligence."

The business judgment rule does not necessarily protect a director with respect to transactions in which he is interested. It simply means that the action will have to be challenged on duty of loyalty rather than duty of care grounds.⁶⁷

Directors may "in good faith and with ordinary care, rely on information, opinions, reports or statements, including financial statements and other financial data," prepared by officers or employees of the corpora-

61. FDIC v. *Harrington*, 844 F. Supp. 300, 306 (N.D. Tex. 1994); see also RTC v. *Ac-ton*, 844 F. Supp. 307, 314 (N.D. Tex. 1994); RTC v. *Norris*, 830 F. Supp. 351, 357 (S.D. Tex. 1993); FDIC v. *Brown*, 812 F. Supp. 722, 726 (S.D. Tex. 1992). Cf. RTC v. *Miramón*, 22 F.3d 1357 (5th Cir. 1994) (followed *Harrington* analysis of § 1821(K) of the Financial Institutions Reform, Recovery and Enforcement Act ("FIRREA"), which held that federal common law of director liability did not survive FIRREA and applied Texas' gross negligence standard for financial institution director liability cases under FIRREA).

62. *Harrington*, 84 F. Supp. at 307 n.8; see Tex. H. B. 1076, § 2, 73d Leg., R.S. (1993).

63. *Id.*

64. *Harrington*, 844 F. Supp. at 307, 307 n.8

65. *Burk Royalty Co. v. Walls*, 616 S.W.2d 911, 920 (Tex. 1981).

66. FDIC v. *Harrington*, 844 F. Supp. 300, 306 n.7 (N.D. Tex. 1994).

67. See *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 723, 723 n.9 (5th Cir. 1984).

tion, counsel, accountants, investment bankers or “other persons as to matters the director reasonably believes are within the person’s professional or expert competence.”⁶⁸

3. *Other (Obedience)*

The duty of obedience in Texas requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the powers of the corporation as defined by its articles of incorporation and Texas law.⁶⁹ An *ultra vires* act may be voidable under Texas law, but the director will not be held personally liable for such act unless the act is in violation of a specific statute or against public policy.

The RTC’s complaint in *RTC v. Norris*,⁷⁰ asserted that the directors of a failed financial institution breached their fiduciary duty of obedience by failing to cause the institution to adequately respond to regulatory warnings: “The defendants committed *ultra vires* acts by ignoring warnings from [regulators], by failing to put into place proper review and lending procedures, and by ratifying loans that did not comply with state and federal regulations and Commonwealth’s Bylaws.”⁷¹ In rejecting this RTC argument, the court wrote:

The RTC does not cite, and the court has not found, any case in which a disinterested director has been found liable under Texas law for alleged *ultra vires* acts of employees, absent pleadings and proof that the director knew of or took part in the act, even where the act is illegal.

.....

Under the business judgment rule, Texas courts have refused to impose personal liability on corporate directors for illegal or *ultra vires* acts of corporate agents unless the directors either participated in the act or had actual knowledge of the act.⁷²

D. FIDUCIARY DUTIES IN DELAWARE CASES

1. *Loyalty*

The duty of loyalty in Delaware imposes on the director an obligation to refrain from doing anything that would effect an injury to the corporation, or deprive it of profits or advantages which the director’s skill and ability might properly bring to the corporation, or enable the corporation to make in the reasonable and lawful exercise of its powers. The duty of loyalty requires an undivided and unselfish loyalty by the director to the corporation and demands that there not be any conflict between the director’s duty to the corporation and the self-interest of the director.⁷³

68. TEX. BUS. CORP. ACT ANN. art. 2.41(D) (Vernon Supp. 2000).

69. *Gearhart*, 741 F.2d at 719.

70. 830 F. Supp. 351 (S.D. Tex. 1993).

71. *Id.* at 355 (emphasis added).

72. *Id.* at 357 (emphasis added).

73. *Guth v. Loft*, 5 A.2d 503, 510 (Del. Ch. 1939) (“Corporate officers and directors are not permitted to use their position of trust and confidence to further their private

The standard which must be followed by a director in complying with the duty of loyalty will not be subject to any fixed schedule and will be dependent upon the facts and circumstances.⁷⁴

2. Care

a. Duty of Care

The duty of care under Delaware law is a duty that requires the director exercise his business judgment in the management of the corporation with due care and good faith. In 1962, the Delaware Supreme Court stated:

[D]irectors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances. Their duties are those of control, and whether or not by neglect they have made themselves liable for failure to exercise proper control depends upon the circumstances of and facts of the particular case.⁷⁵

This duty requires the director to inform himself of all material information reasonably available to him prior to making a decision.⁷⁶

b. Business Judgment Rule

The business judgment rule is premised on the fact that courts are ill equipped to engage in substantive reviews of business decisions taken by directors in the management of their corporations and a public policy that encourages entrepreneurial risk taking by corporate managers without the specter of personal liability for decisions that in hindsight prove to be wrong or imprudent. In Delaware the business judgment rule provides that an independent corporate director who makes a business decision on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation will not be held personally liable for mistakes of business judgment that damage corporate interests.⁷⁷

interests . . . an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.”).

74. *Id.* at 514-15.

75. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1962).

76. *See Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

77. *In re J.P. Stevens & Co. Shareholders Litig.*, 542 A.2d 770, 780 (Del. Ch. 1988) (“a decision made by an independent board will not give rise to liability . . . if it is made in good faith and in the exercise of due care”); *Brehm v. Eisner*, 746 A.2d 244, 256 (Del. 2000) (evaluating charge that directors breached fiduciary duties in approving employment and subsequent severance of Michael S. Ovitz as president of The Walt Disney Company, and holding that the “issues of disinterestedness and independence” turn on whether the directors were “incapable due to personal interest or domination and control, of objectively evaluating” an action). *Brehm* followed in this respect, and overruled as to the standards for appellate review. *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) (addressing approval by directors of lucrative consulting contract with founder/controlling shareholder in his seventies that gave him a percentage of the corporation’s profits above a threshold without any requirement that he be able to work plus interest-free loans, the court found the directors “independent” because they had no financial interest in the transactions, al-

The business judgment rule in Delaware is both a presumption (i.e., a burden-allocating mechanism used in litigation), and a substantive rule of law. As a presumption, the rule provides that acts by independent directors will be presumed to have been taken with due care and good faith and in a belief that the act was in the best interest of the corporation.⁷⁸ The standard for liability under the Delaware business judgment rule is gross negligence.⁷⁹ Thus, a challenge to an action by an independent director requires the complaining party to prove that the action by the director was grossly negligent or was not taken in an honest attempt to foster the corporation's interests. As a substantive rule of law, the business judgment rule provides that there is no liability to a director for authorizing a corporate action if the director acted in good faith and with appropriate care in informing himself of all material information reasonably available to him under the circumstances.⁸⁰

c. Duty of Oversight

The Delaware Court of Chancery has suggested that business judgment protection is unavailable where directors failed to act because they were ignorant of the operative facts.⁸¹ In such a case, ordinary negligence would be the standard by which the directors' conduct is measured.⁸²

Other decisions, however, indicate that director inaction will be entitled to some level of protection. The Delaware Supreme Court has made clear that director inaction standing alone is not determinative, and "a conscious decision to refrain from acting may none the less be a valid exercise of business judgment and enjoy the protections of the [business judgment] rule."⁸³ Thus, a conscious decision not to act should be measured by the business judgment rule, with the likely result that an informed decision not to act would be protected.

Because deliberate inaction is protected by the business judgment rule, the focus in a director inaction case must be on the process by which the

though they were dependent upon the founder for their positions, and applied business judgment rule).

78. *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986) (stating that business judgment rule is "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company").

79. *See Van Gorkom*, 488 A.2d at 873.

80. *Brehm v. Eisner*, 746 A.2d 244, 259 ("[T]he standard for judging the informational component of the directors' decision does not mean that the Board must be informed of every fact. The Board is responsible for considering only material facts that are reasonably available, not those that are immaterial or out of the board's reasonable reach." The "term 'material' is used in this context to mean relevant and of a magnitude to directors in carrying out their fiduciary care in decisionmaking," which is "distinct from the use of the term 'material' in disclosure to stockholders in which [a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.").

81. *Rabkin v. Philip A. Hunt Chem. Corp.*, 1987 Del. Ch. LEXIS 522, 1987 WL 28436, at *1 (Del. Ch.).

82. *Id.*

83. *Aronson*, 473 A.2d at 813.

decision not to act was made. In *In re Caremark International, Inc. Derivative Litigation*,⁸⁴ the Delaware Court of Chancery approved the settlement of a derivative action that involved claims that members of Caremark's board of directors breached their fiduciary duty of care to the company in connection with alleged violations by the company of anti-referral provisions of Federal Medicare and Medicaid statutes. In so doing, the court discussed the scope of a board of directors' duty to supervise or monitor corporate performance and to stay informed about the business of the corporation as follows:

[I]t would . . . be a mistake to conclude . . . that corporate boards may satisfy their obligations to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.⁸⁵

Stated affirmatively, "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may . . . render a director liable."⁸⁶ While *Caremark* recognizes a cause of action for uninformed inaction the holding is subject to the following:

First, the court held that "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."⁸⁷ It is thus not at all clear that a plaintiff could recover based on a single example of director inaction, or even a series of examples relating to a single subject.

Second, *Caremark* noted that "the level of detail that is appropriate for such an information system is a question of business judgment,"⁸⁸ which indicates that the presence of an existing information and reporting system will do much to cut off any derivative claim, because the adequacy of the system itself will be protected.

Third, *Caremark* considered it obvious that "no rationally designed information system . . . will remove the possibility" that losses could occur.⁸⁹ As a result, "[a]ny action seeking recovery for losses would logically entail a judicial determination of proximate cause."⁹⁰ This holding indicates that a loss to the corporation is not itself evidence of an

84. 698 A.2d 959 (Del. Ch. 1996).

85. *Id.* at 970.

86. *Id.*

87. *Id.* at 971.

88. *Id.* at 970.

89. *Id.*

90. *Id.* at 970 n.27.

inadequate information and reporting system. Instead, the court will focus on the adequacy of the system overall and whether a causal link exists.⁹¹

Delaware has also imposed a duty of candor. The duty of candor in Delaware is an unremitting obligation of a director to fair dealing with the corporation.⁹² This duty requires disclosure to stockholders of “all germane or material information”⁹³ and information that “would have been viewed by the reasonable investor as having significantly altered the “total mix of information made available.”⁹⁴ This duty requires, at a minimum, that a director not use superior information or knowledge to mislead others in the performance of their fiduciary obligations to the corporation, and the breach thereof can be established without any showing that the directors acted with *scienter*. The judicial focus in the reported cases has been on information related to the process followed by the directors leading up to its decision to recommend that the shareholders approve a transaction and to the relative value to be received by the shareholders, rather than on compliance with Securities and Exchange Commission (“SEC”) disclosure rules.⁹⁵

3. Standard of Review in Change-of-Control Context

Before the Delaware Supreme Court’s decision in *Unocal Corp. v. Mesa Petroleum Co.*,⁹⁶ it was believed that (in the absence of a traditional conflict of interest) director action would be afforded the protection of the business judgment rule which respected adequately informed business decisions. Beginning with *Unocal*, however, the conduct of directors was subjected to “enhanced scrutiny” in circumstances involving a change in control where a traditional conflict of interest was absent. This places a burden on directors not only to be adequately informed but also to have “acted reasonably.”⁹⁷ The range of reasonableness addressed by enhanced scrutiny may be a middle ground between the “any rational purpose” standard deferred to under the business judgment rule and the “entire fairness” sought for transactions in which directors or other affili-

91. See generally Melvin A. Eisenberg, *Corporate Governance The Board of Directors and Internal Control*, 19 CARDOZO L. REV. 237 (1997); Harvey L. Pitt et al., *Talking the Talk and Walking the Walk: Director Duties to Uncover and Respond to Management Misconduct*, 1005 PLI/CORP. 301, 304 (1997); Richard S. Gruner, *Director and Officer Liability for Defective Compliance Systems: Caremark and Beyond*, 995 PLI/CORP. 57, 64-70 (1997); Stephen F. Funk, *Recent Developments in Delaware Corporate Law: In re Caremark International Inc. Derivative Litigation: Director Behavior, Shareholder Protection, and Corporate Legal Compliance*, 22 DEL. J. CORP. L. 311 (1997).

92. *Mills Acquisition Co. v. Macmillan, Inc.*, No. 10168, 1988 WL 108332 (Del. Ch. 1988), *rev'd*, 559 A.2d 1261 (Del. 1989).

93. *Stroud v. Milliken Enters., Inc.*, 552 A.2d 476, 480 (Del. 1989).

94. *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 846 (Del. 1987); see also *Day v. Quotron Sys., Inc.*, No. 8502, 16 DEL. J. CORP. L. 297, 306-07 (Del. Ch. 1989).

95. See generally, Donald F. Pease, *Delaware’s Disclosure Rule: The “Complete Candor” Standard, Its Application, and Why Sue in Delaware*, 14 DEL. J. CORP. L. 445 (1989).

96. 493 A.2d 946, 954 (Del. 1985).

97. *Paramount Commun., Inc. v. QVC Network, Inc.* 637 A.2d 34, 45 (Del. 1994)

ates have an interest.⁹⁸

Enhanced scrutiny was initially the product of court review of defensive techniques used to respond to an unwanted suitor.⁹⁹ The burden of enhanced scrutiny was extended to director responses to competing bids when a decision is made to sell a company.¹⁰⁰ More recently, in *QVC*, the Delaware Supreme Court suggested that enhanced scrutiny is applicable to change in control transactions generally: "In the sale of control context, the directors must focus on one primary objective—to secure the transaction offering the best value reasonably available for the stockholders."¹⁰¹

A merger or other business combination in which stockholders are *cashied out* or one in which a stockholder or an affiliated group of stockholders of the corporation *control* the continuing entity is generally viewed as a "sale of control" because the transaction at hand represents the only opportunity to receive a control premium. Delaware courts have held, however, that control is generally *not* affected by a "stock for stock" merger, where as a majority of the shares in the continuing entity will continue to be held after the merger by a "fluid aggregation of unaffiliated shareholders representing a voting majority."¹⁰² This type of transaction is not considered a change of control because the target stockholders continue to have the opportunity to receive a control premium, even if the target stockholders will represent only a minority of the ongoing entity.¹⁰³

4. *Entire Fairness*

Both the Delaware business judgment rule and the Delaware enhanced scrutiny standard should be contrasted with the standard applied in transactions with affiliates. In reviewing board action in transactions involving management, board members, or a principal shareholder, the Delaware Supreme Court has imposed an "entire fairness" standard.¹⁰⁴ Under this standard the burden is on directors to show both fair dealing and a fair price:

The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the

98. *Unocal*, 493 A.2d at 949 (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)).

99. *See id.* at 949-53; *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1348-50 (Del. Supr. 1985).

100. *See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* 506 A.2d 173, 182 (Del. 1986) (stating that where the directors have determined that a sale of control or breakup of the company is "inevitable," their duty is "the maximization of the company's value at a sale for the stockholders' benefit").

101. *QVC*, 637 A.2d at 44.

102. *Paramount Commun., Inc. v. Time, Inc.*, 571 A.2d 1140, 1150 (Del. 1989); *Arnold v. Society for Savings Bancorp, Inc.*, 650 A.2d 1270, 1290 (Del. 1994).

103. *Time*, 571 A.2d at 1151.

104. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983); *see also Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989).

directors, and how the approvals of the directors and the stockholders were obtained. The later aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.¹⁰⁵

The burden shifts to the plaintiff to show the transaction was unfair where (i) the transaction was approved by the majority of the minority shareholders, though the burden remains on the directors to show that they completely disclosed all material facts relevant to the transaction,¹⁰⁶ or (ii) the transaction was negotiated by a special committee of independent directors that was truly independent, not coerced, and had real bargaining power.¹⁰⁷ However, application of the "entire fairness" standard will vary from case to case:

The judgment whether a transaction satisfies the fairness test is, however, not a bifurcated one but is a single judgment that considers each of these aspects. In some contexts price may be a relatively minor or an inapplicable consideration. In other contexts price may predominate as a salient consideration. Plainly in a cash-out merger, price is a dominant concern, most especially where the buyer already has voting control of the enterprise, such as a parent-sub merger. . . . But in a cash-out merger that is the second step of an arm's-length transaction, the presumed reliance by the shareholders on the integrity of the process by which the price recommended by the board was arrived at, makes the fairness and adequacy of the process a more significant factor in assessing overall fairness than in the parent-sub merger context.¹⁰⁸

5. *Action Without Bright Lines*

Whether the burden will be on the party challenging board action under the business judgment rule or on the directors under enhanced scrutiny, the care with which the directors acted in a change-in-control transaction will be subjected to a close review. For this review there will be no "bright-line" tests, and it may be assumed that the board may be called upon to show care commensurate with the importance of the decisions made, whatever they may have been in the circumstances. Thus directors, and those advising them, are faced with the words of the *QVC* court as it left other scenarios for another day:

Unsolicited tender offers in other contexts may be governed by different precedent. For example, where a potential sale of control by a corporation is not the consequence of a board's action, this Court has recognized the prerogative of a board of directors to resist a third party's unsolicited acquisition proposal or offer. The decision

105. *Weinberger*, 457 A.2d at 711.

106. *Id.* at 703.

107. *See Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994).

108. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1140 (Del. Ch. 1994) (citations omitted).

of a board to resist such an acquisition, like all decisions of a properly-functioning board, must be informed, and the circumstances of each particular case will determine the steps that a board must take to inform itself, and what other action, if any, is required as a matter of fiduciary duty.¹⁰⁹

In *Moran v. Household International, Inc.*,¹¹⁰ the Supreme Court of Delaware considered a shareholder rights plan adopted not during a takeover contest, "but as a preventive mechanism to ward off future advances."¹¹¹ The court upheld the pre-planned poison pill but noted that its ruling was not absolute. The court determined that when a board of directors "is faced with a tender offer and a request to redeem the [rights plan], they will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism."¹¹²

E. FIDUCIARY DUTIES/LIABILITIES OF OFFICERS

Under both Texas and Delaware law, a corporate officer owes a fiduciary duty to the corporation and may be sued in a corporate derivative action just as a director may be.¹¹³ Derivative claims against officers for failure to exercise due care in carrying out their responsibilities as assigned by the board of directors are uncommon.

A corporate officer is an agent of the corporation.¹¹⁴ If an officer commits a tort while acting for the corporation, under the law of agency, the officer is liable personally for his actions.¹¹⁵ The corporation may also be liable under *respondent superior*.

F. CONSEQUENCES OF BREACH

1. Equitable Relief

Many of the reported fiduciary-duty cases, particularly in the arena of contested acquisitions, arise in the context of injunctive proceedings. Frequently, the plaintiff seeks to invalidate defenses such as poison pills.¹¹⁶

109. *QVC*, 637 A.2d at 43 n.13 (citations omitted); see also *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989) ("there is no single blueprint that a board must follow to fulfill its duties. A stereotypical approach to the sale and acquisition of corporate control is not to be expected in the face of the evolving techniques and financing devices employed in today's corporate environment.").

110. 500 A.2d 1346 (Del. 1985).

111. *Id.* at 1349.

112. *Id.* at 1354; see also *Quickturn Design Sys., Inc. v. Mentor Graphics Corp.*, 721 A.2d 1281 (Del. 1998); *Unitrin Inc. v. American Gen. Corp.*, 651 A.2d 1361 (Del. 1995); *Moore Corp. Ltd. v. Wallace Computer Servs.*, 907 F. Supp. 1545 (D. Del. 1995).

113. See *Faour v. Faour*, 789 S.W.2d 620, 621 (Tex. App.—Texarkana 1990, writ denied); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

114. *Joseph Greenspon's Sons Iron & Steel Co. v. Pecos Valley Gas Co.*, 156 A. 350 (Del. Ch. 1931); *Hollaway v. Skinner*, 898 S.W.2d 793, 795 (Tex. 1995).

115. *Dana M. Muir & Cindy A. Schipani, The Intersection of State Corporation Law and Employee Compensation Programs: Is it Curtains for Veil Piercing?* 1996 U. ILL. L. REV. 1059, 1078-1079 (1996).

116. See *Gearhart*, 741 F.2d at 712.

Courts can also order judicial dissolution of a merger that has already been consummated.¹¹⁷

2. Damages

Courts can also award actual and punitive damages for breach of fiduciary duty.¹¹⁸ However, there is probably some judicial reluctance to award substantial damages where there is no selfdealing or other personal benefit on the part of the defendant directors.¹¹⁹

Recovery for breach of fiduciary duties owed by a director to the corporation ordinarily belongs to the corporation and may be recovered through a derivative action on behalf of the corporation.¹²⁰ A director does not owe fiduciary duties to an individual shareholder unless there is some contract or special relationship with the shareholder.¹²¹

3. Aiders and Abettors

Any person who knowingly participates in a director's breach of fiduciary duty can be personally liable to the corporation's shareholders.¹²²

V. STATUTORY COMPARISON

Additional important differences between Texas and Delaware corporation law lie in the corporation statutes themselves. Imbedded in the Texas statute is an underlying public policy favoring the freedom of contract and a desire to provide flexibility to corporations in managing their internal affairs and corporate lives. The following sets forth a discussion of certain of the major distinctions between the Texas Business Corporation Act ("TBCA") and the Delaware General Corporate Law ("DGCL") unless otherwise indicated.

117. See *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 386 (1970).

118. See, e.g., *Van Gorkom*, 488 A.2d at 893 (holding directors who voted for merger of the corporation with an unaffiliated entity in an arms-length transaction not involving any selfdealing personally liable for difference between amount of consideration received and the fair value of the corporation's shares because they failed "to inform themselves of all information reasonably available to them and relevant to their decision to recommend the [merger]").

119. See Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEXAS L. REV. 591 (1983).

120. *Wingate v. Hajdik*, 795 S.W.2d 717, 719 (Tex. 1990).

121. See *Faour*, 789 S.W.2d at 622, *Schautteet v. Chester State Bank*, 707 F. Supp. 885, 887 (E.D. Tex. 1988).

122. See Ronald A. Brown, Jr., *Claims of Aiding and Abetting a Director's Breach of Fiduciary—Does Everybody Who Deals with a Delaware Director Owe Fiduciary Duties to that Director's Shareholders?*, 15 DEL. J. CORP. L. 943 (1990).

A. DIRECTOR DUTIES AND LIABILITIES

1. *Limitation of Director Liability—Article 1302-7.06 of the TMCL and Section 102(b)(7) of the DGCL*

In response to the director and officer liability insurance crisis of the 1980s and a concern about the ability of corporations to attract and retain qualified persons willing to serve as directors in light of *Van Gorkom* (holding outside directors liable for a hasty and imprudent business decision),¹²³ both Texas and Delaware adopted statutes expressly authorizing corporations to limit the liability of their directors for certain matters. The limitations permitted by the Texas and Delaware statutes are based on long-standing fiduciary and contract principles that permit parties to establish by contract the duties of a fiduciary subject to public policy limitations.

The Texas limitation on director liability is set forth in article 1302-7.06 of the Texas Miscellaneous Corporation Laws (the "TMCL").¹²⁴ A Texas corporation may include a provision in its articles of incorporation that eliminates or limits the liability of a director to his corporation and the corporation's shareholders for monetary damages for any act or omission in the director's capacity as a director except where the director is found liable under one of the following four circumstances. Those circumstances are where the director is found to be liable for (i) a breach of the director's duty of loyalty, (ii) an act or omission not in good faith that constitutes a breach of duty of the director or an act or omission that involves intentional misconduct or a knowing violation of law, (iii) a transaction from which the director received an improper personal benefit, and (iv) an act or omission for which liability of a director is expressly provided by an applicable statute.¹²⁵ Article 1302-7.06, through its description of exceptions, is essentially a codification of the standard of liability of directors articulated in *Gearhart*.¹²⁶ It assures corporations that include this provision in their articles of incorporation that the *Gearhart* standards of liability (fraud, *ultra vires*, and breach of duty of loyalty) will be the applicable standard for their directors even if the standard of liability for a director under the business judgment rule in Texas is ultimately determined to be gross negligence as envisioned by *Resolution Trust Corp. v. Norris*¹²⁷ and *FDIC v. Brown*.¹²⁸

Section 102(b)(7) of the DGCL similarly provides a means for a corporation to limit the liability of a director through a provision contained in the corporation's certificate of incorporation.¹²⁹ Like the Texas statute, section 102(b)(7) permits the elimination or limitation of liability of a

123. See *supra* note 76 and accompanying text.

124. TEX. REV. CIV. STAT. ANN. art. 1302-7.06 (Vernon 1980 & Supp. 1999-2000).

125. *Id.* art. 1302-7.06(B).

126. *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 719-22 (5th Cir. 1984).

127. 830 F. Supp. 351, 357-58 (S.D. Tex. 1993).

128. 812 F. Supp. 722, 725-26 (S.D. Tex. 1992).

129. DEL. CODE ANN. tit. 8, § 102(b)(7) (1991 & Supp. 1998).

director for breaches of fiduciary duty except under enumerated circumstances: (i) a breach of a duty of loyalty, (ii) an act or omission not in good faith or involving “intentional misconduct or a knowing violation of law,” (iii) certain unlawful distributions, and (iv) transactions in which the director derived “an improper person benefit.”¹³⁰

2. *Indemnification—Article 2.02-1 of the TBCA and Section 145 of the DGCL*

Both Texas and Delaware permit corporations to indemnify their directors and officers for liabilities incurred by serving as directors or officers of their corporations or of other corporations and entities at the request of their corporations.

Under TBCA art. 2.02-1, there are two standards for indemnification for directors depending on whether the indemnification arrangement has been approved by shareholders.¹³¹ Where the indemnification has not been approved by shareholders, the scope and right to indemnification will be limited by law and be dependent on whether the conduct of the director met certain specified standards.¹³² Where the indemnification is approved by shareholders, the corporation will be permitted to provide indemnification for acts of the director that may not otherwise be subject to indemnification under the statute.¹³³ As a result, under Texas law, a corporation and its shareholders may in essence establish its own standards and criteria for defining when and under what terms and circumstances indemnification will be made available. Expenses may also be advanced to a director in respect of a proceeding if the corporation receives a written affirmation of the director’s good faith belief that the director has met the standards for indemnification and undertakes to reimburse the corporation for the expenses if it is ultimately determined that the director did not meet the standard or is otherwise not entitled to indemnity.¹³⁴ Indemnification of officers and other persons other than directors in Texas is restricted only by concepts of public policy.

Sections B and C of article 2.02-1 of the TBCA sets forth the general standard of conduct that will permit a corporation to provide indemnification when shareholder approval is not obtained.¹³⁵ These provisions provide that a corporation may indemnify a director for liabilities and expenses in respect of actions brought against the director by reason of serving as a director or officer of the corporation (or of another entity at the request of the corporation) if the conduct of the director was in good faith and the director reasonably believed that (i) in the case of conduct in the director’s official capacity as a director, the director’s conduct was in the corporation’s best interests, and (ii) in all other cases, the director’s

130. *Id.*

131. TEX. BUS. CORP. ACT ANN. art. 2.02-1 (Vernon Supp. 1999-2000).

132. *Id.* art. 2.02-1(K).

133. *Id.* art. 2.02-1(B).

134. *Id.* art. 2.02-1(K).

135. *Id.* art. 2.02-1(B), (C).

conduct was at least not opposed to the best interest of the corporation.¹³⁶ Indemnification for criminal actions also requires a director to have had no reasonable cause to believe the director's conduct was unlawful.¹³⁷ In addition, if a director is found liable to the corporation or on the basis that a personal benefit was improperly received by him, indemnification will be limited to expenses actually incurred and will not be available if the director is found liable for willful or intentional misconduct in the performance of the director's duty to the corporation.¹³⁸

Although the scope of indemnification is subject to limitation where shareholder approval has not been obtained, article 2.02-1(R) provides a broad exception to this rule. Under TBCA art. 2.02-1(R), a corporation with the approval of its shareholders may adopt any form of indemnification arrangement with its directors covering all forms of liability and standards of conduct, including conduct and liabilities that the corporation would otherwise lack power to indemnify under article 2.02-1.¹³⁹ This provision was adopted to address the difficulties experienced by many corporations in obtaining liability insurance for directors and officers and provides corporations with substantial flexibility in establishing indemnification arrangements to cover liabilities that could be insured against but would not otherwise be within the scope of indemnity permitted by the statute. Section R also specifically authorizes alternative forms of indemnification arrangements, including self-insurance, the creation of trust funds to pay indemnification claims, and indemnification contracts.¹⁴⁰ In the absence of fraud, the judgment of directors as to the terms of an indemnification arrangement adopted in accordance with article 2.02-1 will be conclusive and will not be voidable or subject the directors to liability on any ground.¹⁴¹ This exculpatory provision is intended to address the potential conflict of interest issues that arise when directors approve indemnification arrangements that benefit themselves and overrides the provisions of article 2.35-1 of the TBCA (discussed below).

In contrast to the TBCA, the DGCL provides only one standard for indemnification, whether or not approved by stockholders. Under section 145 of the DGCL, a director or officer may be indemnified if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the interest of the corporation, and, in the case of a criminal action or proceeding, had no reasonable ground to believe his conduct was unlawful.¹⁴² If the action is in the name of the corporation, no indemnification may be provided if the person is adjudged liable unless the court determines that such indemnification is proper.¹⁴³ Expenses may

136. *Id.* art. 202-1(B)(1), (2).

137. TEX. BUS. CORP. ACT ANN. art. 2.02-1(B)(3) (Supp. 1999-2000).

138. *Id.* art. 2.02-1(E).

139. *Id.* art. 2.02-1(R).

140. *Id.* art. 2.02-1(R).

141. *Id.* art. 2.02-1(R).

142. DEL. CODE ANN. tit. 8, § 145(a) (1991 & Supp. 1998).

143. *Id.* § 145(b).

also be advanced to a director or officer on an undertaking that the amounts advanced will be repaid if it is ultimately determined that the director or officer is not entitled to indemnification.¹⁴⁴ Like the TBCA, section 145(f) of the DGCL provides that the indemnification permitted by statute is not exclusive.¹⁴⁵ However, unlike the TBCA, uncertainties exist as to the ability of a corporation to expand the scope of conduct for which indemnification may be provided beyond the statute, particularly where the indemnification relates to a proceeding by or in the name of the corporation.

3. *Interested Director Transactions—Article 2.35-1 of the TBCA and Section 144 of the DGCL*

Both Texas and Delaware have embraced the principle that a transaction or contract between a director and the director's corporation is presumed to be valid and will not be voidable solely by reason of the director's interest so long as certain conditions are met.

Section 144 of the DGCL provides that a contract between a director and the director's corporation will not be voidable due to the director's interest if (i) the transaction or contract is approved in good faith by a majority of the disinterested directors after the material facts as to the relationship or interest and as to the transaction or contract are disclosed or known to the directors, (ii) the transaction or contract is approved in good faith by shareholders after the material facts as to the relationship or interest and as to the transaction or contract is disclosed or known to the shareholders, and (iii) the transaction or contract is fair to the corporation as of the time it is authorized, approved, or ratified by the directors or shareholders of the corporation.¹⁴⁶ In *Flieger v. Lawrence*, however, the Delaware Supreme Court held that a transaction or contract may still be set aside and liability imposed on a director if the transaction is not fair to the corporation even if approved by the corporation's board or shareholders as contemplated by the statute.¹⁴⁷

In 1985, Texas followed Delaware's lead in the area of interested director transactions and adopted article 2.35-1 of the TBCA.¹⁴⁸ In general, article 2.35-1 provides that a transaction between a corporation and one or more of its directors or officers will not be voidable solely by reason of that relationship if the transaction is approved by shareholders or disinterested directors after disclosure of the interest, or if the transaction is otherwise fair.¹⁴⁹ Although Article 2.35-1 is essentially identical to § 144 of the DGCL, some uncertainty on the scope of Article 2.35-1 arose because of *Flieger's* interpretation of § 144. This imposition of a fairness

144. *Id.* § 145(e).

145. *Id.* § 145(f).

146. *Id.* § 144(a).

147. *See Flieger v. Lawrence*, 361 A.2d 218, 222 (Del. 1976).

148. TEX. BUS. CORP. CODE ANN. art. 2.35-1 (Supp. 1996).

149. *Id.*

gloss on the Texas statute rendered the effect of the safe harbor provisions in article 2.35-1 uncertain.

In 1997, article 2.35-1 of the TBCA was amended to address the ambiguity created by *Flieger* and to clarify that contracts and transactions between a corporation and its directors and officers or in which a director or officer has a financial interest are valid notwithstanding that interest as long as any one of the following are met: (i) the disinterested directors of the corporation approve the transaction after disclosure of the interest, (ii) the shareholders of the corporation approve the transaction after disclosure of the interest or (iii) the transaction is fair.¹⁵⁰ Under the statute, if any one of these conditions is met, the contract will be considered valid notwithstanding the director or officer has an interest in the transaction.¹⁵¹ Article 2.35-1 relies heavily on the statutory definition of “disinterested” contained in Article 1.02.¹⁵² Under the definition, a director will be considered “disinterested” if the director is not a party to the contract or transaction or does not otherwise have a material financial interest in the outcome of the contract.¹⁵³

Article 2.35-1 also changed the general approach of the statute from a mere presumption that a contract is not voidable by reason of the existence of an affiliated relationship if certain conditions are met to an absolute safe harbor that provides that an otherwise valid contract will be valid if the specified conditions are met.¹⁵⁴ Although the difference between the Texas and Delaware constructions is subtle, the distinction is significant and provides more certainty as transactions are structured. However, article 2.35-1 does not eliminate a director’s or officer’s fiduciary duty to the corporation.

4. *Director Consideration of Long-Term Interests*

It has been implicit under Texas law that a director may consider the long-term interests of the corporation. However, because short-term market valuations of a corporation may not always reflect the benefits of long-term decisions and inherent long-term values, article 13.06 was added to the TBCA in 1997 to expressly allow directors to consider the long-term interests of a corporation and its shareholders when considering actions that affect the interest of the corporations.¹⁵⁵ Although this provision was viewed as a mere codification of existing law, it was intended to eliminate any ambiguity that might exist as to the right of a board of directors to consider long-term interests when evaluating a take-over proposal. There is no similar provision in the DGCL.

150. *Id.* art. 2.35-1 (Supp. 2000).

151. *Id.* art. 2.35-1(A)

152. *Id.* art. 1.02(A)(12).

153. *Id.*

154. Compare TEX. BUS. CORP. ACT ANN. art. 2.35-1(A) (Supp. 1996) with TEX. BUS. CORP. ACT ANN. art. 2.35-1(A) (Supp. 2000).

155. TEX. BUS. CORP. ACT ANN. art. 13.06 (Supp. 2000).

5. *Director Elections and Removal*

Both Texas and Delaware provide that the board of directors of a corporation may consist of one or more persons. Directors are to be elected annually under both laws.¹⁵⁶ Corporations may, however, provide for a classification of their boards into two or three classes having two and three year terms, respectively.¹⁵⁷ Corporations may also provide for special classes of directors, with such terms of office and voting rights as may be provided in their charters.¹⁵⁸ These latter provisions permit the creation of what could be called super directors, with generally unlimited terms and voting rights. In addition, in recognition of the special nature of investment companies, Texas law permits a registered investment company to provide for any director terms without regard to annual elections.¹⁵⁹ A similar provision is not found in Delaware.

Vacancies, whether by resignation, death, removal, or by reason of an increase in the size of the board, may be filled by the remaining members of the board under both Texas and Delaware law.¹⁶⁰ Texas law, however, limits the number of vacancies that may be filled by action of the board where the vacancy is created through an increase in the size of the board to two persons during the period between any two successive annual meetings.¹⁶¹

Directors in Delaware may be removed by a vote of the shareholders entitled to vote in the election of that director, with or without cause, unless the board of directors is classified. In such a case, unless the certificate of incorporation provides otherwise, directors may only be removed for cause.¹⁶² Texas takes a different approach and provides that, whether or not the board of directors is classified, directors may be removed only for cause unless otherwise provided by the articles of incorporation or bylaws of the corporation.¹⁶³ The removal of a director under Texas law may also be subject to such further restrictions as may be provided in the corporation's bylaws.¹⁶⁴

6. *Director Actions and Quorums*

Actions by the board of directors in both Texas and Delaware may be taken either at a meeting (in person or by telephone) or by unanimous

156. *Id.* art. 2.32(A) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 211(b) (Supp. 1998).

157. DEL. CODE ANN. tit. 8, § 141(d).

158. TEX. BUS. CORP. ACT ANN. art. 2.32(A) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 141(d) (1991).

159. TEX. BUS. CORP. ACT ANN. art. 2.32(B) (Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 141(d) (1991).

160. TEX. BUS. CORP. ACT ANN. art. 2.34 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 223 (1991).

161. TEX. BUS. CORP. ACT ANN. art. 2.34(C) (Vernon Supp. 1999-2000). Delaware has no similar restriction.

162. DEL. CODE ANN. tit. 8, § 141(k) (Supp. 1998).

163. TEX. BUS. CORP. ACT ANN. art. 2.32(C) (Vernon Supp. 1999-2000).

164. *Id.*

written consent.¹⁶⁵ Unless otherwise provided in the charter or bylaws of the corporation, a quorum for a meeting of a board of directors is defined to be a majority of the number of directors constituting the whole board.¹⁶⁶ This quorum requirement may be reduced in both Texas and Delaware to one-third of the board.¹⁶⁷

7. *Committees of the Board*

Both Texas and Delaware provide that the board of directors may delegate authority to committees of the board subject to limitations on delegation for fundamental corporate transactions.¹⁶⁸ Among the matters that a committee of a board of directors will not have the authority to approve are (i) charter amendments, except to the extent such amendments are the result of the issuance of a series of stock permitted to be approved by a board of directors, (ii) approving a plan of merger or similar transaction, (iii) recommending the sale of all or substantially all of the assets of the corporation outside the ordinary course of its business, (iv) recommending a voluntary dissolution of the corporation and (v) amending bylaws or creating new bylaws of the corporation.¹⁶⁹ In addition, under Texas law, a committee of the board of directors may not fill any vacancy on the board of directors, remove any officer, fix the compensation of a member of the committee or amend or repeal a resolution approved by the whole board to the extent that such resolution by its terms is not so amendable or repealable.¹⁷⁰ Further, under both Texas and Delaware law, no committee of a board of directors has the authority to authorize a distribution (a dividend in the case of Delaware law) or authorize the issuance of stock of a corporation unless that authority is set forth in the charter or bylaws of the corporation.¹⁷¹ Alternative members may also be appointed to committees under both states' laws.¹⁷²

8. *Liability for Unlawful Distributions*

Both Texas and Delaware impose personal liability on directors who authorize the payment of distributions to shareholders (including share

165. TEX. BUS. CORP. ACT ANN. art. 9.10(B) (Vernon 1980); DEL. CODE ANN. tit. 8, § 141(f), (i) (1991).

166. TEX. BUS. CORP. ACT ANN. art. 2.35 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 141(b) (Supp. 1998).

167. TEX. BUS. CORP. ACT ANN. art. 2.35 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 141(b) (Supp. 1998).

168. TEX. BUS. CORP. ACT ANN. art. 2.36 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 141(c) (1991).

169. TEX. BUS. CORP. ACT ANN. art. 2.36 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 141(c) (1991).

170. TEX. BUS. CORP. ACT ANN. art. 2.36(B) (Vernon Supp. 1999-2000).

171. TEX. BUS. CORP. ACT ANN. art. 2.36(C) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 141(c)(1). See *infra* note 317 and accompanying text for information regarding the Delaware and Texas provisions governing dividends and distributions to shareholders. DEL. CODE ANN. tit. 8, § 141(c)(1) (Supp. 1998).

172. TEX. BUS. CORP. ACT ANN. art. 2.36(A) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 141(c)(1).

purchases) in violation of the statutory requirements.¹⁷³

Under Delaware law, liability for an unlawful distribution extends for a period of six years to all directors other than those who expressly dissent, with the standard of liability being negligence.¹⁷⁴ Section 172 of the DGCL, however, provides that a director will be fully protected in relying in good faith on the records of the corporation and such other information, opinions, reports, and statements presented to the corporation by the corporation's officers, employees and other persons. This applies to matters that the director reasonably believes are within that person's professional or expert competence and have been selected with reasonable care as to the various components of surplus and other funds from which distributions may be paid or made.¹⁷⁵ Directors are also entitled to receive contribution from other directors who may be liable for the distribution and are subrogated to the corporation against shareholders who received the distribution with knowledge that the distribution was unlawful.¹⁷⁶ Under the TBCA, liability for an unlawful distribution extends for two years instead of six years and applies to all directors who voted for or assented to the distribution (assent being presumed if a director is present and does not dissent).¹⁷⁷ A director will not be liable for an unlawful distribution if *at any time* after the distribution, it would have been lawful.¹⁷⁸ A similar provision does not exist in Delaware. A director will also not be liable under the TBCA for an unlawful distribution if the director:

(i) relied in good faith and with ordinary care on information relating to the calculation of surplus available for the distribution under TBCA art. 2.38-3;

(ii) relied in good faith and with ordinary care on financial and other information prepared by officers or employees of the corporation, a committee of the board of directors of which he is not a member or legal counsel, investment bankers, accountants and other persons as to matters the director reasonably believes are within that person's professional or expert competence;

(iii) in good faith and with ordinary care, considered the assets of the corporation to have a value equal to at least their book value; or

(iv) when considering whether liabilities have been adequately provided for, relied in good faith and with ordinary care upon financial statements of, or other information concerning, any other person that is contractually obligated to pay, satisfy, or discharge those liabilities.¹⁷⁹

173. TEX. BUS. CORP. ACT ANN. art. 2.41(A)(i) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 174(a) (Supp. 1998).

174. DEL. CODE ANN. tit. 8, § 174 (1991 & Supp. 1998).

175. *Id.*

176. DEL. CODE ANN. tit. 8, § 174(b) (1991).

177. TEX. BUS. CORP. ACT ANN. art. 2.41(A) (Vernon Supp. 1999-2000).

178. *Id.*

179. TEX. BUS. CORP. ACT ANN. art. 2.41(C), (D).

As in Delaware, a director held liable for an unlawful distribution under the TBCA will be entitled to contribution from the other directors who may be similarly liable. The director can also receive contribution from shareholders who received and accepted the distribution knowing it was not permitted in proportion to the amounts received by them.¹⁸⁰ The TBCA also expressly provides that the liability of a director for an unlawful distribution provided for under article 2.41 is the only liability of the director for the distribution to the corporation or its creditors, thereby negating any other theory of liability of the director for the distribution such as a separate fiduciary duty to creditors or a tortious violation of the Uniform Fraudulent Transfer Act.¹⁸¹ No similar provision is found in the DGCL.

9. *Reliance on Reports and Opinions*

Both Texas and Delaware provide that a director in the discharge of his duties and powers may rely on information, opinions and reports prepared by officers and employees of the corporation and on other persons as to matters that the director reasonably believes are within that person's professional or expert competence.¹⁸² In Delaware, this reliance must be made in good faith and the selection of outside advisors must have been made with reasonable care.¹⁸³ In Texas, reliance must be made both in good faith and with ordinary care.¹⁸⁴

10. *Inspection of Records*

Both Texas and Delaware have codified the common law right of directors to examine the books and records of a corporation for a purpose reasonably related to the director's service as a director.¹⁸⁵

B. MERGERS, SHARE EXCHANGES, CONVERSIONS AND OTHER BUSINESS COMBINATIONS AND ASSET SALES

1. *General*

A fundamental distinction between Texas and Delaware corporation law is the treatment of mergers and business combinations. The principal distinctions between the two laws are primarily the result of major revisions adopted to the TBCA merger statutes in 1989 and 1997 to provide Texas corporations with greater flexibility in structuring acquisition or restructuring transactions and to provide a framework under which Texas corporations could engage in commercial transactions in an ever-chang-

180. *Id.* art. 2.41(E), (F).

181. *Id.* art. 2.41(G).

182. *See id.* art. 2.41(D) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 141(e) (Supp. 1998).

183. DEL. CODE ANN. tit. 8, § 141(e) (Supp. 1998); *see also* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

184. TEX. BUS. CORP. ACT ANN. art. 2.41(D) (Vernon Supp. 1999-2000).

185. TEX. BUS. CORP. ACT ANN. art. 2.44(B) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 220(d) (Supp. 1998).

ing global economy.¹⁸⁶

Among the transactions that may be effected under the TBCA that may not be effected under the DGCL are (i) a merger in which there are multiple surviving corporations and entities, (ii) a division of the assets and liabilities of a single corporation among multiple corporations and other entities through a statutory merger, (iii) a share exchange, and (iv) a conversion of a corporation into a general partnership or other form of entity without the necessity of completing a merger.¹⁸⁷ In addition, although Texas and Delaware both permit corporations to merge and combine with entities other than corporations, the TBCA permits a substantially wider range of transactions with a broader group of entities to be effected through statutory mergers than is currently permitted under the DGCL.

The TBCA also permits sales of assets by a corporation to be made without shareholder approval under many more circumstances than are permitted under Delaware law. Finally, the TBCA is clearer as to the exclusivity of the appraisal remedy for challenges by dissenting shareholders seeking monetary damages with respect to a merger or similar transaction.¹⁸⁸

2. *Conventional Mergers*

Both Texas and Delaware law permit corporations to merge with other corporations by adopting a plan of merger and obtaining the requisite shareholder approval.¹⁸⁹ Under Texas law, approval of a merger will generally require approval of the holders of at least two-thirds of the outstanding shares entitled to vote on the merger, while Delaware law provides that mergers may be approved by a vote of the holders of a majority of the outstanding shares.¹⁹⁰ As with other transactions, article 2.28 of the TBCA permits a corporation's articles of incorporation to reduce the required vote to an affirmative vote of the holders of a majority of the outstanding shares.¹⁹¹

Both Texas and Delaware permit a merger to be effected without shareholder approval if the corporation is the sole surviving corporation, the shares of stock of the corporation are not changed as a result of the merger and the total number of shares of stock issued pursuant to the merger does not exceed 20% of the shares of the corporation outstanding

186. Huff, *Choice of State of Incorporation*, *supra* note 3.

187. *Id.*

188. For a detailed discussion with respect to the Texas merger provisions and the types of transactions that may be effected thereunder, see generally Curtis W. Huff, *The New Texas Business Corporation Act Merger Provisions*, 21 ST. MARY'S L.J. 109 (1989).

189. See TEX. BUS. CORP. ACT ANN. art. 5.01 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 251-58 (1991 & Supp. 1998).

190. TEX. BUS. CORP. ACT ANN. art. 5.03(E) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 251(c) (Supp. 1998).

191. TEX. BUS. CORP. ACT ANN. art. 2.28.

immediately prior to the merger.¹⁹²

Board action on a plan of merger is required under both Texas and Delaware law. However, Texas law does not require that the board of directors approve the plan of merger, but rather it need only adopt a resolution directing the submission of the plan of merger to the corporation's shareholders.¹⁹³ Such a resolution must either recommend that the plan of merger be approved or communicate the basis for the board's determination that the plan be submitted to shareholders without any recommendation.¹⁹⁴ The TBCA's allowance of directors to submit a plan of merger to shareholders without recommendation is intended to address those few circumstances in which a board may consider it appropriate for shareholders to be given the right to vote on a plan of merger but for fiduciary or other reasons the board has concluded that it would not be appropriate for the board to make a recommendation.¹⁹⁵ Delaware law has no similar provision and requires that the board approve the agreement of merger and declare its advisability, and then submit the merger agreement to the stockholders for the purpose of their acting on the agreement.¹⁹⁶ Delaware, however, does permit a merger agreement to contain a provision requiring that the agreement be submitted to the stockholders whether or not the board of directors determines at any time subsequent to declaring its advisability that the agreement is no longer advisable and recommends that the stockholders reject it.¹⁹⁷

Under TBCA article 5.06A(2), when a merger takes effect, all rights, title, and interests to all property owned by each entity that is a party to the merger are allocated to and vested in one or more of the surviving or new entities as provided in the plan of merger without reversion or impairment, without further act or deed, and *without any transfer or assignment having occurred*, but subject to any existing liens or other encumbrances thereon.¹⁹⁸ Without an express statutory statement like TBCA article 5.06A(2) that the vesting of assets in a surviving entity is accomplished without a transfer or assignment having occurred, it is possible that a merger would be deemed to constitute a transfer in the context of a contract or license that required prior approval for a transfer or assignment. A limited number of cases in other jurisdictions have held that a merger constituted a transfer for such purposes.¹⁹⁹ The DGCL does not contain a provision comparable to the TBCA article 5.06A(2)

192. TEX. BUS. CORP. ACT ANN. art. 5.03(G) (Vernon Supp. 1999-2000); DEL. CODE ANN. § 251(f) (1991).

193. TEX. BUS. CORP. ACT ANN. art. 5.03(B)(1).

194. *Id.*

195. Huff, *Choice of State of Incorporation*, *supra* note 3, at 36-37.

196. *See* DEL. CODE ANN. tit. 8, § 251 (1991 & Supp. 1998).

197. *Id.*

198. TXO Prod. Co. v. M.D. Mark, Inc., 999 S.W.2d 137, 142 n.7 (Tex. Civ. App.—Houston [14th Dist.] 1999, *pet. denied*).

199. *See* Egan & French, *1987 Amendments supra* note 3; *see also*, Steven E. Ballew, *Assignment of Rights, Franchises and Obligations of the Disappearing Corporation in a Merger*, 38 BUS. LAW. 45 (1982) (discussing cases dealing with transfer of assets in a merger context).

statement that a merger does not involve a transfer.²⁰⁰

3. *Mergers with Other Entities*

Both Texas and Delaware permit the merger of corporations with other entities, including foreign corporations, non-profit corporations and limited partnerships. Texas, however, allows a wider range of entities to merge with Texas corporations than those that are permitted to merge with Delaware corporations under Delaware law.

The principal provisions of the TBCA authorizing mergers of corporations with other entities are found in articles 5.01, 5.03, and 5.06, which are the operative provisions that permit mergers with “other entities,” and article 1.02A(14), which defines what is an “other entity.”²⁰¹ An “other entity” is defined in the TBCA as any entity, whether organized for profit or not, that is a corporation, limited or general partnership, joint venture, joint stock company, cooperative, association, bank, insurance company or other legal entity organized pursuant to the laws of any state or country.²⁰² Thus, the only restrictions in Texas on the types of entities that a Texas corporation may merge with are those relating to the other entity.

The operative provisions of the DGCL with respect to mergers of corporations with other entities are found in DGCL §§ 251-264.²⁰³ Mergers with foreign corporations are governed under § 252, while mergers with or between non-stock and non-profit corporations are governed under DGCL §§ 255, 256, 257, and 258.²⁰⁴ Mergers with limited partnerships are governed under DGCL § 263. Although likely the least used, the most unique provision of the DGCL relating to mergers with other entities is found in § 254.²⁰⁵ Under this section, a Delaware corporation may merge with one or more joint-stock associations unless the laws under which the joint-stock association is formed forbid that type of merger.²⁰⁶ A “joint-stock association” is defined in § 254(a) as “any association of the kind commonly known as a joint-stock association or a joint-stock company and any unincorporated association, trust, or enterprise having members or having outstanding shares of stock or other evidences of financial or beneficial interest therein, whether formed by agreement or under statutory authority or otherwise, but not including a corporation, partnership, or limited liability company.”²⁰⁷

200. *Cf. Star Cellular Tel. Co., Inc. v. Baton Rouge CGSA, Inc.*, No. 12507, 1993 WL 294847 (Del. Ch. 1993), *aff'd*, 647 A.2d 382 (Del. 1994).

201. *See* TEX. BUS. CORP. ACT ANN. arts. 5.01, 5.03, 5.06, 1.02, § A(2) (Vernon Supp. 1999-2000).

202. TEX. BUS. CORP. ACT ANN. art. 1.02(A)(20) (Vernon Supp. 1999-2000).

203. DEL. CODE ANN. tit. 8, §§ 251-64.

204. *Id.* §§ 255-58.

205. *Id.* § 254.

206. *Id.* § 254.

207. *Id.* § 254(a).

Although the definition of a joint-stock association is quite broad and would seem to pick up almost all forms of non-corporate entities, there exists substantial ambiguity in the statute as to exactly what is a joint stock association given the exclusion of partnerships, corporations and limited liability companies from the definition. For example, is a joint venture (which is nothing more than a partnership under another name) a joint-stock association under Delaware law? Similarly, would a joint venture be considered a joint-stock association if the agreement creating the joint venture provided that all the investors would receive shares and that the joint venture is not a partnership? While the answers to these questions are unclear under the DGCL, there is no question that under the TBCA a corporation could merge with either of these types of entities. Thus, greater certainty is provided under the TBCA for these types of mergers than is available under the DGCL.

4. *Mergers with Multiple Survivors*

Under the TBCA, a corporation may enter into a merger agreement where there are multiple surviving or new corporations or other entities created in the merger.²⁰⁸

In addition, the TBCA permits a single corporation to adopt a plan of merger in which it is divided into multiple corporations or entities and its assets and liabilities are allocated among the surviving or new corporations or other entities as provided in the plan of merger solely by operation of law and without any transfer or assignment being made.²⁰⁹

Delaware does not provide for the possibility of multiple surviving entities in a merger or a division of a corporation through a statutory merger. In Delaware, as well as in most other jurisdictions, when parties to a plan of merger desire to place certain assets and liabilities of one of the constituent corporations in another entity and distribute the ownership interest of that entity to the shareholders of one or more of the parties to the merger, the transaction must be effected through multiple steps utilizing common law conveyancing of assets, assumptions of liabilities, and distributions to shareholders.²¹⁰ Similarly, in Delaware, if a single corporation desires to divide its businesses and operations into two or more separate corporations or entities and distribute the ownership interests of those corporations or entities to its shareholders, the transaction must be effected through a traditional "spin off" of the new corporation or entity after transferring the desired assets to, and having the unwanted liabilities assumed by, the corporation or entity to be spun off.²¹¹

To effect a transaction with two or more surviving corporations or other entities or a division of a single corporation into multiple entities

208. See TEX. BUS. CORP. ACT ANN. arts. 5.01, 1.02(A)(18) (Vernon Supp. 1999-2000).

209. See *id.* arts. 1.02(A)(18), 5.03.

210. Curtis W. Huff, *The New Texas Business Corporation Act Merger Provisions*, 21 ST. MARY'S L.J. 109, 114-15 (1989).

211. *Id.*

through a merger under the TBCA, the plan of merger, in addition to other statutory requirements, need only specify the manner and basis for vesting and allocating the assets and liabilities among the surviving or new entities and provide for the creation of any new entities to be created under the merger.²¹² The manner and basis for converting the shares and other evidences of ownership of the parties to the merger must also be set forth in the plan of merger as in any typical merger.²¹³ The TBCA also makes clear that, as a matter of substantive law in Texas, once a merger with multiple surviving entities has taken place, only those entities to which liabilities and obligations have been allocated will be responsible for the liabilities and obligations allocated to them.²¹⁴

5. Share Exchanges

The TBCA permits a transaction known as a “share exchange.”²¹⁵ A “share exchange” is a transaction in which share interests of a corporation are acquired by another corporation or entity without the necessity of a merger of the two entities.²¹⁶ A share exchange possesses advantages over a traditional merger transaction in that it permits the acquisition of all of the share interests of one or more classes or series of stock of a corporation without the acquiring entity going out of existence and with the acquired entity becoming a subsidiary of the acquiring entity.²¹⁷ A share exchange is often desirable where the acquiring entity is a holding company operating through its subsidiaries or where the acquiring entity desires to acquire only one class or series of stock of the acquired corporation.²¹⁸ Absent the availability of a share exchange, this type of transaction would have to be accomplished through an agreement with each shareholder or through a “reverse triangular merger” in which a new subsidiary of the acquiring corporation merges with the acquired corporation and the holders of the shares of the acquired corporation receive cash, securities, or other property.²¹⁹ The procedures for approving a share exchange under the TBCA are substantially the same as those for the approval of a merger.²²⁰

The DGCL does not permit share exchanges.

6. Conversions

Texas created a new form of transaction known as a “conversion” in 1997. In its simplest terms, a “conversion” is a transaction that allows an entity to convert its organizational form from one type of entity to an-

212. TEX. BUS. CORP. ACT ANN. art. 5.01(B)(2)(C) (Vernon Supp. 1999-2000).

213. *Id.* art. 5.01(B)(3).

214. TEX. BUS. CORP. ACT ANN. art. 5.06(A)(3) (Vernon Supp. 1999-2000).

215. *See id.* art. 5.02.

216. Huff, *New Texas Business Corporation Act*, *supra* note 210, at 134.

217. *Id.* at 135.

218. *Id.*

219. *Id.*

220. *See* TEX. BUS. CORP. ACT ANN. arts. 5.02, 5.03 (Vernon Supp. 1999-2000).

other type of entity while allowing it to continue its business enterprise without interruption and without the need to effect a merger or transfer of assets.²²¹

The conversion provisions of the TBCA are set forth in articles 5.17 through 5.20 of the TBCA. Under the conversion provisions, a Texas corporation may convert into another corporation or entity if:

- (1) the conversion is approved by the shareholders of the Texas corporation in same manner that a merger would be approved where the corporation is not the surviving entity;
- (2) the conversion is permitted by, or not inconsistent with, the laws of the state or country in which the entity into which the corporation is to be converted (the "converted entity") is to be incorporated, formed, or organized and the incorporation, formation, or organization of the converted entity is effected in compliance with such laws;
- (3) at the time the conversion becomes effective, each shareholder of the converting corporation (other than dissenting shareholders who perfect their rights of dissent under the TBCA) will, unless otherwise agreed to by that shareholder, own an equity interest or other ownership or security interest in, and be a shareholder, partner, member, owner or other security holder of, the converted entity;
- (4) no shareholder of the converting corporation will, as a result of the conversion, become personally liable, without the shareholder's consent, for the liabilities or obligations of the converted entity; and
- (5) the converted entity is incorporated, formed, or organized as part of or pursuant to the plan of conversion (i.e., the converted entity may not be a preexisting operating business entity).²²²

A foreign corporation or other entity (including a Texas partnership or limited liability company) may similarly convert into a Texas corporation (or in the case of a Texas partnership or limited liability company, into another entity) under the parallel provisions of the statute governing those entities if:

- (1) the conversion is permitted by the laws of the state or country in which the foreign corporation is incorporated, if a foreign corporation is converting;
- (2) the conversion is either permitted by the laws under which the other entity is formed or organized or by the constituent documents of the other entity that are not inconsistent with the laws of the state or country in which the other entity is formed or organized, if an other entity is converting; and
- (3) the converting entity takes all action that may be required by the laws of the state or country under which it is incorporated, formed, or organized and by its constituent documents to effect the conversion.²²³

221. J. Scott Sheehan & David Harrell, *Business Law*, 60 TEX. B.J. 744, 747 (1997); see also TEX. BUS. CORP. ACT ANN. arts. 5.17-5.20 (West 2001).

222. TEX. BUS. CORP. ACT ANN. art. 5.17(A) (Vernon Supp. 1999-2000).

223. *Id.* art. 5.17(B).

The procedures for a conversion, including the vote requirement, rights to dissent and filings, are essentially the same as those for a merger.

Because a conversion represents a mere continuation of an organization in a different organizational form, a conversion may only be effected where the new entity has no other business and may not be used in lieu of a merger between two pre-existing operating entities.²²⁴ To the extent another jurisdiction does not expressly provide for a conversion, a Texas corporation may still convert into such an entity by organizing that entity in connection with the conversion.²²⁵ In this circumstance, the entity could be a pre-existing entity as long as it was organized solely for the conversion.

In September 1999, Delaware added a conversion statute that allows a Delaware limited liability company, limited partnership, or business trust to convert into a Delaware corporation and for a Delaware corporation to convert to a Delaware limited liability company, limited partnership, or business trust.²²⁶ The Delaware statute, which is modeled after the Texas statute, is substantially more limited than the Texas statute in that it does not permit conversions from or into entities outside of Delaware or conversions into or from partnerships and other non-corporate entities.²²⁷

The tax consequences of a conversion will be dependent upon the specific transaction and upon whether under the Internal Revenue Service "check the box" rules the entity changes its organizational form from an association to a partnership or vice versa for tax purposes.²²⁸

7. Sales of Substantially All Assets

a. Shareholder Approval

Texas and Delaware law differ substantially with respect to the approval that is necessary to authorize a sale of all or substantially all of the assets of a corporation. In Texas, shareholder approval is not required for any sale, lease, exchange, or other disposition of all or substantially all of the property and assets of a corporation if made in the usual and regular course of the business of a corporation.²²⁹ A transaction will be considered to be made in the usual and regular course of business of a corporation if the corporation either continues to engage in one or more businesses following the transaction or applies a portion of the consideration received in the transaction to the conduct of a business following the

224. Byron F. Egan, *Choosing the Business Entity and Drafting the Documents*, nn.19-28, in *University of Houston Real Estate Documents, Workouts and Closings*, Dallas/Houston, TX, (June 8, 2000), available at <http://www.jw.com/articles/articles.cfm>; Alan W. Tompkins & Ted S. O'Neil, *Annual Survey of Texas Law - Corporations*, 49 SMU L. REV. 821, 835-836 (1996); Tex. S. B. 555 § 32, 75th Leg., R.S. 1997.

225. *Id.*

226. DEL. CODE ANN. tit. 8, §§ 265, 266 (1999).

227. TEX. BUS. CORP. ACT ANN. arts. 5.17-5.20 (1997).

228. See Egan, *Choosing the Business Entity*, *supra* note 224.

229. See TEX. BUS. CORP. ACT ANN. arts. 5.09-5.10 (Vernon 1980 & Supp. 1999-2000).

transaction.²³⁰ If either of these two conditions ARE met, it is irrelevant whether or not the sale involves all or substantially all of a corporation's assets.²³¹ A corporation could thus consummate an asset disposition without obtaining the shareholder approval otherwise required by TBCA article 5.10 because the transaction is by definition within the "usual and regular course of business" and therefore covered by TBCA article 5.09.²³² In effect no disposition of assets by a corporation will require shareholder approval unless the corporation liquidates and ceases to do business after the disposition.²³³

Where shareholder approval is required under the TBCA for a sale of all or substantially all of the assets of a corporation, the required approval will be the affirmative vote of the holders of at least two-thirds of the outstanding shares.²³⁴ This percentage may be decreased to the holders of a majority of the outstanding shares if so provided in the articles of incorporation of the corporation.²³⁵

In Delaware, stockholder approval is required for any sale, lease or exchange of all or substantially all of the corporation's property and assets.²³⁶ The DGCL, however, does not define what constitutes all or substantially all of the property and assets of a corporation and this concept has been left open for the courts to determine on a case-by-case basis. In general, where the value or income of the assets to be sold represents more than 50% of the assets of the corporation on an ongoing or historical basis, the question of whether the assets or income constitute substantially all of the assets of the corporation is uncertain and will turn on very fact specific issues that can only be definitively resolved by litigation.²³⁷ To avoid this uncertainty, corporations are often forced to seek stockholder approval and delay their transactions when the numbers are close and counsel is unable to provide a satisfactory legal opinion. Where stockholder approval is considered necessary for the sale of assets by a Delaware corporation, the required vote is a majority of the holders of the outstanding stock.²³⁸

b. Successor Liability

A major reason parties structure a business combination as an asset purchase is to allow them to contractually allocate which assets the buyer will purchase, which liabilities the buyer will assume and which assets and

230. TEX. BUS. CORP. ACT ANN. art. 5.09(B) (Vernon Supp. 1999-2000).

231. TEX. BUS. CORP. ACT ANN. arts. 5.17-5.20 (1997).

232. Egan & French, *1987 Amendments*, *supra* note 3, at 11.

233. *See id.* at 11-12.

234. TEX. BUS. CORP. ACT ANN. art. 5.10(A)(4) (Vernon Supp. 1999-2000).

235. TEX. BUS. CORP. ACT ANN. art. 2.28 (Vernon Supp. 1999-2000).

236. DEL. CODE ANN. tit. 8, § 271(a) (1991).

237. *See Gimbel v. The Signal Cos., Inc.*, 316 A.2d 599, 606-608 (Del. Ch. 1974), *aff'd*, 316 A.2d 619 (Del. 1974); *Katz v. Bregman*, 431 A.2d 1274, 1276 (Del. Ch. 1981).

238. DEL. CODE ANN. tit. 8, § 271(a) (1991).

liabilities will be retained by the seller.²³⁹ There have developed a number of exceptions to the buyer's ability to avoid assuming seller liabilities, some of which are statutory (such as bulk sales and fraudulent transfer laws) and some have developed through court decisions.²⁴⁰ Both Delaware and Texas have repealed their bulk sales statutes and have adopted versions of the Uniform Fraudulent Transfer Act.²⁴¹

In 1979, Art. 5.10B was added to the TBCA to repeal the *de facto* merger doctrine in any sale, lease, exchange or other disposition of all or substantially all of the assets of a corporation.²⁴² While by its terms Art. 5.10B is applicable only to Texas corporations, the TBCA provision is a powerful statement of Texas public policy.²⁴³ Since the 1979 amendment, Texas courts have consistently held that a successor corporation that purchases all or substantially all of a predecessor corporation's assets is not liable for the predecessor's obligations except where such liability is expressly assumed.²⁴⁴ In addition, Courts have limited successor liability under the theories of "mere continuation" or "product line."²⁴⁵

Since 1933, Courts in Delaware have recognized the *de facto* merger doctrine.²⁴⁶ The doctrine has been invoked in cases of sales of assets for

239. See Byron F. Egan, *Asset Acquisition Agreement Issues for Corporate Counsel*, in University of Texas 22nd Annual Corporate Counsel Institute, Dallas/Houston, TX (March 23, April 14, 2000), available at <http://www.texasbusinesslaw.org/members/reports.html>; Byron F. Egan et al., *Negotiating Business Acquisitions—Asset Deals (MAPA)*, in ABA National Institute on Negotiating Business Acquisitions, Boca Raton, FL (Nov. 7, 2000), available at <http://www.jw.com/articles/articles.cfm>.

240. *Id.*

241. TEX. BUS. & COMM. CODE § 24.001 (West 2001); Del. Code Ann. tit. 6 §§ 1301-1311 (2001).

242. TEX. BUS. CORP. ACT art. 5.10 cmt. (West 2001). The 1979 amendment was in response to the adoption of the *de facto* merger doctrine by the court in *Western Resources Life Insurance Co. v. Gerhardt*, 553 S.W.2d 783 (Tex. Civ. App.—Austin 1977, writ ref'd n.r.e.). TBCA art. 5.10(B) now provides:

B. A disposition of all, or substantially all, of the property and assets of a corporation requiring the special authorization of the shareholders of the corporation under Section A of this article:

- (1) is not considered to be a merger or consolidation pursuant to this Act or otherwise; and
- (2) Except as otherwise expressly provided by another statute, does not make the acquiring corporation responsible or liable for any liability or obligation of the selling corporation that the acquiring corporation did not expressly assume.

243. The Texas cases have not tended to focus on article 5.10(B) being literally applicable only if the corporation is incorporated under the TBCA. In the absence of article 5.10(B) applicability, the legal effect of a sale of assets transaction generally would be determined by the law chosen by the parties. TEX. BUS. AND COMM. CODE § 35.51 (West 2001); see also *Duncan v. Cessna Aircraft Co.*, 665 S.W.2d 414, 421 (Tex. 1984); *DeSantis v. Wackenhut*, 793 S.W.2d 670, 677 (Tex. 1990). Otherwise, the law of the state with the "most significant relationship" to the transaction. *Elmer v. Tenneco Resins, Inc.*, 698 F. Supp. 535, 540 (D. Del. 1988) (citing *In re Asbestos Litig.*, 517 A.2d 697, 699 (Del. 1986)); *Lockheed Martin Corp. v. Gordon*, 16 S.W.3d 127, 133 (Tex. Civ. App.—Houston [1st Dist.] 2000, no pet. h.).

244. *Suarez v. Sherman Gin Co.*, 697 S.W.2d 17 (Tex. Civ. App.—Dallas 1985, no writ); *Mudgett v. Paxson Mach. Co.*, 709 S.W.2d 755 (Tex. Civ. App.—Corpus Christi 1986, no writ); *Mims v. HRC Autostaff*, 2000 WL 251732, at *5 (N.D. Tex. 2000).

245. *Mudgett*, 709 S.W.2d at 758.

246. *Drug v. Hunt*. 168 A. 87, 95 (Del. 1933).

the protection of creditors or stockholders who have suffered an injury by reason of failure to comply with the statute governing such sales.²⁴⁷ The general rule in Delaware is that, when one company sells or transfers all of its assets to another, the purchaser does not become liable for the debts and liabilities, including torts, of the transferor.²⁴⁸ However, a purchaser may be liable for the obligations of the selling corporation in any one of the following four situations:

- (1) the purchaser expressly or impliedly assumes such obligations;
- (2) the transaction amounts to a consolidation or merger of the seller into the purchaser;
- (3) the purchaser is merely a continuation of the seller; or
- (4) the transaction has been entered fraudulently.²⁴⁹

8. *Different Treatment of Shareholders in Mergers and Share Exchanges*

Articles 5.01 and 5.02 of the TBCA were amended in 1997 to address an ambiguity that has existed for years under both Texas and Delaware law as to whether it is permissible to treat holders of shares of a same class or series of stock differently in the plan of merger or exchange. Historically, other than in the context of a merger in which the acquiring corporation's shares are to be treated differently than all other shareholders' shares, practitioners have been concerned whether the language in Articles 5.01 and 5.02 and their merger counterparts in Delaware permit a plan of merger or exchange to provide that the holders of shares of the same class or series will be treated differently in the merger or share exchange. Although the language of Articles 5.01 and 5.02 was sufficiently broad to permit different treatment of shareholders in a merger, there was a concern as to whether the authority actually existed because the language of the statute did not specifically address the issue. The absence of this express authorization resulted in disagreements among practitioners and the creation of complex transactional structures aimed at avoiding the issue. Articles 5.01 and 5.02 were amended in 1997 to clarify the issue by expressly recognizing the possibility of different treatment of shareholders in a plan of merger or exchange.²⁵⁰

Articles 5.01 and 5.02 require that where shareholders are to be treated differently in a plan of merger or exchange, the plan of merger or exchange must set forth the manner and basis for the conversion of shares of each class or group of shareholders who are to be treated differently. In order to protect shareholders who may be treated differently in a plan

247. *Id.*; *Heilbrunn v. Sun Chem. Corp.*, 150 A.2d 755, 757-58 (Del. Ch. 1959).

248. *Elmer v. Tenneco Resins, Inc.*, 698 F. Supp. 535, 540 (D. Del. 1988) (citing *Polius v. Clark Equip. Co.*, 802 F.2d 75, 77 (3d Cir. 1986)); *Fehl v. S.W.C. Corp.*, 433 F. Supp. 939, 945 (D. Del. 1977).

249. *Elmer*, 698 F. Supp. at 540 (citing *Knapp v. North American Rockwell Corp.*, 506 F.2d 361, 363-64 (3d Cir. 1974)); *Fehl*, 433 F. Supp. at 945).

250. See TEX. BUS. CORP. ACT ANN. arts. 5.01(B)(3), 5.02(B)(3) (Vernon Supp. 1999-2000).

of merger or exchange, Article 5.11 of the TBCA adds a requirement to the provisions eliminating dissenters' rights for transactions involving the issuance of shares of a public corporation.²⁵¹ This additional requirement is that a shareholder not be required by the terms of the plan of merger or exchange to accept any consideration that is different than the consideration to be provided to the holder of any other shares of the same class or series of shares held by that shareholder. This new requirement does not require dissenters' rights where the acquiring entity's shares in the target company are canceled without consideration and all other shareholders are otherwise treated the same. Claims for breaches of fiduciary duty and injunctive relief for mergers and exchanges where shareholders are improperly treated differently may still be brought prior to the merger. After a merger or exchange, however, the right to dissent will continue to be the sole remedy.

9. *Dissenters' Rights and Exclusivity of Remedy*

Both Texas and Delaware law provide shareholders of corporations with dissenters' rights in merger transactions.²⁵² Texas also provides dissenters' rights for share exchanges and asset sales that require shareholder approval under the TBCA.²⁵³ Delaware does not provide dissenters' rights for asset sales. Dissenters' rights under the TBCA and DGCL permit a shareholder to seek an appraisal of and payment for the fair value of his shares in lieu of receiving the consideration that would be received by him in the merger or other transaction. The procedures for perfecting dissenters' rights are substantially the same under Texas and Delaware law.²⁵⁴ The fair value of shares under both the TBCA and the DGCL is the value of the shares of the corporation as a going concern, without any appreciation or depreciation in anticipation of the transaction.²⁵⁵ Interest on the fair value of the shares must also be paid on the amount due the shareholder.²⁵⁶

An exception to the right of a shareholder to dissent and seek an appraisal and payment for his shares is provided under both the TBCA and the DGCL where the shareholder's shares are part of a class or series of publicly traded equity securities and the shareholder will only receive publicly traded equity securities and cash in lieu of fractional shares as a result of the transaction.²⁵⁷ The rationale for denying dissenters' rights under these circumstances is that an efficient market exists for the shares

251. *Id.* art. 5.11.

252. TEX. BUS. CORP. ACT ANN. art. 5.11; DEL. CODE ANN. tit. 8, § 262.

253. TEX. BUS. CORP. ACT ANN. art. 5.11(A)(2).

254. *See* TEX. BUS. CORP. ACT ANN. arts. 5.12-5.13 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 262 (Supp. 1998).

255. TEX. BUS. CORP. ACT ANN. art. 5.12(D) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 262(h) (Supp. 1998).

256. TEX. BUS. CORP. ACT ANN. art. 5.12(D) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 262(h) (Supp. 1998).

257. TEX. BUS. CORP. ACT ANN. art. 5.11(B) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 262(b) (Supp. 1998).

both before and after the merger in which the shareholder will have the right to "vote with his feet" by selling his shares in the market. The exception also reflects a legislative policy that the market price of shares of a public company will be the best indication of the fair value of a dissenting shareholder's shares.

A publicly traded equity security for purposes of the TBCA is a stock that is listed on a national securities exchange "or held of record by not less than 2,000 shareholders."²⁵⁸ In addition to these types of securities, the DGCL and the TBCA include equity securities designated as a national market security on an interdealer quotations system by the National Association of Securities Dealers Inc.²⁵⁹

Both Texas and Delaware law also provide that shareholders not entitled to vote on a merger or other transaction for which dissenters' rights are available will not have dissenters' rights.²⁶⁰

Although dissenters' rights under the TBCA and the DGCL are similar in substance and procedure, the TBCA is much clearer in its treatment of the relationship between the appraisal remedy and other remedies that a dissenting shareholder may have with respect to a transaction. Article 5.12 section G of the TBCA provides that, absent fraud in the transaction, the dissent and appraisal remedy under the TBCA is the sole remedy available to the shareholder for monetary relief for a merger, share exchange or asset sale. Article 5.12 section G further provides that if the corporation complies with its obligations under the statute by offering the dissenting shareholder the right to dissent and receive a cash payment equal to the fair value of his shares through the appraisal process under the statute, the shareholder will not be entitled to bring suit for the recovery of the value of his shares or for any other money damages. This rule applies even if the shareholder's claim is based on an allegation of unfairness or fraud in that the statute contemplates that if the remedy sought by a shareholder is money damages, a statutory appraisal subject to court review is the most efficient and proper means for compensating the shareholder for his alleged damage. Article 5.12 section G, however, does not prohibit a shareholder from seeking equitable relief based on fraud or a breach of fiduciary duty. Thus, a shareholder is free to seek injunctive or other equitable relief with respect to a proposed transaction.

The dissent and appraisal provisions of the DGCL are silent on whether appraisal is the sole remedy of a stockholder seeking monetary damages for the fair value of a stockholder's shares. although the Delaware courts have generally provided that appraisal is the exclusive remedy for a dissenting stockholder seeking monetary damages, the courts have on occasion held that appraisal may not be the exclusive remedy in

258. TEX. BUS. CORP. ACT ANN. art. 5.11(B) (Vernon Supp. 1999-2000).

259. TEX. BUS. CORP. ACT ANN. art. 5.11 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 262(b)(1)(i) (Supp. 1998).

260. TEX. BUS. CORP. ACT ANN. art. 5.11 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 262(b)(1) (Supp. 1998).

cases involving fraud or breach of duty of fair dealing.²⁶¹

10. Short Form Mergers With Other Entities

Article 5.16 of the TBCA relating to short form mergers permits a Texas corporation to merge with all forms of entities through a short form merger.²⁶² Prior to the 1989 amendments, only corporations that held 90% or more of the outstanding shares of each class or series of another corporation could engage in a short form merger. To effect a short form merger with a non-corporate entity, the parent corporation must own at least 90% of the outstanding shares of each class or series of shares, membership interests, or other ownership interests of the other entity. Additionally, the laws of the jurisdiction of the other entity must either permit the merger or the organizational documents of that entity must not be inconsistent with those laws. A similar provision exists where a Texas corporation is merged into its non-corporate entity parent.

11. Holding Company Mergers; Shareholder Vote Exception

Neither the TBCA nor the DGCL require shareholder approval where a corporation engages in a merger for the sole purpose of creating a holding company.

12. Interested Stockholder Transactions

Both Delaware and Texas provide protections to shareholders of public companies against interested shareholder transactions that occur after a shareholder has acquired a 15% to 20% ownership interest. The Delaware limitations are found in § 203 of the DGCL and the Texas limitations are found in Part Thirteen of the TBCA.²⁶³

13. Section 203 of the DGCL

Section 203 of the DGCL imposes restrictions on transactions between public corporations and certain stockholders defined as “interested stockholders” unless specific conditions have been met. In general, § 203 provides that a publicly held Delaware corporation may not engage in a business combination with any interested stockholder for a period of three years following the date the stockholder first became an interested stockholder unless (i) prior to that date the board of directors of the corporation approved the business combination or the transaction that resulted in the stockholder becoming an interested stockholder,²⁶⁴ (ii) the

261. See, e.g., *Weinburger v. UOP, Inc.*, 457 A.2d 701, 703-704 (Del. 1983); *Sealy Mattress Co., Inc. v. Sealy, Inc.*, 532 A.2d 1324, 1341 (Del. Ch. 1987).

262. TEX. BUS. CORP. ACT ANN. art. 5.16 (Vernon Supp. 1999-2000).

263. TEX. BUS. CORP. ACT ANN. art. 13; DEL. CODE ANN. tit. 8, § 203.

264. A vote to so waive the protection of DGCL § 203 is sometimes referred to as a “§ 203 waiver” and requires that the directors act consistently with their fiduciary duties of care and loyalty. *In re Digex, Inc. Shareholders Litig.*, C.A. No. 18336, 2000 WL 1847679, at *7 (Del. Ch. Dec. 13, 2000).

interested stockholder became an interested stockholder as a result of acquiring at least 85% of the voting stock of the corporation,²⁶⁵ excluding shares held by directors and officers and employee benefit plans in which participants do not have the right to determine confidentially whether their shares will be tendered in a tender or exchange offer, or (iii) the transaction is approved by stockholders by an affirmative vote of at least two-thirds of the outstanding shares excluding the shares held by the interested stockholder.

An interested stockholder is generally defined under DGCL § 203(c)(3) as any person that directly or indirectly owns or controls or has beneficial ownership or control of at least 15% of the outstanding shares of the corporation.²⁶⁶ A business combination is defined under DGCL § 203 to include (i) mergers, (ii) consolidations, (iii) direct or indirect sales, leases, exchanges, mortgages, transfers and other dispositions of assets to the interested stockholder having an aggregate market value greater than 10% of the total aggregate market value of the assets of the corporation, (iv) various issuances of stock and securities to the interested stockholder that are not issued to other stockholders on a similar basis and (v) various other transactions in which the interested stockholder receives a benefit, directly or indirectly, from the corporation that is not proportionally received by other stockholders.²⁶⁷

The provisions of DGCL § 203 apply only to public corporations (*i.e.*, corporations the stock of which is listed on a national securities exchange, authorized for quotation on interdealer quotation system of a registered national securities association or held of record by more than 2,000 stockholders).²⁶⁸ The provisions of DGCL § 203 also will not apply to certain stockholders who held their shares prior to the adoption of DGCL § 203 or to stockholders whose acquisition of shares is approved by the corporation prior to the stockholder becoming an interested stockholder. In addition, DGCL § 203 will not apply if the certificate of incorporation of the corporation or the bylaws approved by stockholders provides that the statute will not apply; provided that any amendment eliminating the application of DGCL § 203 will not become effective for twelve months after approval and the statute will continue to apply to any person who was an interested stockholder prior to the adoption of the amendment.

14. Part Thirteen of the TBCA

Part Thirteen of the TBCA, like § 203 of the DGCL, imposes a special voting requirement for the approval of certain business combinations and related party transactions between public corporations and affiliated

265. In the context of a corporation with more than one class of voting stock where one class has more votes per share than another class, there is an "interesting interpretative challenge" whether "85% of the voting stock" refers to the number of shares or the number of votes. *In re Digex*, 2000 WL 1847679 at *18.

266. DEL. CODE ANN. tit. 8, § 203(c)(3) (1991).

267. *Id.* § 203(b).

268. *Id.*

shareholders unless the transaction or the acquisition of shares by the affiliated shareholder is approved by the board of directors prior to the affiliated shareholder becoming an affiliated shareholder.²⁶⁹

In general, Part Thirteen prohibits certain mergers, sales of assets, re-classifications and other transactions (defined as business combinations) between shareholders beneficially owning 20% or more of the outstanding stock of a Texas public corporation (such shareholders being defined as affiliated shareholders) for a period of three years from the time the shareholder acquires shares representing 20% or more of the corporation's voting power, unless two-thirds of the unaffiliated shareholders approve the transaction at a meeting held no earlier than six months after the shareholder acquires that ownership. The provisions requiring the special vote of shareholders will not apply to any transaction with an affiliated shareholder if the transaction or the purchase of shares by the affiliated shareholder is approved by the board of directors before the affiliated shareholder acquires beneficial ownership of 20% of the shares, or if the affiliated shareholder was an affiliated shareholder prior to December 31, 1996, and continued as such through the date of the transaction. Part Thirteen does not contain the Delaware 85% of the unaffiliated shares tender offer exception, which was considered by the drafters to be a major loophole in the Delaware statute, and attempts to clarify various uncertainties and ambiguities contained in the Delaware statute.

Part Thirteen applies only to an "issuing public corporation", which is defined to be a corporation organized under the laws of Texas that has: (i) 100 or more shareholders, (ii) any class or series of its voting shares registered under the Securities Exchange Act of 1934, as amended, or similar or successor statute, or (iii) any class or series of its voting shares qualified for trading in a national market system.²⁷⁰ For the purposes of this definition, "a shareholder is a shareholder of record as shown by the share transfer records of the corporation."²⁷¹ Part Thirteen also contains an opt-out provision that allows a corporation to elect out of the statute by adopting a by-law or charter amendment prior to December 31, 1997.²⁷²

C. STOCKHOLDER VOTING RIGHTS AND ACTIONS; LIABILITIES AND PREEMPTIVE RIGHTS

1. *General Voting Requirements*

Both Texas (TBCA art. 2.28) and Delaware (DGCL § 216) provide that the general requirement for a quorum of shareholders at a meeting of shareholders will be the holders of a majority of the outstanding shares

269. See TEX. BUS. CORP. ACT ANN. arts. 13.01-13.08 (Vernon Supp. 1999-2000).

270. *Id.* art. 13.02(A)(6).

271. *Id.*

272. *Id.* art 13.04(A)(1).

entitled to vote at the meeting.²⁷³ This requirement may be increased or decreased to as few as one-third of the holders of the outstanding shares if so provided in the certificate of incorporation or bylaws in the case of a Delaware corporation and in the articles of incorporation in the case of a Texas corporation.²⁷⁴ In Texas and Delaware, once there is a quorum of shareholders at a meeting of shareholders, there is a quorum for all matters to be acted on that meeting.

Under both Texas and Delaware law, the vote required for approval of certain matters varies depending on the matter requiring action. The vote required for the election of directors, in Texas and in Delaware, is a plurality of votes cast unless otherwise provided in the charter or bylaws of the corporation.²⁷⁵ The vote required for approval of fundamental corporate transactions, such as charter amendments, mergers, and dissolutions, is the holders of a majority of the outstanding voting power entitled to vote on the matter in Delaware and the holders of at least two-thirds of the outstanding shares entitled to vote on the matter.²⁷⁶ A corporation may increase this voting requirement under both Texas and Delaware law.²⁷⁷ This requirement may also be reduced in Texas in the articles of incorporation of the corporation to not less than the holders of a majority of the voting power entitled to vote on the matter.²⁷⁸

As for all other actions that may be taken by shareholders, unless otherwise provided in the corporation's certificate of incorporation or bylaws, Delaware provides that approval requires a majority of the shares represented at the meeting, in person or by proxy, entitled to vote on the matter.²⁷⁹ In Texas, unless otherwise provided in the corporation's articles of incorporation or bylaws, the general vote requirement for shareholder action on matters other than the election of directors and extraordinary transactions is a majority of the votes cast "for", "against" or expressly abstaining on the matter.²⁸⁰ This provision adds clarity to the Securities and Exchange Commission's rules for determining the effect of "broker non-votes."²⁸¹ As a result, under Texas law, "broker non-votes" will be considered for purposes of a quorum, but will not be considered a vote for or against the matter.

In Texas, unless expressly prohibited by the articles of incorporation, shareholders will have the right to cumulate their votes in the election of

273. TEX. BUS. CORP. ACT ANN. art. 2.28 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 216 (1991 & Supp. 1998).

274. TEX. BUS. CORP. ACT ANN. art. 2.28 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 216 (1991 & Supp. 1998).

275. TEX. BUS. CORP. ACT ANN. art. 2.28(C) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 216 (1991 & 1998 Supp.).

276. TEX. BUS. CORP. ACT ANN. arts. 4.02(A)(3), 5.03(E), 6.03(A)(3) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, §§ 242(b)(1), 252(c), 275(b) (Supp. 1998).

277. TEX. BUS. CORP. ACT ANN. art. 2.28 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 216 (Supp. 1998).

278. TEX. BUS. CORP. ACT ANN. art. 2.28(D) (Vernon Supp. 1999-2000).

279. DEL. CODE ANN. tit. 8, § 216(2) (Supp. 1998).

280. TEX. BUS. CORP. ACT ANN. art. 2.28(B) (Vernon Supp. 1999-2000).

281. *See id.*

directors if they notify the corporation at least one day before the meeting of their intent to do so.²⁸² In Delaware, stockholders will not have any cumulative voting rights unless provided in the certificate of incorporation.²⁸³

2. Voting Rights

Under both Texas and Delaware law, each outstanding share is entitled to one vote unless otherwise provided in the corporation's charter.²⁸⁴ Shares of the same class are required to be identical unless divided into one or more series.²⁸⁵ Both Texas and Delaware, however, permit limitations on the voting rights of holders of the same class or series of shares, depending on the characteristics of the shares.²⁸⁶

3. Proxies

Both Texas and Delaware permit the voting of shares by proxy. Under Texas law, no proxy will be valid eleven months after execution unless otherwise provided in the proxy. Proxies in Delaware will not be valid after three years unless otherwise provided in the proxy.²⁸⁷ Proxies under both Texas and Delaware law may be made irrevocable only if coupled with an interest.²⁸⁸ Article 2.29 of the TBCA sets forth a non-exhaustive list of relationships that constitute a sufficient interest to support an irrevocable proxy.²⁸⁹ These interests include (i) a pledgee, (ii) an option or purchase agreement, (iii) a creditor relationship, (iv) an employee whose contract with the corporation requires the proxy and (v) any party to a voting agreement permitted by the TBCA.²⁹⁰ The DGCL does not provide a similar list of safe harbor relationships and relies on case law to determine what does and does not constitute a sufficient interest to support an irrevocable proxy.²⁹¹

Texas and Delaware both permit proxies to be given through electronic transmission, such as telegrams, cablegrams and other similar process.²⁹² Under Article 9.10 of the TBCA, such proxies are considered valid without any further conditions. In Delaware, electronic proxies must set forth or be submitted with information from which it can be determined that

282. *Id.* art. 2.29.

283. DEL. CODE ANN. tit. 8, § 214 (Supp. 1998).

284. TEX. BUS. CORP. ACT ANN. art. 2.29 (Vernon 1980 & Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 212 (1991 & Supp. 1998).

285. TEX. BUS. CORP. ACT ANN. art. 2.12(A) (Vernon 1980 & Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 151 (1991 & Supp. 1998).

286. TEX. BUS. CORP. ACT ANN. art. 2.29(A) (Vernon 1980 & Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 212 (1991 & Supp. 1998).

287. DEL. CODE ANN. tit. 8, § 212 (1991 & Supp. 1998).

288. TEX. BUS. CORP. ACT ANN. art. 2.29(C) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 212(e) (1991 & Supp. 1998).

289. TEX. BUS. CORP. ACT ANN. art. 2.29(C) (Vernon Supp. 1999-2000).

290. *Id.*

291. Huff, *Choice of State of Incorporation*, *supra* note 3, at 24.

292. TEX. BUS. CORP. ACT ANN. art. 9.10(A)(3) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 212(c) (Supp. 1999).

the transmission was authorized by the stockholder and requires that the inspectors of election specify the information upon which they relied.²⁹³

4. *Action by Written Consent*

Both Texas and Delaware permit any action that may be effected at an annual or special meeting of shareholders to be taken by written consents signed by all of the shareholders entitled to vote on such matter.²⁹⁴ Stockholder action may also be taken in Delaware by the written consent of less than all stockholders unless prohibited in the corporation's certificate of incorporation.²⁹⁵ Shareholders of a Texas corporation may act through written consents executed by less than all shareholders entitled to vote on the matter only if permitted in the corporation's articles of incorporation.²⁹⁶ Under both Texas and Delaware law, if shareholder action is taken by the written consent of less than all shareholders entitled to vote on the matter, the required vote will be the minimum vote that would have been necessary at a meeting at which all holders of shares entitled to vote on the matter were present and voted.²⁹⁷ Prompt notice of any action by shareholders by written consent is required to be provided under both Texas and Delaware law to those shareholders who did not consent to the matter.²⁹⁸

5. *Voting of Shares Held in Trust*

Article 2.29 of the TBCA does not permit a corporation to vote shares of the corporation held by it.²⁹⁹ Historically, there was some question as to the effect of this provision on shares held by or on behalf of the corporation in trust or other fiduciary capacity on behalf of employee benefit plans and in other similar situations. To clarify the issue, Article 2.29B of the TBCA was amended in 1997 to expressly allow a corporation to vote shares of its own stock that are held in a trust.

6. *Class Voting*

Both Texas and Delaware law provide that each outstanding share will be entitled to one vote on all matters presented to shareholders unless otherwise provided in the corporation's charter.³⁰⁰ In addition, whether or not entitled to vote on matters presented to shareholders generally, special class voting rights are provided to shareholders in Texas and Dela-

293. DEL. CODE ANN. tit. 8, § 212(c)(2) (Vernon Supp. 1999-2000).

294. TEX. BUS. CORP. ACT ANN. art. 9.10(A) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 228 (Supp. 1999).

295. DEL. CODE ANN. tit. 8, § 228 (Supp. 1999).

296. TEX. BUS. CORP. ACT ANN. art. 9.10(A) (Vernon Supp. 1999-2000).

297. TEX. BUS. CORP. ACT ANN. art. 9.10(A) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 228 (Supp. 1998).

298. TEX. BUS. CORP. ACT ANN. art. 9.10(A) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 228 (Supp. 1999).

299. TEX. BUS. CORP. ACT ANN. art. 2.29(A) (Vernon 1980).

300. *Id.*; DEL. CODE ANN. tit. 8, § 212(a) (Supp. 1999-2000).

ware for certain types of actions, such as charter amendments, mergers and share exchanges.

In Texas, unless effected pursuant to an amendment to the articles of incorporation of the corporation by the board of directors pursuant to their authority to fix the terms of a new class or series of blank check stock, a class vote will be provided to holders of shares in connection with any amendment to the corporation's articles of incorporation if the amendment would (i) increase or decrease the authorized number of shares of the class or series of shares, (ii) change the par value of the shares, (iii) effect an exchange, reclassification or cancellation of all or part of the shares of that class or series, (iv) require an exchange of all or any part of the shares of that class or series, (v) change the designations, preferences, limitations or relative rights of the shares of that class or series, (vi) create a senior class or series of shares, (vii) limit or deny existing preemptive rights, (viii) cancel or otherwise affect dividends that have accrued but that have not been declared, or (ix) elect or make a change from close corporation status.³⁰¹ Shareholders of a Texas corporation will also have a class vote on (i) a merger if the merger effects a change in the rights of the holders of the shares that if contained in an amendment to the corporation's articles of incorporation would require a class vote, (ii) a share exchange involving that class or series of shares and (iii) dissolutions.³⁰²

In Delaware, the holders of shares of a class or series will have a class vote on an amendment to the corporation's certificate of incorporation if the amendment would increase or decrease the aggregate number of authorized shares of that class or series, change the par value of the shares or alter or change the powers, preferences or special rights of the shares of that class or series adversely, which term is not defined and must be determined on a case-by-case basis.³⁰³ Stockholders in Delaware will also be entitled to a class vote on a merger if the merger effects such an amendment to the corporation's certificate of incorporation.

Although the class voting provisions of Texas and Delaware are similar, one fundamental difference between Texas and Delaware law with respect to class voting relates to a quirk in the Delaware statute that permits the holders of common stock or other shares entitled to vote on all matters generally to vote on an amendment to the terms of the shares of another class of securities even if the amendment would not adversely affect them unless the charter expressly provides otherwise. This right extends even to changes in terms of shares that are created pursuant to the blank check authority reserved in the board of directors to designate the terms of the shares and where the board would otherwise have the

301. TEX. BUS. CORP. ACT ANN. art. 4.03(A) (Vernon Supp. 1999-2000).

302. TEX. BUS. CORP. ACT ANN. arts. 5.03(F)(1), 5.03(F)(2), 6.03(A)(3) (Vernon 1999-2000).

303. DEL. CODE ANN. tit. 8, § 242(b)(2) (1991).

authority to create a new class of stock with those terms.³⁰⁴ To address this issue, Article 4.03 section C of the TBCA provides that unless otherwise required in the corporation's articles of incorporation, the approval of an amendment to a corporation's articles of incorporation that would solely effect changes in the designations, preferences, limitations and relative rights of one or more classes or series of shares of the corporation that have been established pursuant to board authority to designate blank check stock will not require any approval of the holders of any other class or series of stock as long as the amended terms are within the scope of authority of the board of directors to establish in connection with a new issuance of blank check stock.³⁰⁵

7. *Inspectors of Election*

Delaware law imposes certain obligations on public companies to appoint one or more inspectors of election to act at a meeting of stockholders and to make a written report thereon. Under DGCL § 231, the inspectors at a meeting must: (i) ascertain the number of shares outstanding and the voting power thereof, (ii) determine the number of shares represented at the meeting and the validity of all proxies and ballots, (iii) count all votes and ballots, (iv) determine and retain records of all challenges made to any determination made by the inspectors and (v) certify their determination of the number of shares represented at the meeting and their count of all votes and ballots. Section 231 of the DGCL also requires public companies to announce at all meetings of stockholders the date and time of the opening and closing of the polls for voting on each matter presented to shareholders for consideration. Texas has no similar mandatory requirement for the appointment of inspectors of election or for the procedures to be followed in receiving the vote of shareholders of a public company.

8. *Special Meetings*

Under Texas law, holders of at least 10% of all the shares of stock entitled to vote at a special meeting on a matter may call a special meeting of shareholders to act on that matter unless the articles of incorporation of the corporation require a larger percentage of the shares, not to exceed 50% of the shares, to call such a meeting.³⁰⁶ Delaware law does not provide an express right of stockholders to call a special meeting of stockholders. Stockholders, however, can act by majority written consent in Delaware, unless otherwise provided in the corporation's certificate of incorporation.³⁰⁷

304. *Id.* §§ 212(a), 242(b)(2).

305. TEX. BUS. CORP. ACT ANN. art. 4.03(c) (Vernon Supp. 1999-2000).

306. TEX. BUS. CORP. ACT ANN. art. 2.24(C) (Vernon Supp. 1999-2000).

307. DEL. CODE ANN. tit. 8, § 228 (Supp. 1998).

9. *Shareholder Lists and Access to Other Information*

Under Texas law, any shareholder who holds at least 5% of all of the outstanding shares of a corporation or who has held his shares for at least six months will have the right to examine at any reasonable time, for any proper purpose, the relevant books and records of account, minutes and share transfer records of the corporation.³⁰⁸ Delaware does not impose a minimum share ownership or period of ownership condition on the right of a stockholder to inspect the stock ledger and other books and records of a corporation for a proper purpose.³⁰⁹ A proper purpose is defined in Delaware as a purpose reasonably related to the person's interest as a stockholder.³¹⁰ Texas does not define a proper purpose, but it is implicit under Article 2.44 that a proper purpose must be one that relates to the shareholder's interest in the corporation. Both Texas and Delaware set forth strict procedures to be followed when a shareholder exercises this right.³¹¹

10. *Shareholder Liability*

Both Texas and Delaware recognize the corporate fiction and the importance of the limited liability nature of corporations from a public policy standpoint. In fact, both Texas and Delaware have historically provided in their statutes that shareholders of corporations will not be held liable for the debts of their corporations solely by reason of being a shareholder.³¹² Notwithstanding this general principle, case law in the States of Texas and Delaware has on occasion imposed liability on shareholders of corporations under various equitable theories. Generally, the corporate veil has been vulnerable to attack where the courts have found the corporation was used by the shareholder for fraudulent purposes, with the courts using catch phrases such as actual fraud, constructive fraud and sham to perpetuate a fraud. Shareholders have also been found liable for the obligations of their corporations where their corporations have been inadequately capitalized. In addition, although not the sole basis for imposing liability, the failure to follow certain corporate formalities has been cited by some courts as a factor to be considered in holding shareholders liable for corporate obligations.

To provide greater certainty with respect to the liability of shareholders for the obligations of their corporations in light of existing case law, various amendments have been made to Article 2.21 of the TBCA since 1989, to make clear that a shareholder will not be liable for any contractual obligations of the shareholder's corporation or its affiliate on the theory

308. TEX. BUS. CORP. ACT ANN. art. 2.44(C) (Vernon Supp. 1999-2000).

309. DEL. CODE ANN. tit. 8, § 220 (Supp. 1998).

310. *Id.* § 220(b).

311. *See* TEX. BUS. CORP. ACT ANN. art. 2.44 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 220 (Supp. 1998).

312. TEX. BUS. CORP. ACT ANN. art. 2.21 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 102(b)(6) (Supp. 1998).

that the shareholder was the alter ego of the corporation or on the basis of actual fraud or constructive fraud, a sham to perpetrate a fraud or any other similar theory unless the plaintiff can demonstrate that the shareholder caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the plaintiff primarily for the direct personal benefit of the shareholder.³¹³ In addition, Article 2.21 section A(3) of the TBCA expressly provides that the failure to comply with corporate formalities cannot be used as a basis to impose liability on a shareholder for liabilities (contractual, tort or otherwise) of the corporation.³¹⁴

The provisions of Article 2.21 reflect a legislative recognition of the fact that when parties contract with a corporation, they have expressly chosen the party they will look to for any breaches of the contract and that it would be manifestly unfair to the corporation's shareholders, and would reap an unintended benefit to the obligee, to impose personal liability on the shareholder for obligations of his corporation unless the corporation was used for the purpose of intentionally perpetrating an actual fraud for the direct personal benefit of the shareholder.

Delaware does not contain a similar provision to that set forth in Article 2.21 and the circumstance under which the corporate veil may be pierced is subject to judicial application of broad equitable principles to specific factual circumstances.

11. Shareholder Preemptive Rights

The TBCA provides that shareholders of a corporation have preemptive rights to acquire newly issued shares of a corporation except to the extent limited or denied in the corporation's articles of incorporation.³¹⁵ Delaware law provides that shareholders will have no preemptive rights unless set forth in the corporation's certificate of incorporation.³¹⁶

The existence of preemptive rights in Texas and other jurisdictions has created various legal uncertainties for corporate practitioners over the years when shares have been issued by clients in violation of preemptive rights. Often a violation of the preemptive rights is not discovered many years, at which point it may be difficult to locate all of the corporation's prior shareholders and obtain waivers of the prior violation. In addition, the remedy for a past violation is often unclear.

To address the potential problems of preemptive rights violations, while maintaining the general rule in Texas that shareholders should have preemptive rights unless otherwise denied in the articles of incorporation, Article 2.22-1 of the TBCA imposes limits on the exercise of preemptive rights. Under Article 2.22-1, unless the articles of incorporation of a corporation otherwise provide, preemptive rights will not extend to (i) shares offered and sold to employees pursuant to a plan that has been

313. TEX. BUS. CORP. ACT ANN. art. 2.21(A)(2) (Vernon Supp. 1999-2000).

314. TEX. BUS. CORP. ACT ANN. art. 2.21(A)(3) (Vernon Supp. 1999-2000).

315. TEX. BUS. CORP. ACT ANN. art. 2.22-1 (Vernon Supp. 1999-2000).

316. DEL. CODE ANN. tit. 8, § 102(b)(3) (Supp. 1998).

approved by the holders of a majority of the shares entitled to vote on the plan at a meeting of shareholders or (ii) shares that are sold for consideration other than cash.³¹⁷ Thus, while preemptive rights will apply to sales of stock to third parties for cash, shares issued pursuant to shareholder-approved employee benefit plans or as part of acquisitions, mergers and similar transactions will not trigger a shareholder's preemptive rights.

Article 2.22-1 provides that, unless otherwise stated in a corporation's articles of incorporation, shares that are preferred and limited as to dividends or assets will not be entitled to preemptive rights as to other shares, and shares that are not preferred or limited as to dividends or assets will not be entitled to preemptive rights in regard to shares that are preferred or limited as to dividends or assets. In addition, holders of shares without voting power have no preemptive rights to acquire shares with voting power. Article 2.22-1B further provides that the board of directors is authorized to establish a fair and reasonable opportunity for the shareholders to exercise their preemptive rights.

Article 2.22-1C of the TBCA establishes a statute of limitations for violations of preemptive rights. Under Article 2.22-1C, no action with respect to a violation of preemptive rights may be made after the earlier of (i) one year from the date that the shareholder was advised that his preemptive right was violated or (ii) four years after the date on which the corporation issued, sold or otherwise distributed the shares subject to the preemptive right. Article 2.22-1 section D of the TBCA further provides a general rule that only the original shareholders of record at the time of the violation will have a right to bring a claim and that a transferee of shares will not acquire that claim unless the preemptive right is separately assigned to the transferee.

Delaware does not contain similar provisions dealing with the difficulties of curing past violations of preemptive rights.

D. STOCK ISSUANCES

1. *General*

Both Texas and Delaware provide corporations with a wide latitude of options for establishing the rights and preferences of different classes and series of stock.³¹⁸ In general, shares of Texas and Delaware corporations may have differing rights as to voting, redemption, dividends, distributions on liquidation, rights of exchange for securities or other property and conversion into other securities. Delaware law, however, restricts the right of a corporation to establish certain rights (such as preferential dividends and special rights on liquidation) for stock referred to as preferred or special stock.³¹⁹ Although the Delaware restrictions can generally be drafted around, they do require the existence of some class or series of

317. TEX. BUS. CORP. ACT ANN. art. 2.22-1(B)(1) (Vernon Supp. 1999-2000).

318. TEX. BUS. CORP. ACT ANN. art. 2.13 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 151 (1991).

319. DEL. CODE ANN. tit. 8, § 151(c), (d) (1991 & Supp. 1998).

stock that is essentially common stock and has general rights to vote and receive dividends and distributions after the rights of the holders of preferred and special stock have been satisfied. In Texas, the terms of shares can generally be structured in any manner desired by the corporation without the need for a general class or series of common stock. In addition, Delaware does not permit shares to be redeemable unless at least one class or series of stock with full voting rights has no redemption rights.³²⁰ Texas has no such restriction.

Both Texas and Delaware provide that shares of the same series are to be identical. However, both Texas and Delaware allow for limitations to be placed on the rights of certain holders of shares of the same class or series to have differing voting rights. In Texas, this right is expressly set forth in TBCA article 2.29 section A(1)(a), while in Delaware it has been judicially determined by an implicit reference to this right in § 212 of the DGCL.³²¹

Both Texas and Delaware permit the use of blank check preferred and common stock, the terms of which may be fixed by the corporation's board of directors.³²² In this regard, both Texas and Delaware law compare favorably to other jurisdictions where this right is generally limited to preferred stock and in some states to only certain terms.

2. *Valid Consideration for Shares; Partially Paid Shares*

Texas and Delaware law differ substantially on the type of consideration that may be received for the issuance of shares. Under the TBCA, shares may be issued for consideration consisting of any tangible or intangible benefit to the corporation, including cash, promissory notes, services performed, contracts for services to be performed and other securities of the corporation.³²³ Under the Delaware Constitution and § 152 of the DGCL, shares of stock may only be issued for money paid, labor done or personal property, or real estate or leases thereof actually acquired.³²⁴ Thus, the type of consideration that may be received by a Texas corporation is materially broader than that which is permitted under Delaware law and specifically includes debt obligations and contracts for future services. Delaware law, however, does permit shares to be considered fully paid and nonassessable if valid consideration is received for at least the par value of the shares and a binding obligation such as a promissory note to pay the remainder is received.³²⁵

Although Delaware limits the type of consideration that may be used for the valid issuance of stock, it does allow the issuance of partially paid

320. DEL. CODE ANN. tit. 8, § 151(b)-(d) (1991 & Supp. 1998).

321. *See Providence & Worcester Co. v. Baker*, 378 A.2d 121, 122-24 (Del. 1977).

322. TEX. BUS. CORP. ACT ANN. art. 2.13 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 151(g) (Supp. 1998).

323. TEX. BUS. CORP. ACT ANN. art. 2.16(A) (Vernon Supp. 1999-2000).

324. *See* DEL. CONST. of 1897, art. IX, § 3; DEL. CODE ANN. tit. 8, § 152 (1991).

325. DEL. CODE ANN. tit. 8, § 152 (1991).

stock, which will be limited as to rights to dividends.³²⁶ Texas corporations are not permitted to issue partially paid stock, but this restriction is of little consequence given a corporation's right to receive debt obligations and executory contracts as valid consideration for the issuance of shares.

Both Texas and Delaware law provide that in the absence of fraud in the transaction, the determination by a corporation's board of directors of the value of the consideration received for shares of the corporation will be conclusive.³²⁷

3. *Stock Options and Convertible Securities*

Both Texas and Delaware expressly permit the use of options and other rights to purchase and acquire securities.³²⁸ Both states also require as general matter that options and other rights to acquire stock must be supported by consideration and that, absent fraud in the transaction by the board of directors, the judgment of the board of directors as to the adequacy of the consideration will be conclusive.³²⁹ In recognition of the difficulties that sometimes exist in identifying sufficient consideration for options and other rights to purchase shares that are issued to shareholders, employees, officers and directors in connection with rights plans, rights offerings and stock option arrangements, Texas expressly permits options and other rights to purchase shares to be granted to shareholders, employees, officers and directors without consideration if, in the judgment of the board of directors, the issuance of those options or rights would be in the interest of the corporation.³³⁰ Delaware does not have such a provision.

Texas also provides a means by which the consideration paid for an option or other right to purchase shares will be considered for purposes of determining the sufficiency of the consideration for shares purchased on the exercise of an option or other right.³³¹ Thus, if in connection with a financing, restructuring or leveraged buyout of a corporation, a person advances funds or other consideration for a package of securities that includes warrants or options to purchase shares without further payment or at an exercise price below the par value of the shares, the consideration received for the warrants or options on issuance will be applied to determine if adequate consideration under the statute (*i.e.*, an amount equal to at least the par value of the shares) is received upon the issuance of the underlying shares. Delaware has no similar provision for applying

326. *Id.* § 156.

327. TEX. BUS. CORP. ACT ANN. art. 2.16(B) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 152 (1991).

328. *See* TEX. BUS. CORP. ACT ANN. art. 2.14-1 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 157 (1991).

329. TEX. BUS. CORP. ACT ANN. art. 2.16(B) (West 2001); DEL. CODE ANN. tit. 8, § 152 (Supp. 1998).

330. TEX. BUS. CORP. ACT ANN. art. 2.14-1 (Vernon Supp. 1999-2000).

331. *Id.* TEX. BUS. CORP. ACT ANN. art. 2.15(F).

the consideration received for an option or right to acquire shares against the minimum par value consideration requirement for the shares purchased on exercise.³³²

4. *Transfer Restrictions*

Both Texas and Delaware law permit restrictions on transfers of shares to be imposed to enforce buy/sell arrangements, to maintain a corporation's tax status as a Subchapter S corporation and other tax advantages, to restrict transfer to certain designated persons or classes of designated persons as long as the designation is manifestly unreasonable, and to effect other lawful restrictions on transfer or registration.³³³ While presumably implicit under Delaware law under the "other lawful" restriction clause, Texas expressly permits restrictions on transfers that may be necessary to prevent violations of federal or state laws (such as laws restricting foreign ownership).³³⁴

5. *Certificated and Uncertificated Shares*

Both Texas and Delaware law provide for the use of both certificated and uncertificated shares.³³⁵

E. DIVIDENDS AND DISTRIBUTIONS

1. *General*

The provisions under Texas and Delaware law governing dividends and distributions are similar in many respects in that they both use the concept of surplus to determine the availability of funds from which a corporation may declare a lawful dividend or distribution.³³⁶ However, the TBCA and the DGCL differ in their approach toward dividends and distributions in many respects, with the principal distinctions being (i) their means for permitting directors to determine surplus, (ii) Texas' requirement that no distribution may be made if the corporation is insolvent or would be rendered insolvent by the distribution, (iii) Delaware's nimble dividend provision, which permits corporations to pay dividends from earnings even if there is no surplus, (iv) Delaware's treatment of purchases and acquisitions of stock in a different manner than dividends, and (v) the date for determining surplus in the case of a purchase or redemption of shares.

332. Huff, *Choice of State of Incorporation*, *supra* note 3.

333. See TEX. BUS. CORP. ACT ANN. art. 2.22 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 202 (1991).

334. TEX. BUS. CORP. ACT ANN. art. 2.22(D)(3) (Vernon Supp. 1999-2000).

335. See TEX. BUS. CORP. ACT ANN. art. 2.19 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 158 (1991).

336. See TEX. BUS. CORP. ACT ANN. art. 2.38 (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 170 (1991).

2. *Surplus*

“Surplus” is defined under both Texas and Delaware law to be the net assets of the corporation less the total stated value or stated capital of its issued shares.³³⁷ The means by which a board of directors may calculate surplus, however, is more specific and somewhat more expansive under Texas law than it is under Delaware law. In this regard, Article 2.38-3 of the TBCA expressly permits a board of directors to determine a corporation’s surplus and solvency based on (i) the corporation’s consolidated financial statements prepared in accordance with generally accepted accounting principles, (ii) the corporation’s financial statements for tax purposes, (iii) a fair valuation of assets and liabilities of the corporation and (iv) any other information that is considered reasonable under the circumstances.

Texas and Delaware also both permit a director, in determining the surplus of a corporation, to rely on any information, opinion, or statement, including financial statements and other financial data, concerning the corporation or any other person, as prepared by one or more officers or employees of the corporation, legal counsel, public accountants, investment bankers or other persons as to matters the director reasonably believes are within that person’s professional or expert competence, or a committee of the board of directors of which the director is not a member. The DGCL does not expressly permit director reliance on financial statements prepared in accordance with generally accepted accounting principles or fair value appraisals in calculating surplus. A director may consider these items if prepared by an expert that was chosen with reasonable care.

3. *Solvency Requirement*

In addition to a requirement that a corporation have surplus in order to pay a distribution, the TBCA provides that no distribution may be paid by a corporation if, after giving effect to the distribution, the corporation would be insolvent.³³⁸ Insolvency is defined in TBCA art. 1.02 section A(16) to mean the inability of the corporation to pay its debts as they become due in the usual course of its business. Delaware has no solvency test for distributions. However, under the Uniform Fraudulent Transfer Act, a distribution by an insolvent company may be set aside as a fraudulent transfer. The incorporation of an insolvency test in Texas is merely a codification of this concept in the TBCA.

4. *Nimble Dividends*

Under Delaware law, a corporation that does not have available surplus to pay a dividend may nevertheless pay a dividend out of its stated

337. TEX. BUS. CORP. ACT ANN. art. 1.02(A)(27) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 154 (1991).

338. TEX. BUS. CORP. ACT ANN. art. 2.38(B)(1) (Vernon Supp. 1999-2000).

capital if the corporation has net profits for the fiscal year in which the dividend is declared or in the preceding fiscal year.³³⁹ This provision is not available when the dividend would result in the net assets of the corporation being less than the aggregate amount of capital represented by the issued and outstanding stock of all classes that have preference upon the distribution of assets.³⁴⁰ Texas does not have a similar provision.

5. *Share Purchases*

Under Texas law, a purchase, redemption or other acquisition by a corporation of its own shares is considered a distribution and is therefore subject to the same surplus and solvency requirements applicable to the payment of dividends.³⁴¹ Purchases and redemptions of stock under Delaware law are treated somewhat differently under the DGCL than dividends. Under § 160(a) of the DGCL, a corporation may not purchase or redeem its own shares for cash or other property when the capital of the corporation is "impaired" or where the purchase or redemption would cause an impairment of the capital of the corporation.³⁴² Impairment of capital is not defined under the DGCL, but has been construed by the courts to generally mean a reduction of the amount of assets of the corporation below the amount represented by the aggregate outstanding shares of the corporation.³⁴³ Thus, this provision essentially permits a corporation to purchase its shares only if there is available surplus. The DGCL also prohibits a corporation from purchasing shares that are redeemable at the option of the corporation for a price greater than that at which they may then be redeemed.³⁴⁴

Both Texas and Delaware law provide that where a corporation has purchased its own shares through the use of indebtedness or a deferred payment obligation, the date for the determination of the availability of surplus will be the date that the indebtedness or obligation is incurred rather than on each date on which the payment obligations are due.³⁴⁵ This provision is intended to provide certainty as to the enforceability of such obligations.

Texas law also provides that where a corporation purchases, redeems, exchanges or otherwise acquires its own shares, the determination of surplus may, at the election of the corporation, be either the date on which the obligation to redeem, exchange, purchase or otherwise acquire is made or on the date the shares are to be redeemed, exchanged, purchased or acquired.³⁴⁶ This provision conforms the manner in which the

339. DEL. CODE ANN. tit. 8, § 170(a) (Supp. 1998).

340. *Id.*

341. TEX. BUS. CORP. ACT ANN. art. 1.02(A)(13)(b) (Vernon Supp. 1999-2000).

342. DEL. CODE ANN. tit. 8, § 160(a)(1) (Supp. 1998).

343. *See In re Int'l Radiator Co.*, 92 A. 255, 256 (Del. Ch. 1914); *Acker v. Girard Trust Co.*, 42 F.2d 37, 40 (3d Cir. 1930).

344. DEL. CODE ANN. tit. 8, § 160(a)(2) (1991).

345. TEX. BUS. CORP. ACT ANN. art. 2.38-4(B) (Vernon Supp. 1999-2000); DEL. CODE ANN. tit. 8, § 160(a)(1) (1991).

346. TEX. BUS. CORP. ACT ANN. art. 2.38-4(B) (Vernon Supp. 1999-2000).

availability of surplus is determined for contractual redemptions, exchanges, purchases or acquisitions of shares to that used for purchases of shares in which a debt obligation is incurred.³⁴⁷ Delaware does not have a similar provision.

6. *Date for Determination of Surplus*

Under Texas law, the date for determination of surplus and solvency for the payment of a lawful distribution that is not a redemption, exchange, purchase or acquisition of shares will generally be the date of the authorization of the distribution. However, if the distribution is to occur more than 120 days after the authorization, the date for the determination of surplus and solvency will be the date of the distribution unless a date within 120 days prior to the distribution is designated by the board of directors for the date on which the determination is to be made.³⁴⁸ The purpose of establishing a date on which surplus and solvency is to be determined under the TBCA is to provide greater certainty with respect to the legality of distributions. Without this provision, questions could arise as to the legality of a distribution due to changes in circumstances between the date of declaration and payment and the inherent difficulty in confirming solvency and surplus on a current basis as of any given date. Delaware does not have a similar provision.

7. *Director Liability for Unlawful Distributions*

Article 2.41(C) of the TBCA provides that a director will have no liability for approving a distribution based on a calculation of surplus and a determination of solvency using such indices of value and solvency as permitted by Article 2.38-3 described above, if he did so in good faith and with ordinary care, or if in good faith and with ordinary care he considered the assets of the corporation to have a value equal to at least their value.³⁴⁹ A director will not be deemed to have relied in good faith on such information if the director has knowledge concerning the matter that makes reliance otherwise permitted unwarranted.³⁵⁰

Under § 174 of the DGCL, a director will be jointly and severally liable for the authorization and payment of an unlawful dividend if he voted for the dividend or failed to dissent from the declaration of the dividend immediately after he has notice of the same.³⁵¹ However, § 172 of the DGCL provides that a member of a board of directors will be fully protected in relying in good faith on the records of the corporation and on such information, opinions, reports or statements presented to the corporation by any of its officers or employees, or any committee of the board of directors, or of any other person as to matters the director reasonably

347. *See id.*

348. *Id.* art. 2.38-4(A) (Vernon Supp. 1999-2000).

349. *Id.* art. 2.41(C) (Vernon Supp. 1999-2000).

350. *Id.* art. 2.41(D) (Vernon Supp. 1999-2000).

351. DEL. CODE ANN. tit. 8, § 174 (Supp. 1998).

believes are within that person's professional expert competence and who has been selected with reasonable care by or on behalf of the corporation as to the value and amount of the corporation's assets, liabilities or net profits or any other facts pertinent to the existence or amount of surplus or other funds from which dividends might be promptly declared or paid or from which the corporation may promptly purchase or redeem its own stock.³⁵²

F. SHAREHOLDER AGREEMENTS

The TBCA has since 1981 permitted a corporation to elect to be a close corporation and to modify its internal affairs by agreement. To qualify as a close corporation, the corporation and its shareholders had to make various elections and filings with the Secretary of State of Texas. Following the lead of the Revised Model Business Corporation Act, the TBCA was amended in 1997 to extend the flexibility of a closed corporation to all corporations that are not publicly traded through the addition of a new Article 2.30-1.

Article 2.30-1 provides for broad-based and flexible shareholders' agreements that modify and override the mandatory provisions of the TBCA relating to a corporation's operations and internal affairs. An agreement under Article 2.30-1 must be approved by all shareholders and incorporated in the corporation's articles of incorporation or bylaws or in an agreement signed by all shareholders and made known to the corporation.³⁵³ Once adopted, the provisions of the shareholders' agreement will override the general provisions of the TBCA relating to the matters provided for under the agreement.

A shareholders' agreement under Article 2.30-1 may provide for any one or more of the following:

- (1) restrict the discretion or powers of the board of directors;
- (2) eliminate the board of directors and permit management of the business and affairs of the corporation by its shareholders;
- (3) establish the natural persons who shall be the directors or officers of the corporation, their term of office or manner of selection or removal, or terms or conditions of employment of any director, officer or other employee of the corporation, regardless of the length of employment;
- (4) govern the authorization or making of distributions whether or not in proportion to ownership of shares, subject to the limitations in Article 2.38 of the TBCA, or determine the manner in which profits and losses shall be apportioned;
- (5) govern, in general or in regard to specific matters, the exercise or division of voting power by and between the shareholders, directors (if any), or other persons or by or among any of them, including use of disproportionate voting rights or director proxies;

352. DEL. CODE ANN. tit. 8, § 172 (1987).

353. TEX. BUS. CORP. ACT ANN. art. 2.30-1 (Vernon Supp. 1999-2000).

- (6) establish the terms and conditions of any agreement for the transfer or use of property or the provision of services between the corporation and any shareholder, director, officer or employee of the corporation, or other person or among any of them;
- (7) authorize arbitration or grant authority to any shareholder or other person as to any issue about which there is a deadlock among the directors, shareholders or other person or persons empowered to manage the corporation to resolve that issue;
- (8) require dissolution of the corporation at the request of one or more of the shareholders or upon the occurrence of a specified event or contingency in which case the dissolution of the corporation shall proceed as if all the shareholders had consented in writing to dissolution of the corporation as provided in Article 6.02 of the TBCA; or
- (9) otherwise govern the exercise of corporate powers or the management of the business and affairs of the corporation or the relationship among the shareholders, the directors and the corporation, or among any of them, as if the corporation were a partnership or in a manner that would otherwise be appropriate only among partners, and is not contrary to public policy.

Shares of an electing corporation must contain a conspicuous notation on the certificates representing the shares or on the information statement required for uncertificated shares.³⁵⁴ A purchaser who acquires shares of an electing corporation without actual or deemed knowledge of the agreement will have a right of rescission for 90 days after obtaining that knowledge.³⁵⁵ An agreement permitted under Article 2.30-1 will cease to be effective when shares of the corporation become listed on a national securities exchange, quoted on an interdealer quotation system of a national securities association or regularly traded in a market maintained by one or more members of a national or affiliated securities association.³⁵⁶

An agreement authorized under Article 2.30-1 that limits the discretion or powers of the board of directors or supplants the board of directors will relieve the directors of, and impose upon the person or person in whom such discretion or powers or management of the business and affairs of the corporation are vested, liability for action or omissions imposed by the TBCA or other law on directors to the extent that the discretion or powers of the directors are limited or supplanted by the agreement.³⁵⁷

Article 2.30-1 is of substantial benefit to both privately held companies that wish to have maximum flexibility in dealing with the management of their corporations and larger public corporations who wish to have flexibility in operating and running their subsidiaries. Examples of this enhanced flexibility include:

354. *Id.* art. 2.30-1(C).

355. *Id.* art. 2.30-1(D).

356. *Id.* art. 2.30-1(E).

357. *Id.* art. 2.30-1(F).

- (i) The use of corporate entities serving the same role as directors by providing director powers to the corporate entity shareholders;
- (ii) Allocation of votes among directors without creating multiple classes of shares;
- (iii) Providing for director proxies;
- (iv) Providing for disproportionate or different dividends and distributions;
- (v) Providing for extended terms for directors and appointment of new directors by existing director or shareholder groups;
- (vi) Modifying mandatory voting requirements or establishing or reducing rights of shareholders beyond those otherwise permitted by the TBCA; and
- (vii) Modifying, establishing or eliminating the duties (including fiduciary duties) of directors, officers and shareholders.

The existence or performance of an agreement authorized by Article 2.30-1 of the TBCA will not be grounds for imposing personal liability on any shareholder for the acts or obligations of the corporation by disregarding the separate entity of the corporation or otherwise, even if the agreement or its performance treats the corporation as if it were a partnership or in a manner that otherwise is appropriate only among partners, results in the corporation being considered a partnership for purposes of taxation or results in failure to observe the corporate formalities otherwise applicable to the matters governed by the agreement.³⁵⁸ As a result, Article 2.30-1 of the TBCA provides protection beyond Article 2.21 of the TBCA on shareholder liability.

Delaware also permits shareholder agreements, but does not permit the agreements to be modified by agreement of all stockholders the management and statutory rights and provisions of the DGCL.³⁵⁹

G. DISSOLUTIONS

1. *General*

Both Texas and Delaware law provide procedures for the liquidation and dissolution of corporations. The procedures available in Texas, however, provide for a more streamlined and simple method for resolving and satisfying claims on liquidation than that which is provided in Delaware. Texas also treats contingent claims as of the date of dissolution substantially different than Delaware.

2. *Dissolutions under Texas Law*

In Texas, a corporation begins the process of dissolution of action by its board of directors, which is then followed by approval of the holders of at least two-thirds of the corporation's outstanding shares.³⁶⁰ As is the case for other fundamental transactions, the required vote may be reduced to

358. *Id.* art. 2.30-1(G).

359. *See* DEL. CODE ANN. tit. 8, § 218 (Supp. 1998).

360. TEX. BUS. CORP. ACT ANN. art. 6.03 (Vernon Supp. 1999-2000).

the affirmative vote of the holders of a majority of the outstanding shares.³⁶¹ Once a corporation's shareholders have approved the dissolution of the corporation, the corporation begins to proceed to collect on its assets, dispose of its properties that are not to be distributed in kind to its shareholders, and pay, satisfy and discharge all of its debts, liabilities and obligations, or make adequate provision for such payment.³⁶²

To the extent that the property and assets of the corporation are not sufficient to pay all of the corporation's debts, liabilities and obligations, the corporation is required to apply its assets as far as they will go to the just and equitable payment and satisfaction of those debts, liabilities and obligations.³⁶³ Once the corporation has paid, satisfied or discharged all of its debts, liabilities and obligations, or made adequate provision for the same, the remainder of the corporation's properties and assets, either in cash or in kind, are to be distributed to shareholders in accordance with their respective interests. The corporation must then proceed to file articles of dissolution.

In considering the amount and timing of distributions to shareholders in a dissolution, the TBCA permits the board of directors of a dissolving Texas corporation to expressly consider the creditworthiness of any party that agrees to assume the liabilities of the corporation for purposes of determining whether the obligations of the corporation have been "adequately provided for" prior to making a distribution to shareholders in liquidation.³⁶⁴ In so doing, a board of directors of a corporation is entitled to rely on financial and other information of the assuming corporation.³⁶⁵

Once a corporation has filed articles of dissolution in Texas, the corporation will continue in existence for a period of three years for the purpose of prosecuting and defending any remaining actions and holding title and liquidating its properties.³⁶⁶ If any proceedings are continuing at the end of the three year period, the corporation will continue in existence for purposes of completing that proceeding and finalizing its distributions to creditors and shareholders. During the period following the filing of articles of dissolution and the completion of the dissolution, the members of the board of directors will continue to manage the corporation and will have the same duties, liabilities and protections that they had prior to the dissolution.³⁶⁷

Once articles of dissolution have been filed, the corporation will no longer be liable for any claims, other than claims that existed as of the time of the dissolution.³⁶⁸ An existing claim is defined in Article 7.12 to

361. *Id.* art. 2.28.

362. *Id.* art. 6.04(A)(3).

363. *Id.*

364. *See id.* arts. 2.38-3, 2.41, 6.04.

365. *Id.* art. 2.41(C), (D).

366. TEX. BUS. CORP. ACT ANN. art. 7.12A(A) (Vernon Supp. 1999-2000).

367. *Id.* art. 7.12(B).

368. *Id.* art. 7.12(C).

be (i) a right of payment, damages or property, whether liquidated or unliquidated, accrued or contingent, matured or unmatured, that existed before the dissolution and is not otherwise barred by limitations and (ii) a contractual obligation incurred after dissolution.³⁶⁹ A personal injury claim occurring after dissolution is not an existing claim.³⁷⁰ Any claim that existed as of the time of the dissolution will be extinguished unless an action or proceeding is brought within three years following the date of dissolution.³⁷¹ The foregoing provisions represent an express bar to the common law trust fund theory.³⁷²

A corporation may expedite the three-year time period for resolving existing claims by giving written notice to persons having or asserting any existing claims against the corporation.³⁷³ Such a notice must advise the person of when a claim must be presented (which date may not be less than 120 days after the date of the notice) and that a failure to make a notice within the required time period will result in extinguishment of that party's claim.³⁷⁴ This notice must be accompanied with a copy of the applicable provisions of the TBCA relating to the extinguishment of claims in dissolution.³⁷⁵ The corporation will be entitled to object to any claims that are made to it in response to its notice by providing written notice of such objection to the claimant. A disputed claim of a claimant will be extinguished under the TBCA following the notice unless an action is brought by the claimant against the corporation within 180 days after the notice of rejection or before the expiration of the three-year period following the date of dissolution.³⁷⁶

3. Dissolutions Under Delaware Law

In Delaware, the liquidation and dissolution of a corporation begins with approval of a plan of dissolution by the board of directors and requires the approval of a majority of the outstanding shares of the corporation entitled to vote on the dissolution.³⁷⁷ Upon approval of the dissolution, the corporation files a certificate of dissolution and proceeds to settle and close the business of the corporation, dispose of and convey the corporation's property, discharge the corporation's liabilities, and distribute the remaining assets to the corporation's shareholders.³⁷⁸

As in Texas, any action, suit or proceeding begun by or against the corporation prior to the dissolution or within three years after filing of

369. *Id.* art. 7.12(F)(2), (3).

370. *Id.*; see also *Hunter v. Fort Worth Capital Corp.*, 620 S.W.2d 547, 549-500 (Tex. 1981); *Weibel v. Martin Indus., Inc.*, 806 S.W.2d 345, 346 (Tex. App.—Fort Worth 1991, no writ).

371. TEX. BUS. CORP. ACT ANN. art. 7.12(C) (Vernon Supp. 1999-2000).

372. See *Hunter*, 620 S.W.2d at 550.

373. TEX. BUS. CORP. ACT ANN. art. 7.12(D) (Vernon Supp. 1999-2000).

374. *Id.*

375. *Id.*

376. *Id.*

377. DEL. CODE ANN. tit. 8, § 275(a), (b) (1991).

378. *Id.* tit. 8, § 278.

articles of dissolution, may be commenced.³⁷⁹ However, unlike in Texas, proceedings brought against the corporation will not be limited to claims that existed on the date of the filing of the articles of dissolution. Rather, they will extend to claims that occur subsequent to the filing as well as contingent unknown claims that are “likely to arise or to become known to the corporation or successor entity . . . prior to the expiration of applicable statutes of limitations.”³⁸⁰ Thus, in regard to future contingent liabilities, the range of potential liabilities to be resolved during the liquidation and dissolution process is substantially broader under Delaware law than it is under Texas law.

Like the TBCA, the DGCL also sets forth an expedited procedure for resolving claims against a corporation during the dissolution process. Under section 280 of the DGCL, a corporation may elect to follow a procedure in which all claimants are advised of the dissolution by mail and publication in a newspaper of general circulation in a county in which the corporation’s office is located, and in the case of the corporation having more than \$10,000,000 in total assets, at least once in all editions of a daily newspaper with national circulation.³⁸¹ Under this procedure, the corporation may require that claims be submitted to it within sixty days after providing the notice and that any actions be filed in respect to disputed claims within ninety days after notice of a rejection of the claim.³⁸²

The notice provisions under section 280 of the DGCL must be given to all persons having claims, as well as all persons with contractual claims contingent upon the occurrence or non-occurrence of future events.³⁸³ Notice to persons who have contingent claims that are not contractual in nature, which the DGCL defines to include persons with possible warranty and product liability claims, need not be provided notice under the statute.³⁸⁴ Section 280 also establishes a procedure by which the Court of Chancery may determine the amount and form of security reasonably likely to be sufficient to provide compensation for claims that are not known to the corporation or that have not arisen or are likely to arise or to become known to the corporation or successor entity prior to the expiration of applicable statutes of limitations.³⁸⁵ The Court of Chancery may also appoint a guardian ad litem in respect of any proceeding brought under this provision.³⁸⁶

A corporation not electing to follow the procedures set forth in section 280 must pay or make reasonable provision for the payment of all claims and obligations, including all contingent, conditional and unmatu-
red contractual claims known to the corporation or any successor en-

379. *Id.*

380. *Id.* §§ 280(c)(2), 281(b).

381. *Id.* § 280(a)(1)(f).

382. *See id.* at (a)(1), (3).

383. *See* DEL. CODE ANN. tit. 8, § 280(a)(1), (b)(2) (1991).

384. *See id.* § 280(b)(1).

385. *See id.* § 280(c)(1)-(3).

386. *See id.* § 280(c)(3).

tity. The corporation must make provision as will be reasonably likely or sufficient to provide compensation for claims that are not known or that have not arisen but based on facts known to the corporation are likely to arise in the future prior to the expiration of the applicable statute of limitations.³⁸⁷

4. *Derivative Lawsuits*

In Delaware, there has developed a substantial body of case law relating to shareholder demand requirements and the interplay between the business judgment rule and the right of a corporation to dismiss a derivative lawsuit for not being in the interest of the corporation. This case law resulted in somewhat confusing and contrary decisions involving concepts such as what is sufficient demand, when is demand excused, and the role of the court in reviewing the business judgment of a board of directors or committee that is charged with reviewing a particular claim.

Article 5.14 of the TBCA relating to derivative lawsuits was amended in 1997 to provide a rule for the review and handling of shareholder derivative lawsuits. The amendments establish clear procedures for the review of derivative lawsuits while attempting to maintain a balance between the right of a shareholder to pursue a corporate action that has not been properly considered by the corporation's board while giving deference to the business decisions and judgments made by a disinterested and independent committee of a board of directors with respect to the advisability of pursuing such a claim.³⁸⁸

Article 5.14 establishes a universal demand requirement without any "demand excused" exception.³⁸⁹ As a result, the statute requires that under all circumstances a shareholder to make a demand on the corporation before the shareholder may proceed with an action in the name of the corporation.³⁹⁰ This absolute demand requirement is intended to provide greater certainty to both the corporation and the shareholder by eliminating the procedural trap for shareholders that often exists in derivative proceedings. A shareholder's failure to make a demand will result in a dismissal of the shareholder's lawsuit. The demand by the shareholder must be in writing and set forth with particularity the act, omission, or other matter that is the subject of the claim or challenge and request that the corporation take suitable action.³⁹¹ The corporation will then have ninety days to review the matter. During this review period, the shareholder may not file an action unless the shareholder is notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation is being suffered or would result by waiting for the expiration of the ninety-day period.³⁹² A written demand filed

387. *See id.* § 281(b).

388. *See* TEX. BUS. CORP. ACT ANN. art. 5.14 (West, Supp. 2000).

389. *Id.* art. 5.14(C).

390. *See id.*

391. *See id.*

392. *See id.*

with the corporation by a shareholder will toll the statute of limitations on the claim upon which demand is made until the earlier of ninety days and thirty days after the corporation advises the shareholder that the demand has been rejected or the review has been completed.³⁹³

A shareholder whose demand has been rejected or not acted upon within ninety days of notice may file a derivative suit with respect to the matter. A shareholder, however, may not commence or maintain a derivative proceeding unless the shareholder was a shareholder of the corporation at the time of the act or omission complained of or became a shareholder by operation of law from a person that was shareholder at that time. The shareholder must also fairly and adequately represent the interests of the corporation in enforcing the right of the corporation.³⁹⁴ If a derivative proceeding is commenced after a demand is rejected or the 90-day review period expires, the petition must allege with particularity facts that establish that the rejection was not made in accordance with the requirements of statute.³⁹⁵

If following the receipt of a demand by a shareholder, the corporation commences an inquiry into the allegations made in a demand and conducts an active review of the allegations in good faith, the court is required to stay the "derivative proceeding until the review is completed and a determination is made by the person or group as to what further action, if any, should be taken."³⁹⁶ To obtain a stay, the corporation "must provide the court with a written statement containing an undertaking to advise the court and the shareholder making the demand of the determination promptly upon the completion of the review of the matter."³⁹⁷ A stay may "be reviewed as to its continued necessity every sixty days thereafter."³⁹⁸ If the review and determination relating thereto is not completed within sixty days, the stay may be renewed for one or more additional sixty day periods upon the "corporation providing the court and the shareholder making the demand with a written statement of the status of the review and the reasons a continued extension of the stay is necessary."³⁹⁹ The extension of the stay, however, is not automatic and is dependent on the court's determination that the review process is being actively pursued in good faith.

A corporation may seek a dismissal of a derivative proceeding that is filed on the grounds that it is not in the interest of the corporation to pursue. A court will be required to dismiss the proceeding on this basis if (i) a majority of the independent and disinterested directors of the corporation constituting a quorum of the whole board; (ii) a committee of the board consisting of two or more independent and disinterested directors;

393. See TEX. BUS. CORP. ACT ANN. art. 5.14(E) (Vernon Supp. 1999-2000).

394. *Id.* art. 5.14(B).

395. See *id.* art. 5.14(G).

396. TEX. BUS. CORP. ACT ANN. art. 5.14(D)(1) (Vernon Supp. 1999-2000).

397. *Id.*

398. *Id.*

399. *Id.*

or (iii) one or more persons who are independent and disinterested and appointed by the court at the recommendation of the corporation determine in good faith, after conducting a reasonable inquiry and based on the factors as the person or group deems appropriate under the circumstances, that the continuation of the derivative proceeding is not in the best interests of the corporation.⁴⁰⁰ The court may not second-guess the business judgment of the reviewing body nor engage in a review of the substantive claims proposed to be pursued by the shareholder. Rather, the court's review is limited to a review of the good-faith review of the board, committee, or panel and the disinterest and independence of such persons.

If a corporation seeks to have the review of the desirability of pursuing a proceeding delegated to one or more independent and disinterested persons appointed by the court, the persons must be appointed by the court upon a motion by the corporation setting forth the names of the persons to be appointed together with a statement that to the best of the corporation's knowledge the persons proposed are disinterested persons and are qualified to make the determinations contemplated by the statute.⁴⁰¹ A shareholder may not propose a reviewing panel or members of the reviewing panel, nor may the court make such a proposal itself. The court, however, need not appoint the persons proposed by the corporation if the court finds that those persons are not independent and disinterested persons or are otherwise not qualified in regard to expertise, experience, independent judgment and other factors deemed appropriate by the court under the circumstances to make such determinations. "Persons appointed by the court will have no liability to the corporation or its shareholders for any action or omission taken by them in that capacity absent fraud or willful misconduct."⁴⁰²

In determining whether the requirements for dismissal have been met, the initial burden of proof will be on the shareholder "if a majority of the board of directors consists of independent and disinterested directors at the time the determination is made" or if the determination is made by a panel of one or more independent and disinterested persons appointed by the court in accordance with the statute.⁴⁰³ The initial burden of proof will be on the corporation in all other circumstances.⁴⁰⁴ If the corporation presents prima facie evidence that demonstrates that the directors or the members of the special review committee are independent and disinterested, the burden of proof will shift back to the shareholder.⁴⁰⁵

Pending a judicial determination whether a derivative proceeding may be pursued by a shareholder and after the expiration of the stay period, discovery by the shareholder will be limited to facts relating to whether

400. *See id.* art. 5.14(F), (H).

401. *See* TEX. BUS. CORP. ACT ANN. art. 5.15(H) (Vernon Supp. 1999-2000).

402. *Id.*

403. *Id.* art. 5.14(F).

404. *See id.*

405. *See id.*

the person or group undertaking the review in accordance with the statute:

is independent and disinterested, the good faith of the inquiry and review by such person or group, and the reasonableness of the procedures followed by such person or group in conducting its review and will not extend to any facts or substantive matters with respect to the act, omission, or other matter that is the subject matter of the action in the derivative proceeding.⁴⁰⁶

The scope of discovery may be expanded if the court determines after notice and hearing that a good faith review of the allegations has not been made by an independent and disinterested person or group in accordance with the statute.⁴⁰⁷

On termination of a derivative proceeding, the court may order the corporation to pay the plaintiff's expenses incurred in the proceeding if it finds that the proceeding has resulted in a substantial benefit to the corporation.⁴⁰⁸ The court may also order the shareholder "to pay the expenses of the corporation or any defendant incurred in investigating and defending the proceeding if it finds that the proceeding was commenced or maintained without reasonable cause or for an improper purpose."⁴⁰⁹ In addition, the statute provides the courts with the authority to order a party to pay the expenses incurred by another party (including the corporation):

because of the filing of a pleading, motion or other paper, if it finds that the pleading, motion or other paper (i) was not well grounded in fact after reasonable inquiry, (ii) was not warranted by existing law or a good faith argument for the extension, modification or reversal of existing law or (iii) was interposed for an improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation.⁴¹⁰

Article 5.14 applies principally to corporations organized under Texas law and is intended to relate to the substantive internal affairs of the corporation, and therefore applies to cases brought both in and outside of Texas.⁴¹¹ As such, article 5.14 supplants and overrides, to the extent inconsistent, any judicial rules of procedure governing derivative proceedings, including Rule 23(b) of the Federal Rules of Civil Procedure and Rule 42(a) of the Texas Rules of Civil Procedure. In addition, the procedural provisions relating to stays, discovery and expenses will also apply to derivative proceedings in the Texas courts involving foreign corporations.

Central to the operation of article 5.14 are new definitions of "independent" and "disinterested" in article 1.02 of the TBCA. A person will be

406. TEX. BUS. CORP. ACT ANN. art. 5.14(D)(2) (Vernon Supp. 1999-2000).

407. *See id.*

408. *See id.* art. 5.14(J)(1)(a).

409. *Id.* art. 5.14(J)(1)(b).

410. *Id.* art. 5.14(J)(1)(c).

411. *See id.* art. 5.14(K).

considered “independent” for purposes of article 5.14, if for purposes of considering the disposition of a claim or challenge, the person: (i) is disinterested, (ii) is not an associate or member of the immediate family of a party to the contract or transaction, (iii) does not, nor does any associate or member of such person’s immediate family, have a business, financial or familial relationship with a party to the contract or transaction; and (iv) is not otherwise shown, by a preponderance of the evidence, to be under the controlling influence of a party to the contract or transaction subject to challenge or that is alleged to have engaged in conduct that is the subject to the claim or challenge.⁴¹² As a result, the determination of the compliance of the review with the statutory requirements will be a question of fact to be determined by the court in connection with a motion to dismiss.

To eliminate a common area of dispute that has arisen in Delaware and other jurisdictions in regard to independence, the TBCA provides that the following factors will not in and of themselves result in a person not being considered independent:

- (i) the person was nominated as a director by the person against whom the action relates;
- (ii) the person receives normal director’s fees or similar customary compensation and benefits as a director;
- (iii) the person has a direct or indirect ownership interest in the corporation;
- (iv) the corporation or its subsidiaries have an interest in the transaction or was affected by the alleged conduct;
- (v) the person or an associate or affiliate receives customary and ordinary compensation for services rendered to engage in a review, make recommendations or decide the disposition of the claim or challenge; or
- (vi) the person or an associate, immediate family member or affiliate has an ongoing business relationship with the corporation that is not material to that person, associate, family member or affiliate.⁴¹³

A person will be considered “disinterested” for purposes of Article 5.14 if the person is not a party to the contract or transaction that is the subject of the claim or is “not materially involved in the conduct that is subject to the claim or challenge and does not otherwise have a material financial interest in the outcome of the contract or transaction or the disposition of the claim or challenge.”⁴¹⁴

As with the definition of “independent,” a person will not be considered to have such an interest solely by reason of any one or more of the permitted exceptions in the definition of independence or either one of the following:

- (i) the person is a named defendant in the proceeding or is a person who is alleged to have engaged in the complained of conduct; or

412. See TEX. BUS. CORP. ACT ANN. art. 1.02(A)(15) (Vernon Supp. 1999-2000).

413. *Id.*

414. *Id.* art. 1.02(A)(12).

(ii) the person voted for or acquiesced in, as a director, the act being challenged if the act resulted in no material personal or financial benefit to the person and the challenging party fails to allege with particularity facts that, if true, raise a significant prospect that the person would be adjudged liable to the corporation or its shareholders by reason of that conduct; e.g., a breach of the duty of loyalty.⁴¹⁵

H. MISCELLANEOUS

1. *Bylaw Adoption and Amendments*

Under Texas law, unless otherwise provided in the articles of incorporation, directors are authorized to adopt and amend bylaws.⁴¹⁶ Under Delaware law, the initial bylaws are to be adopted by the incorporators or initial directors and thereafter only shareholders can amend the bylaws unless the certificate of incorporation permits the directors to do the same.⁴¹⁷ The right of shareholders to amend bylaws also may not be prohibited under Delaware law. Under Texas law, the articles of incorporation or a bylaw adopted by shareholders may provide that the bylaws may not be amended by shareholders.⁴¹⁸ This provision was adopted to address the sometimes uncertain status of provisions in certificates of incorporation in Delaware that provide for supermajority votes of stockholders to amend bylaws (e.g., is a provision that requires a 99.9% vote of stockholders of a public company to adopt a bylaw a *de facto* prohibition on the right of stockholders to adopt and amend bylaws).

2. *Delayed Effectiveness*

Article 10.03 of the TBCA provides that substantially all transactions that may be effected under the TBCA may be made effective as of a time and date after the time and date otherwise provided in the TBCA and may be made effective upon the occurrence of events or facts that may occur in the future, which events or facts may include future acts of any person or entity, provided that the delayed effectiveness may not occur more than ninety days after the filing of the articles, statement, application or other filings required to be made with the Secretary of State.⁴¹⁹ Further, if the effectiveness is to be based on events or facts that may occur in the future, other than the mere passage of time, a statement of those events or facts must be identified in an initial filing and a subsequent filing must be made within ninety days stating that all the events or facts upon which the effectiveness was conditioned have been satisfied or waived and the date on which the condition was satisfied or waived.⁴²⁰

415. *Id.*

416. *See id.* art. 2.23(B).

417. *See* DEL. CODE ANN. tit. 8, § 109(a) (1991).

418. *See* TEX. BUS. CORP. ACT ANN. art. 2.23(C) (Vernon Supp. 1999-2000).

419. *See id.* art. 10.03(d), (A)(2) (Vernon Supp. 1999-2000).

420. *Id.* at art. 10.03(d)(A)(3).

Under Delaware law, an instrument or filing may be made effective at a time subsequent to the initial filing as long as such time and date is not greater than ninety days after the date of the initial filing.⁴²¹ The DGCL does not permit for delayed effectiveness of filings based on matters other than the passage of time.

VI. PROPOSED TEXAS BUSINESS ORGANIZATIONS CODE

Texas is proceeding forward to update all of its business organization statutes through a new proposed Business Organizations Code (the "Entity Code") for Texas that has been introduced⁴²² in the 77th Session of the Texas Legislature which was convened January 9, 2001. This new Entity Code is intended to provide maximum flexibility to organizations in the establishment of their capital structures, effecting business combination transactions and governing their internal affairs and should become a model for future statutes and solidifying Texas' position as a leader in corporate law.⁴²³

The Entity Code is intended to be a substantive codification of the existing Texas statutes governing non-profit and for-profit, private-sector entities. These statutes consist of the following: Texas Business Corporation Act, Texas Non-Profit Corporation Act, Texas Miscellaneous Corporation Laws Act, Texas Limited Liability Company Act, Texas Revised Limited Partnership Act, Texas Real Estate Investment Trust Act, Texas Uniform Unincorporated Nonprofit Associations Act, Texas Professional Corporation Act, Texas Professional Associations Act, the Texas Revised Partnership Act, the Cooperative Associations Act and other existing provisions of Texas statutes governing private entities.

The Entity Code is a joint project of the Business Law Section of the State Bar of Texas, The Office of the Texas Secretary of State and the Texas Legislative Council.⁴²⁴ The Code has been under development since 1995.⁴²⁵

421. DEL. CODE ANN. tit. 8, § 103(d) (1991).

422. Tex. H.B. 327 77th Leg., R.S. (2001), available at <http://www.capitol.state.tx.us/tlo/77r/billtext/HB00327L.HTM> (Rep. Fred Bosse).

423. See Thomas F. Blackwell, *Finally Adding Method to Madness: Applying Principles of Object Oriented Analysis to Legislative Drafting*, 3 NYU J. of Legis. and Pub. Pol'y 227, 249-257 (2000).

424. Ad Hoc Codification Committee of the Business Law Section, *Report of the Codification Committee of the Section of Business Law of the State Bar of Texas on the Proposed Business Organizations Code*. The Bar Committee was primarily responsible for drafting the Code in collaboration with the Office of the Texas Secretary of State and the Texas Legislative Council.

425. A version of the Entity Code was introduced on March 9, 1999 in the 76th Texas Legislative Session as House Bill 2681 by Rep. Fred Bosse. The bill was heard by and reported favorably out of the Business & Industry Committee, but was never set on the House Calendar during the 76th Legislative Session. For information regarding the bill as introduced in 1999, see <http://www.texasbusinesslaw.org/1999code/originalprelimrpt.html>. In preparing for the 77th Legislative Session, the Bar Committee worked with the Texas Secretary of State and the Legislative Council in preparing the form of Entity Code introduced on December 5, 2000 as House Bill 327.

The Texas Legislative Council is required by law⁴²⁶ to revise and reorganize statutes into codes. The codification process involves reclassifying and rearranging the statutes in a more logical order, emphasizing a numbering system and format that will accommodate future expansion of the law, eliminating repealed, invalid, duplicative and other ineffective provisions, and improving the draftsmanship of the law if practicable. These efforts are carried out to make the statutes more accessible, understandable and useable.

The proposed Entity Code adopts a “hub and spoke” organizational approach under which provisions common to all entities are included in a central “hub” of the Entity Code found in Title 1. These common provisions are collected in and include the provisions governing (i) indemnification of directors and partners, (ii) mergers among entities and (iii) purposes and powers of entities. Outside Title 1, separate “spokes” contain provisions governing different types of entities which are not common or similar among the different entities.

In the codification process, the Legislative Council’s mandate is not to make any substantive revisions to the Texas statutes. As a result, the principles of Texas law discussed above will be carried forward into the Entity Code.

VII. CONCLUSION

As is evident from the above discussion, the TBCA has evolved over the last decade into one of the most modern, flexible, and progressive corporation law statutes in the country. As such, it is on par with the DGCL and, in many areas, provides corporations with greater flexibility, options, and alternatives than are available to corporations under Delaware law.

The choice of jurisdiction of incorporation, however, is not always a simple one and cannot be based solely on the corporation laws of the proposed state of incorporation. The decision must also take into account factors such as franchise taxes and other financial and business concerns. Often while one state’s corporation laws may be more desirable than another state’s, the choice of jurisdiction of incorporation will be mandated by these other items. Where non-financial or business concerns do not require a different decision, practitioners should seriously consider Texas as a potentially more desirable alternative to Delaware when making the incorporation decision.

426. TEX. GOV’T CODE ANN. § 323.007 (West 2001).

