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CORPORATIONS

by

*Robert W. Hamilton**

THE principal developments during the survey period were decisions by Texas and federal courts breaking new ground in several areas.¹ In addition, the Securities Exchange Commission issued significant new regulations relating to the intrastate and private offering exemptions to the Securities Act of 1933.

I. GENERAL CORPORATE DEVELOPMENTS

Corporate Repurchases of Stock. Corporate repurchases of stock for promissory notes are very common since in effect they involve repurchase of stock out of future earnings of the corporation and, therefore, are convenient devices to liquidate the interest of shareholders in close corporations. In *Williams v. Nevelow*² the Texas Supreme Court authoritatively construed the pre-1973 version of article 2.03 of the Texas Business Corporation Act³ which regulates such transactions, and, by dictum, cast unnecessary doubt as to how the post-1973 version of that article should be construed. This decision has considerable practical importance and has potential application outside of Texas because the problem of construction raised under the 1973 amendments is also present in the language of the corresponding provision of the Model Business Corporation Act.⁴

In *Nevelow* a corporation repurchased its stock for a promissory note and the issue was the proper time to apply the earned surplus requirement and the insolvency limitation of article 2.03. The note that was given was secured by a lien on all the assets of the corporation; at the time the stock was surrendered and the note issued the corporation had sufficient earned surplus to cover the note, and its issuance did not render the corporation insolvent. However, at the time the lien was foreclosed to pay the note, the corporation was insolvent and in the hands of a bankruptcy trustee, who sued to set aside the foreclosure and sale. Since the transactions occurred before the effective date of the 1973 amendments, the court was faced with

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1. One legislative development that should receive at least footnote recognition is the enactment of the Federal Employee Retirement Income Security Act of 1974. Pub. L. No. 93-406 (Sept. 2, 1974). This statute not only regulates pension and retirement plans but also increases the maximum permissible income tax deductions for self-employed retirement plans (Keogh plans) to \$7,500 per year. The old maximum was \$2,500 per year. As a practical matter, this change may tend to make professional corporations and professional associations less attractive by improving the tax benefits available to the professional in a traditional proprietorship or partnership.

2. 513 S.W.2d 535 (Tex. 1974).

3. Ch. 64, art. 2.03, [1955] Tex. Laws 239.

4. ABA MODEL BUS. CORP. ACT ANN. § 6 (2d ed. 1971).

the question whether the payment of the note was valid under the following statutory provisions:

C. Upon resolution of its board of directors authorizing the purchase . . . a corporation may *purchase* its own shares to the extent of unrestricted earned surplus available therefor. . . .

[F.] In no case shall a corporation *purchase* its own shares when there is a reasonable ground for believing that the corporation is insolvent, or will be rendered insolvent by such purchase or when, after such purchase, the fair value of its total assets will be less than the total amount of its debts.⁵

Under these provisions, two tests had to be met at the time of the "purchase": there must be available earned surplus and the corporation must be solvent in both the equity and bankruptcy senses. If the "purchase" occurred when the stock was surrendered and the secured note issued, the shareholder wins, while if the "purchase" occurred when the note was paid, the shareholder certainly loses under article 2.03(F) and probably under article 2.03(C) as well. Most of the cases that have considered the question have concluded that the "purchase" occurs when assets leave the corporation, *i.e.*, when the note is paid—but there is some authority to the contrary,⁶ and until *Nevelow* the issue was an open one in Texas. The Texas Supreme Court rejected the majority view and held that the "purchase" took place when the note was given. It relied primarily on a case-law definition of "purchase" as "the transmission of property from one person to another by voluntary act and agreement, founded on a valuable consideration;"⁷ this definition appears in early cases dealing with problems totally unrelated to corporate purchase of stock.⁸ The court further stated that "no statute is known to use the term 'purchase' " to mean the time tangible assets leave the corporation rather than the giving of a note.⁹ The court then cited the Business and Commerce Code¹⁰ and the Texas Sales Tax Act¹¹ definitions of "purchase," again, statutes involving totally different contexts from the one before the court. Finally, and most persuasively, the court argued

5. Ch. 64, arts. 2.03(C), (F), [1955] Tex. Laws 241 (emphasis added).

6. The leading cases supporting the proposition that these tests are to be applied at the time of each payment on the note are *Mountain State Steel Foundries, Inc. v. Commissioner*, 284 F.2d 737 (4th Cir. 1960), and *Robinson v. Wangemann*, 75 F.2d 756 (5th Cir. 1935). See generally *Herwitz, Installment Repurchase of Stock: Surplus Limitations*, 79 HARV. L. REV. 303 (1965). The minority view is set forth in *Wolff v. Heidritter Lumber Co.*, 112 N.J. Eq. 34, 163 A. 140 (Ch. 1932), and is advocated in *Hartmann & Wilson, Payment for Repurchased Shares Under the Texas Business Corporation Act*, 26 Sw. L.J. 725 (1972).

7. *E.g.*, *Spur Ind. School Dist. v. W.A. Holt Co.*, 88 S.W.2d 1071, 1073 (Tex. Civ. App.—Waco 1935, no writ).

8. The court relied on *Cobb v. Webb*, 26 Tex. Civ. App. 467, 64 S.W. 792 (1901, writ ref'd), relating to the application of a statute giving a purchaser 90 days from the date of "purchase" to pay past-due property taxes and avoid a tax sale, and *Spur Ind. School Dist. v. W.A. Holt Co.*, 88 S.W.2d 1071 (Tex. Civ. App.—Waco 1935, no writ), involving the question whether an independent school district or a semi-related athletic association "purchased" (and therefore had to pay for) certain athletic equipment.

9. 513 S.W.2d at 537.

10. TEX. BUS. & COMM. CODE ANN. § 1.201(32) (1968).

11. TEX. TAX.-GEN. ANN. art. 20.01(G) (1969).

that the opposite construction of "purchase" would be inconsistent with article 2.03(E), which requires earned surplus to be "restricted" during the period reacquired shares are held as treasury shares; the court pointed out that such "restrictions" may be eliminated by the cancellation of the shares even though the note is still outstanding. The court argued that "[i]f it were held that the corporation must have a surplus when the cash payment is made on the note, the effect would be to require as much as double the amount of the surplus as the price paid for the stock."¹² While this is true, the simple explanation is that article 2.03(E) was apparently drafted on the assumption that tangible assets rather than promissory notes would be used to repurchase the shares. On this assumption the accounting treatment set forth in article 2.03(E) makes sense: so long as repurchased shares are held as treasury shares, the earned surplus they represent is restricted so that it can be written off if the shares are cancelled, or suitably adjusted if the shares are resold for a valuable consideration. Nevertheless, the court is correct that article 2.03(E) is anomalous if the majority view is adopted, and that certainly is an argument for adopting the minority view, as the court in fact did.

The basic problem with article 2.03, before it was amended in 1973, was that both the earned surplus and insolvency tests were tied to the same event, the "purchase." Abstractly, it makes sense to apply the earned surplus test only at the point in time when the shares are surrendered and the notes issued, and the insolvency test both at the point in time when assets leave the corporation and at the point in time when the shares are surrendered. First, it makes sense to apply the earned surplus test at the time promissory notes are issued and the shares surrendered, since at that time the corporation must account for the increase in liabilities reflected by the notes. This usually will be offset by a reduction or segregation of the earned surplus account. Second, it does *not* make sense to apply the earned surplus test at the time notes are paid because of the problem pointed out by the court and because the payment of a note as an accounting matter reduces the asset accounts of the corporation to match the reduction of liabilities of the corporation and does not affect the earned surplus account. Third, it makes sense to apply the insolvency test at the time the notes are issued, since if the corporation is insolvent, creditors should be able to object to a transaction that increases the corporation's liabilities without increasing its real assets. Finally, it also makes sense to apply the insolvency test at the time the note is being paid: if the corporation is insolvent, one creditor is being favored over other creditors, and it is entirely reasonable to treat a debt that reflects the earlier repurchase of an equity interest in the corporation as being of lesser status than debts to trade and other creditors generally, even though they may be subsequent to the issuance of the notes. This has been the historical justification for limiting the power of a corporation to repurchase its shares and is consistent with the fact that a corporate repurchase of its own stock is essentially equivalent to a disproportionate dividend distribution.

In effect, the Texas Supreme Court determined to apply the insolvency

12. 513 S.W.2d at 538.

test only at the time the note was issued because both tests are tied to an event denominated a "purchase," and since the earned surplus test should be applied at the point of "purchase," the insolvency test should also be applied then. Even though the court's reasoning is involuted, it is not necessarily wrong. Given the language of the statute before it was amended in 1973, its conclusion seems reasonable enough even though it reflects a minority position in the case law and it permits a former shareholder sometimes to get ahead of legitimate trade creditors, as in the *Nevelow* case. In any event, the decision would appear to have limited effectiveness because the 1973 amendments to article 2.03(F) are applicable to all redemptions after August 27, 1973.

The 1973 amendments did not affect article 2.03(C) which requires the presence of earned surplus at the time of the "purchase." However, article 2.03(F) was amended by adding the italicized language:

- F. In no case shall a corporation purchase *or make payment, directly or indirectly*, for its own shares when there is a reasonable ground for believing that the corporation is insolvent, or will be rendered insolvent by such purchase *or payment*, or when, after such purchase, *or payment*, the fair value of its total assets will be less than the total amount of its debts.¹³

This article obviously draws a distinction between "purchase" and "payment," and, in the words of Professor Herwitz, "the inference is well-nigh irresistible that the surplus test is to be applied to the total repurchase obligation at the outset"¹⁴ and the insolvency test is to be applied both at the outset and at the time of each payment. But the Texas Supreme Court did not think that was necessarily so. In commenting on the 1973 amendments, the court said:

We note that sec. F of art. 2.03 of the Texas Business Corporation Act was amended in 1973 The addition of 'payment' indicates some distinction between 'payment' and 'purchase.' It does not necessarily follow that a different result would be reached in the present case if the amended language of the statute with reference to the solvency of the corporation were applicable. The issuance of a secured negotiable instrument could be considered 'payment' for the repurchased stock. Hartman and Wilson, *supra*, 26 Sw. L.J. 725, 735. A decision on this point is not necessary to the disposition of the present case. In view of the historical judicial prohibition against enforcement of otherwise unconditional promises of payment after the time of insolvency, it would be well for the Legislature to settle the question expressly.¹⁵

The law review article which the court cited is addressed primarily to the thesis that the earned surplus requirement should be met at the time the shares are surrendered and the note issued. However, in the course of their discussion, the writers assert that giving a negotiable promissory note may constitute "payment" for the sales of goods sections of the Uniform Commer-

13. TEX. BUS. CORP. ACT ANN. art. 2.03(F) (Supp. 1974) (emphasis added).

14. Herwitz, *supra* note 6, at 323.

15. 513 S.W.2d at 538-39.

cial Code.¹⁶ Throughout the discussion by Hartmann and Wilson, and throughout the opinion by the supreme court, there is a regrettable tendency to consider elastic words such as "purchase" and "payment" as having invariant meanings irrespective of the context in which they are used. Undoubtedly, for some purposes, such as ascertaining who bears the risk of loss of goods after they have been delivered in exchange for a check or promissory note, the giving of the check or note may constitute "payment;" such a transaction also constitutes a "purchase." However, it is a serious mistake in legal analysis to assume that these words must have the same meaning in a carefully drawn statutory provision which obviously attempts to distinguish between "purchase" and "payment." In this respect, the Bar Committee comment describing the 1973 amendments should not be ignored: "The 1973 amendments to Art. 2.03 also added the phrase 'or make payment, directly or indirectly,' to Section F. This amendment assures that the insolvency limitation is applied both at the time of purchase and at the time of payment. The surplus restriction of Art. 2.03(E) is not affected by the amendment and applies only at the date of purchase"¹⁷

At the risk of restating the obvious, I would like to summarize how I feel that article 2.03, as amended, should be construed, the dictum in *Nevelow* to the contrary notwithstanding: (1) Where a corporation acquires its own shares in exchange for one or more promissory notes, the transaction must meet both the earned surplus test of article 2.03(C) and the insolvency test of article 2.03(F) at that time. In other words, there must be sufficient earned surplus to cover all the promissory notes issued,¹⁸ and after the notes are issued the corporation must not be insolvent in either the equity or bankruptcy sense. Either is possible, even if the corporation has sufficient earned surplus on its books to cover the notes. For example, because of declines in market value of corporate assets, the issuance of the notes may cause the "fair value of its total assets" to be less than "the total amount of its debts" (the bankruptcy test), and the additional liability on the notes may make it impossible for the corporation to pay its debts as they mature (the equity test). (2) When each note is paid, the corporation must be solvent in both the equity and bankruptcy sense. A corporation that is or will be rendered insolvent cannot pay the notes. In this sense, a person who becomes a creditor of the corporation by the sale of his shares to the corporation is subordinate to all other creditors. Since the corporation was insolvent in *Nevelow* when Williams' note was paid, it follows that that case should have been de-

16. Hartmann & Wilson, *supra* note 6, at 735. The word "payment" is not itself defined in the Uniform Commercial Code; the argument is based on the definition of "value," TEX. BUS. & COMM. CODE ANN. § 1.201(44) (1968), plus an inference based on the provision of the UCC relating to passing of title. *Id.* § 2.401.

17. Comment of Bar Committee to Art. 2.03, 3A TEX. REV. CIV. STAT. ANN. 28 (Supp. 1974).

18. In this respect, the requirements of art. 2.03 are more onerous than the requirements imposed by the majority view in cases such as *Mountain States Steel Foundries, Inc. v. Commissioner*, 284 F.2d 737 (4th Cir. 1960). See note 6 *supra*. Those cases require that there be sufficient earned surplus to cover each note at the time each is paid, but do not require that there be sufficient earned surplus to cover all the notes at the time they are issued.

cided differently if it had arisen under the post-1973 version of article 2.03.

The Texas Supreme Court also recognized a general principle that repurchase of shares by a corporation is subject to equitable limitations on the purpose of the acquisition.¹⁹ Thus, Professor Hornstein points to repurchases designed to perpetuate or shift control, to bail out selected shareholders, and the like.²⁰ In addition, the principle known as the "Deep Rock" doctrine permits courts in insolvency proceedings to subordinate the claims of officers and shareholders when it appears that the claims are the result of "the violation of rules of fair play and good conscience by the claimant; [or] a breach of the fiduciary standards of conduct which he owes the corporation, its stockholders and creditors."²¹ In *Nevelow* the Texas Supreme Court stated that "fraud or bad faith or conduct misleading to the creditors" must be shown in order for the bankruptcy trustee to rescind the purchase and foreclosure, a considerably narrower test.²² Nevertheless, on the facts of *Nevelow*, the bankruptcy trustee had a reasonable argument for rescission under the principles set forth by the court;²³ the court rejected these arguments in part because they apparently had not been raised or fully developed below.

Where mandatory buy-out arrangements are being considered and a question exists as to the lawfulness of a repurchase under article 2.03, it may be sensible to require other shareholders who are interested in the transaction to guarantee, in their individual capacities, the performance of the buy-sell transaction. This may take the form either of a promise to purchase the shares if the corporation does not, or a guarantee of payment of notes issued by the corporation if the purchase price is to be paid over a period of time. Recent case law squarely holds that such individual obligations are enforceable without regard to the status of the corporation.²⁴

Sale of Control Premiums. One of the more perplexing problems in the area of fiduciary duties is the proper treatment of the controlling shareholder who sells his shares at a premium over the current market price or over the price offered to minority shareholders. The premium, of course, represents the practical value that a corporate office and working control of a corporation represent. Where a purchaser is willing to pay a substantial premium for control, there is obviously some risk that the corporation will suffer at his hands. Furthermore, there is a deep-seated notion that since shares are fungible, it is unfair for the controlling shareholder to receive a higher price than other shareholders. Finally, transfers of control can often be recast as mergers or other transactions in which all shareholders are treated equally; a

19. 513 S.W.2d at 538.

20. 1 G. HORNSTEIN, CORPORATION LAW AND PRACTICE § 495 (1959).

21. *Pepper v. Litton*, 308 U.S. 295, 310-11 (1939).

22. 513 S.W.2d at 538.

23. The note given was a secured note covering all the assets of the corporation. It provided that it could not be prepaid if another promissory note given by the persons who were assuming control of the corporation from Williams was unpaid, and also the note of the corporation could be matured at the option of the holder upon default of payment on the other note. 513 S.W.2d at 538.

24. *Olivares v. Zars*, 508 S.W.2d 482 (Tex. Civ. App.—San Antonio 1974, writ ref'd n.r.e.); *Hall v. Weller, Hall & Jeffery, Inc.*, 497 S.W.2d 374 (Tex. Civ. App.—Houston [1st Dist.] 1973, writ ref'd n.r.e.).

controlling shareholder who sells at a premium may be usurping an opportunity that arguably belongs to all. On the other hand, there is an equally deep-seated notion that a person should be able to dispose of his property at whatever price he can get, and that fungible property may be willingly sold by different persons at different prices. These fundamental and essentially conflicting principles have given rise to a series of troubled opinions in other jurisdictions. While the state of the law is in flux, the majority view is that a control premium is not inherently improper, and is not automatically a corporate asset, to be shared by all shareholders proportionately, but that in a variety of circumstances, the controlling shareholders might be called upon to share the premium with the other shareholders.²⁵

This question was raised squarely in Texas during the survey period. In *Thompson v. Hambrick*²⁶ the controlling shareholders received an offer to buy stock (presumably all of the shares of the corporation, though that is not entirely clear) at forty-five dollars per share. They rejected this offer, but then agreed with the purchaser that they would sell sufficient shares to assure control at fifty-five dollars per share. At about the same time, the controlling shareholders purchased the stock of one of the minority shareholders for forty dollars per share.

The Dallas court rejected the position extensively espoused in law review articles that control should be considered to be a corporate asset that must be shared with the minority shareholders. Rather, after considering the classic cases that arguably lead the way toward such a conclusion²⁷—and the leading Texas case on the doctrine of corporate opportunity²⁸—the court adopted the more standard view that controlling shareholders may sell their shares at a premium subject to the following exceptions: (1) Where there is fraud on the part of the dominant directors and shareholders; (2) where the controlling shareholders turn over their shares to purchasers who mismanage the corporation or loot the corporate assets; (3) where non-controlling shareholders are induced to sell their shares by concealment of the fact that a premium is to be paid to the controlling shareholders; (4) where controlling shareholders make a “secret profit” from the transaction; or (5) where directors are dealing directly with the corporation to their own personal advantage, known or unknown. These rather loosely phrased exceptions cover the principal situations in which courts in other jurisdictions have held the controlling shareholder accountable; the basic problem with such an enumeration is that if literally applied one or more of them will be applicable in virtually every case.

25. See 20 R. HAMILTON, TEXAS PRACTICE: BUSINESS ORGANIZATIONS § 729 (1973) for a discussion of the principal cases and law review commentary on the problem of control premiums.

26. 508 S.W.2d 949 (Tex. Civ. App.—Dallas 1974, writ ref'd n.r.e.). The problem had been discussed in dicta in *Calvert v. Capital Sw. Corp.*, 441 S.W.2d 247 (Tex. Civ. App.—Austin 1969, writ ref'd n.r.e.), *appeal dismissed*, 397 U.S. 321 (1970).

27. *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955); *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

28. *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963).

In the actual case, the trial court granted summary judgment in favor of the controlling shareholders. The appellate court reversed, stating that there clearly were fact issues as to the alleged breach of fiduciary duty, based on the following circumstances: “[T]he defendants, shortly after joining in the rejection of the \$45 per share offer, made a secret agreement to sell their stock at \$55 per share to the same people who had made the previous offer, without notice to the minority shareholders and giving them neither the right of first refusal nor any participation whatever in the transaction.”²⁹ If it is true that the original forty-five dollars per share offer was made to all the shareholders, the conclusion seems clearly justified. While an offer to all the shareholders individually may not technically constitute a *corporate* opportunity, it is the economic equivalent of an offer to purchase the assets of the corporation followed by a subsequent liquidation. As such, it seems clearly improper for controlling shareholders to reject this offer in order to work out their own arrangement at a higher price to the exclusion of the minority shareholders.

Rather surprisingly, the court also held that it was proper to grant summary judgment against the shareholder who sold at forty dollars per share at about the time the fifty-five dollar offer was made.³⁰ This shareholder, an employee of the corporation, testified that he had made a profit of over fourteen dollars per share and that he thought it was to his economic advantage to make the sale. Apparently he did not say that he would have refused to make the sale at the lower price if he had known that the controlling shareholders had received an offer at a considerably higher price.

Liability of Officers and Directors for Corporate Actions. In *Seale v. Nichols*³¹ the Texas Supreme Court was faced with the question whether the following form of execution of a promissory note imposed personal liability on the defendant officer:

THE FASHION BEAUTY SALON (Typewritten in capital letters)

Carl V. Nichols (typewritten)

Carl V. Nichols (handwritten)

The printed portion of the note began, “I, we, or either of us, promise to pay” When Nichols was sued on the promissory note, he filed an affidavit stating that he signed only in a representative capacity as president of a corporation, Mr. Carl’s Fashion, Inc., a Texas corporation doing business as the Fashion Beauty Salon. The supreme court held that this affidavit did not create a fact issue and that summary judgment was properly granted against Nichols.³² The suit was by the payee. The court relied primarily upon section 3.403(b)(2) of the Business and Commerce Code³³ and the

29. 508 S.W.2d at 954.

30. *Id.*

31. 505 S.W.2d 251 (Tex. 1974).

32. *Id.* at 255.

33. “An authorized representative who signs his own name to an instrument . . . (2) except as otherwise established between the immediate parties, is personally obligated if the instrument names the person represented but does not show that the repre-

basic contractual notion that even if Nichols intended to sign only in a representational form, that intention was ineffective because it was not communicated to the plaintiff. The parol evidence rule might also be cited in view of the apparent unambiguous form of execution. The case emphasizes the extreme importance of using the standard form of execution when a person is executing a promissory note or other document on behalf of a corporation. That form is:

ABC Corporation
 "X"
 By _____
 President

While some variations in this form may be possible without subjecting X to personal liability, any variation involves some risk.

The sometimes complex problem of whether a corporation may be personally liable for tortious conduct was also considered by the Texas Supreme Court during the survey period. In *Maxey v. Citizens National Bank*³⁴ the court construed a petition as charging that a bank had breached its duty as a mortgagee under a chattel mortgage, and could, therefore, be liable even though none of its officers or agents were personally liable. The court of civil appeals had construed the petition as charging only fraud, conversion, and conspiracy, for which, it argued, the bank could be liable only on the theory of *respondeat superior*.³⁵ In the course of its opinion, the Texas Supreme Court restated many of the principles underlying the immunity of corporate officers and directors from liability for good faith, non-tortious conduct, even though poor judgment was exercised.

Finally, a federal district court held that a director may not avoid his statutory liability under article 2.41(A)(2) of the Texas Business Corporation Act³⁶ for the repurchase of his shares while the corporation was insolvent by the simple expedient of resigning before the purchase is approved.³⁷ The court simply stated that the transaction was an integrated one, though the same result could be reached on other theories as well.

Authority of Officers and Agents. The scope of the implied authority of officers and agents has long been unsettled and unsatisfactory.³⁸ During the survey period, the Texas Supreme Court had the opportunity to clarify this area but did not choose to do so, possibly on the ground that the case under consideration did not lend itself to suitable generalization. In *Douglas v. Panama, Inc.*³⁹ the court simply held that the president of a corporation lacked actual authority to promise bonuses to employees, a fact which the

sentative signed in a representative capacity" TEX. BUS. & COMM. CODE ANN. § 3.403(b)(2) (1968).

34. 507 S.W.2d 722 (Tex. 1974).

35. 489 S.W.2d 697, 705 (Tex. Civ. App.—Amarillo 1973, writ granted).

36. TEX. BUS. CORP. ACT ANN. art. 2.41(A)(2) (1956).

37. *In re Gribbin Supply Co.*, 371 F. Supp. 664 (N.D. Tex. 1974).

38. See 20 R. HAMILTON, *supra* note 25, § 585. Dissatisfaction with the state of the law in this area is also expressed in the earlier treatise by Dean Hildebrand. 2 J. HILDEBRAND, TEXAS CORPORATIONS § 640 (1942).

39. 504 S.W.2d 776 (Tex. 1974).

president himself recognized, and that in any event the bonuses were unenforceable, because they were indefinite and uncertain.

In *Dowdle v. Texas American Oil Corp.*⁴⁰ a former director and president of a publicly held corporation claimed that he was entitled to severance pay on the basis of a "policy" established by him two years earlier for other employees. The "policy" was adopted by the president after consultation with members of the board of directors and executive committee of the corporation but without formal action by either. The court rejected the former president's claim, relying partially on cases involving self dealing,⁴¹ partially on the language of the plaintiff's employment resolution that made no mention of severance pay, and partially on the idea that a board of directors must act as a board when setting compensation. The court did not specifically consider whether the president had authority to establish such a "policy" covering all employees but himself without directoral approval.

Informal Dividends. In *Ramo, Inc. v. English*⁴² the Texas Supreme Court carefully considered whether an informal distribution from a subsidiary to a parent corporation constituted an "informal dividend" which would trigger an acceleration clause in a loan agreement. The advances were called "loans," "open accounts," and "advance receivables" on the books and records of both corporations, but a jury found that the parent had no intention of repaying them at the time they were made. Disagreeing with the court of appeals,⁴³ the supreme court held that such advances did not trigger the acceleration clause. Acceleration, the court argued, is a harsh remedy that should be permitted only where the clause is clear, unequivocal, and open to no other construction. An intention not to repay is not conclusive since the parent may have been legally obligated to do so despite its intention, given the treatment of the advances on the books of the corporation. Further, at the time the loan agreement was made, both the creditor and debtor had reason to be aware of the possibility of advances and had not specifically prohibited them.⁴⁴

The case seems to be a close one on its facts, and the emphasis given by the court to the harsh nature of acceleration probably means that the case should not be considered authority in other contexts, *e.g.*, federal income taxation. The opinion itself contains a useful discussion of the difference between a loan and an informal dividend:

A distribution of money or property by a corporation to its shareholders may constitute a dividend in law even though not formally designated as such by the board of directors.

40. 503 S.W.2d 647 (Tex. Civ. App.—El Paso 1973, no writ).

41. *Id.* at 651-52, citing *Nelms v. A & A Liquor Stores, Inc.*, 445 S.W.2d 256 (Tex. Civ. App.—Eastland 1969, writ ref'd n.r.e.); *Wiberg v. Gulf Coast Land & Dev. Co.*, 360 S.W.2d 563 (Tex. Civ. App.—Beaumont 1962, writ ref'd n.r.e.).

42. 500 S.W.2d 461 (Tex. 1973).

43. 474 S.W.2d 600 (Tex. Civ. App.—Dallas 1971, writ granted).

44. The transaction arose in connection with the sale of the shares of the subsidiary by the plaintiff to the defendant corporation. The subsidiary had made informal advances to the former shareholders when they were in control; the failure to specifically prohibit such advances in the agreement is at least some indication that they were not to be prohibited. 500 S.W.2d at 465.

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 A loan is an advance of money on an agreement, express or implied, to repay at some time in the future, while the term 'dividend' as ordinarily used means a corporate distribution that the shareholder is entitled to receive and retain without any obligation of repayment. A basic and essential difference between a loan and a dividend then is the presence or absence of a legal obligation to repay⁴⁵

Shortly after *Ramo* was decided, a court of civil appeals, faced with the question whether a payment from a subsidiary to a parent constituted a loan or a payment for stock, applied analogous principles and concluded that "a legal obligation to repay" existed under the complex circumstances of that case.⁴⁶

Piercing the Corporate Veil. The Texas courts continue to resolve issues relating to the nature of the corporate entity on the basis of the conclusion-oriented language of "alter ego" rather than by an analysis of the policy issues that are involved in the case.⁴⁷ Thus, in one case arising during the survey period, this conceptual analysis was applied to give one creditor priority over another creditor under the materialmen's lien statute, even though the first creditor dealt with an "alter ego" of the corporation owning the land on which the materials were placed.⁴⁸ In another case, a court permitted a wholly owned subsidiary corporation to enforce a covenant not to compete, even though the covenant was made with the parent corporation and there had been no formal assignment. The court stated that because the subsidiary was wholly owned, to require a formal assignment would be "to compel a formalistic, empty act."⁴⁹ On the other hand, a federal district court held that the existence of a wholly owned and dominated subsidiary corporation doing business in Texas did not make the foreign parent corporation, Procter and Gamble Company, subject to suit in Texas to declare a patent invalid, since the affairs of the parent and subsidiary were sufficiently differentiated so that two separate entities existed.⁵⁰ In a personal injury case where the injury occurred in Texas, the presence in Texas of a totally dominated and integrated corporation was sufficient to permit service on a sister corporation not

45. *Id.*

46. *Star Corp. v. General Screw Prods. Co.*, 501 S.W.2d 374 (Tex. Civ. App.—Houston [1st Dist.] 1973, writ ref'd n.r.e.). The court also concluded that if corporation *A* pays an obligation of corporation *B*, under circumstances that indicate no gift was intended, corporation *B* is obligated as a matter of law to reimburse corporation *A* for such payment. *Id.* at 380-81.

47. See Hamilton, *The Corporate Entity*, 49 TEXAS L. REV. 979 (1971). See also Lebowitz, *Corporations, Annual Survey of Texas Law*, 26 SW. L.J. 86, 144 (1972), where the author suggests that judges and lawyers, "although probably aware that use of the corporate fiction has its conceptual limits if they stop to think about the matter, instinctively resort to the time-worn, but resounding, expressions and pejoratives that abound in the disregard cases."

48. *First Nat'l Bank v. Whirlpool Corp.*, 502 S.W.2d 185 (Tex. Civ. App.—Waco 1973), *rev'd*, 517 S.W.2d 262 (Tex. 1975). The Texas Supreme Court also used the "alter ego" analysis and cited with approval the discussion by the court of civil appeals on this point. 517 S.W.2d at 265.

49. *Williams v. Powell Elec. Mfg. Co.*, 508 S.W.2d 665, 667 (Tex. Civ. App.—Houston [14th Dist.] 1974, no writ).

50. *Frito-Lay, Inc. v. Procter & Gamble Co.*, 364 F. Supp. 243 (N.D. Tex. 1973).

itself present in Texas. The court stated that “[w]hile the Jones family of corporations may, on paper, look like separate entities for bookkeeping convenience and tax purposes, they are for all *operational* purposes one big, albeit well organized, corporation controlled from the top by John Wiley Jones, his son Robert B. Jones, and a few trusted employees”⁵¹ To support this conclusion, the court pointed to transfers of personnel freely between corporations, organization-wide advertising, cooperative marketing, and the like. I do not mean to suggest that these cases were wrongly decided. My plea is only that courts base their decisions on reasoned policy and notions of basic justice to litigants, and articulate their reasons for reaching a decision. The phrase “alter ego” and similar language simply mask the real reasons for a court’s decision.

A string of parking lots in Houston, with a habit of allowing automobiles in its control to be stolen, seems intent on establishing the permissible limits of the abuse of multiple corporations in litigation. In one case, the defendant’s representative stated upon deposition that the owner of the parking lot was “Allright, Inc.,” after the two-year statute of limitations had run, it moved to amend its answers to this question to “Allright Houston Company.” While the court reversed a judgment in favor of the plaintiff on procedural grounds,⁵² it seems plain that a subsequent motion to dismiss on the ground that the wrong party defendant was named should not be permitted either on the ground of estoppel or on the theory that the original filing tolled the statute of limitations. In another case, a judgment against “Allright Texas, Inc.” and “Allright Garage, Inc.” was upheld against the claim that the named defendants did not operate the garage in question, since the interlocking nature of five Allright corporations “constituted in reality a single business enterprise.”⁵³

Finally, in *Bell v. Bell*⁵⁴ a divorced spouse unsuccessfully argued that the increments in values of assets owned by two corporations should have been further taken into account in a property settlement on the theory that the corporations were the “alter ego” of the other spouse. While shares of stock may be community property, the assets of the corporations themselves clearly should not be so considered, since the value of the corporate assets will be reflected in the valuation of the shares, and there is no reason even to consider an “alter ego” argument. In *Bell* the spouse lost because the value of the shares had been taken into account by the trial court in the exercise of the broad discretion it possesses to allocate property under section 3.63 of the Family Code.⁵⁵

Shareholder/Executors. In closely held corporations share transfer restrictions are imposed in part to establish a mechanism by which the interest of

51. *Reul v. Sahara Hotel*, 372 F. Supp. 995, 1000 (S.D. Tex. 1974).

52. *Allright, Inc. v. Yeager*, 512 S.W.2d 731 (Tex. Civ. App.—Houston [1st Dist.] 1974, writ ref’d n.r.e.).

53. *Allright Texas, Inc. v. Simons*, 501 S.W.2d 145, 150 (Tex. Civ. App.—Houston [1st Dist.] 1973, writ ref’d n.r.e.).

54. 513 S.W.2d 20 (Tex. 1974), *rev’g* 504 S.W.2d 610 (Tex. Civ. App.—Beaumont 1974).

55. TEX. FAMILY CODE ANN. § 3.63 (1975).

deceased shareholders may be liquidated and by which the value of the shares may be ascertained for estate tax purposes. It is not uncommon in such situations for the executor of the estate himself to be a shareholder in the corporation. In a case of considerable practical importance to such corporations, the Austin court of civil appeals⁵⁶ held that if a *principal* shareholder is an executor of the estate, the *corporation* may not exercise a preexisting option to purchase the deceased shareholder's stock, since the result would be a violation of section 352 of the Texas Probate Code by the executor. That section provides that the personal representative of an estate "shall not become the purchaser, *directly or indirectly*, of any property of the estate sold by him"⁵⁷ The purchase by the corporation may be deemed an "indirect" purchase of the estate's shares by the executor.

Recovery of Attorneys' Fees by Corporations. Prior to 1971 the Texas statutes⁵⁸ permitted "any person" to recover attorneys' fees in suits involving a valid claim for "personal services." In 1970 the Texas Supreme Court held that a corporation could not recover fees under this article.⁵⁹ In 1971 this statute was amended to delete the word "personal" and to permit fees to be recovered by "any person, corporation, partnership, or other legal entity."⁶⁰ It seems perfectly clear that the purpose of the amendments was to permit corporations and other entities to recover attorneys' fees in successful suits for compensation for the performance of services, and not surprisingly, two cases during the survey period specifically so held.⁶¹

Self-Incrimination. It is well established that a corporation may not plead a privilege against self-incrimination under the fifth amendment of the United States Constitution, either to shield itself or its officers, directors, or shareholders.⁶² Relying on the federal precedent, a Texas court has held that a corporation also does not have a privilege against self-incrimination under the Texas Constitution.⁶³ The court was not impressed with arguments based on the slight differences in wording between article 1, section 10, of the Texas Constitution and the fifth amendment.⁶⁴

56. 7-Up Bottling Co. v. Capital Nat'l Bank, 505 S.W.2d 624 (Tex. Civ. App.—Austin 1974, writ ref'd n.r.e.). See the related case of Knebel v. Capital Nat'l Bank, 518 S.W.2d 795 (Tex.), *aff'g in part and rev'g in part* 505 S.W.2d 628 (Tex. Civ. App.—Austin 1974).

57. TEX. PROB. CODE ANN. § 352 (1956) (emphasis added).

58. Ch. 67, [1953] Tex. Laws 101.

59. Tenneco Oil Co. v. Padre Drilling Co., 453 S.W.2d 814 (Tex. 1970). See also Vahlsing Christina Corp. v. Ryman Well Service, Inc., 512 S.W.2d 803 (Tex. Civ. App.—Corpus Christi 1974, no writ).

60. TEX. REV. CIV. STAT. ANN. art. 2226 (Supp. 1974).

61. Clark Advertising Agency, Inc. v. Tice, 490 F.2d 834 (5th Cir. 1974); Maxwell Lumber Co. v. Merle Greer Co., 501 S.W.2d 454 (Tex. Civ. App.—Tyler 1973, no writ).

62. Hale v. Henkel, 201 U.S. 43 (1906).

63. Super X Drugs v. State, 505 S.W.2d 333 (Tex. Civ. App.—Houston [14th Dist.] 1974, no writ).

64. U.S. CONST. amend. V states that "no person . . . shall be compelled in any criminal case to be a witness against himself," while TEX. CONST. art. I, § 10 provides that "[in] all criminal prosecutions the *accused* . . . shall not be compelled to give evidence against himself." (emphasis added).

In the past there has been considerable litigation with respect to the extent to which the privilege against self-incrimination is available to partners, labor union officials, and officers of unincorporated associations when the Government has sought information or records that technically belonged to the unincorporated enterprise rather than the individual himself. During the survey period, the United States Supreme Court rejected earlier tests and established new principles that sharply restrict the availability of the privilege. In *Bellis v. United States*⁶⁵ a partner in a three-man partnership sought to invoke the privilege in declining to produce partnership records in his possession. The Court rejected the claim, stating that decisive considerations were whether the partnership had "an established institutional identity independent of its individual partners" and whether the partner was holding the records in a "representative" capacity.⁶⁶ The Court relied on the fact that the privilege would not have been available if the business had been incorporated, and argued that the "applicability of the privilege should not turn on an insubstantial difference in the form of the business enterprise."⁶⁷ The Court added, however, that it "might be a different case if it involved a small family partnership" or if "there were some other pre-existing relationship of confidentiality among the partners."⁶⁸ Of course, every partnership involves a fiduciary relationship among partners;⁶⁹ obviously the Court meant some relationship in addition to this legal obligation.

Dissolved Corporations. Litigation continues to arise with respect to corporations whose charters are forfeited for non-payment of franchise taxes. In *Greig v. First National Bank*⁷⁰ Greig had signed a continuing guarantee of payment of loans up to \$50,000 made to a corporation in which he was interested. The corporation's certificate of incorporation was forfeited for non-payment of franchise taxes, but the corporation continued conducting its business. During this period it executed a promissory note, and the question was whether Greig's continuing guarantee covered this note. Not surprisingly, the court held that forfeiture did not affect the validity of corporate acts or contracts, and Greig was liable under his guarantee. The court added that forfeiture was a revenue measure only and that the only specified penalty for non-payment (closing the courts to the corporation) seemed sufficient for that purpose.⁷¹

Escheat. The Texas escheat statute⁷² has been described as "custodial in nature."⁷³ Persons conveying property to the state treasurer under this statute are relieved from all liability, while persons with claims to the property may file a claim with the treasurer and obtain judicial review of adverse de-

65. 417 U.S. 85 (1974).

66. *Id.* at 95.

67. *Id.* at 101.

68. *Id.*

69. See TEX. REV. CIV. STAT. ANN. art. 6132b, § 21 (1970).

70. 511 S.W.2d 86 (Tex. Civ. App.—Beaumont 1974, writ ref'd n.r.e.).

71. *Id.* at 89.

72. TEX. REV. CIV. STAT. ANN. art. 3272 (1968).

73. *State v. Liquidating Trustees of Republic Petroleum Co.*, 510 S.W.2d 311, 313 (Tex. 1974).

cisions by him. Presumably, other states with claims that they are entitled to the property in question under their escheat statutes may seek to reclaim property under this statute. The Texas Supreme Court held in a case decided during the survey period that Texas may escheat property held by liquidating trustees of a New Mexico corporation, even though the last known addresses of the shareholders entitled to the funds were not Texas addresses.⁷⁴ However, the funds were physically present in Texas, the trustees were Texas residents, and most significantly, no other state was claiming the right to escheat the funds. In reaching this result, the court relied on the custodial nature of the Texas statute and the right of states to make claims to the property under that statute.⁷⁵

Share Transfer Restrictions. In the last few years Texas courts have wrestled with several significant cases involving share transfer restrictions, and such restrictions also have been the subject of recent legislation. During the survey period, however, only two share transfer restriction cases arose. In a decision principally important for its discussion of sale of control premiums, the court held that it was error to grant summary judgment on the issue whether a share transfer restriction was designed solely to benefit majority shareholders and need not be complied with when they decided to sell their shares at a price substantially above the market value of the stock.⁷⁶ In another case the Fifth Circuit concluded that under Delaware law, a share transfer restriction requiring resale to the corporation at book value could not lawfully be imposed on outstanding unrestricted stock without the consent or acquiescence of the holder.⁷⁷ The court relied in part on the restrictive nature of the bylaw provision, since the evidence indicated that fair market value was substantially higher than book value, and on the fact that the restriction appeared to be broader than necessary to accomplish the valid corporate purpose of limiting shareholders to van line companies.

Foreign Corporations. Article 8.02 of the Texas Business Corporation Act provides that a foreign corporation with a certificate of authority shall "enjoy the same, but no greater, rights and privileges as a domestic corporation."⁷⁸ Relying on this provision, a court of civil appeals held that it was improper to dismiss a suit between two qualified corporations on a theory of *forum non conveniens*.⁷⁹ The court stated that Texas courts "are required to try such a case just as such courts would be required to try a case brought against a Texas corporation by another Texas corporation . . . regardless of where the cause of action might have arisen."⁸⁰

74. *Id.*

75. *Id.* at 315.

76. *Thompson v. Hambrick*, 508 S.W.2d 949 (Tex. Civ. App.—Dallas 1974, writ ref'd n.r.e.), discussed in text accompanying notes 26-29 *supra*.

77. *B & H Warehouse, Inc. v. Atlas Van Lines, Inc.*, 490 F.2d 818 (5th Cir. 1974).

78. TEX. BUS. CORP. ACT ANN. art. 8.02 (1956).

79. *Continental Oil Co. v. P.P.G. Indus.*, 504 S.W.2d 616 (Tex. Civ. App.—Houston [1st Dist.] 1973, writ ref'd n.r.e.).

80. 504 S.W.2d at 620. The court also cited a pre-TBCA case, *H. Rouw Co. v. Railway Express Agency*, 154 S.W.2d 143 (Tex. Civ. App.—El Paso 1941, writ ref'd), in support of this proposition.

Receiverships. Decisions involving the receivership provisions of the Texas Business Corporation Act have been relatively infrequent. One such proceeding, apparently involving an affiliate of King Commodity Company, was reported during the survey period.⁸¹ The court held that the only court with authority to appoint a receiver for a domestic corporation was a court in the county in which the registered office was located, that the Texas Business Corporation Act contained the exclusive provisions relating to receiverships for domestic corporations, and that a court could not transfer a receivership proceeding brought in the wrong county to the proper county.⁸² These conclusions seem to be soundly based on the language of articles 5.05(A), 5.07(A), and 7.07(E) of the Texas Business Corporation Act.⁸³

Procedural Developments. As in every year, a number of cases involve the more or less routine application of the Texas long-arm statute and the complex Texas venue statutes to specific corporations. The developments discussed below involve only those which in some sense break new ground.

The United States Supreme Court placed a sharp brake on the trend toward large and formless class actions by holding that the plaintiff in every class action must bear the cost of notice to all members of the class he claims to represent.⁸⁴ In many instances, of course, such cost will be prohibitive. For example, the "class" involved in this litigation constituted all persons who had paid odd lot premiums for transactions involving less than the normal trading unit of securities during the period May 1, 1962, through June 20, 1966. This "class," it was estimated, contained 6,000,000 members, 2,250,000 of whom would be easily identified.⁸⁵

In a state case,⁸⁶ the plaintiff in a derivative suit was held not to represent adequately the class of all shareholders and therefore was not eligible to be a plaintiff. The plaintiff was simultaneously maintaining a separate suit seeking to rescind the transaction by which he purchased his shares, and the court thought this indicated an inconsistent position.

Finally, additional procedural requirements were imposed on default judgments. In *James Edmond, Inc. v. Schilling*⁸⁷ a default judgment was set aside for failing to allege and prove that the defendant was a foreign corporation not maintaining a regular business in Texas, and for failing to have a court reporter at the hearing so that there could be a statement of facts available to enable the reviewing court to determine the sufficiency of the facts to support the judgment. In another case, the Texas Supreme Court held that to support a default judgment the record must contain proof that the secretary of state properly forwarded process served on him to the defendant, where

81. *King Commodity Co. v. State*, 508 S.W.2d 439 (Tex. Civ. App.—Dallas 1974, no writ).

82. *Id.* at 446.

83. TEX. BUS. CORP. ACT ANN. arts. 5.05(A), 5.07(A), 7.07(E) (Supp. 1974).

84. *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156 (1974).

85. *Id.* at 166.

86. *Ford v. Bimbo Corp.*, 512 S.W.2d 793 (Tex. Civ. App.—Houston [14th Dist.] 1974, no writ).

87. 501 S.W.2d 432 (Tex. Civ. App.—Waco 1973, no writ).

such service of process is authorized by statute.⁸⁸ In order to meet this requirement, the secretary of state has established a standard procedure for furnishing the required certificate for a nominal fee of two dollars.⁸⁹

A Partnership as a Separate Entity. A long and somewhat sterile debate has raged as to whether a partnership should be considered an entity distinct from the partners or simply an aggregate of the partners.⁹⁰ A surprisingly large number of procedural and substantive consequences flow from this basic characterization. The early Texas common law treated a partnership as an aggregate of the partners, but the Uniform Partnership Act emphasizes the entity aspects of partnership. The "Sources and Comments" note to section 1 of the Texas version of that act prepared by Professor Bromberg states that "the great preponderance" of the Texas version of the Uniform Partnership Act favors the entity theory.⁹¹ As a result, several courts of appeal have declined to follow the early precedents classifying a partnership as an aggregate. During the survey period the Texas Supreme Court for the first time reviewed such a holding and specifically adopted the view that, for most purposes at least, a partnership should be considered as a separate entity rather than as merely an extension of the partners themselves.⁹² The case involved the situs of personal property for purposes of taxation by a school district. The supreme court specifically approved findings by the lower court that each partnership "constituted a separate legal entity" and that they were "engaged in separate business enterprises conducted from their principal offices and domiciles"⁹³ Of course, in some circumstances it may be inappropriate to treat a specific partnership as a separate entity; a partnership has both entity and aggregate aspects, and the way a partnership should be treated as a conceptual matter depends in part on the context in which the question arises and the consequences of adopting one concept or the other. Nevertheless, it now seems clear that the entity concept should generally be favored.

Incorporation of Going Business. Generally, if a corporation is formed to take over a going business, it will be held, on one theory or another, to have assumed the liabilities of the business at least in the absence of an express disclaimer. One recent case,⁹⁴ however, apparently refused to apply this principle, though the opinion is not very satisfactory or clear on the point. An individual opened a service station, and a year later a corporation was formed to continue the business. The supplier of diesel fuel to the station inadvertently failed to collect the Texas fuel tax for several years, and then brought suit for the unpaid tax against both the corporation and the individ-

88. *Whitney v. L & L Realty Corp.*, 500 S.W.2d 94 (Tex. 1973). *Southwestern Remodelers of Houston, Inc v. Lumaside, Inc.*, 501 S.W.2d 759 (Tex. Civ. App.—Houston [1st Dist.] 1973, no writ), follows *Whitney*.

89. See 36 TEX. B.J. 1118 (1973).

90. 19 R. HAMILTON, *supra* note 25, §§ 151-54 (1973).

91. Bromberg, *Source and Comments*, 17 TEX. REV. CIV. STAT. ANN. 299 (1970).

92. *Nacogdoches Ind. School Dist. v. McKinney*, 504 S.W.2d 832 (Tex. 1974).

93. *Id.* at 834.

94. *Cannon Ball Truck Stop, Inc. v. Mobil Oil Corp.*, 501 S.W.2d 927 (Tex. Civ. App.—Houston [14th Dist.] 1973, writ ref'd n.r.e.).

ual. A judgment holding the corporation liable for all the unpaid tax was modified to exclude the tax due on sales prior to incorporation. Perhaps the tax liability was divisible on a purchase-to-purchase basis; even so, however, one normally would have expected the corporation to have assumed all the liabilities of the business when it took over the service station, and the unpaid diesel fuel tax on prior purchases would appear to fall into this category. Of course, if the individual is still the principal shareholder of the corporation, the separate liability of the corporation probably makes little difference, as the shares presumably could be levied upon to satisfy the personal judgment against the shareholder; however, the case may have significance where he is no longer a shareholder in the corporation and is judgment-proof.

Partnership Dissolution. Three cases involving the dissolution of partnerships arising during the survey period should be briefly noted. It is well understood that partnership continuation agreements providing for the systematic liquidation of the interests of deceased partners are binding on the heirs of the deceased. One recent case extended this principle to other aspects of the relationship between heirs and the partnership.⁹⁵ The partnership agreement provided that a loan made by the partner to the partnership was to be repaid only out of future profits; the court held that this provision precluded the estate of the deceased partner from ignoring the agreement and treating the entire debt as immediately due.

The Texas Uniform Partnership Act contains rules of contribution between partners that may sometimes result in an allocation of financial responsibility that is a surprise to the partners. Of course, such rules may be altered by agreement, and it is often important that this be done. One recent case⁹⁶ illustrates the risk of not doing so. Five partners agreed that they would share equally in the profits of a restaurant after paying a reasonable salary to the partner actually operating the business. There was apparently no written partnership agreement. The managing partner contributed assets and cash worth over \$61,000; the other partners contributed cash for working capital of \$2,400 each. The business was not successful and was liquidated after running through the bulk of the assets. Virtually all creditors were paid; the partner contributing the \$61,000 (Corsi) then successfully sought contribution from the other four partners, so as to equalize the contributions. This result seems called for by the provisions of the Texas Uniform Partnership Act, which state that in the absence of an agreement to the contrary, each partner "must contribute toward the losses, whether of capital or otherwise, sustained by the partnership according to his share in the profits."⁹⁷ However, it is likely that the partners did not contemplate this result, which in effect requires the four partners who contributed working capital to restore a substantial part of Corsi's capital.

95. *Langston v. Hoenig*, 494 S.W.2d 615 (Tex. Civ. App.—Fort Worth 1973, writ ref'd n.r.e.).

96. *Cortez v. Corsi*, 513 S.W.2d 648 (Tex. Civ. App.—Corpus Christi 1974, no writ).

97. TEX. REV. CIV. STAT. ANN. art. 6132b, § 18(1)(a) (1970).

Another case decided during the survey period carefully reviews the various elections that the estate of a deceased partner has in the absence of a partnership agreement.⁹⁸ These various options are clearly set forth in various provisions of the Texas Uniform Partnership Act. Section 38(1)⁹⁹ gives the estate of the deceased partner the right to elect to have the partnership assets liquidated, debts paid, and the share of each partner in the surplus paid in cash. If this option is not elected (as it was not in the reported case), the estate then has the status of a subordinate creditor, and section 42¹⁰⁰ gives the estate an option to receive either interest on its share so long as it remains in the business or its share of the profits arising after the date of dissolution. This second election gives the estate a choice after the fact, and at first blush appears unfair; it may be justified, however, on the ground that it encourages the partnership to make a prompt settlement of accounts with the estate of the deceased partnership. The case also holds that when valuing partnership assets for the purpose of determining the share of the deceased partner, the proper measure of value is current market value rather than cost or book value.¹⁰¹ Finally, the case holds that as a general rule the expense of valuing the partner's interest should be paid out of the partnership estate, rather than being assessed solely against the share of the deceased partner.¹⁰²

II. SECURITIES REGULATION

Administrative Developments. During the survey period, the Securities and Exchange Commission promulgated two significant regulations in its 140-series. Rule 146¹⁰³ relates to the exemption of transactions not involving a public offering while rule 147¹⁰⁴ relates to the exemption of intrastate issues. Of course, there has been a great deal of experience and precedent under these two exemptions. The new rules generally do not reverse or change the principles that have thereby been created, and indeed in many instances it is questionable whether the SEC could do so if it wished. Rather, the new rules provide more objective standards by which the availability of the exemptions may be determined; a transaction that does not fall within these objective standards may still qualify for the exemption under preexisting principles. Moreover, the SEC has announced that it will hereafter issue "no action" letters under the private offering exemption "infrequently and only in the most compelling circumstances."¹⁰⁵ In other words, if a transaction does not fall within rule 146, the person entering into the transaction is pretty much on his own, since the SEC is unlikely to rule on the availability of the exemption.

98. *Cauble v. Handler*, 503 S.W.2d 362 (Tex. Civ. App.—Fort Worth 1973, writ ref'd n.r.e.).

99. TEX. REV. CIV. STAT. ANN. arts. 6132b, § 38(1) (1970).

100. *Id.* § 42.

101. 503 S.W.2d at 364.

102. *Id.* at 367.

103. 39 Fed. Reg. 15266 (1974).

104. 17 C.F.R. § 230.147 (1974).

105. SEC Securities Act Release No. 5487 (April 23, 1974).

Rule 147 is essentially a codification of prior judicial interpretations of the intrastate exemption. The rule is based on the proposition that the purpose of this exemption is to permit issuers with localized operations to sell securities as part of a plan of local financing. It is limited to local financing provided by local investors to local companies. Of course, most such transactions will involve registration under the state blue sky laws, and presumably it is in such transactions that state regulation is most effective. Rule 147 provides rather specific criteria as to when the issuer is deemed a resident of a particular state, when prior securities are deemed "part of the issue," and the precautions that the issuer must take to prevent inadvertent interstate offers and resale. The rule also requires that resales must be limited to residents of the same state during a nine-month period following the last sale of the securities.

Rule 146 relates to the much more difficult area of defining the phrase "transactions . . . not involving any public offering." It is difficult to give an accurate summary of a complex rule such as rule 146. Essentially, it places the availability of the private offering exemption on the touchstones of (1) the access by the offerees to the same kind of information about the issuer that registration would disclose, and (2) the ability of the offerees to "fend for themselves" so as not to need the protections afforded by the registration. The rule makes the exemption available to offerings in which there are no more than thirty-five purchasers, but there are substantial additional conditions relating to limitations on the manner of offering, the nature of offerees, access to or furnishing of information, and limitations on dispositions of securities, including legends on certificates and share transfer restrictions. Rule 146 does not attempt to resolve all questions relating to the "integration" of prior offerings with a proposed offering, but provides material assistance in resolving that thorny question by providing a "safe haven" for transactions in which there has been no prior offering during the previous six months and no subsequent offering during the following six months.

Rule 146 also defines when persons receiving stock in a rule 145(a) transaction (mergers, consolidations, reclassifications, and asset transfers) may obtain an exemption under rule 146. In such a transaction, no inquiry need be made into the nature of the offerees; the stock received, however, is restricted stock and subject to the various restrictions and limitations of rule 146.

In general, whenever questions arise under either rules 146 or 147 it is important to examine not only the text of the rule itself but also the explanatory SEC release that accompanied the rule. These releases contain useful illuminating descriptions of the scope of, and reasons for, specific provisions, and in the case of rule 147, illustrative examples of the application of the rule.¹⁰⁶

106. Also helpful is the burgeoning law review commentary on rule 147. See Hicks, *Intrastate Offerings Under Rule 147*, 72 MICH. L. REV. 463 (1974); Kant, *SEC Rule 147—A Further Narrowing of the Intrastate Offering Exemption*, 30 BUS. LAW. 73 (1974); Tilley, *The Intrastate Offering Exemption*, 37 TEX. B.J. 549 (1974).

The new rules in the 140-series rely heavily on opinions of counsel as to the availability of exemptions and seek to limit sharply the use of "no action" letters issued by the SEC. When an attorney is requested to give a formal, disinterested opinion as to the availability of an exemption, he may be faced with a difficult problem as to how searching an inquiry he should make into the facts. On the one hand, the SEC has stated that an opinion based solely on hypothetical facts supplied by a client without any inquiry would raise a "serious question" as to the propriety of the attorney's professional conduct.¹⁰⁷ On the other hand, it is hardly practical to conduct a full scale audit into the affairs of each client. The Committee on Ethics and Professional Responsibility of the American Bar Association has issued a formal opinion on this subject¹⁰⁸ which goes into considerable detail as to the responsibilities of the attorney in such a situation. In general, the ABA seeks to preserve the commonly accepted practice of accepting the facts as supplied by the client, at least in the normal situation where the client is reputable and the attorney has no reason to doubt the accuracy of the facts so presented. Whether or not this practice will satisfy the SEC, which is attempting to enlist attorneys to prevent securities violations, remains to be seen.

Definition of a "Security." The classic definition of an "investment contract," and, therefore, a "security" for purposes of both the Securities Act of 1933¹⁰⁹ and the Texas Securities Act,¹¹⁰ is "a contract, transaction or scheme whereby a person invests his money in a *common enterprise* and is led to expect profits *solely* from the efforts of the promoter or a third party . . ."¹¹¹ The Fifth Circuit has been liberal in applying this language to two well known and widely publicized schemes. Glenn Turner's pyramid scheme of selling distributorships for cosmetics¹¹² and the issuance of "naked" commodity options in discretionary accounts¹¹³ were both held to involve a "common enterprise" and "solely" the efforts of others. In effect, the court "expressed its preference for a resilient standard which would comport with the uniformly acclaimed remedial purposes of the Securities Act"¹¹⁴ rather than a "litmus test." Both of the schemes under discussion involved some effort and decision-making by the investor; in effect, "solely" has been redefined to mean "primarily." The "naked" commodities option was also successfully attacked by the State Securities Commissioner, who persuaded a court of appeals that such accounts constituted "securities" despite the fact that the arrangements involved some participation in decision-making by the investors.¹¹⁵

107. SEC Securities Act Release No. 5168 (July 7, 1971).

108. Formal Opinion 335 (Feb. 2, 1974), published in 60 A.B.A.J. 488 (1974).

109. 15 U.S.C. § 77b(1) (1971).

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

111. SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (emphasis added).

112. SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974).

113. SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974).

114. *Id.* at 521.

115. King Commodity Co. v. State, 508 S.W.2d 439 (Tex. Civ. App.—Dallas 1974, no writ). See also Clayton Brokerage Co. v. Mouer, CCH BLUE SKY L. REP. ¶ 71,132 (Dist. Ct. of Travis County, 200th Judicial Dist. of Texas, April 18, 1974) (London commodity options).

Also during the survey period, the Fifth Circuit substantially rewrote another part of the definition of a "security." A "security" includes "any note . . . but shall not include . . . any note . . . which has a maturity at the time of issuance of not exceeding nine months . . ." ¹¹⁶ In connection with refinancing commodities options, a corporation in financial trouble and with problems under the Securities Act issued highly speculative short-term notes having maturities of less than nine months to its customers; these notes represented a portion of the amounts previously paid by the customers into accounts to be invested in commodities options. The corporation argued that the notes could not be "securities" under the literal definition of the Securities Act; the court held, however, that this exemption should be limited only to high quality *commercial* paper and not investment securities which have most of the characteristics of equity investment. ¹¹⁷ In other words, an equity investment is not exempt merely because it is dressed up as a promissory note with a maturity date of less than nine months. To be exempt, the court stated, a note must be (1) of prime quality, (2) used to finance a current transaction, (3) not offered to the public, and (4) discountable at a Federal Reserve Bank. ¹¹⁸ Continuing along the line of construing definitions in order to reach sensible results, the Fifth Circuit also held that a note with a maturity date of *more* than nine months may *not* be a security if it involves essentially a "commercial" transaction. ¹¹⁹ The result of these various opinions is a total revision of the statutory definition. As stated in *McClure v. First National Bank*:

We realize that our holding today that the Act does not apply to commercial notes of a longer duration than nine months, taken with the decisions voiding the short-term exemption as to investment paper, virtually writes that exemption out of the law. On one hand, the Act covers all *investment* notes, no matter how short their maturity, because they are encompassed by the 'any note' language of the exemption. On the other hand, the Act does not cover any *commercial* notes, no matter how long their maturity, because they fall outside the 'any note' definition of a security. Thus, the investment or commercial nature of a note entirely controls the applicability of the Act, depriving of all utility the exemption based on maturity-length. The original scrivener of the definitional section may well wonder what happened to his carefully drawn exemption on the way to the courthouse, but if the judicial decisions do not properly reflect the intent of Congress as to the coverage of the Act, only that body can properly rectify the situation at this point, if *stare decisis* is to apply and the Supreme Court does not make some definitive decision contrary to the presently decided cases. ¹²⁰

116. 15 U.S.C. § 78c(a)(10) (1970).

117. *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974). See also *United States v. Rachal*, 473 F.2d 1338 (5th Cir.), *cert. denied*, 412 U.S. 927 (1973).

118. 497 F.2d at 525. Of course, a six month note of a "commercial" nature is not a "security" under either the Securities Act of 1933 or the Securities Exchange Act of 1934. *Bellah v. First Nat'l Bank*, 495 F.2d 1109 (5th Cir. 1974).

119. *McClure v. First Nat'l Bank*, 497 F.2d 490 (5th Cir. 1974).

120. *Id.* at 494-95.

Exemption for Distributions to Existing Shareholders. The Texas Securities Act¹²¹ contains a transaction exemption for distributions to existing shareholders. However, an attempt by the Spence and Green Chemical Company to take advantage of this exemption was enjoined at the request of the Securities Commissioner¹²² on the theory that this exemption was unavailable if the shareholders had become such in transactions which themselves were in violation of the Securities Act. The Spence and Green Chemical Company had sold shares to 53 persons who had in turn resold to more than 750 persons totally without registration under either the federal or state acts.

Rule 10b-5. Cases involving fundamental questions about the scope and applicability of rule 10b-5 continue to arise. For example, perhaps the best known limitation on recovery under that rule is that the plaintiff must himself be a purchaser or seller of securities, the famous *Birnbaum* doctrine first enunciated in 1952.¹²³ While this rule undoubtedly had been undercut by the Supreme Court's decision in *Bankers Life*,¹²⁴ it suffered further erosion during the current survey period. The Seventh Circuit went all the way and concluded that the *Birnbaum* rule had lost all vitality and should not be followed.¹²⁵ However, during the same period a panel of the Fifth Circuit decided to adhere to *Birnbaum* in an opinion that reviews many of the problem areas of rule 10b-5.¹²⁶

In another recent 10b-5 case, the Ninth Circuit concluded that the duty imposed by that rule should be a flexible one depending on the circumstances and the relationships between the parties. Even though most common law fraud concepts have disappeared from rule 10b-5, including strict ideas of *scienter*, the Ninth Circuit concluded that it was error to instruct a jury to the effect that a defendant could be found liable for false statements when he did not know that they were false when they were made.¹²⁷

121. TEX. REV. CIV. STAT. ANN. art. 581-5(E) (1964).

122. *Spence & Green Chem. Co. v. Mouer*, 510 S.W.2d 620 (Tex. Civ. App.—Beaumont 1974, writ ref'd n.r.e.).

123. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

124. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971). This case inferentially eliminated a second requirement set forth in *Birnbaum*, that rule 10b-5 is "directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs . . ." 193 F.2d at 464. *Bankers Life* held that rule 10b-5 reached a scheme to misappropriate the proceeds of a sale of securities, and seems clearly to constitute a garden variety of fraudulent conduct actionable under state law.

125. *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974). While the Supreme Court denied certiorari, three justices noted that they felt that certiorari should be granted. The Supreme Court later granted certiorari in another case that applies the *Birnbaum* limitation as well as raising other issues. *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136 (9th Cir. 1974), *cert. granted*, 42 L. Ed. 2d 264 (1974) (No. 74-124). [Editor's Note: Subsequent to this Article's going to print, the Supreme Court reversed the Ninth Circuit's *Manor Drug* decision, holding that a private damage action under rule 10b-5 is confined to actual purchasers or sellers of securities and that the *Birnbaum* rule in this case barred Manor from maintaining suit. *Blue Chip Stamps v. Manor Drug Stores*, 43 U.S.L.W. 4707 (U.S. June 9, 1975)].

126. *Sargent v. Genesco, Inc.*, 492 F.2d 750 (5th Cir. 1974). This opinion also discusses problems under the proxy and tender offer provisions of the Securities Exchange Act of 1934. 15 U.S.C. §§ 78n(a), (e) (1970).

127. *White v. Abrams*, 495 F.2d 724, 735-36 (9th Cir. 1974).

In recent years the great bulk of the cases involving alleged fraud in connection with the purchase or sale of securities has been brought in the federal courts under rule 10b-5. From the standpoint of a plaintiff, the federal forum offers procedural advantages and quite possibly a more sympathetic judge. Nevertheless, there are provisions of blue sky and other state statutes¹²⁸ which give remedies for conduct that also is cognizable under rule 10b-5, and a trickle of cases continue to be brought under these state statutes. In *Ryan v. Collins*,¹²⁹ for example, the court held that representations that the stock was "hot," that it had "unlimited possibilities," and that it was a "solid buy" were statements of opinion, not representations of fact. The court also concluded that a promise that stock certificates would be delivered in six or eight weeks was actionable only if made with the intention of not fulfilling it. While such holdings may be consistent with good, classical principles of the law of fraud, they seem out of harmony with recent developments under rule 10b-5. At the very least, such statements—without further explanation as to the speculative or fraudulent nature of the venture—would constitute an omission "to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading" under rule 10b-5(2).¹³⁰ Holdings such as *Ryan* will undoubtedly encourage future suits to be brought in the federal rather than the state forum, at least if the attorney is aware that substantive federal law is more favorable to plaintiffs than the classic state law relating to fraud.

In Pari Delicto. The extent to which the defense of *in pari delicto* should be available in suits involving violations of the securities law is a troublesome one. There is a strong public interest in ensuring compliance with these statutes, and arguably the defense of *in pari delicto* may tend to defeat this interest. Nevertheless, the defense was recognized by the Fifth Circuit in a rule 10b-5 proceeding, where it appeared that the plaintiff was an active participant in a scheme to avoid old rule 133 by backdating documents.¹³¹

The same question also arose in a case under the Texas Securities Act during the survey period.¹³² The plaintiff desired to "get in on the ground floor" in a venture to computerize feed lot operations on the high plains. Since

128. For example, TEX. BUS. & COMM. CODE ANN. art. 27.01 (1968) gives a remedy for fraud in connection with the purchase of securities.

129. 496 S.W.2d 205, 210 (Tex. Civ. App.—Tyler 1973, writ ref'd n.r.e.).

130. 17 C.F.R. § 240.10b-5(b) (1974).

131. *James v. DuBreuil*, 500 F.2d 155 (5th Cir. 1974). The case follows the Fifth Circuit's earlier decision that a "tippee" given knowingly false information by a tipper is barred from suing the tipper by the doctrine of *in pari delicto*. *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969). The court argued that the tipper's intent to violate rule 10b-5 defeated recovery under that rule. There is also a "free ride" element if the tippee is permitted to sue on false information, since if the information is true he presumably will enter into a profitable transaction in violation of rule 10b-5. Essentially inconsistent with this holding on similar facts is *Nathanson v. Weiss, Voisin, Cannon, Inc.*, 325 F. Supp. 50 (S.D.N.Y. 1971). The role between public policy and the defense of *in pari delicto* has often arisen in the antitrust context, where it has generally been rejected. See, e.g., *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968).

132. *Ladd v. Knowles*, 505 S.W.2d 662 (Tex. Civ. App.—Amarillo 1974, writ ref'd n.r.e.).

all the original shares had been sold pursuant to the private offering exemption, the plaintiff persuaded shareholders to enter into letter agreements in which the shareholders agreed to sell shares to the plaintiff to be delivered when restrictions on transfer of certificates had been eliminated by registration. There was immediate payment of the purchase price. These transactions in unregistered shares almost certainly constituted flat violations of the Texas Securities Act and were rescindable under section 33 of that Act.¹³³ The plaintiff apparently did not bring suit to rescind the purchase until four years later, and suit was therefore barred under the three-year provision of section 33(C). The court, however, did not place its decision solely on this ground. It also stated that suit to rescind was also barred by section 33(D): "No person who has made or engaged in the performance of any contract in violation of any provision of this Act or any rule or order or requirement hereunder, or who has acquired any purported right under any such contract with knowledge of the facts by reason of which its making or performance was in violation, may base any suit on the contract."¹³⁴ This provision was apparently designed only to avoid circularity: it makes little sense to enforce a contract that the defendant may avoid. In any event, however, its literal language does not support the court's conclusion: a suit to rescind a contract under section 33 is hardly a suit based *on* a contract.

Furthermore, it is widely conceded that the major impetus to registration under state blue sky laws is the fear of civil liability under these statutes. Given the broad public policy in favor of registration, the defense of *in pari delicto*, whether of common law origin or derived by construction of section 33(D), would appear to have no place. This certainly is the position taken by the federal courts under section 12 of the Securities Act of 1933.¹³⁵

Brokers and Dealers. Article 8 of the Uniform Commercial Code defines an "intermediary" to be a person who delivers a security when "known to be entrusted with delivery of the security on behalf of another or with collection of a draft or other claim against such delivery."¹³⁶ An "intermediary" warrants "only his own good faith and authority even though he has purchased or made advances against the claim to be collected against the delivery."¹³⁷ In contrast, a person transferring a security to a purchaser for value makes much broader warranties, including a warranty that the security is genuine and has not been materially altered. In *First National Bank v. H. Hentz & Co.*¹³⁸ a bank unsuccessfully sought to claim the status of "inter-

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

134. *Id.* art. 581-33(D). This provision is § 410(f) of the Uniform Securities Act. L. LOSS & E. COWETT, BLUE SKY LAW 394 (1958).

135. 3 L. LOSS, SECURITIES REGULATION 1694 (2d ed. 1961): "And application of the *in pari delicto* doctrine, at least on the basis solely of the buyer's knowledge of the violation, is so foreign to the purpose of the section that there is hardly a trace of it in the decisions . . ." See *Wolf v. Frank*, 477 F.2d 467 (5th Cir.), *cert. denied*, 414 U.S. 975 (1973), upholding a district judge's conclusion that *in pari delicto* was not available in a suit based on violation of the Securities Act of 1933.

136. TEX. BUS. & COMM. CODE ANN. § 8.306(c) (1968).

137. *Id.*

138. 498 S.W.2d 478 (Tex. Civ. App.—Waco 1973, no writ).

mediary" in order to shift a loss caused by the bank's customer to a broker. The bank had lent money to the customer in question on the security of shares of stock. Later, on the order of the customer, the bank sold the shares through the broker, Hentz, and credited the proceeds against the loan. The shares turned out to be forgeries and Hentz was forced to purchase covering shares on the open market at a cost of over \$78,000. The bank refused to accept responsibility for this amount, arguing that it was only an "intermediary" and therefore not liable. The court, however, held that the bank was a principal and that "[i]t is an established rule of law that a broker or agent is entitled to reimbursement from his principal for the amount of expenditures or losses resulting proximately or necessarily from the good faith execution of the principal's contract."¹³⁹ The court referred to pre-Code cases to support this statement, but the same rule is embodied in section 8.306(e): "A broker gives to his customer and to the issuer *and a purchaser* the warranties provided in this section *and has the rights and privileges of a purchaser under this section*. The warranties of and in favor of the broker acting as an agent are in addition to applicable warranties given by and in favor of his customer."¹⁴⁰ The decision that the bank was a principal rather than an intermediary seems clearly correct on the facts since the account with Hentz was in the name of the bank and Hentz never dealt directly with the bank's customer who ordered the forged securities sold.

In another case, a federal district court refused to permit a broker to recover an amount otherwise clearly due from a customer on two grounds: first, the broker had failed to keep accurate records of the securities held by a customer, and second, the broker did not liquidate the customer's account promptly after discovering that a transaction ordered by the customer was a "fail."¹⁴¹ It appeared that the broker had frozen some securities in the customer's account but it was unclear whether they then (or ever) equaled in value the amount paid to the customer as a result of the failed transaction. In any event, a prompt liquidation of frozen securities would appear to be essential if the broker is to recover from a customer, since otherwise the customer is defenseless against changes in market value.

139. *Id.* at 482.

140. TEX. BUS. & COMM. CODE ANN. § 8.306(e) (1968) (emphasis added).

141. *Pfanenstiel v. Ling & Co.*, 371 F. Supp. 845 (N.D. Tex. 1974).