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# CORPORATIONS

by

George A. Pelletier, Jr.\*

**M**OST corporate litigation today involves small, closely held corporations whose shares are seldom traded.<sup>1</sup> Texas is no exception in this regard, and the majority of corporate cases reported last year dealt with questions typical of the small corporation. A dominant issue in many cases was whether the corporate entity should be upheld to insulate the controlling shareholder/manager from liability. Another common issue concerned the right or standing to attack corporate actions. Other than these common strands, the questions presented were quite diverse and do not easily lend themselves to a comparative or interrelated analysis. Thus, this survey has been divided into six functional categories based primarily on the nature of the action brought: (1) fiduciary duty of officers and directors, (2) creditor's right to sue officers and directors for mismanagement, (3) disregard of the corporate entity, (4) ultra vires, (5) corporate securities, and (6) shareholder rights.

## I. THE FIDUCIARY DUTY OF OFFICERS AND DIRECTORS

In their corporate posture, the officers, directors<sup>2</sup> and controlling shareholders<sup>3</sup> of a corporation, as the management group, occupy a position of

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<sup>1</sup> Defining what is a "close" or "small" corporation is no simple task. See 1 O'NEAL, CLOSE CORPORATIONS § 102 (1958); Note, *Corporations—Definition of the Close Corporation*, 16 VAND. L. REV. 1267 (1963). In those states that have special statutory provisions covering the operation of these corporations, the usual definition is corporations whose shares are not generally traded in the securities market. E.g., N.Y. BUS. CORP. LAW § 620(c); N.C. GEN. STAT. §§ 55-73 (b) (1965). The Texas Business Corporation Act will be cited as "TBCA" with the appropriate article number.

<sup>2</sup> E.g., *Tenison v. Patton*, 95 Tex. 284, 67 S.W. 92, 94 (1902) ("... directors ... occupy towards the company and its shareholders a fiduciary relation which brings them within the operation of equitable principles"); *Wiberg v. Gulf Coast Land & Dev. Co.*, 360 S.W.2d 563, 567 (Tex. Civ. App. 1962) ("The director of a corporation stands in a fiduciary relationship to his company. He must act fairly and honestly with it."); *Milam v. Cooper Co.*, 258 S.W.2d 953 (Tex. Civ. App. 1953); *Trinity—Universal Ins. Co. v. Maxwell*, 101 S.W.2d 606 (Tex. Civ. App. 1937). The courts generally consider officers and directors to be under the same fiduciary duty.

<sup>3</sup> E.g., *Pepper v. Litton*, 308 U.S. 295 (1939); *Pelman v. Feldmann*, 219 F.2d 173, 175 (2d Cir.), cert. denied, 349 U.S. 952 (1955) ("Both as director and as dominant stockholder, Feldmann stood in a fiduciary relationship to the corporation and to the minority stockholders as beneficiaries thereof."), 50 A.L.R.2d 1135; *Patton v. Nicholas*, 154 Tex. 385, 279 S.W.2d 848 (1955); *Morrison v. St. Anthony Hotel*, 295 S.W.2d 246 (Tex. Civ. App. 1956) error ref. n.r.e. (two cases involving actions by minority shareholder against majority shareholder to recover dividends allegedly due from the corporations); See also *Milam v. Cooper Co.*, 258 S.W.2d 953 (Tex. Civ. App. 1953) error ref. n.r.e. (shareholder who gained majority interest and elected himself president was held liable to operate in the best interest of the corporation). See Comment, *Fiduciary Duties of Majority or Controlling Shareholders*, 44 IOWA L. REV. 734 (1959).

trust. If they fail in their fiduciary duty to the corporation, they become liable to the corporation<sup>4</sup> or, by a derivative action, to someone standing in the shoes of the corporation.<sup>5</sup> A breach of fiduciary duty also occurs vis-à-vis the individual shareholder when an officer or controlling shareholder purchases stock from the shareholder without divulging important facts about the corporation of which he has special knowledge because of his position, and which would increase the value of such shares.<sup>6</sup> The common explanations given for this liability of the management group are that they are trustees of the corporate powers for the shareholders,<sup>7</sup> and that they are also considered agents of the corporation to insure service of process, signing of contracts, etc.<sup>8</sup> While officers and directors are not trustees in the strict sense, as they do not possess ownership of a trust *res*, they do "occupy a fiduciary, or more exactly a quasi-fiduciary, relation to the corporation and its shareholder."<sup>9</sup> They may not usurp corporate opportunities,<sup>10</sup> benefit from an interest adverse to their corporation,<sup>11</sup> compete with their corporation,<sup>12</sup> or sell their powers of management.<sup>13</sup> Much has been

<sup>4</sup> E.g., *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963); *Milam v. Cooper Co.*, 258 S.W.2d 953, 956 (Tex. Civ. App. 1953) *error ref. n.r.e.* ("A director or officer of a corporation occupies the position of a fiduciary toward the corporation for the stockholders."); cases cited *supra* notes 2, 3.

<sup>5</sup> Actions by shareholders may be initiated only where the corporation, acting through its controlling officers, refuses to sue, where there are not regular officers to act on its behalf, or where corporate action cannot be expected because the corporation is controlled by the persons whose conduct is the subject of the complaint. 14 TEX. JUR. 2D 239 (1960); see, e.g., *Dunagan v. Bushey*, 152 Tex. 630, 263 S.W.2d 148 (1953); *Robinson v. Bradley*, 141 S.W.2d 425 (Tex. Civ. App. 1940).

<sup>6</sup> 3 FLETCHER, CYCLOPEDIA CORPORATIONS §§ 1167-74 (1965); *Westwood v. Continental Can Co.*, 80 F.2d 494 (5th Cir. 1935).

<sup>7</sup> 3 FLETCHER, *op. cit. supra* note 6, § 838; *Dollar v. Lockey Supply Co.*, 164 S.W. 1076 (Tex. Civ. App. 1914).

<sup>8</sup> TBCA art. 2.11; "Directors are both agents and trustees; that is, they are agents of the corporation and trustees for the shareholders.", 14 TEX. JUR. 2D 408 (1960); *Conrick v. Houston Civic Opera Ass'n*, 99 S.W.2d 382 (Tex. Civ. App. 1936).

<sup>9</sup> *Paddock v. Siemoneit*, 147 Tex. 571, 218 S.W.2d 428 (1949); *Wiberg v. Gulf Coast Land & Dev. Co.*, 360 S.W.2d 563, 567 (Tex. Civ. App. 1962); *International Bankers Life Ins. Co. v. Holloway*, 354 S.W.2d 198, 203-04 (Tex. Civ. App. 1962), *rev'd on other grounds*, 368 S.W.2d 567 (1963). See 3 FLETCHER, *op. cit. supra* note 6, § 838; Comment, *Fiduciary Duty of Directors and Officers of Private Corporations*, 27 TENN. L. REV. 284, 284-86 (1960).

<sup>10</sup> *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (1963), 42 TEXAS L. REV. 252. For two very fine student comments on the corporate opportunity doctrine see, 74 HARV. L. REV. 765 (1960); 18 SW. L.J. 96 (1964).

<sup>11</sup> *Dunagan v. Bushey*, 152 Tex. 630, 263 S.W.2d 148 (1953).

<sup>12</sup> We do not hold that a corporate stockholder and fiduciary is presumptively guilty of fiduciary breach in all cases when he sells personal stock during a time when the stock of the corporation is also on the market. We do hold that the making of such sales, under circumstances such as here, (special issue by the corp.) imposed on the defendants and stockholder fiduciaries the burden of proving fairness when called to equitable accounting by the corporation.

*International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 578 (Tex. 1963).

<sup>13</sup> The leading case in this area is *Perlman v. Feldman*, 279 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955); *Annor.*, 50 A.L.R.2d 1135 (1955). On Texas law, *cf.*, *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963), 42 TEXAS L. REV. 252. See generally Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986 (1957); Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956).

written on just what this fiduciary duty is, to whom it is owed and when,<sup>14</sup> but little can be found concerning the question of just who is bound by this fiduciary duty.<sup>15</sup> The Texas Supreme Court was recently faced with just this question in *Tennessee-Louisiana Oil Co. v. Cain*.<sup>16</sup>

The principal issue of the *Cain* case was whether a former corporate officer, serving only in an "advisory capacity," was still under a fiduciary duty to the corporation. The officer, Cain, had been the president of Fifteen Oil Company, which was acquired by Tennessee-Louisiana Oil Co. Cain agreed to remain available in an advisory capacity for six months to insure against an "abrupt change in management" and to enable Tennessee to avail itself of Cain's "special knowledge concerning the affairs and properties of Fifteen Oil Company." Shortly before the expiration of this six-month period, Cain wrote a letter to Tennessee as attorney-in-fact for his father in regard to his father's interest in a mineral lease acquired by Tennessee through its merger with Fifteen Oil Company. The letter notified Tennessee of an adjoining well and demanded further development of the leasehold. Under the terms of the lease, nonaction by the lessee in the face of such a demand terminated the lease. Tennessee chose not to develop the lease further and surrendered the leasehold except for a small amount of property around the existing wells. Tennessee alleged that Cain's action was a breach of fiduciary duty.

The five-man majority opinion held that Cain was in a fiduciary relation only when asked for advice by Tennessee, and was under no duty to refrain from acting adversely to Tennessee's interest in other matters. Whatever general fiduciary duty Cain had was terminated when he resigned as president. Since Cain had not been asked by Tennessee about the matter, he was not liable.

The dissent's position was premised upon the belief that a fiduciary duty exists in law whenever one's trust is placed in another. This duty includes not only formal relations but also would include those where one trusts and relies upon another.<sup>17</sup> What appears to have had the most suasion on the

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<sup>14</sup> Some of the more general articles are: Bayne, *The Fiduciary Duty of Management: The Concept in the Courts*, 35 U. DET. L.J. 561 (1958); Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); Grissom & King, *Liabilities of Directors of Closely Held Corporations*, 36 U. COLO. L. REV. 95 (1964); Comment, *Economic Institutions and Values: Fiduciary Responsibility of Corporate Officers and Directors*, 36 NOTRE DAME LAW. 343 (1961); Comment, *Fiduciary Duty of Directors and Officers of Private Corporations*, 27 TENN. L. REV. 284 (1960). See also FEUER, *PERSONAL LIABILITIES OF CORPORATE OFFICERS AND DIRECTORS* (1961).

<sup>15</sup> *But see*, 3 FLETCHER, *op. cit. supra* note 6, § 860 on the termination of the fiduciary duty; 19 AM. JUR. 2D *Corporations* § 1273 (1965).

<sup>16</sup> 400 S.W.2d 318 (Tex. 1966), 20 Sw. L.J. 418. For further discussion see Flittie, *Oil and Gas*, this Survey at footnote 13.

<sup>17</sup> *Reeves v. Crum*, 97 Okla. 293, 225 P. 177, 179 (1924). (Emphasis added by court.) Other similar authorities cited by the court were, *Kingback Tool Co., Inc. v. Corbett-Wallace Corp.*, 138 Tex. 565, 160 S.W.2d 509, 512-13 (1942); *Higgins v. Chicago Title & Trust Co.*, 312 Ill. 11, 143 N.E. 482 (1924), 36A C.J.S. § 381 (1961).

dissenting justices was the fact that Cain was seeking to enforce a liability which he himself had at least partially created by failing to explore further the lease while he was president of the predecessor company that held the lease. Admittedly, it must have galled Tennessee to receive a letter from Cain saying, "During the past ten years, you and your predecessors have not, to my knowledge, conducted any drilling operations, either exploratory or developmental, upon this property." "Your predecessors," of course, referred to the company which Cain headed before the merger. The dissent pointed out that Cain, in signing the merger agreement as president, warranted that the company held peaceful possession of all leases and mineral interests conveyed to Tennessee and that he knew no reason or claim that would affect title to the properties. To now assert a claim dispositive of this quiet possession was a breach of the general trust and confidence Tennessee reposed in Cain when he signed the merger agreement.

The dissent is in a strong equitable position, but the weakness in its argument is apparent in light of the principle that fiduciary responsibility should be predicated upon either the status of the individual at the time the breach is alleged to have occurred or upon his use of this position to secure an opportunity or advantage not otherwise available to him.<sup>18</sup> Cain's status in matters other than those in which he was consulted was no more than that of a former officer of the corporation. Comparing Cain's status with the usual corporate fiduciary, it is evident that the ingredients necessary to constitute a fiduciary relationship are missing. Cain had no control over property of the corporation, and he exercised no control over the affairs of the corporation.<sup>19</sup> The real touchstone of the majority opinion was quite properly not what *former* fiduciary duty Cain owed, but what *present* fiduciary duty he owed to Tennessee at the time he wrote the letter. And, as to the warranties of good title he signed, it is difficult to see what "status" if any was created by such. This warranty constituted merely a contractual relation whereby Cain as president of Fifteen guaranteed the

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<sup>18</sup> Even the terms of reference for explaining the fiduciary's duty—trustee and agent—are based on a relationship which must be breached before there can be liability. In cases involving questions of fiduciary responsibility after an officer or director has retired there are statements to the effect that the fiduciary duty exists only so long as there is some *mutuality* between the trustee and the beneficiary, or simply that the fiduciary duty ends upon severance of the relation. See, e.g., *Marine Forwarding & Shipping Co. v. Barone*, 154 So. 2d 528 (La. App. 1963); *Holmes v. Doe Run Lead Co.*, 223 S.W. 772 (Mo. App. 1920); *Commonwealth Sanitation Co. v. Fox*, 107 N.Y.S.2d 935 (Misc. 1951). However, this does not mean that officers and directors can resign with impunity so as to take advantage of opportunities engendered by their corporate position.

The fiduciary responsibility of officers and directors must not be confused with the tort liability of officers and directors to third parties, where there is no liability in the absence of participation in the wrongful act. Liability of officers and directors in these cases does not arise out of the fact that they occupy such positions, but rather it springs out of their participation in the wrong. *Sutton v. Reagan & Gee*, 405 S.W.2d 828, 833-34 (Tex. Civ. App. 1966) *error ref. n.r.e.*; cited as authority in *Sutton v. Belo & Co. v. Fuller*, 84 Tex. 450, 19 S.W. 616 (1892).

<sup>19</sup> See, e.g., 19 AM. JUR. 2D *Corporations* § 1272 (1965).

title to the transferred property,<sup>20</sup> which obligation was not breached by Cain's action against Tennessee. Further, there was no showing that Cain took advantage of a transaction or opportunity that arose out of the fiduciary relationship. Cain merely asserted a valid legal right his father held against his former company. There was no showing that Cain created this situation while acting as president of Fifteen or that he even knew at the time of the sale that further development of the lease was necessary. Indeed, in view of the fact that the warranties were not breached, it must be assumed that Tennessee bought the properties subject to just such claims.

It is questionable whether Cain, even had he been in a fiduciary position to Tennessee, would have violated his duty by asserting this claim. The majority never reached this question, and the dissent simply assumed a breach because Cain's action had been contrary to the interests of Tennessee. No cases can be found that are directly on point, but the assertion of legal claim is analagous to the case of an officer or director who as a creditor of his corporation has been allowed to attach its property by the Texas courts.<sup>21</sup>

In the future, if a corporation wishes to hold a retiring officer who is to serve in an advisory capacity to a fiduciary duty, the agreement on his advisory services should include an understanding that the officer will not act contrary to the interests of the corporation during such period. This solution is hardly foolproof. For one thing, it will create only a general fiduciary relationship for the length of the advisory services contract. A broad statement that the officer would never act contrary to the interests of the corporation would, like a clause not to compete for a similar period, probably be struck down as unreasonable.<sup>22</sup> Creation of a general fiduciary

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<sup>20</sup> *Oelwein Chem. Co. v. Baker*, 204 Iowa 414, 214 N.W. 595, 596 (1927) ("A warranty rests on contract . . ."); *Hollingsworth v. Mexia*, 37 S.W. 455, 459 (Tex. Civ. App. 1896) ("The warrantor fixes by his contract the limit of his own liability and that cannot be changed by the contracts of others.").

<sup>21</sup> *Martin v. Chambers*, 214 F. 769 (5th Cir. 1914); *Wolfe v. State Inv. Co.*, 95 S.W.2d 511 (Tex. Civ. App. 1936) (solvent corporation may give director security for his loan); *McCormick v. Cornell & Wardlaw*, 193 S.W. 1083 (Tex. Civ. App. 1916) (director-creditor can in good faith secure preference over other creditors by attachment or garnishment); see Note, 4 Sw. L.J. 285 (1950); *cf.*, *Popperman v. Rest Haven Cemetery, Inc.*, 162 Tex. 255, 345 S.W.2d 715, 717 (1961) ("Officers and directors of a corporation are not disqualified from dealing with the corporation but such dealings are subject to strict scrutiny.").

<sup>22</sup> An agreement on the part of an employee not to compete with his employer after the termination of the employment is in restraint of trade and will not be enforced unless the terms are reasonable. Tests used for determining if terms are reasonable are if it imposes on the employee any greater restraint than is reasonably necessary to protect the business and goodwill of the employer . . . . The period of time which the restraint is to last and the territory that is included are important factors to be considered.

*Weatherford Oil Tool Co. v. Campbell*, 161 Tex. 310, 340 S.W.2d 950, 951 (1960), 40 TEXAS L. REV. 152 (1961); *Holiday Hill Stone Prods., Inc. v. Peek*, 387 S.W.2d 731 (Tex. Civ. App. 1965); RESTATEMENT, CONTRACTS §§ 515, 516 (1932).

duty in the retiring officer also runs the risk that actions of the officer could, on agency principles, be imputed to the corporation.

## II. CREDITORS RIGHT TO SUE OFFICERS AND DIRECTORS FOR MISMANAGEMENT.

In addition to fiduciary duties imposed on corporate officers and directors, they may also be liable for mismanagement or negligence in their conduct of the corporation's affairs.<sup>23</sup> The standard of conduct applicable to them is the usual one of "reasonable care" or "prudent man."<sup>24</sup> Any action by shareholders or creditors against officers and directors for mismanagement, or for a breach of the fiduciary duty is derivative in nature and is for the benefit of the corporation.<sup>25</sup> When discussing the right of corporate creditors to sue officers and directors, it is necessary to first draw the distinction between an act which directly injures a creditor and an act which constitutes mismanagement of the corporation. For example, the officer or director will be personally liable to the creditor if he misappropriates the funds of a creditor<sup>26</sup> or if he induces a creditor to loan money under representations he could but does not keep.<sup>27</sup> This liability of the officers and directors is one of tort, usually for fraud, deceit, or misrepresentation.<sup>28</sup> If, however, the wrong is one done to the corporation, as where an officer misappropriates corporate funds, the officer or director is liable only to the corporation or to one standing in the shoes of the corp-

<sup>23</sup> Management is said to have three duties: (1) to act *intra vires* and within their respective authority, (2) to exercise due care (avoid negligence), and (3) to observe applicable fiduciary duties. HENIN, *CORPORATIONS* § 231 (1961). For a recent article on the due care requirement, see Dyson, *Director's Liability for Negligence*, 40 *IND. L.J.* 341 (1965).

<sup>24</sup> "The common expression of duty of care is that care which a reasonably prudent director of a similar corporation would have used under the circumstances of the particular case." LATTIN, *CORPORATIONS* § 10, at 241 (1959).

<sup>25</sup> "The liability of directors for a loss to a corporation due to their mismanagement is an asset of the corporation and any recovery on such a clause of action belongs solely to the corporation." Johnson v. Baldwin, 221 S.C. 141, 69 S.E.2d 585, 588 (1952).

Schwartz v. Mims, 40 S.W.2d 853, 854 (Tex. Civ. App. 1931) indicates there is generally no privity between officers and shareholders and right of recovery for malfeasance of officers is in the corporation. However if the corporation refuses to sue the shareholder can bring an equitable proceeding against the guilty to protect the corporation as trustee for shareholders and creditors. See 3 FLETCHER, *op. cit. supra* note 6, § 1179.

<sup>26</sup> McCollum v. Dollar, 213 S.W. 259 (Tex. Comm'n App. 1919). See 3 FLETCHER, *op. cit. supra* note 6, §§ 1134-66.

<sup>27</sup> Emmert v. Drake, 224 F.2d 299 (5th Cir. 1955), 10 Sw. L.J. 71 (1956).

<sup>28</sup> See *supra* notes 26 and 27. Also, there is statutory authority in certain limited instances for creditors to sue officers and directors personally for a violation of duties they owe the corporation. TEX. REV. CIV. STAT. ANN. art. 12.14 (1960) (Taxation—General). A recent case construing this section was First Nat'l Bank v. Silberstein, 398 S.W.2d 914 (Tex. 1966). See also Gentry v. Jeffrey, 389 P.2d 519 (Okla. 1964). But some obligations of officers and directors are by statute a liability running to the corporation and not for the benefit of corporate creditors. See Blond Lighting Fixture Supply Co. v. Funk, 392 S.W.2d 586 (Tex. Civ. App. 1965) (construing article 2.41 of the TBCA to this effect).

oration.<sup>29</sup> If the corporation is rendered insolvent by the mismanagement, the creditor is still without sufficient standing in most jurisdictions to sue the misfeasants directly, provided there is someone else available, such as a corporation, trustee or shareholder, to bring the action.<sup>30</sup>

In a recent civil appeals case,<sup>31</sup> the right of corporate creditors to hold officers and directors personally liable for mismanagement was tested. A small family corporation was in bankruptcy, and a creditor had brought suit on his own behalf against the officers and directors for the damage caused him by their mismanagement which had resulted in insolvency. The court held that the creditor lacked standing to sue because the officers and directors of the corporation were agents of the corporation, and, as agents, they were responsible solely to the corporation or to one suing on behalf of the corporation for any breach of a duty. Since the officers and directors were not hired by the creditors, they had no contractual relation with the creditors; and in their dealings with creditors, they were acting not as individuals but rather as agents of the corporation. Neither were the officers and directors trustees for the creditors' interests in the corporation, for this would make the officers and directors trustees for two different interests, a position where conflict of interest would be inevitable.

The creditor must thus rely upon either a shareholder or the trustee in bankruptcy to recover from the officers and directors for the general benefit of the corporation and in this way recover the debts due him. Should such relief not be forthcoming, the court said, the creditor may himself bring suit against the wrongdoers by means of a creditor's bill on behalf

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<sup>29</sup> See *supra* note 25.

Officers and directors of a corporation who fraudulently convert or mismanage the corporate assets are primarily liable to the corporation and ultimately liable to its creditors and stockholders. But the right of creditors, and for that matter, of stockholders, to sue and recover rests upon the doctrine of subrogation and may be asserted only after the directors of the corporation have refused to sue for its recovery or upon a showing in the bill of circumstances that would render it useless to demand action by the corporate authorities. *State v. Allstadt*, 166 Tenn. 349, 61 S.W.2d 473, 475 (1933).

<sup>30</sup> *Sutton v. Reagan & Gee*, 405 S.W.2d 828 (Tex. Civ. App. 1966); cited by this court were *Lawson-Richards, Inc. v. Blalock Lumber Co.*, 30 S.W.2d 797 (Tex. Civ. App. 1930); Annot., 50 A.L.R. 462 (1927). See also *Creamery Package Mfg. Co. v. Wilhite*, 149 Ark. 576, 233 S.W. 710 (1921); *Craig v. Stacy*, 330 Mo. 569, 50 S.W.2d 104 (1932); *Conrick v. Houston Civic Opera Ass'n*, 99 S.W.2d 382 (Tex. Civ. App. 1936); Comment, *Fiduciary Duty of Directors and Officers of Private Corporations*, 27 TENN. L. REV. 284, 298-300 (1960); Comment, 34 MICH. L. REV. 521 (1936). "It is generally held . . . that the duties of care imposed upon directors and officers are owed only to the corporation and not to its creditors, and the liability they may incur for negligent mismanagement is to the corporation and not to its shareholders." *BAKER & CAREY, CORPORATIONS—CASES AND MATERIALS* (3d ed. 1959).

<sup>31</sup> *Sutton v. Reagan & Gee*, 405 S.W.2d 828 (Tex. Civ. App. 1966); accord, see cases *supra* note 30. In the *Sutton* case three members of the same family owned all but one share of the stock of the corporation which had gone bankrupt primarily as a result of the unauthorized use of company funds by the general manager, who was also one of the principal shareholders.



of all the creditors.<sup>32</sup> Actually, Texas courts in the past had been considered rather liberal toward creditors' standing to sue corporate misfeasants.<sup>33</sup> The courts indicated willingness to construe particular acts of mismanagement as aimed directly at the creditor.<sup>34</sup> Here, however, the court was evidently impressed by the fact that suit had already been brought by the trustee in bankruptcy against the officers and directors for their mismanagement. To allow recovery by the creditor in this suit would run the risk of dual recovery. Although this last result appears unlikely due to the equities of the situation, the court's decision seems proper, as there is no logical reason why one corporate creditor should be in a better position over another so long as there is someone, such as a trustee, to represent all the creditors equally.

### III. DISREGARD OF THE CORPORATE ENTITY

The corporation is an entity separate and distinct from its stockholders, thus insulating shareholders from personal liability for activities conducted on behalf of the corporation.<sup>35</sup> When the corporation is properly chartered, there is a prima facie presumption of limited liability which can be overcome only if it is shown that the corporate form is being used for purposes violative of public policy. To "pierce the corporate veil," it is necessary to present a fact situation where the equities justify "piercing." While these cases are questions of fact, the courts often fail to state adequately the factual premises relied upon in their decisions.<sup>36</sup>

Disregard of the corporate entity under Texas law is considered an exceptional remedy<sup>37</sup> and requires proof of two elements: (1) a substantial

<sup>32</sup> *Sutton v. Reagan & Gee*, 405 S.W.2d 828, 834 (Tex. Civ. App. 1966); *Contra*, *Conrick v. Houston Civic Opera Ass'n*, 99 S.W.2d 382 (Tex. Civ. App. 1936); this case was not mentioned by the court in *Sutton*. The law is confusing on this point, although *Sutton* does seem to be following what is the majority rule in saying that a creditor can maintain a creditor's bill if no other relief is forthcoming. See 3 FLETCHER, *op. cit. supra* note 6, §§ 1180-81.

<sup>33</sup> *Emmert v. Drake*, 224 F.2d 299 (5th Cir. 1955), 10 Sw. L.J. 71 (1956). See also, *McCullum v. Dollar*, 213 S.W. 259 (Tex. Civ. App. 1919); *Dollar v. Lackney Supply Co.*, 164 S.W. 1076 (Tex. Civ. App. 1914).

<sup>34</sup> *Ibid.*

<sup>35</sup> On the nature of the corporation see WORMSER, *DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATE PROBLEMS* 3-41 (1929); Berle, *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 342 (1947); Latty, *The Corporate Entity as a Solvent of Legal Problems*, 34 MICH. L. REV. 597 (1936); Weiner, *The Berle-Dodd Dialogue on the Concept of the Corporation*, 64 COLUM. L. REV. 1458 (1964).

<sup>36</sup> See, e.g., *American Pet. Exch. v. Lord*, 399 S.W.2d 213 (Tex. Civ. App. 1966) *error ref. n.r.e.*; *Westwood Dev. Co. v. Esponge*, 342 S.W.2d 623 (Tex. Civ. App. 1961) *error ref. n.r.e.* In both of these cases the veil was pierced without any meaningful discussion of the facts upon which this decision was premised. Similar criticisms have been raised by other writers: Cataldo, *Limited Liability With One-Man Companies and Subsidiary Corporations*, 18 LAW & CONTEMP. PROB. 473 (1953); Comment, *Theory of the Corporate Entity and the One-Man Corporation in Louisiana*, 38 TUL. L. REV. 738 (1964).

<sup>37</sup> *Gill v. Phillips*, 337 F.2d 258 (5th Cir. 1964); *Radio KBUY, Inc. v. Licurance*, 390 S.W.2d 16 (Tex. Civ. App. 1965).

identity of interest and ownership between an individual and a corporation, such that the action of one can be said to be the action of the other; and (2) the danger that the corporate form is being used or will be used to achieve an inequitable result.<sup>38</sup> The first requirement is a common failing of small corporations where management and ownership are frequently the same. All too often these incorporated small businesses are treated by their owners as if the business was still a proprietorship or a partnership. There is nothing in the law that prohibits one- or two-man corporations, provided that corporate formalities are maintained.<sup>39</sup> Among the most frequent violations are the failure to hold stockholder and board of directors meetings,<sup>40</sup> failure to issue the corporate stock,<sup>41</sup> neglect on the part of the corporate officers to make clear that they are representing their

<sup>38</sup> First Nat'l Bank v. Gamble, 134 Tex. 112, 132 S.W.2d 100, 103 (Tex. Comm'n App. 1939), where it is stated that disregard of the corporate entity:

is an exception to the general rule which forbids disregarding corporate existence or entity and is not to be applied unless it is made to appear that there is such unity that the separateness of the corporation has ceased and "the facts are such that an adherence to the fiction of the separate existence of the corporation would under the particular circumstances, sanction a fraud or promote injustice.

Citing *Minifie v. Rowley*, 187 Cal. 481, 202 P. 673, 676 (1921); *Annot.*, 125 A.L.R. 265 (1940). See also *Sutton v. Reagan & Gee*, 405 S.W.2d 828 (Tex. Civ. App. 1966) *error ref. n.r.e.*; *McDonald & Co. v. Kemper*, 386 S.W.2d 215 (Tex. Civ. App. 1965); *Sidram v. Tanenbaum*, 391 S.W.2d 93 (Tex. Civ. App. 1965) (quoting from *Gamble*); *Houston-American Life Ins. Co. v. Tate*, 358 S.W.2d 645 (Tex. Civ. App. 1962); *Moore v. Savage*, 359 S.W.2d 95 (Tex. Civ. App.) *error ref. n.r.e.*, 362 S.W.2d 298 (1962); *Kaufert, Pleading Fact Sufficient To Disregard the Corporate Entity*, 40 Los Angeles Bar Bul. 131, 148 (Jan. 1965). The dual nature of this test is not always clearly expressed by the courts; often the second requirement is used by the court as the test. The effect, however, is essentially the same for the courts tend to discuss the same facts. See *Radio KBUY, Inc. v. Lieurance*, 390 S.W.2d 16 (Tex. Civ. App. 1965); *Atomic Fuel Extraction Corp. v. Slick Estate*, 386 S.W.2d 180 (Tex. Civ. App. 1964), *error ref. n.r.e.*, 403 S.W.2d 784 (1965); *Wells v. Hiskett*, 288 S.W.2d 257 (Tex. Civ. App. 1956) *error ref. n.r.e.*

<sup>39</sup> *Sutton v. Reagan & Gee*, 405 S.W.2d 828, 837 (Tex. Civ. App. 1966); *Sayers v. Navillus Oil Co.*, 41 S.W.2d 506 (Tex. Civ. App. 1931) *error ref.*; *cf.*, *State v. Swift & Co.*, 187 S.W.2d 127, 131 (Tex. Civ. App. 1945) *error ref.* ("The same persons may form as many separate corporations to carry on as many separate businesses as they may wish."). See also *Cataldo, Limited Liability With One-Man Companies and Subsidiary Corporations*, 18 LAW & CONTEMP. PROB. 473 (1953); *Fuller, The Incorporated Individual: A Study of the One-Man Company*, 51 HARV. L. REV. 1373 (1938).

There are some states which have specific provisions in their corporate law designed to validate one-man corporations. See IOWA CODE ANN. § 491.2 (1949); MICH. STAT. ANN. § 21.3 (1963); N.Y. BUS. CORP. LAW § 702(a) (1963); N.C. BUS. CORP. ACT § 55-3.1 (1957); WIS. STAT. § 180.44 (1957). The North Carolina statute was added in 1957 to overturn a case which had questioned the viability of a one-man corporation. The case is *Park Terrace v. Phoenix Indem. Co.*, 243 N.C. 595, 91 S.E.2d 584 (1956), which is critically discussed in *Latty, A Conceptualistic Tangle and the One- or Two-Man Corporation*, 34 N.C.L. REV. 471 (1956). Texas does not have such a provision in the TBCA.

<sup>40</sup> *E.g.*, *Edward Finch Co. v. Robie*, 12 F.2d 360 (8th Cir. 1926); *Taylor v. Newton*, 117 Col. App. 2d 938, 257 P.2d 68 (1953); *International Aircraft Trading Co. v. Mfrs. Trust Co.*, 297 N.Y. 285, 79 N.E.2d 249 (1948); *First Nat'l Bank v. Gamble*, 134 Tex. 112, 132 S.W.2d 100, 104 (Tex. Comm'n App. 1939); *cf.*, *Alfred P. Sloan Found., Inc. v. Atlas*, 42 Misc. 2d 603, 248 N.Y.S.2d 524 (1964) (where the court noted the failure to hold meetings but refused to hold the corporation an alter ego because no injustice or inequity was shown).

<sup>41</sup> *E.g.*, *Auer v. Frank*, 227 Cal. App. 2d 396, 38 Cal. Rep. 684 (1964), 8 A.L.R. 3d 1108 (1966); *Mabry Corp. v. Dobry*, 141 So. 2d 335 (Fla. App. 1962); *Detroit Elec. Works v. Riverside S.R.R.*, 29 S.W. 412 (Tex. Civ. App. 1895).

corporations and not themselves,<sup>42</sup> neglect in separating individual and corporate property<sup>43</sup> and lack of adequate capitalization of the corporation.<sup>44</sup> The second requirement is tied to the concept that disregard of the corporate form is in essence an equitable remedy and will only be interposed to prevent inequitable results. The Texas courts have stated that to uphold the corporate entity, the court must be shown that such structure will not facilitate fraud or promote injustice.<sup>45</sup>

In the past year there were eight cases attacking the corporate entity.<sup>46</sup> The majority involved creditors who were attempting to reach the assets of an individual or his corporation by reason of his ownership of the corporation.<sup>47</sup> Several cases, however, do not fit this basic mold. One involved a shareholder derivative suit charging that officers of the corporation had benefited from a loan made to a corporation, allegedly the alter ego of the officers.<sup>48</sup> Another case was an agency problem, involving a question of

<sup>42</sup> *E.g.*, McKay v. Vesley, 163 So. 2d 121 (La. App. 1964); Lange v. Baker, 377 S.W.2d 5 (Mo. App. 1964); Anderson v. Smith, 398 S.W.2d 635 (Tex. Civ. App. 1965).

<sup>43</sup> *E.g.*, Evans v. General Ins. Co. of America, 390 S.W.2d 818 (Tex. Civ. App. 1965) (mentioned as a factor to be considered); Lawson-Richards, Inc. v. Blalock Lumber Co., 30 S.W.2d 797 (Tex. Civ. App. 1930) *error dismissed*. This requirement is directed towards preventing inequities where the corporate form is used (1) to perpetrate fraud, (2) as a mere tool or business conduit of another corporation, (3) to evade an existing legal obligation, (4) to achieve or perpetrate a monopoly, (5) as a means of circumventing a statute, or (6) as a protective cover for crime or to justify wrong; Continental Supply Co. v. Gilmore, 55 S.W.2d 622, 628 (Tex. Civ. App. 1932). More specifically, the Texas courts have struck down the corporate form where it was being used as a shield for unreasonable collection efforts, Moore v. Savage, 359 S.W.2d 95 (Tex. Civ. App. 1962) *error ref. n.r.e.*, where corporate stock rather than corporate property was sold in an attempt to avoid payment of a real estate commission, McDonald & Co. v. Kemper, 386 S.W.2d 215 (Tex. Civ. App. 1965), and to allow recovery against a common holding company of defendant for a usurious contract, Houston-American Life Ins. Co. v. Tate, 358 S.W.2d 645 (Tex. Civ. App. 1962). But the courts have found an absence of any wrongdoing or injustice where the creditor dealt with the corporation knowing that it was the alter ego of the sole shareholder and entirely dependent on him, Atomic Fuel Extraction Corp. v. Slick Estate, 386 S.W.2d 180, 190-91 (Tex. Civ. App. 1964) *error ref. n.r.e. per curiam*, 403 S.W.2d 784 (Tex. 1965) (opinion by Justice Pope) citing Hanson v. Bradley, 298 Mass. 371, 10 N.E.2d 259 (1937); Pace Corp. v. Jackson, 155 Tex. 179, 284 S.W.2d 340 (1955), and where, in the absence of bad faith, the only purpose for the corporate formation appeared to be to limit liability, Moore & Moore Drilling Co. v. White, 345 S.W.2d 550 (Tex. Civ. App. 1961) *error ref. n.r.e.*

<sup>44</sup> *E.g.*, Automotriz del Golfo de California S.A. de C. V. v. Resnick, 47 Cal. 2d 792, 306 P.2d 1 (1957), 63 A.L.R.2d 1042; Oriental Inv. Co. v. Barclay, 64 S.W. 80 (1901) *error ref.*; State v. Swift & Co., 187 S.W.2d 127 (Tex. Civ. App. 1945) *error ref. But cf.*, Arnold v. Phillips, 117 F.2d 497 (5th Cir. 1941). See Dix, *Adequate Risk Capital: The Consideration for Benefits of Separate Incorporation*, 53 N.W.U.L. REV. 478 (1958).

<sup>45</sup> See First Nat'l Bank v. Gamble, 134 Tex. 112, 132 S.W.2d 100 (Tex. Comm'n App. 1939), which has been cited numerous times. It was quoted and relied on in Sidram v. Tanenbaum, 391 S.W.2d 93 (Tex. Civ. App. 1965).

<sup>46</sup> First Nat'l Bank v. Silberstein, 398 S.W.2d 914 (Tex. 1966); Sutton v. Reagan & Gee, 405 S.W.2d 828 (Tex. Civ. App. 1966); Manney & Co. v. Texas Reserve Life Ins. Co., 407 S.W.2d 345 (Tex. Civ. App. 1966); Long Falls Realty Co. v. Anchor Elec. Co., 405 S.W.2d 170 (Tex. Civ. App. 1966); American Petroleum Exch. v. Lord, 399 S.W.2d 213 (Tex. Civ. App. 1966) *error ref. n.r.e.*; Verastique v. Terrace Associates, Ltd., 398 S.W.2d 348 (Tex. Civ. App. 1966) *error ref. n.r.e.*; Anderson v. Smith, 398 S.W.2d 635 (Tex. Civ. App. 1965); Allen v. Wilkerson, 396 S.W.2d 493 (Tex. Civ. App. 1965) *error ref. n.r.e.*

<sup>47</sup> American Petroleum Exch. v. Lord, Long Falls Realty Co. v. Anchor Elec. Co., Verastique v. Terrace Associates, Ltd., First Nat'l Bank v. Silberstein, Sutton v. Reagan & Gee, *supra* note 46.

<sup>48</sup> Manney & Co. v. Texas Reserve Life Ins. Co., 407 S.W.2d 345 (Tex. Civ. App. 1966).

whether the creditor intended to contract with the individual or his corporation.<sup>49</sup> Still another concerned the statutory liability of officers and directors for corporate debts when they failed to pay the franchise tax.

The most important of these cases is *Sutton v. Reagan & Gee*,<sup>50</sup> where a creditor argued that the principal shareholders should be held liable because they treated the corporation as their alter ego. The defendants were the inactive owners, at least until just prior to the corporation's bankruptcy. They allegedly allowed another family member to misappropriate corporate funds by their failure to act even after they knew that corporate funds were being taken. As to the identity of interest and ownership, the court stated that being a small corporation, or even one with only a single shareholder, does not necessarily mean that the separate corporate entity is to be disregarded.<sup>51</sup> Something more is needed. "Whether or not a shareholder will be insulated from personal liability," said the court, "should depend on the use, or misuse, which *that* shareholder is making of the corporate form."<sup>52</sup> The court declined to hold that there was any misuse of the corporate form. Important to the court was the fact that while the defendants may have been "derelict" in their duty to the corporation in failing to prevent the misappropriation of corporate funds, there was no showing that the corporation had been used "as a vehicle for injustice or inequity, or for the purpose of perpetrating a fraud."<sup>53</sup> The court noted that the bankruptcy of the corporation caused considerable loss to the shareholders, and that the creditor was probably going to be able to recover anyway by reason of the suit by the trustee against the officers and directors for mismanagement.

The court's failure to emphasize the lack of shareholder and board of directors meetings is somewhat unusual, for this has been relied on in the past as one of the factors showing that the corporation lacked separate existence.<sup>54</sup> Also, under Texas law there is authority for the proposition that corporate action in the absence of formal authorization by the board of directors is illegal unless ratified by the shareholders or by the benefits

<sup>49</sup> *Anderson v. Smith*, 398 S.W.2d 635 (Tex. Civ. App. 1965).

<sup>50</sup> *Sutton v. Reagan & Gee*, 405 S.W.2d 828 (Tex. Civ. App. 1966).

<sup>51</sup> *Id.* at 837. See *supra* note 39.

<sup>52</sup> *Id.* at 837.

<sup>53</sup> *Ibid.*

<sup>54</sup> See *supra* note 40. Dean F. Hodge O'Neal in his treatise, 1 O'NEAL, CLOSE CORPORATIONS 23 (1958), states that the cases that have disregarded corporate entity generally fall into two categories, one being where:

the participants in the enterprise neglected conventional formalities of the corporate ritual (for instance, the holding of shareholders' and directors' meetings) and failed to keep separate corporate books and accounts or otherwise to distinguish between corporate assets and liabilities and those of the shareholders; . . .

(Emphasis added.)

and the other where the participants failed to adequately capitalize the corporation.

being accepted by the corporation.<sup>55</sup> Many states now recognize informal board of directors action,<sup>56</sup> and the Section on Corporation, Banking and Business Law of the State Bar of Texas has recently proposed just such a change in the Texas law.<sup>57</sup> The court in *Sutton* seeks to explain away the lack of formal action on the basis that since all the shareholders had acted together, "their action is substantially corporate action, even in the absence of formal meetings or formal votes."<sup>58</sup> True, it may be considered corporate action under the New York authority cited by the court,<sup>59</sup> but absence of such formalities is certainly an additional indicator that the corporate form was not being observed. If the shareholders had the requisite identity of interest in the operation and ownership of this enterprise, it would be unjust to allow them to rely on the corporate form to deny recovery to a creditor who had dealt with this business. The injustice would accrue from the fact that the defendants had been responsible in part for the loss of capital in the corporation by reason of their failure to prevent the misappropriation.<sup>60</sup>

The corporate entity is a statutory concept which can be withdrawn by the legislature when the management group commits a wrongful act,<sup>61</sup> as in the failure to pay franchise taxes.<sup>62</sup> In effect these statutes ignore the corporate form and impose personal liability on those who participate in a corporate wrongdoing. In the reporting year a supreme court case, *First*

<sup>55</sup> See *Curtis v. Pipeline Corp.*, 370 S.W.2d 764 (Tex. Civ. App. 1963); *Duncan v. Ponton*, 102 S.W.2d 517 (Tex. Civ. App. 1937).

<sup>56</sup> E.g., COLO. REV. STAT. ANN. § 31-4-22 (1963); N.M. STAT. ANN. § 51-6-1 (1941); N.C. GEN. STAT. § 55-29 (1963); 18 OKLA. STAT. ANN. § 1.38 (1947). Some states have achieved the same result notably in the case of small corporations. *Philadelphia-Life Ins. Co. v. Crosland-Cullen Co.*, 234 F.2d 780 (4th Cir. 1956); *Winchell v. Plywood Corp.*, 324 Mass. 171, 85 N.E.2d 313 (1949).

See Kessler, *The Statutory Requirement of a Board of Directors: A Corporate Anachronism*, 27 U. CHI. L. REV. 696 (1960); Comment, *Extent to Which Corporate Directors May Act Without a Formal Board Meeting*, 11 SYRACUSE L. REV. 68 (1959); Note, *Corporations, Informal Meeting of Directors as Constituting Corporate Actions*, 6 ARK. L. REV. 229 (1952).

<sup>57</sup> See Amsler, *Proposed Amendments—Texas Business Corporation Act*, 29 TEXAS B.J. 1013, 1014 (1966). This is now an optional provision in the MBCA, see 3 MODEL BUS. CORP. ACT ANN. § 39A (Supp. 1966).

<sup>58</sup> *Sutton v. Reagan & Gee*, 405 S.W.2d 828, 836 (Tex. Civ. App. 1966).

<sup>59</sup> *Elyea v. Lehigh Salt Mining Co.*, 169 N.Y. 29, 61 N.E. 992 (1901).

<sup>60</sup> See 3 FLETCHER, CYCLOPEDIA CORPORATIONS § 1151, at 830 (1965) where it is stated "it may be a fraud for officers of a bank to permit a deposit when they know, or ought to know, that it is insolvent . . ." (Emphasis added.)

<sup>61</sup> See generally *id.* §§ 1197-1269.

<sup>62</sup> Texas, like many other states, holds officers and directors personally liable as partners to corporate creditors if the corporation forfeits its charter by failing to pay the franchise tax, TEX. REV. CIV. STAT. ANN. art. 12.14 (1960), or if the creditors are not notified that an existing business has incorporated without a change in name, TEX. REV. CIV. STAT. ANN. art. 1302-2.02 (1961) which was applied in *Hobbs v. Triangle Supply Co.*, 378 S.W.2d 726 (Tex. Civ. App. 1964). See also *Philipp Lithographing Co. v. Babich*, 27 Wis. 2d 645, 135 N.W.2d 343 (1965).

Also, Article 2.41 of the TBCA holds directors liable to their corporation for such things as wrongful declaration of dividends, loans to officers and directors, and for the \$1,000 of necessary incorporation capital.

*Nat'l Bank v. Silberstein*,<sup>63</sup> involved statutory liability of officers and directors where the corporation lost its franchise to do business.<sup>64</sup> The defendant officers and directors denied liability on the basis that they did not know the franchise taxes had not been paid and that they did not personally participate in the purchases for which liability was being urged. The court held them liable. The statute was clear, the court felt, and knowledge of the delinquencies was not a prerequisite to liability under the statute. "The statute takes for granted that officers and directors will know these facts or, in any event, does not make such knowledge a condition to liability."

The defendants had a stronger argument as to the lack of knowledge of individual purchases because the statute provides for personal liability only where debts are "created or incurred, with . . . officer or director knowledge, approval *and* consent" after the forfeiture. The purchases in question had been made by the manager of the Fort Worth store, after which the invoices had been sent to the defendants in Austin. The court was of the opinion that the statute did not mean that officers and directors had to create personally or have contemporaneous knowledge of the creation of the debt before they would be personally liable. The reasonable interpretation of the statute would be that if they set up the conditions for such purchases, they will be held responsible for them. The court expressly declined to state that this was a form of imputed knowledge, although this seems the most likely explanation of the court's holding.

Another case involving a corporate creditor's right of action against a shareholder-officer was decided.<sup>65</sup> While this case is not strictly concerned with the question of whether there is a real or a sham corporation, it does center its attention on the question of what constitutes corporate existence separate from that of a majority stockholder. The case involved a judgment creditor of the corporation who brought a garnishment action against Allen, who was a debtor of the corporation as well as its majority shareholder and manager. Allen defended in part on the basis that the debt was barred by limitation. The court of appeals rejected this argument, citing a recent supreme court case<sup>66</sup> which held that for the limitation to run there must be notice to a disinterested board of directors. As the corporation had a four-man board of directors, there had to be notice of Allen's withdrawals of corporate funds to three disinterested members. Allen was one of these members, and as to two others there was a showing that they did not

<sup>63</sup> 398 S.W.2d 914 (Tex. 1966). See also *Radio Electronics Supply Corp. v. Smith*, 372 Mich. 393, 126 N.W.2d 729 (1964), 11 WAYNE L. REV. 195; *Schwab v. Schlumberger Well Surveying Corp.*, 145 Tex. 379, 198 S.W.2d 79 (1946), 168 A.L.R. 1074; *Sheffield v. Nobles*, 378 S.W.2d 391 (Tex. Civ. App. 1964) *error ref.*

<sup>64</sup> TEX. REV. CIV. STAT. ANN. art. 12.14 (1960).

<sup>65</sup> *Allen v. Wilkerson*, 396 S.W.2d 493 (Tex. Civ. App. 1965) *error ref. n.r.e.*

<sup>66</sup> *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 580 (Tex. 1963), 42 TEXAS L. REV. 252.

have full knowledge of the circumstances surrounding the withdrawals. In addition, there was probably sufficient evidence to show that the directors were not disinterested since two of the four members were Allen's brothers. Allen argued that the limitation had run against the corporation because Lankford, the only other stockholder, could have brought a derivative suit on behalf of the corporation against Allen to recover the withdrawals. The court said that this was primarily a corporate right of action, and could not have been released by Lankford nor directly sued on by him. Besides, it was rather fanciful to imagine that Lankford could have successfully prosecuted such an action where the management was so completely under the domination and control of Allen.

Three cases involving the corporate entity concept were actions by creditors who were trying to reach the assets of a corporation or association that was owned by, or affiliated with, the debtor.<sup>67</sup> In one case the court somewhat cryptically found that the evidence warranted piercing the corporate veil.<sup>68</sup> The only evidence cited by the court was that the defendant owned or held in trust nearly all the shares of the corporation and that he had treated the corporation as his alter ego. Facts to substantiate this latter point were not cited in the court's opinion. In another case,<sup>69</sup> a corporate creditor unsuccessfully tried to reach the assets of a limited partnership that had leased a motel to the corporation. The creditor urged liability on the basis that the corporation and the partnership were one and the same, due to the control over the corporation retained by the partnership through the lease. The court rejected this argument, citing the facts that none of the partners owned any stock in the corporation and the absence of any other control by the partnership over the corporation. Although the lease specified in detail that the premises were to be used for operating in a "first-class manner" a motel, restaurant, and associated retail business, the court determined that the limitations upon the use of the property were general in nature and of a character not uncommon in commercial leases. Another court of civil appeals refused, in the absence of fraud, to disregard the corporate entity, stating that alter ego corporations are not illegal per se.<sup>70</sup> This case involved an action by a judgment creditor of a former shareholder seeking indemnity from surplus funds of the shareholder's defunct corporation. The court held that the creditor was on notice of the conveyance of certain property held by the former shareholder to the corporation

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<sup>67</sup> Long Falls Realty Co. v. Anchor Elec. Co., 405 S.W.2d 170 (Tex. Civ. App. 1966); American Petroleum v. Lord, 399 S.W.2d 213 (Tex. Civ. App. 1966) *error ref. n.r.e.*; Verastique v. Terrace Associates, Ltd., 398 S.W.2d 348 (Tex. Civ. App. 1966) *error ref. n.r.e.*

<sup>68</sup> *Supra* note 67. See *supra* note 36.

<sup>69</sup> *Supra* note 67. Compare Willem Van Driel, Sr. v. Pennsylvania R.R., 252 Fed. 35 (4th Cir. 1918), where a corporation was held liable as an alter ego of its subsidiary by reason of the control it retained in a 999-year lease to the subsidiary.

<sup>70</sup> *Supra* note 67.

by virtue of the fact that the corporation had actual physical possession of the premises prior to the recording of the creditor's judgment and at all times thereafter. No fraud was found in converting an individually owned business into a corporation, of the conveyance of the real estate to that corporation, nor in the fact that the former shareholder unintentionally failed to record the deed at the time of the conveyance.

The alter ego issue arose in a case involving a derivative action by a minority shareholder of an insurance company directed primarily against its officers.<sup>71</sup> At issue was the investment of corporate funds in a \$1,000,000 bond of a development company whose controlling interest was held by the officers of the insurance company. The court held there was nothing to justify a finding that the development company was the alter ego of the insurance company officers. There was no showing that the development company was a conduit for the transaction of the officer's private business, and the plaintiff failed to present any evidence that the loan to the development company was detrimental to or caused loss to the minority shareholder. In fact, the loan was still outstanding, the development company was solvent, and the shareholder of the insurance company was entitled to share in the proceeds of the loan by virtue of his owning shares in the insurance company.

In a civil appeals case an individual defendant tried to escape personal liability on a written contract for compensation to the plaintiff architects by claiming that while the contract was signed by the defendant he was acting as an agent for the corporation.<sup>72</sup> The appellate court upheld the trial court's finding that the contract was made with the individual and not with the corporation. The defendant attempted to show that the plaintiffs had notice that they were dealing with the corporation because the plaintiffs had provided contract forms used by the corporation in its business and had received checks made out to plaintiffs and drawn on the corporate account. The court noted that there is some Texas authority for the principle of inquiry notice as being sufficient to relieve the agent of individual liability,<sup>73</sup> but this case did not present the necessary circumstances. The case illustrates once more the importance of keeping up the indicia of corporate existence and the necessity of corporate officers making clear that they represent the corporation.

In recent years there has been a significant upsurge in the number of

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<sup>71</sup> *Manney & Co. v. Texas Reserve Life Ins. Co.*, 407 S.W.2d 345 (Tex. Civ. App. 1966).

<sup>72</sup> *Anderson v. Smith*, 398 S.W.2d 635 (Tex. Civ. App. 1965). See *supra* note 42. Compare, *National Educators Life Ins. Co. v. Master Video Sys., Inc.*, 398 S.W.2d 358 (Tex. Civ. App. 1965) *error ref. n.r.e.*; *Clubb Testing Serv., Inc. v. Singletary*, 395 S.W.2d 956 (Tex. Civ. App. 1965) (plaintiff failed to prove he had contracted with someone authorized to bind the corporation).

<sup>73</sup> Cited by the court were *Johnson v. Armstrong*, 83 Tex. 325, 18 S.W. 594 (1892); *Veazie v. Beach Plumbing & Heating Co.*, 235 S.W. 695 (Tex. Civ. App. 1921).



cases involving the question of disregard of the corporate entity and related issues. Since 1960 in Texas there have been at least thirty-one cases where this was a significant issue,<sup>74</sup> and in the reporting year alone there were some eight cases.<sup>75</sup> Undoubtedly, the reason for the increase in this type of litigation is the increasing incorporation of small businesses.

As incorporation procedures simplify, more corporations are being formed and most are of the small, family variety where attention to the corporate form and manner of doing business is often perfunctory at best. In some states, notably North Carolina, South Carolina, New York, and Florida, there has been an attempt to tailor the laws not only to make incorporation easier, but also to make special provisions for the small, closed corporations so that their informal operation will not result in violations of the corporate law.<sup>76</sup> Although the adoption of the Texas Business Corporation Act in 1955 did much to alleviate this problem, there still remains much to be done. For example, a number of states have recently adopted provisions allowing informal board of directors action or even abolishing the need for separate board of directors action in small corporations.<sup>77</sup>

Another aspect of Texas corporation law that undoubtedly fails to instill

<sup>74</sup> Gill v. Phillips, 337 F.2d 258 (5th Cir. 1964); Fitz-Patrick v. Commonwealth Oil Co., 285 F.2d 726, 730 (5th Cir. 1960) ("The defendant wants to dance without paying [for] the music. To escape payment the defendant hides behind the corporate facade . . ."); Blond Lighting Fixture Supply Co. v. Funk, 392 S.W.2d 586 (Tex. Civ. App. 1965); Sidram v. Tanenbaum, 391 S.W.2d 93 (Tex. Civ. App. 1965); Associates Dev. Corp. v. Air Control Prods., Inc., 392 S.W.2d 542 (Tex. Civ. App. 1965); Evans v. General Ins. Co. of America, 390 S.W.2d 818 (Tex. Civ. App. 1965); Radio KBUY, Inc. v. Lieurance, 390 S.W.2d 16 (Tex. Civ. App. 1965); McDonald & Co. v. Kemper, 386 S.W.2d 215 (Tex. Civ. App. 1965) (defendant who owned 100% of the stock tried to avoid real estate commission by selling the stock of the corporation instead of the corporate property for which the broker had found a buyer); Shultz v. Resthaven Cemetery, Inc., 375 S.W.2d 493 (Tex. Civ. App. 1964) *error ref. n.r.e.*; Kroger Co. v. J. Weingarten, Inc., 380 S.W.2d 145 (Tex. Civ. App. 1964) *error ref. n.r.e.*; Sheffield v. Nobles, 378 S.W.2d 391 (Tex. Civ. App. 1964) *error ref.*; Atomic Fuel Extraction Corp. v. Slick Estate, 386 S.W.2d 180 (Tex. Civ. App. 1964) (the court refused to pierce the corporate veil where the creditor knew that the corporations were entirely dependent on the sole shareholder); Anderson v. King, 370 S.W.2d 775 (Tex. Civ. App. 1963); Eastwood Model Market v. State, 359 S.W.2d 294 (Tex. Civ. App.) *aff'd*, 365 S.W.2d 781 (1963) (even though the corporation was the alter ego of the individual, the court would not transfer the individual's unemployment experience rating to his corporation); Moore v. Savage, 395 S.W.2d 95 (Tex. Civ. App.) *error ref. n.r.e.*, 362 S.W.2d 298 (1962); Holloway v. International Bankers Life Ins. Co., 354 S.W.2d 198 (Tex. Civ. App.), *rev'd on other grounds*, 368 S.W.2d 567 (1962); Houston-American Life Ins. Co. v. Tate, 358 S.W.2d 645 (Tex. Civ. App. 1962); Moore & Moore Drilling Co. v. White, 345 S.W.2d 550 (Tex. Civ. App. 1961) *error ref. n.r.e.*; Westwood Dev. Co. v. Esponge, 342 S.W.2d 623 (Tex. Civ. App. 1961); W. T. Grant Co. v. Wilson Indus., Inc., 346 S.W.2d 629 (Tex. Civ. App. 1961) *error ref. n.r.e.*; Maurice Angly Lumber Co. v. Converse, 341 S.W.2d 510 (Tex. Civ. App. 1960); Five Star Transfer & Terminal Warehouse Corp. v. Flusche, 339 S.W.2d 384 (Tex. Civ. App. 1960) *error ref. n.r.e.*; Cockrell v. Craugh, 338 S.W.2d 516 (Tex. Civ. App. 1960); a listing of the eight decisions that were handed down in the reporting year can be found in note 46 *supra*.

<sup>75</sup> *Supra* note 46.

<sup>76</sup> For a discussion of these statutes and their special provisions see Bradley, *Toward a More Perfect Close Corporation—The Need for More and Improved Legislation*, 54 GEO. L.J. 1145 (1966); Folk, *Corporation Statutes: 1959-1966*, 1966 DUKE L.J. 876, 946-57; O'Neal, *Developments in the Regulation of the Close Corporation*, 50 CORNELL L.Q. 641 (1965).

<sup>77</sup> See *supra* note 56; Bradley, *supra* note 76, at 1176-89.

respect for it among the owners of small corporations is the requirement of having three incorporators or three directors.<sup>78</sup> This is a mere formality that may be easily avoided by the use of dummy incorporators and directors. If public policy decides to make it easier for small corporations to be formed then the law must comport with the factual realities in which small corporations are known to conduct their business.

#### IV. ULTRA VIRES

The case of *Whitten v. Republic Nat'l Bank*<sup>79</sup> was one of the most significant decisions rendered this past year. The supreme court in *Whitten* disallowed an action by the trustee of a bankrupt corporation to recover from a bank a sum representing a personal debt of the corporation's president which had been paid by the corporation. The bank had, as a condition for a loan to the corporation, required that the corporation pay off a large debt owed by its president to the bank, with the result that the president became the debtor of his corporation instead of the bank. The court interpreted article 2.02A (6) of the TBCA, which empowers a corporation to loan funds to its employees but not to its officers and directors, as being merely a limit on a grant of powers to a corporation, something less than a positive prohibition against loaning funds to officers. Therefore, the loan in question to the corporation's president was merely ultra vires as beyond the powers of the corporation and was not illegal. Moreover, the trustee was held estopped to assert ultra vires as the basis of his claim for recovery because the corporation received sufficient direct and substantial benefits from the funds it received in the transaction.<sup>80</sup> Left unanswered were two important questions: first, whether the plea of ultra vires is abrogated by article 2.04 of the TBCA, a provision enacted to limit specifically the plea of ultra vires as a basis for claim or defense; second, whether the corporation had ratified, and whether it could ratify, the ultra vires act.<sup>81</sup>

#### V. CORPORATE SECURITIES

The Texas Constitution in article 12, section 6, provides: "No corpora-

<sup>78</sup> TBCA arts. 2.32, 3.01.

<sup>79</sup> 397 S.W.2d 415 (Tex. 1965), 20 Sw. L.J. 861 (1966).

<sup>80</sup> The direct and substantial benefits received were: (1) \$73,800 with which the corporation refinanced the claims of other creditors and (2) \$20,474.17 in free funds, 397 S.W.2d at 417.

<sup>81</sup> The Dallas Court of Civil Appeals held knowledge of the loan to the president was imputed to the board of directors, which passed a resolution ratifying the acts of its officers, from a director who countersigned all checks written in connection with the agreement with the bank. Furthermore, with actual knowledge of the loan to its president, the board acquiesced in the payment of the note to the bank. *Republic Nat'l Bank v. Whitten*, 383 S.W.2d 207, 213 (Tex. Civ. App. 1964). The supreme court's opinion did not touch on this point and hence the court of civil appeals opinion must be considered as controlling. For the opposite view, see Lidchowitz, *Director Misconduct and Shareholder Ratification in Texas*, 6 BAYLOR L. REV. 1 (1953); See a Note on the *Whitten* court of civil appeals decision, 43 TEXAS L. REV. 796 (1965).

tion shall issue stock or bonds except for money paid, labor done or property actually received." Article 2.16 of the TBCA repeats this, adding that neither promissory notes nor promises of future services are good consideration. The Waco Court of Civil Appeals handed down two decisions relating to the payment for stock and the purchase of its own stock by a corporation.<sup>82</sup> In the first case the court affirmed the cancellation of stock belonging to two shareholders because part of their stock had been issued for future services.<sup>83</sup> As to one of these shareholders, the court canceled all his stock, although part had been issued for past services. In refusing to apportion, the court relied on dictum in a recent Fifth Circuit case<sup>84</sup> involving a fact situation where, contrary to the instant case, all the shares had been issued for future services. There is, however, additional support for refusing to apportion in such circumstances.<sup>85</sup> The court also considered the effect of written approval by the board of directors on the type of consideration received for the stock. Article 2.16C of the TBCA provides that, in the absence of fraud, the judgment of the board of directors or the shareholders shall be conclusive as to the *value* of the consideration received for the shares. Speaking to this issue the court said: "The judgment of the board of directors as to the value of consideration received for shares is conclusive, but such does not authorize the board to issue shares contrary to the Constitution, for services to be performed in the future . . . or for property not received."<sup>86</sup> There is substantial authority under Texas law and in other jurisdictions that a declaration by the board of directors is presumed valid in regard to the adequacy of consideration absent fraud.<sup>87</sup> In fact, the courts have not shown any great willingness to question this presumption, but will do so only where there is a clear abuse of discretion by the board of directors.<sup>88</sup> When the issue was raised in another recent civil appeals case, the court brushed aside the argument, stating that in the absence of fraud, the judgment of the board of directors was conclusive; and the adequacy of the consideration could not then be questioned.<sup>89</sup> Where, as here, there was substantial disagreement as to the nature of the

<sup>82</sup> *United Steel Indus., Inc. v. Manhart*, 405 S.W.2d 231 (Tex. Civ. App. 1966); *Lanpar Co. v. Stull*, 405 S.W.2d 235 (Tex. Civ. App. 1966) *error ref. n.r.e.*

<sup>83</sup> *United Steel Indus., Inc. v. Manhart*, 405 S.W.2d 231 (Tex. Civ. App. 1966).

<sup>84</sup> *Champion v. Commissioner*, 303 F.2d 887 (5th Cir. 1962).

<sup>85</sup> *Rice & Hutchins, Inc. v. Triplex Shoe Co.*, 16 Del. Ch. 298, 147 A. 317, *aff'd*, 17 Del. Ch. 356, 152 A. 342, 72 A.L.R. 932 (1929); see also BALLANTINE, *CORPORATIONS* 791 (1946).

<sup>86</sup> See *supra* note 83 at 233.

<sup>87</sup> *Coit v. North Carolina Gold Amalgamating Co.*, 119 U.S. 343 (1886); *Sandor Petroleum Corp. v. Williams*, 321 S.W.2d 614 (Tex. Civ. App. 1959) *error ref. n.r.e.*; *Smith v. Ideal Laundry Co.*, 286 S.W. 285 (Tex. Civ. App. 1926) *error dismissed*; *Peden Iron & Steel Co. v. Jenkins*, 203 S.W. 180 (Tex. Civ. App. 1918) *error ref.*; *cf.*, *Edward v. Peabody Coal Co.*, 9 Ill. App. 2d 234, 132 N.E.2d 549 (1956). Recent cases discussing adequacy of consideration are rare because of increasing use of no par or nominal par value stock. 1 MODEL BUS. CORP. ACT ANN. 334 (1960).

<sup>88</sup> *Ibid.*

<sup>89</sup> *Sandor Petroleum Corp. v. Williams*, 321 S.W.2d 614 (Tex. Civ. App. 1959) *error ref. n.r.e.*

consideration and its adequacy, it was unusual that the court failed to give presumptive effect to the board of directors' determination.<sup>90</sup>

The other contemporary case by the Waco Court of Civil Appeals, in which the corporation attempted to deny liability on a bond, involved the question of what is proper consideration for bonds.<sup>91</sup> An important contention of the corporation was based on article 2.03F of the TBCA which makes illegal a corporation's purchase of its own shares if there is reasonable ground for believing the corporation is insolvent or will be rendered insolvent by the purchase. The corporation in this case had traded its bond for its own stock at a time when the corporation itself alleged it was insolvent. The court rejected this argument, explaining that article 2.03F was designed to safeguard the rights of creditors and no creditor had complained. The corporation, as purchaser of the stock, was therefore estopped to deny the validity of the transaction. Cited as authority for this proposition was the recent supreme court case of *Whitten v. Republic Nat'l Bank*<sup>92</sup> where a trustee of a bankrupt corporation was held unable to assert ultra vires in the absence of harm to the corporation in the transaction complained of. In the instant case the issue of harm to the corporation was not raised; indeed, the exchange of the stock for the bond was beneficial to the corporation as it was done to settle a lawsuit against the corporation.

## VI. SHAREHOLDER RIGHTS

A civil appeals decision dealt with the issue of a shareholder's right to inspect corporate records.<sup>93</sup> Article 2.44B of the TBCA allows inspection of the corporate records by a shareholder of record for over six months, or by a shareholder owning more than 5 per cent of the outstanding corporate stock, upon written demand stating the purpose for such inspection. Article 2.44C further provides that this grant shall not impair the common law power of a court to enforce inspection by a shareholder upon a showing of proper purpose, regardless of how long he has been a shareholder of record or how much stock he owns. This provision of the TBCA was first considered by a Texas court of civil appeals in 1965.<sup>94</sup> It was there held that an owner of the beneficial interest in stock, held by a trustee pursuant to a divorce decree, had the right to inspect the records of the corporation upon proof of a proper purpose under 2.44C. The court extended the protection afforded by section C, which refers to "shareholders" and shareholders "of record," to those who own merely a

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<sup>90</sup> See *supra* note 87.

<sup>91</sup> *Lanpar Co. v. Stull*, 405 S.W.2d 235 (Tex. Civ. App. 1966).

<sup>92</sup> *Whitten v. Republic Nat'l Bank*, 397 S.W.2d 415 (Tex. 1965), 20 Sw. L.J. 861 (1966).

<sup>93</sup> *Texas Infra-Red Radiant Co. v. Erwin*, 397 S.W.2d 491 (Tex. Civ. App. 1965) *error ref. n.r.e.*, 19 Sw. L.J. 851.

<sup>94</sup> *Ibid.*

beneficial interest in stock of the corporation and are not shareholders of record. While there is no previous authority in Texas for such an extension of the right to inspect, the beneficial owner does have a real interest in the management of the corporation which should entitle him to access to the corporate books and records. In such a case, the corporation is protected by the requirement that the party seeking inspection prove a proper purpose.<sup>95</sup>

The courts of civil appeals decided a variety of other cases in the past year involving shareholder rights. As the cases offer no uniformity or trend, they can best be noted in summary form.

A civil appeals decision involved the right of minority shareholders to recover attorneys' fees in a derivative class action instituted against a former officer-majority shareholder for \$3,000,000 wrongfully taken from the corporation.<sup>96</sup> The suit was settled, the former officer repaying the money to the corporation. The court upheld the jury's award of \$200,000 for attorney's fees as not unreasonable.

A case involving a bill of review proceeding concerned the right of a former shareholder, officer, and director of a corporation, to intervene in a corporation's bill of review suit by use of a quo warranto action.<sup>97</sup> The corporate charter was forfeited by default in the action by the state for nonpayment of franchise taxes. The corporation based its bill of review on a claim that the records were in a state of confusion due to reorganization during the period in question. The shareholder claimed a right to intervene because the allegations of disorganization reflected upon him personally and upon his skill exercised as accountant of the corporation during the period in question. The court denied his right to intervene in the bill of review. Since the intervenor was, in effect, attempting something only the state can do—question the corporate existence by quo warranto—the intervenor could not bring the original action as sole party.

The final case involves the relation between article 9.14 of the TBCA, which specifies to which corporations the act applies, and the Banking Code.<sup>98</sup> The case was a quo warranto proceeding contesting the election of directors of a state bank in which the relators had attempted to cumulate their votes according to article 2.29 of the TBCA to elect themselves to two of the seven director posts. The trial court, upholding the right of cumulative voting in bank elections, was reversed by the court of civil appeals. The appellate court held that article 9.14 of the TBCA specifically excepts state banks from its coverage unless the specific statutes under which banking corporations are organized contain no provision in regard

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<sup>95</sup> Note, 19 Sw. L.J. 851 (1965).

<sup>96</sup> National Bankers Life Ins. v. Rosson, 400 S.W.2d 366 (Tex. Civ. App. 1966) *error ref. n.r.e.*

<sup>97</sup> Mulchay v. Houston Steel Drum Co., 402 S.W.2d 817 (Tex. Civ. App. 1966).

<sup>98</sup> 406 S.W.2d 90 (Tex. Civ. App. 1966).

to the matter in question. The Banking Code, which provides for one vote for each director for each share of stock held,<sup>99</sup> also states that the code provides a *complete system* of laws governing the organization, operation, supervision, and liquidation of state banks.<sup>100</sup> The court found that it clearly was not the intention of the legislature to amend the Banking Code's provisions on voting in state bank elections with the adoption of the cumulative voting provisions of the TBCA.

## VII. CONCLUSION

The diverse nature of the corporate decisions discussed presented little opportunity for case analysis in terms of trends in the law and significant new developments. If any overall significance is to be drawn from the cases, it would be the observation that the issues raised were overwhelmingly those typical to small corporations. This was nowhere more evident than in the eight decisions where the corporate entity was attacked.<sup>101</sup> These decisions, as did a number of others, strikingly brought out the value of contemporaneous formal records of corporate action. Another common thread was that several of the cases, notably *Cain*,<sup>102</sup> *Sutton*,<sup>103</sup> and *Whitten*,<sup>104</sup> involved status or standing to sue for wrongs done to the corporation. In all three cases the claims were unsuccessful; the corporation in *Cain* was unable to hold a former officer who was in an advisory capacity to a general fiduciary duty; a creditor lacked standing to sue officers and directors individually for mismanagement in *Sutton*; and in *Whitten* a trustee for a bankrupt corporation was estopped to use ultra vires where the corporation had not been harmed by its ultra vires action. Inconsistencies or undelineated areas in the TBCA were cleared up by several of the decisions. One decision<sup>105</sup> clarified an aspect of shareholder inspection rights, and the *Cain* case, a decision of almost-certain first impression in the United States, construed the fiduciary duty of a retired corporate officer who was serving in an advisory capacity.

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<sup>99</sup> Texas Banking Code, TEX. REV. CIV. STAT. ANN. art. 342-406 (Supp. 1966).

<sup>100</sup> Texas Banking Code, TEX. REV. CIV. STAT. ANN. art. 342-101 (1959).

<sup>101</sup> *Supra* note 46.

<sup>102</sup> Tennessee-Louisiana Oil Co. v. Cain, 400 S.W.2d 318 (Tex. 1966).

<sup>103</sup> Sutton v. Reagan & Gee, 405 S.W.2d 828 (Tex. Civ. App. 1966).

<sup>104</sup> Whitten v. Republic Nat'l Bank, 397 S.W.2d 415 (Tex. 1965).

<sup>105</sup> Texas Infra-Red Radiant Co. v. Erwin, 397 S.W.2d 491 (Tex. Civ. App. 1965) *error ref.*