

COMMENT

DELAWARE VERSUS TEXAS CORPORATE LAW: HOW DOES TEXAS COMPARE?*

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I. INTRODUCTION

The corporation has long been the preferred choice of form for publicly held businesses.¹ Due to this preference, society has daily interaction with corporations. Banks, automobile manufacturers, airlines, phone companies, and energy suppliers are all examples of businesses that have chosen to incorporate.² Corporations are popular business entities for various reasons. Among these reasons are: limited liability for corporate managers and shareholders, free transfer of ownership interests, perpetual existence, centralized management, and recognition as independent legal entities.³

The state of Delaware has been successful in attracting publicly held corporations for many years because of its corporation-friendly laws.⁴ In 1996, 56% of all corporations listed on major stock exchanges were Delaware corporations, an increase of almost twelve percent since 1981.⁵ Delaware continued to break records in 2000, when 59,000 new companies were organized in that state.⁶

1. MELVIN ARON EISENBERG, *CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS* 100 (8th ed. 2000).

2. See *Fortune 500: America's Largest Corporations*, available at <http://www.fortune.com/fortune/fortune500> (last visited February 13, 2003) (listing top-performing corporations as ranked by revenues received, including Wal-Mart Stores, Exxon Mobil, General Motors, Ford Motor, Citigroup, Delta Airlines, and Enron).

3. EISENBERG, *supra* note 1, at 100.

4. Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 553-54 (2002).

5. Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 538 (2001).

6. Harriet Smith Windsor, *Message from the Secretary*, THE CORPORATE EDGE,

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In recent years, a few states have attempted to challenge Delaware as the leader in corporate law.⁷ Texas is one of these states,⁸ and the improvements that have been made over the last fifteen years to Texas' corporation laws have resulted in much discussion of Texas law amongst legal scholars.⁹ Texas has made revisions to the Texas Business Corporation Act ("TBCA") to compete with Delaware's favorable corporation laws.¹⁰ However, the fact that Texas lacks settled case law in some areas cannot be dismissed as entirely unimportant.¹¹

Part II of this comment discusses the development of corporate law in Delaware and Texas, and how this history affects the states' current corporate law. Part III outlines the differences in the two states' court systems. Part IV pertains to initial organizational considerations, taxation, and director liability differences between the two states. This comment is not intended to serve as a comparison of all points of corporate law in Delaware and Texas, but rather to point out some of the additional improvements that may be needed in Texas' corporate law before the state can emerge as a corporate leader.

II. DEVELOPMENT OF CORPORATE LAW

A. *Delaware*

The State of Delaware has an extensive history of actively encouraging businesses to incorporate within its borders. Originally modeled after New Jersey's liberal general corporation laws, Delaware enacted the General Corporation Law of 1899 according to its 1897 Constitution.¹² The Corporation Service

available at <http://www.state.de.us/corp/sp01wlc.htm> (Spring 2001).

7. David Mace Roberts & Rob Pivnick, *Tale of the Corporate Tape: Delaware, Nevada, and Texas*, 52 BAYLOR L. REV. 45, 46–47 (2000) (comparing the corporate laws of Texas and Nevada to that of Delaware).

8. See Byron F. Egan & Curtis W. Huff, *Choice of State of Incorporation—Texas Versus Delaware: Is It Now Time to Rethink Traditional Notions?*, 54 SMU L. REV. 249, 250 (2001) (describing the actions taken by the Texas legislature "to address the Delaware bias").

9. *Id.*; see Roberts & Pivnick, *supra* note 7, at 47.

10. See Egan & Huff, *supra* note 8, at 250–51 ("The resurgence of Texas as a desirable jurisdiction in which to incorporate was not merely an accident of nature. Rather, it was the product of a concerted effort by the Texas Legislature and the corporate bar to revise the Texas Business Corporation Act . . .").

11. Roberts & Pivnick, *supra* note 7, at 47.

12. Hon. Andrew G. T. Moore II, *A Brief History of the General Corporation Law of the State of Delaware and the Amendatory Process*, Introduction to R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* at H–6 (3d ed. 1998 & Supp. 1999). Delaware's first constitution, enacted

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Company, formed by several Delaware attorneys after the adoption of the general law, encouraged businesses around the country to incorporate in Delaware by promoting the liberality of the new statute:

“[A Delaware corporation] may engage in ‘any lawful business’ except banking.” . . . “[I]ts existence may be perpetual or limited . . . [I]t may conduct business anywhere in the world.” . . . “[S]tock may be issued for property purchased or services rendered, and, in the absence of fraud, the judgment of directors as the value of such property or services is conclusive.” . . . “The amount of capital stock it . . . may issue is unlimited.” . . . “[I]t . . . may commence business before any sum whatever is paid in.” . . . [I]t may “have different classes of stock with different privileges or restrictions. . . . [I]ts charter may be easily amended” [I]ts “capital stock may be easily increased or decreased.” . . . [I]t “may be readily merged into or consolidated with other corporations” . . . “[I]t may own and vote upon the stock of other corporations.” . . . “The original fee to be paid for incorporation is small” “The annual tax is very small.” . . . “Stockholders and directors may hold their meetings wherever they please, and need never meet in the State of Delaware.” . . . “The Stock and Transfer Books . . . may be kept in or out of Delaware, in the discretion of the company.” . . . “The liability of the stockholder is absolutely limited when the stock has once been issued for cash, property or services.”¹³

The Delaware legislature amended forty-eight of the 137 sections of its General Corporate Law over the next two years.¹⁴ Although the rate at which the legislature amended its corporate laws later decreased, it was evident that Delaware intended to

in 1776, did not address corporations; however, it did state that English statutory and common law would still govern. *Id.* at H-1; *see also* DEL. CONST. art. XXV (1776). Thus, in order for a business to incorporate, a special legislative act was needed. Moore, *supra* at H-1.

13. Note, *Little Delaware Makes a Bid for the Organizations of Trusts*, 33 AM. L. REV. 418, 420-24 (1899).

14. Moore, *supra* note 12, at H-9; Act of Mar. 7, 1901, ch. 166, 22 Del. Laws 255.

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maintain its newly found position as a leader in corporate law.¹⁵ Delaware wished to retain its position because corporations could provide a large portion of the state's total state revenue.¹⁶ After a brief decline in corporate filings in 1963,¹⁷ and after learning that two other states were restructuring their corporate law to compete with Delaware,¹⁸ the state again commenced amending its statute in 1967.¹⁹

Currently, the Delaware State Bar Association Section of General Corporation Law has the responsibility of updating the General Corporation Law.²⁰ Delaware's most elite corporate lawyers comprise the membership of the Section.²¹ The General Corporation Law is, thus, "under constant scrutiny and review,"²² thereby allowing Delaware to maintain its status as the preeminent state for corporate domicile.²³

B. *Texas*

The Texas Constitution of 1875 was drafted during a period when the country was skeptical and had reservations about the corporate form.²⁴ For these reasons, several provisions were

15. See Moore, *supra* note 12, at H-9.

16. David A. Skeel, Jr., *Lockups and Delaware Venue in Corporate Law and Bankruptcy*, 68 U. CIN. L. REV. 1243, 1271 (2000) (articulating Delaware's dependence on taxes and fees collected from its corporations); see also Joel Seligman, *A Brief History of Delaware's General Corporation Law of 1899*, 1 DEL. J. CORP. L. 249, 279 n.153 (1976) (noting that corporate revenues provided 42.5 percent of Delaware's total state revenues in 1929, but that the percentage dropped to 16.3 percent in 1945, and then to 7.2 percent in 1955).

17. Seligman, *supra* note 16, at 279-80.

18. See *id.* at 279.

19. Act of July 3, 1967, ch. 50, 56 Del. Laws 151; see Moore, *supra* note 12, at H-13.

20. See Moore, *supra* note 12, at H-13 to H-14 (explaining that "[i]t is a hallmark of the General Assembly's respect for the expertise of the Section that it will rarely consider or adopt any changes in the General Corporation Law which have not been sponsored by the Section").

21. *Id.* at H-13.

22. *Id.*

23. Leo Herzel & Laura D. Richman, *Delaware's Preeminence by Design, Foreword* to R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* at F-1 (3d ed. 1998 & Supp. 2001). According to the Delaware Division of Corporations, 300,000 companies have incorporated in Delaware, and 200,000 limited liability companies and partnerships have been set up in the state. Delaware Division of Corporations, at <http://www.state.de.us/corp> (last visited August 14, 2003). Over half of all publicly-traded companies, including 58% of the Fortune 500, have made Delaware their "legal home." *Id.* Additionally, Delaware's state revenue is increased by corporate and franchise taxes, and the private sector in Delaware benefits from those revenues. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 668-69 (1974).

24. ROBERT W. HAMILTON & NANCY SAINT-PAUL, in 19 TEX. PRACTICE § 1(1) (1973 & Supp. 2002).

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included for the purpose of protecting shareholders and the public.²⁵ Article 12, sections 1 and 2 required the enactment of laws to “provide fully for the adequate protection of the public and of the individual stockholders,” and allowed the creation of corporations only by general laws.²⁶ Before its repeal in 1993, article 12, section 6 allowed the issuance of stocks or bonds by corporations only “for money paid, labor done or property actually received,” and provided that “all fictitious increase of stock or indebtedness shall be void.”²⁷

A second source of Texas corporate law is the Texas Business Corporation Act (“TBCA”), enacted in 1955.²⁸ The TBCA was the first general corporation statute to be passed in Texas since 1874,²⁹ and it was largely based on the 1950 Model Business Corporation Act.³⁰ Many revisions have been made to update the TBCA since its adoption, including important revisions made in 1969, which were “strongly influenced” by amendments made to Delaware’s corporate laws.³¹ However, the Act has not been updated to reflect most of the changes made to the Model Act since 1955.³²

Each article of the TBCA and most of the Act’s amendments have corresponding “Comments,” drafted by the Committee of the State Bar, which explain, clarify, and discuss the source of each article of the TBCA.³³

Another source of corporate law in Texas is the Texas Miscellaneous Corporation Laws Act (“TMCLA”).³⁴ The TMCLA was passed in 1960 and applies to foreign and domestic corporations, except when it is inconsistent with the TBCA or a special state statute.³⁵ TMCLA provisions serve to: (1) “requir[e]

25. *Id.*

26. TEX. CONST. art. XII, §§ 1–2; HAMILTON & SAINT-PAUL, *supra* note 24, § 1(1) (discussing sections 1 and 2).

27. TEX. CONST. art. XII, § 6 (repealed 1993); HAMILTON & SAINT-PAUL, *supra* note 24, § 1.

28. TEX. BUS. CORP. ACT ANN. (Vernon 2002); *see* HAMILTON & SAINT-PAUL, *supra* note 24, § 1(2)(a) (discussing the sources of business associations law in Texas).

29. HAMILTON & SAINT-PAUL, *supra* note 24, § 1(2)(a) (referring to Act approved Apr. 23, 1874, 14th Leg., R.S., ch. 97, reprinted in 8 H.P.N. GAMMEL, THE LAWS OF TEXAS 1822-1897, at 122, 122 (Austin, Gammel Book Co. 1898)).

30. HAMILTON & SAINT-PAUL, *supra* note 24, § 1(2)(a); MODEL BUS. CORP. ACT (1950).

31. HAMILTON & SAINT-PAUL, *supra* note 24, § 1(2)(a).

32. *Id.*

33. *Id.*

34. *See id.* § 1(2)(b).

35. TEX. REV. CIV. STAT. ANN. art. 1302, § 1.03(B) (Vernon 1997); *see also*

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published notice before a going business is incorporated without a change in firm name,” (2) “restrict[] the power of a corporation to act as surety or guarantor,” and (3) “defin[e] the power of the State to inspect corporate records and enforce the antitrust laws,” among other things.³⁶

Similar to the Delaware State Bar’s Section of General Corporation Law,³⁷ the State Bar of Texas created a Banking and Business Law Section in 1953 for the purpose of modernizing the state’s corporate laws.³⁸ This Section, the largest section of the State Bar with 5,500 members as of 1991, helped the TBCA pass through the Legislature in 1955.³⁹ In 2001, the Business Law Section was working in conjunction with the Office of the Secretary of State to codify Texas’ business organizations law.⁴⁰ The proposed new code, titled the Business Organizations Code, has been considered since 1995⁴¹ and will primarily codify existing statutes.⁴² However, certain substantive changes will be made for the purpose of “modernizing, simplifying, and standardizing” existing code provisions.⁴³ At least two commentators expect Texas corporations to benefit from the new code because it will “provide maximum flexibility to organizations in the establishment of their capital structures, effecting business combination transactions and governing their internal affairs”⁴⁴ Byron Egan and Curtis Huff⁴⁵ also state that the new code will be a suitable model for similar statutes in the future, and that it should “solidif[y] Texas’ position as a leader in corporate law.”⁴⁶

HAMILTON & SAINT-PAUL, *supra* note 24, § 1(2)(b).

36. See HAMILTON & SAINT-PAUL, *supra* note 24, § 1(2)(b) (citing TEX. REV. CIV. STAT. ANN. art. 1302, §§ 2.02, 2.06, 5.10–19 (Vernon 1997 & Supp. 2003)).

37. See *supra* note 20 and accompanying text.

38. Robert S. Trotti, *Brief History of the Corporation, Banking and Business Law Section*, 20 BULL. BUS. L. SEC. ST. B. TEX. 1 (Oct. 1982).

39. *Id.*; Charles Szalkowski, *Chairman’s Letter*, 28 BULL. BUS. L. SEC. ST. B. TEX. 1 (Jun. 1991).

40. HOUSE COMM. ON BUSINESS & INDUSTRY, BILL ANALYSIS, Tex. H.B. 327, 77th Leg., R.S. (2001).

41. *Id.*

42. *Id.*

43. *Id.*

44. Egan & Huff, *supra* note 8, at 322.

45. Byron F. Egan and Curtis W. Huff are both former Chairmen of the Corporation Law Committee of the Business Law Section of the Texas State Bar. *Id.* at 249 nn.*–**.

46. *Id.* at 322.

III. THE COURT SYSTEMS

A. *Delaware*

1. Specialized Court

The Delaware Court of Chancery was created in 1792 under article VI, section 14 of the Delaware Constitution,⁴⁷ during a time when most other American states were combining their courts of law and equity into one.⁴⁸ The court was not originally established to serve as an expert on corporate issues.⁴⁹ It was only after more than one hundred years of litigating corporate disputes that the court became such a popular forum.⁵⁰ The Delaware Court of Chancery gained its popularity because the equitable principles and remedies available in the court were attractive to litigants.⁵¹

Today the Court of Chancery serves the corporate world both quickly and efficiently, as it has no jurisdiction over criminal or tort matters.⁵² Two commentators list several of the reasons for the Court of Chancery's success in helping to reinforce Delaware's status as one of the best states in which to incorporate:

- (1) Much established law exists because of the large volume of cases that have been heard, which creates predictability and consistency;
- (2) Cases are handled in an efficient manner;
- (3) Much sophistication and integrity is evidenced in the Court's decisions;

47. DEL. CONST. art. VI, § 14 (1792); DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, *CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY* § 1-2 (Matthew Bender ed., 1998).

48. WOLFE & PITTENGER, *supra* note 47, § 1-2 (discussing the history of the Delaware Court of Chancery).

49. *Id.* § 1-2.

50. *See id.* §§ 1-2, 1-3.

51. *Id.* § 1-3 (mentioning specifically the "precepts of fiduciary obligations, the right of stockholders to sue derivatively, and the power of the court to issue injunctive relief").

52. *See* HERZEL & RICHMAN, *supra* note 23, at F-6. The Supreme Court of Delaware has been known to act swiftly when the necessity arises. *See, e.g.,* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949 n.2, 953 & n.5 (Del. 1985) (describing the expedited basis under which the case was decided).

- (4) The Chancellors and Vice Chancellors appointed to the Court are highly respected and capable;
- (5) The court has limited subject matter jurisdiction;
- (6) Decisions can be made quickly in very complex situations; and
- (7) Over time, the Delaware legislature has granted additional authority to the Court, and it can now handle a great variety of intracorporate issues.⁵³

2. Maturity, Formality, and Finality of the Law

When determining whether or not a corporate transaction is valid, Delaware courts have been “directed to look to compliance with the formal statutory authority” upon which the parties relied, rather than the substance of the transaction.⁵⁴ Delaware corporate law is said to be very formal for this reason, which “promotes certainty and efficiency by allowing corporate planners to order their conduct to comply with fixed norms.”⁵⁵

3. Jurisdictional Considerations

Jurisdictional rules of the state of Delaware facilitate the exercising of personal jurisdiction over defendants.⁵⁶ Sequestration was used for some time by the state of Delaware for the purpose of asserting broad jurisdiction over directors,

53. See WOLFE & PITTENGER, *supra* note 47, § 1-3.

54. Ellen Taylor, *New and Unjustified Restrictions on Delaware Directors' Authority*, 21 DEL. J. CORP. L. 837, 852 (1996); see, e.g., *Uni-Marts, Inc. v. Stein*, Nos. CIV.A. 14713, 14893, 1996 WL 466961, at *9 (Del. Ch. Aug. 12, 1996) (mem.) (stating that the formal examination of Delaware statutes to determine their meaning is a fundamental component of the state's corporate law system); *Heilbrunn v. Sun Chem. Corp.*, 146 A.2d 757, 760 (Del. Ch. 1958) (explaining that if the statutory requirements are satisfied, the substance of the transaction need not be looked at unless fraud is suspected).

55. See Taylor, *supra*, note 54. This formality is the very reason that the Delaware Supreme Court does not recognize de facto merger. The court has indicated that it “will look to the words of a statute rather than the effect of the transaction when determining what rights shareholders may have in such a transaction. As long as the directors' actions are permitted under some section of the statute [no matter what the outcome is in fact], the court will not intervene.” *Id.* at 854-55 (using the example of a corporation whose directors have the power to issue, and do issue, authorized but unissued stock without the approval of the shareholders, creating a merger via the issuance of stock to an acquirer); see *Hariton v. Arco Elec., Inc.*, 188 A.2d 123, 125 (Del. 1963) (finding a reorganization to have been accomplished under a sale-of-assets statute, and that a merger statute is not the sole manner of achieving this goal).

56. HERZEL & RICHMAN, *supra* note 23, at F-6.

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officers, and stockholders of Delaware corporations.⁵⁷ Currently, Delaware directors are subject to substituted service.⁵⁸ Delaware Code title 10, section 3114 was modeled after statutes mentioned by the United States Supreme Court in *Shaffer v. Heitner*, including those in place in Connecticut, North Carolina, and South Carolina.⁵⁹ Section 3114 has been held constitutional by the Delaware Supreme Court.⁶⁰

Directors, trustees, and members of governing bodies of Delaware corporations agree to accept substituted service under section 3114 at the time that they are elected and when they serve in that capacity.⁶¹ However, this consent to substituted service applies only with regard to acts performed in the individual's capacity as a director, trustee, or member of such governing body.⁶² The Delaware Court of Chancery has reasoned that a director "cannot plausibly claim any undue inconvenience from having to defend himself against claims for breach of fiduciary duty in [a Delaware] court . . . [where he] voluntarily chose to serve as the director and principal operating officer of a Delaware corporation."⁶³

57. Rodman Ward, Jr., *A Delaware Phoenix: The Fall of Sequestration and The Enactment of a Director Service Statute*, 3 DEL. J. CORP. L. 1, 1-2 (1977) (noting that sequestration could apply even though the directors and officers were non-residents of Delaware and the corporation did all of its business outside of the state). Sequestration was subsequently held unconstitutional. *Shaffer v. Heitner*, 433 U.S. 186 (1977) (striking down Delaware's *quasi in rem* sequestration statute which allowed the seizure of corporate stock to compel the personal appearance of directors in breach-of-fiduciary duty actions, and requiring minimum contacts for all assertions of state court jurisdiction); HERZEL & RICHMAN, *supra* note 23, at F-6 n.23.

58. DEL. CODE ANN. tit. 10, § 3114 (1999) (called a "director-consent-to-service" statute); HERZEL & RICHMAN, *supra* note 23, at F-6 n.23; *see* Ward, *supra* note 57, at 12-13 (noting that as of 1977, Alaska, Connecticut, Indiana, Maine, Michigan, Montana, North Carolina, North Dakota, South Carolina, South Dakota, and Wisconsin had similar statutes). A nonresident of Delaware who accepts a position as a manager of a Delaware limited liability company is subject to the same type of consent statute, found in Delaware Code Annotated title 6, section 18-109. *Assist Stock Mgmt. L.L.C. v. Rosheim*, 753 A.2d 974, 975 (Del. Ch. 2000); DEL. CODE ANN. tit. 6, § 18-109 (1999 & Supp. 2002).

59. WOLFE & PITTENGER, *supra* note 41, § 3-5(a)(2)(ii).

60. *See* *Armstrong v. Pomerance*, 423 A.2d 174, 180 (Del. 1980); *see also In re Mid-Atlantic Toyota Antitrust Litig.*, 525 F. Supp. 1265, 1271 (D. Md. 1981) (agreeing with the Delaware Supreme Court's holding in *Armstrong*).

61. § 3114; WOLFE & PITTENGER, *supra* note 47, § 3-5(a)(2)(ii).

62. § 3114. Selling shares of stock in a company on whose board a director sits does not constitute a directorial act; however, if the director is also involved in a negligent transfer of corporate control, section 3114 authorizes service of process on that director. *Harris v. Carter*, 582 A.2d 222, 223 (Del. Ch. 1990).

63. *Caithness Res., Inc. v. Ozdemir*, No. CIV.A.18073, 2000 WL 1741941, at *5 (Del. Ch. Nov. 22, 2000) (mem.), *appeal ref'd*, 768 A.2d 470 (Del. 2001). Delaware section 3114 is designed to protect Delaware's "substantial interest in defining, regulating and enforcing the fiduciary obligations which directors of Delaware corporations owe to such corporations and the shareholders who elected them." *Pestolite v. Cordura Corp.*, 449

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For an individual to be subject to service of process, he or she must have been a director, trustee, or member of a governing body of a Delaware corporation at the time of the alleged wrongdoing or transaction being challenged.⁶⁴ Delaware section 3114 does not require the person to be acting in that same capacity at the time they are actually served with process.⁶⁵ When considering bringing a lawsuit against a deceased individual who was an officer, trustee, or member, the Court of Chancery has recently held that service can be made on a personal representative of the decedent.⁶⁶ The service of process allowed on the director, trustee, or member may not be imputed to other persons who act as the director's alter ego or agent.⁶⁷

4. Attorney's Fees

Attorneys in Delaware receive attorney's fees based on the amount of the benefit achieved for the corporation through the litigation, rather than based on the amount of time the attorney devotes to the case.⁶⁸ In class actions and derivative suits, the court will look at the benefits to the shareholders that were brought about by the attorney.⁶⁹ The result accomplished by the attorney "is the common yardstick by which a plaintiff's counsel is compensated in a successful derivative action."⁷⁰ This proportional benefit to the attorney encourages the settlement of disputes, and has other desirable effects which benefit both stockholders and corporations.⁷¹

A.2d 263, 265 (Del. Super. Ct. 1982) (quoting *Armstrong*, 423 A.2d at 179 n.8).

64. See *Instituto Bancario Italiano SpA, v. Hunter Eng'g Co.*, 449 A.2d 210, 227-28 (Del. 1982); *In re Chambers Dev. Co., Inc. S'holders Litig.*, No. C.A.12508, 1993 WL 179335, at *4 (Del. Ch. May 20, 1993); see also DEL. CT. CH. R. 4(dc) (listing the information needed and the steps that should be taken when filing a lawsuit against a director, trustee, or member).

65. § 3114; WOLFE & PITTINGER, *supra* note 47, § 3-5(a)(2)(ii).

66. *Carlton Invs. v. TLC Beatrice Int'l Holdings, Inc.*, No. CIV.A.13950, 1995 WL 694397, at *18-*19 (Del. Ch. Nov. 21, 1995) (mem.).

67. See *HMG/Courtland Props., Inc. v. Gray*, 729 A.2d 300, 305 (Del. Ch. 1999) (stating that the Delaware General Assembly did not intend for section 3114 to permit service upon people who are the alter egos or agents of Delaware directors).

68. Donald E. Pease, *Delaware's Disclosure Rule: The 'Complete Candor' Standard, Its Application, and Why Sue in Delaware*, 14 DEL. J. CORP. L. 445, 490 (1989).

69. *Id.*

70. *Sugarland Indus., Inc. v. Thomas*, 420 A.2d 142, 147 (Del. 1980); Pease, *supra* note 68, at 490.

71. See Leo Herzel & Robert K. Hagan, *Plaintiffs' Attorneys' Fees in Derivative and Class Actions*, LITIG., Winter 1981, at 25, 26.

2003] *DELAWARE VERSUS TEXAS CORPORATE LAW* 301B. *Texas*

1. Court of General Jurisdiction

Texas corporate disputes are not handled in a special court, but are heard in law courts of general jurisdiction, alongside other civil cases.⁷² Unlike Chancellors of the Delaware Court of Chancery,⁷³ Texas judges are elected to their positions rather than appointed.⁷⁴ In addition, in Texas, questions of fact are resolved in a trial by jury,⁷⁵ which also differs from Delaware's handling of corporate matters in its Chancery Court.⁷⁶

2. Uncertainties in Texas Case Law

Texas case law regarding corporate matters is uncertain in several areas.⁷⁷ For example, uncertain standards for director liability in Texas may discourage businesses from incorporating in Texas.⁷⁸ Also, while Texas law seems to be clear on corporate veil piercing in contract cases, Texas law on veil piercing law is unsettled in tort cases.⁷⁹ Another area of uncertainty in Texas case law exists regarding the duties of directors in defensive corporate takeover situations.⁸⁰

3. Jurisdictional Considerations

Texas does not have a director-consent-to-service statute similar to title 10, section 3114 in Delaware.⁸¹ Instead, the Texas long-arm statute confers jurisdiction over persons doing business in Texas.⁸² A nonresident does business in Texas if:

72. See Egan & Huff, *supra* note 8, at 259.

73. See WOLFE & PITTENGER, *supra* note 47, § 1-3.

74. See Egan & Huff, *supra* note 8, at 259.

75. See *id.*

76. See William M. Lafferty & W. Leighton Lord III, *Towards a Relaxed Summary Judgment Standard for the Delaware Court of Chancery: A New Weapon Against "Strike" Suits*, 15 DEL. J. CORP. L. 921, 931 (1990) (stating that "there are no jury trials in the court of chancery").

77. See Roberts & Pivnick, *supra* note 7, at 47 (expressing that this uncertainty will dissuade corporations from incorporating in Texas rather than in Delaware).

78. *Id.* at 48.

79. *Id.* at 63-64.

80. *Id.* at 71-72.

81. See generally, *Haught v. Agric. Prod. Credit Ass'n*, 39 S.W.3d 252, 258 (Tex. App.—Tyler 2000, no pet.) (discussing the Texas long-arm statute); *Vosko v. Chase Manhattan Bank, N.A.*, 909 S.W.2d 95, 98 (Tex. App.—Houston [14th Dist.] 1995, writ denied) (discussing the Texas long-arm statute); TEX. CIV. PRAC. & REM. CODE ANN. § 17.042 (Vernon 1997).

82. See § 17.042.

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- (1) he contracts with a Texas resident and either party will perform the contract in the state;
- (2) he commits a tort in the state;
- (3) he recruits Texas residents for employment; or
- (4) he commits “other acts” that constitute doing business in Texas.⁸³

“Other acts” extend only as far as federal due process allows.⁸⁴ For this reason, when attempting to obtain jurisdiction over a corporate director or officer, it is only necessary to make a due process determination.⁸⁵

For due process to be served, minimum contacts with the state of Texas must be established, and the exercise of jurisdiction must comport with fair play and substantial justice.⁸⁶ Minimum contacts will not be established for a nonresident officer or director of a Texas corporation solely because of that individual’s status with the corporation.⁸⁷ This statement is true even if the person has had contacts with the state in his capacity as a representative of that corporation.⁸⁸ In general, only an individual using a corporation as his alter ego will subject himself to jurisdiction based on his relationship with that corporation.⁸⁹ When a corporation and an individual unite such that the corporation is no longer a separate entity and an injustice would be served if there were corporate liability alone, the alter ego theory may be used for the purpose of “disregarding the corporate fiction.”⁹⁰

83. *Id.*

84. *Haught*, 39 S.W.3d at 258; *Guardian Royal Exch. Assurance, Ltd. v. English China Clays, P.L.C.*, 815 S.W.2d 223, 226 (Tex. 1991).

85. *See Vosko*, 909 S.W.2d at 98 (“Since the ‘doing business’ concept extends as far as due process will allow, it follows that any activity or contact which satisfies due process also constitutes doing business, and that any activity or contact which does not satisfy due process does not constitute doing business. As a practical matter, therefore, we need not analyze the ‘doing business’ requirement apart from the due process requirement since the scope of each is coextensive.”).

86. *Haught*, 39 S.W.3d at 258 (quoting *Guardian Royal Exch. Assurance*, 815 S.W.2d at 226).

87. *Vosko*, 909 S.W.2d at 99–100.

88. *See id.*

89. *Id.*

90. *Puri v. Mansukhani*, 973 S.W.2d 701, 712–13 (Tex. App.—Houston [14th Dist.] 1998, no pet.); *Castleberry v. Branscum*, 721 S.W.2d 270, 272 (Tex. 1986).

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4. Attorney's Fees

Attorney's fees will be awarded in Texas in a shareholder derivative action when the lawsuit is determined to have resulted in a substantial benefit to the corporation and its shareholders.⁹¹ However, it is within the discretion of the trial court to award attorney's fees, due to the permissive language contained in section 5.14 of the Texas Business Corporations Act.⁹² If a trial court acts arbitrarily and unreasonably in awarding or not awarding attorney's fees, an appellate court will overturn the decision.⁹³

IV. INITIAL ORGANIZATION AND MONETARY CONSIDERATIONS

A. *Minimum Capital Requirements*

When Delaware's General Corporation Law was first passed, the minimum amount of capital required for incorporation was \$2,000.⁹⁴ This amount was reduced to \$1,000 in 1929,⁹⁵ and the requirement was finally eliminated in the statutory revisions passed in 1967.⁹⁶ In Delaware the most widely used system of financing is the private or public sale of securities.⁹⁷

Texas has a minimum capital requirement of \$1,000 that must be met before a corporation transacts business or incurs indebtedness.⁹⁸ The only activities a corporation may participate in before it receives \$1,000 for the issuance of shares of stock are those incidental to the corporation's organization or incidental to obtaining subscriptions to or payment for its shares.⁹⁹ The \$1,000 of minimum capital can be satisfied through consideration

91. *Bayoud v. Bayoud*, 797 S.W.2d 304, 315 (Tex. App.—Dallas 1990, writ denied) (explaining that section 5.14 does not expressly authorize attorney's fees in shareholder derivative actions, but that Texas common law and equitable principles may justify an award).

92. *Pace v. Jordan*, 999 S.W.2d 615, 625–26 (Tex. App.—Houston [1st Dist.] 1999, pet. denied) (relying on *Bocquet v. Herring*, 972 S.W.2d 19, 20 (Tex. 1998), which determined that “may” language in the Uniform Declaratory Judgment Act allowed the trial court discretion in determining whether to allow attorney's fees).

93. *Id.*; see also *Downer v. Aquamarine Operators, Inc.*, 701 S.W.2d 238, 241–42 (Tex. 1985) (discussing the test for abuse of discretion).

94. See R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS* § 1.9 (3d ed. 1998 & Supp. 2001).

95. *See id.*

96. *See id.*

97. *See id.*

98. TEX. BUS. CORP. ACT ANN. art. 3.05(A) (Vernon 1980); HAMILTON & SAINT-PAUL, *supra* note 24, § 265.

99. Art. 3.05(A); HAMILTON & SAINT-PAUL, *supra* note 24, § 265.

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conferring any tangible or intangible benefit upon the corporation.¹⁰⁰

In Texas, when the minimum capital requirement of a corporation is not initially met, the directors who agree to conduct the business of a corporation regardless of this fact are jointly and severally liable for the part of the consideration that the corporation does not yet have.¹⁰¹ Once the capital requirement has been fully satisfied, the directors are no longer liable.¹⁰²

In addition to meeting the \$1,000 requirement, a Texas corporation must include the following statement in its articles of incorporation: "The corporation will not commence business until it has received for the issuance of shares consideration of the value of a stated sum which shall be at least One Thousand Dollars (\$1,000.00)."¹⁰³

B. *Income Taxes*

1. Delaware

With the exception of those corporations listed in Delaware Code title 30, section 1902(b), all domestic and foreign corporations are taxed on their "net income derived from business activities carried on and property located within [Delaware] during the income year."¹⁰⁴ Delaware provides exemptions for certain corporations which are not generally exempt from income taxation in other states.¹⁰⁵ Specifically, Delaware provides a tax exemption for:

Corporations whose activities within [Delaware]
are confined to the maintenance and management

100. TEX. BUS. CORP. ACT ANN. art. 2.16(A) (Vernon 2003) (stating that consideration may consist of "cash, promissory notes, services performed, contracts for services to be performed, other securities of the corporation, or securities of any other corporation, domestic or foreign, or other entity").

101. TEX. BUS. CORP. ACT ANN. art. 2.41(A)(2) (Vernon Supp. 2003); HAMILTON & SAINT-PAUL, *supra* note 24, § 265.

102. Art. 2.41(A)(2).

103. TEX. BUS. CORP. ACT ANN. art. 3.02(A)(7) (Vernon Supp. 2003); HAMILTON & SAINT-PAUL, *supra* note 24, § 265.

104. DEL. CODE ANN. tit. 30, § 1902(a) (1997); Thomas P. Sweeney & Richard G. Bacon, *Taxation of Delaware Corporations*, in *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* § 18.9[A] (R. Franklin Balotti & Jesse A. Finkelstein eds., 1998 & Supp. 1999).

105. Sweeney & Bacon, *supra* note 104, § 18.15; DEL. CODE ANN. tit. 30, § 1902(b)(8) (Supp. 2002).

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of their intangible investments or of the intangible investments of corporations or business trusts registered as investment companies . . . and the collection and distribution of the income from such investments or from tangible property physically located outside [of Delaware].¹⁰⁶

These section 1902(b)(8) corporations are often called “holding companies,” and are those corporations that do not manage investments for other persons, but exist solely to manage their own investments.¹⁰⁷

Corporations which have numerous dividend-paying subsidiaries or a great deal of passive investment income should consider establishing a Delaware holding company to receive that income.¹⁰⁸ A holding company could be beneficial to these corporations “whether the income is comprised of dividends from subsidiaries, interest income, rent from tangible property located outside of Delaware, or gains on the sales of intangible investments,”¹⁰⁹ because payment of state income tax on the passive investment income would be avoided.¹¹⁰ The formation of a holding company could benefit the corporation even though it would have to pay franchise taxes, and a significant savings could be had if no payments were being made by the holding company to its parent as dividends subject to tax in another jurisdiction.¹¹¹

A credit against the corporate income tax is also available for various types of corporations which are establishing or expanding their business facilities in Delaware.¹¹² The new investment in the facility must be valued at \$200,000 or more during the tax year, and the corporation must employ at least

106. § 1902(b)(8); *see* Sweeney & Bacon, *supra* note 104, § 18.15.

107. Sweeney & Bacon, *supra* note 104, § 18.15.

108. *Id.*

109. § 1902(b)(8); Sweeney & Bacon, *supra* note 104, at § 18.15.

110. Sweeney & Bacon, *supra* note 104, § 18.15; § 1902(b)(8).

111. Sweeney & Bacon, *supra* note 104, § 18.15; § 1902(b)(8).

112. DEL. CODE ANN. tit. 30, § 2011 (1997). The corporation must use a two part formula to determine the amount of credit it is due. *Id.* § 2011(a)–(b). First, a credit for \$400 is allowed for each new qualified employee hired after July 1, 1984 if the investment in the facility equals or exceeds \$40,000 per employee. *Id.* § 2011(b)(1). Second, a credit of \$400 is allowed for each “\$100,000 (or major fraction thereof) of qualified investment in the facility.” *Id.* § 2011(b)(2). The credit allowed in any one year may not exceed 50% of the tax, but unused credit may be carried forward. *Id.* § 2011(d), (f). The credit extends for a period of ten years. *Id.* § 2011(a).

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five persons in Delaware.¹¹³ At least 25% of those employees must be Delaware residents.¹¹⁴

2. Texas

Texas, along with three other states, is unique in that it does not impose a corporate income tax.¹¹⁵ However, according to two Texas practitioners, Texas franchise tax laws essentially operate to impose an income tax on Texas corporations.¹¹⁶

C. Franchise Taxes

1. Delaware

Annual franchise taxes are imposed on almost all Delaware corporations under Delaware Code Annotated title 8, section 501.¹¹⁷ Franchise taxes are calculated using “either the number of authorized shares or adjusted gross assets.”¹¹⁸ The tax will be either (1) “approximately \$50 for each 10,000 authorized shares (regardless of par value);” or (2) “a tax on ‘assumed par value capital,’” whichever is the lower amount.¹¹⁹ Assumed par value capital is gross assets divided by issued shares; then, depending on whether that amount is greater or less than stated par value, either the actual or assumed par value is multiplied by the total authorized shares.¹²⁰ An assessment of the Delaware franchise tax usually means that a corporation will be charged 0.02% of its assumed par value capital.¹²¹

Corporations that are not required to pay franchise taxes include banking corporations, savings banks or building and loan associations, corporations for drainage and reclamation of lowlands, religious corporations, and charitable corporations.¹²² Corporations that are chartered in Delaware but do not conduct

113. *Id.* § 2011(a).

114. *Id.* § 2011(e).

115. *See* Roberts & Pivnik, *supra* note 7, at 79. The other states are Nevada, Wyoming, and Washington. *Id.* at 80 & n.281.

116. *See* Egan & Huff, *supra* note 8, at 252 (discussing strategies for minimizing the franchise tax impact and the taxes that will be imposed depending on the state in which business is conducted).

117. DEL. CODE ANN. tit. 8, § 501 (2001).

118. Egan & Huff, *supra* note 8, at 253; DEL. CODE ANN. tit. 8, § 503(a) (2001).

119. Egan & Huff, *supra* note 8, at 253–54; § 503(a).

120. Egan & Huff, *supra* note 8, at 254; § 503(a).

121. Egan & Huff, *supra* note 8, at 254.

122. § 501.

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business in Delaware are still subject to paying franchise taxes, although the rate of taxation for such corporations is one-half the usual rate.¹²³

2. Texas

Corporations formed under the TBCA or chartered or authorized to do business in Texas are subject to the Texas corporate franchise tax.¹²⁴ The corporation will be taxed the greater of 4.5% of its “net taxable earned surplus” or a 0.25% tax on its net worth (“taxable capital”).¹²⁵ These two calculations are apportioned to Texas based on the ratio of gross receipts in Texas to total gross receipts.¹²⁶ Two commentators have opined that “[a]lthough labeled a ‘franchise tax,’ the tax on ‘net taxable earned surplus’ is really a 4.5% income tax levied at the entity level.”¹²⁷ The Texas franchise tax will be imposed whether or not the corporation is incorporated in Texas or in another state, as long as it has its physical operations in Texas.¹²⁸ If a corporation holds a Texas charter but has no other activity in Texas, the Texas franchise tax will be 0.25% of its net worth, apportioned to Texas based on gross receipts.¹²⁹ Texas franchise taxes cannot be not consolidated.¹³⁰

V. DIRECTOR AND OFFICER DUTIES

Directors and officers of corporations in most states have a duty “to act in good faith, with loyalty to the corporation, and with due care.”¹³¹ A director’s negligence is usually not enough on which to base a claim for the breach of these duties, because most states have either adopted a director shield statute, or they allow the individual to invoke the business judgment rule.¹³²

123. DEL. CODE ANN. tit. 8, § 503(f) (2001).

124. TEX. TAX CODE ANN. § 171.001(a)(1) (Vernon 2002); Egan & Huff, *supra* note 8, at 253.

125. TEX. TAX CODE ANN. § 171.002 (Vernon 2002); Egan & Huff, *supra* note 8, at 253 & n.7.

126. *See* Tex. Tax Code Ann. § 171.1032 (Vernon Supp. 2003); Egan & Huff, *supra* note 8, at 253 & n.7.

127. Egan & Huff, *supra* note 8, at 253 n.7.

128. *Id.* at 254.

129. *See id.* at 255; *cf.* Rylander v. Bandag Licensing Corp., 18 S.W.3d 296, 301 (Tex. App.—Austin 2000, pet. denied) (holding that a foreign corporation’s passive possession of a certificate of authority to do business in Texas is insufficient to give the state jurisdiction to impose a franchise tax on the corporation).

130. 34 TEX. ADMIN. CODE § 3.544(c) (West 2002).

131. *See* Michael Sean Quinn & Andrea D. Levin, *Directors’ and Officers’ Liability Insurance: Probable Directions in Texas Law*, 20 REV. LITIG. 381, 386 (2001).

132. *Id.* at 386–87.

308 *HOUSTON BUSINESS AND TAX LAW JOURNAL* [Vol. III]A. *Delaware*

1. Standards for Director Liability

An advantage of Delaware's Court of Chancery and the state's well-established corporate law is reflected in the opinion that "Delaware's standard for director liability is as certain as the sun will rise each and every day."¹³³ The fiduciary obligation of a Delaware corporate director requires the director to act with due care and loyalty.¹³⁴ Delaware's standard for liability is gross negligence,¹³⁵ meaning that the director must act in good faith and "in an informed and deliberate manner."¹³⁶ Directors may be held personally liable for monetary damages for gross negligence under *Smith v. Van Gorkom*,¹³⁷ subject to a corporate provision limiting those damages.¹³⁸

2. Business Judgment Rule

"The business judgment rule is a presumption that, 'in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company [and its shareholders].'"¹³⁹ The business judgment rule places the initial burden of proof on the plaintiff as a presumption.¹⁴⁰ To overcome this presumption, a shareholder plaintiff can prove that the

133. Roberts & Pivnick, *supra* note 7, at 48.

134. See *id.*; *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985); see also *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (discussing the business judgment rule).

135. *Van Gorkom*, 488 A.2d at 873. "While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence." *Id.* (quoting *Aronson*, 473 A.2d at 812).

136. *Van Gorkom*, 488 A.2d at 873-75; *Aronson*, 473 A.2d at 812.

137. *Van Gorkom*, 488 A.2d at 873. The duties of directors following this decision has been summarized as follows:

Although the duties of good faith and loyalty were untouched by *Smith v. Van Gorkom*, the *Van Gorkom* court gave directors' and officers' duty of care real teeth. The decision made clear that directors have the specific duty to stay informed and to provide information, both of which fall under the umbrella of "duty of care." The *Van Gorkom* opinion also demonstrated that the business judgment rule would not necessarily protect directors and officers from liability for failing to use care in exercising their business judgment.

Quinn & Levin, *supra* note 131, at 390-91.

138. See *infra* Part V.A.4. and accompanying text.

139. *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001) (quoting *Aronson*, 473 A.2d at 812).

140. *Id.* at 90-91 (quoting *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995)).

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board of directors, in reaching its challenged decision, violated either its duty of care,¹⁴¹ loyalty,¹⁴² or good faith.¹⁴³

The business judgment rule will protect the directors if this burden is not met.¹⁴⁴ However, if the presumption is successfully rebutted, the burden shifts to the directors “to prove to the *trier of fact* that the challenged transaction was ‘entirely fair’ to the shareholder plaintiff.”¹⁴⁵ The Delaware business judgment rule is said to be a substantive rule of law in addition to being a presumption, because the rule provides that the director will not be liable for “authorizing a corporate action if . . . [he] acted in good faith and with appropriate care in informing himself of all material information reasonably available to him under the circumstances.”¹⁴⁶ Inaction probably will not lead to liability on the part of a Delaware director under the business judgment rule, provided that the director made a conscious and informed decision not to act in a particular situation.¹⁴⁷

Delaware directors also must comply with the state’s duty of candor.¹⁴⁸ The duty of candor requires directors to deal fairly with the corporation by communicating all material information to stockholders.¹⁴⁹ At a minimum, the director may not use his information to interfere in the performance of others’ fiduciary obligations to the corporation.¹⁵⁰

141. For example, due care is violated when an officer or director erroneously but in good faith makes a judgment regarding the scope or content of disclosure that is required. *Zirn v. VLI Corp.*, 681 A.2d 1050, 1062 (Del. 1996).

142. *In re Reliance Securities Litigation* explains that the duty of loyalty is breached when self-dealing in some form occurs, or when there is a misuse of the corporate office for the director’s personal gain. *In re Reliance Sec. Litig.*, 91 F. Supp. 2d 706, 732 (D. Del. 2000). A “disclosure violation . . . made in bad faith, knowingly or intentionally” also violates the duty of loyalty. *O’Reilly v. Transworld Healthcare, Inc.*, 745 A.2d 902, 915 (Del. Ch. 1999).

143. *Emerald Partners*, 787 A.2d at 91.

144. *Id.*; *Cinerama, Inc.*, 663 A.2d at 1162.

145. *Emerald Partners*, 787 A.2d at 91 (emphasis in original); *Cinerama, Inc.*, 663 A.2d at 1162.

146. *Egan & Huff*, *supra* note 8, at 265; *Brehm v. Eisner*, 746 A.2d 244, 259 (Del. 2000).

147. *Egan & Huff*, *supra* note 8, at 265; *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984).

148. *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1283 (Del. 1989); *Egan & Huff*, *supra* note 8, at 267. “[T]hose who are privy to material information obtained in the course of representing corporate interests,” not just officers and directors, must comply with the duty of candor. *Mills Acquisition*, 559 A.2d at 1283.

149. *Stroud v. Milliken Enterprises, Inc.*, 552 A.2d 476 (Del. 1989) (noting that the duty of candor applies to corporate governance as well as corporate transactions); *Egan & Huff*, *supra* note 8, at 267.

150. *Mills Acquisition*, 559 A.2d at 1283; *Egan & Huff*, *supra* note 8, at 267.

3. Shareholder Derivative Suits

Delaware shareholder derivative suits may be brought by one or by multiple shareholders to protect a corporation's rights when the corporation has not done so itself.¹⁵¹ Before a stockholder can bring a derivative suit, he must first demand that the corporation's directors pursue the claim and the demand must be wrongfully refused; however, the demand requirement may be excused if the directors cannot make an impartial decision.¹⁵² A proper plaintiff for a shareholder derivative suit is an individual who was a shareholder or member at the time the questionable transaction occurred.¹⁵³ In filing a derivative action, the complaint must allege this fact, and it must explain with particularity information about any efforts made by the individual to influence the directors to act and the reasons why the requested acts were not performed.¹⁵⁴

4. Limiting Director Liability

Section 102(b)(7),¹⁵⁵ a director shield statute, was adopted by the Delaware General Assembly in response to "a directors and officers insurance liability crisis and the . . . decision in *Smith v. Van Gorkom*."¹⁵⁶ The section provides that a certificate of incorporation may contain the following provision:

A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law; (iii) under § 174 of

151. DEL. CT. CH. R. 23.1.

152. *Rales v. Blasband*, 634 A.2d 927, 932 (Del. 1993); *Stepak v. Dean*, 434 A.2d 388, 390 (Del. Ch. 1981). "The requirement of pre-suit demand in [Delaware] Chancery Court Rule 23.1 recognizes that the decision to pursue claims belonging to the corporation falls within the scope of the directors' power to manage the business and affairs of the corporation." *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 731 (Del. 1988).

153. DEL. CT. CH. R. 23.1.

154. *Id.*

155. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).

156. *Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001); *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001); see *Quinn & Levin*, *supra* note 131, at 397-400 (discussing generally director shield statutes).

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this title; or (iv) for any transaction from which the director derived an improper personal benefit.¹⁵⁷

Section 102(b)(7) operates to bar the recovery of monetary damages¹⁵⁸ from directors for a successful shareholder claim that is based exclusively upon establishing a violation of the duty of care, when the corporation has adopted a provision allowing the bar in its charter.¹⁵⁹ The purpose of section 102(b)(7) was to disallow monetary damages for duty of care violations, but not for violations of the duty of loyalty or good faith.¹⁶⁰ After the statute was adopted, stockholders often approved charter amendments containing section 102(b)(7) provisions, because it allowed “directors to take business risks without worrying about negligence lawsuits.”¹⁶¹

The inclusion of a section 102(b)(7) provision in a corporation’s charter does not destroy a plaintiff’s claim on the merits, but may disallow the recovery of monetary damages by the plaintiff.¹⁶² Yet, if the conduct is wrongful and thus exceeds a garden variety duty of care violation, monetary damages are available.¹⁶³ Injunctive proceedings based on gross negligence are allowed notwithstanding the adoption of a charter provision barring monetary damages.¹⁶⁴ Other equitable remedies, such as corrective disclosure, will also be permitted.¹⁶⁵

B. *Texas*

1. Standards for Director Liability

The majority of Texas’ director liability law has developed through common law.¹⁶⁶ Texas’ director liability statute, TBCA

157. § 102(b)(7).

158. *Arnold v. Soc’y for Sav. Bancorp.*, 678 A.2d 533, 541–42 (Del. 1996) (stating that “monetary damages” can arise out of both legal and equitable theories).

159. *Malpiede*, 780 A.2d at 1095; *Emerald Partners*, 787 A.2d at 90.

160. *Malpiede*, 780 A.2d at 1095; *Emerald Partners*, 787 A.2d at 90; see *Zirn v. VLI Corp.*, 621 A.2d 773, 783 (Del. 1993) (stating that the legislative history of section 102(b)(7) indicates that directors are not to be shielded if the duty of loyalty or the duty of disclosure is breached).

161. *Malpiede*, 780 A.2d at 1095; *Emerald Partners*, 787 A.2d at 90; see E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 BUS. LAW. 681, 693–94 (1998).

162. *Emerald Partners*, 787 A.2d at 92.

163. *Arnold*, 678 A.2d at 541–42.

164. *Malpiede*, 780 A.2d at 1095; *Emerald Partners*, 787 A.2d at 90 n.25.

165. *Arnold*, 678 A.2d at 542.

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

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article 2.41, imposes liability on directors only when they have assented to certain unlawful transactions and have, thus, violated their duty of due care to the corporation:¹⁶⁷

- (1) Directors of a corporation who vote for or assent to a distribution by the corporation that is not permitted by Article 2.38 of this Act shall be jointly and severally liable to the corporation
- (2) If the corporation shall commence business before it has received for the issuance of shares consideration of the value of at least One Thousand Dollars (\$1,000) . . . the directors who assent thereto shall be jointly and severally liable to the corporation¹⁶⁸

Directors will not be liable under the Texas statute if they have “relied in good faith and with ordinary care upon the statements” made by an officer or employee of the corporation, legal counsel, an accountant, an investment banker, or another person the director reasonably believes has knowledge or competence in a particular profession.¹⁶⁹ A corporation may choose to alter the liability of its directors and officers by including provisions in its articles of incorporation, but may not limit director liability for the following:

- (1) a breach of the director’s duty of loyalty to the corporation or its stockholders or members; (2) an act or omission not in good faith that constitutes a breach of duty of the director to the corporation or an act or omission that involves intentional misconduct or a knowing violation of the law; (3) a transaction from which the director received an improper benefit, whether or not the benefit resulted from an action taken within the scope of the director’s office; or (4) an act or omission for which the liability of a director is expressly provided by an applicable statute.¹⁷⁰

167. See *Gearhart Indus.*, 741 F.2d at 721, n.7 (stating that violations of Texas Business Corporation Act article 2.41 constitute violations of the duty of due care).

168. TEX. BUS. CORP. ACT ANN. art. 2.41(A) (Vernon Supp. 2003).

169. TEX. BUS. CORP. ACT ANN. art. 2.41(C) (Vernon Supp. 2003).

170. *In re Jackson*, 141 B.R. 909, 915 (Bankr. N.D. Tex. 1992).

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Corporate directors under Texas common law have fiduciary duties of obedience, loyalty, and due care.¹⁷¹ The standard by which a director's conduct will be judged is somewhat ambiguous, though, because Texas courts have applied different tests.¹⁷² The Fifth Circuit has held that courts should not interfere with the business judgment of directors unless the transaction at issue is *ultra vires* or fraudulent.¹⁷³ However, the recent trend in federal district court cases appears to establish gross negligence as the standard for director liability.¹⁷⁴ Courts applying the gross negligence standard have declined to overrule the Fifth Circuit's standard, but have shifted to gross negligence regardless of this fact.¹⁷⁵ Only one federal district court in Texas has held a director liable for less-than-gross negligence,¹⁷⁶ but it is not clear from the record whether or not the director raised a business judgment rule defense in that case.¹⁷⁷

The Fifth Circuit held in *Gearhart Industries, Inc. v. Smith International, Inc.*, that the duty of obedience requires a director to refrain from committing *ultra vires* acts.¹⁷⁸ A director is not personally liable for committing an *ultra vires* act unless the action is illegal.¹⁷⁹ In the director liability context, "illegal acts"

171. *Gearhart Indus.*, 741 F.2d at 719.

172. See Roberts & Pivnik, *supra* note 7, at 48 (noting that "[t]he uncertain standard for director liability in . . . Texas . . . may be enough, in itself, to dissuade anyone from choosing [Texas as a] state in which to incorporate their business"). But see Robert K. Wise, *Demand Futility in Shareholder-Derivative Litigation Under Texas Law*, 28 TEX. TECH L. REV. 59, 86 (1997) (acknowledging that courts and commentators have wrestled with the standard for director liability, but stating that any uncertainty as to the standard has been done away with because of several recent federal district court decisions applying the Texas business judgment rule).

173. *Gearhart Indus.*, 741 F.2d at 723-24; Roberts & Pivnik, *supra* note 7, at 49.

174. Roberts & Pivnik, *supra* note 7, at 49; see *FDIC v. Schreiner*, 892 F. Supp. 869, 881 (W.D. Tex. 1995); *Resolution Trust Corp. v. Acton*, 844 F. Supp. 307, 313 (N.D. Tex. 1994); *FDIC v. Harrington*, 844 F. Supp. 300, 305 (N.D. Tex. 1994).

175. See Roberts & Pivnik, *supra* note 7, at 49-50 & n.24 (mentioning that these decisions may only apply when failed financial institutions are involved); *Harrington*, 844 F. Supp. at 306 (recognizing that most courts interpret *Gearhart* as stating that Texas common law imposes a standard of gross negligence).

176. *Meyers v. Moody*, 693 F.2d 1196, 1211 (5th Cir. 1982).

177. *Id.* (holding an interested director liable for negligence, gross negligence, intentional misconduct, and breach of fiduciary duty of due care in the management of the corporation); see *FDIC v. Brown*, 812 F. Supp. 722, 724 (S.D. Texas 1992) (discussing *Meyers v. Moody*).

178. *Gearhart Indus.*, 741 F.2d at 719. An *ultra vires* act is an act "beyond the scope of the powers of a corporation as defined by its charter or the laws of the state of incorporation." *Id.*

179. *Id.*; see also *Staacke v. Routledge*, 241 S.W. 994, 998-99 (Tex. 1922) (distinguishing between an *ultra vires* act and an illegal act).

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are those that violate a specific statute, are *malum in se*,¹⁸⁰ are *malum prohibitum*,¹⁸¹ or are against public policy.¹⁸² The *Gearhart* court noted that a director must hold the interests of the corporation above his own and act in good faith.¹⁸³ *Gearhart* also upheld the duty of care standard that was originally enunciated in *McCullum v. Dollar*.¹⁸⁴ Under *McCullum* and *Gearhart*, a director must use care as “an ordinarily prudent man would use under similar circumstances.”¹⁸⁵

A violation of the duty of loyalty occurs in Texas when a director is found to have been “interested”¹⁸⁶ in a transaction that has occurred.¹⁸⁷ This determination of director interest is a question of fact.¹⁸⁸

2. Business Judgment Rule

The number of Texas cases that have discussed a director’s standard of care, negligent mismanagement, and business judgment is limited.¹⁸⁹ However, the *Gearhart* court articulated its interpretation of the Texas business judgment rule, stating that “Texas courts to this day will not impose liability upon a noninterested corporate director unless the challenged action is *ultra vires* or is tainted by fraud.”¹⁹⁰ If the director of a corporation is found to have been “interested” in a transaction that has occurred, a breach of the duty of loyalty has occurred,¹⁹¹ and the burden of proof shifts from the shareholders to the

180. *Malum in se* is “[a] crime or an act that is inherently immoral, such as murder, arson, or rape.” BLACK’S LAW DICTIONARY 971 (7th ed. 1999).

181. *Malum prohibitum* is “[a]n act that is a crime merely because it is prohibited by statute, although the act itself is not necessarily immoral.” *Id.*

182. *Gearhart Indus.*, 741 F.2d at 719.

183. *Id.*

184. *Id.* at 720; *McCullum v. Dollar*, 213 S.W. 259 (Tex. Comm’n App. 1919, holding approved).

185. *Gearhart Indus.*, 741 F.2d at 720; *McCullum*, 213 S.W. at 261.

186. A director is “interested” if he or she (1) makes a personal profit from a transaction by dealing with the corporation or usurps a corporate opportunity; (2) buys or sells assets of the corporation; (3) transacts business in his director’s capacity with a second corporation of which he is also a director or significantly financially associated; or (4) transacts business in his director’s capacity with a family member.

Gearhart Indus., 741 F.2d at 719–20 (describing when a director’s transaction will be voidable) (citations omitted).

187. *Id.* at 719; *Int’l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963).

188. *Int’l Bankers Life Ins.*, 368 S.W.2d at 576.

189. *Gearhart Indus.*, 741 F.2d at 721.

190. *Id.*

191. *Id.* at 719; *Int’l Bankers Life Ins.*, 368 S.W.2d at 577.

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directors to show that the corporation was treated fairly in the transaction.¹⁹²

While expressly declining to overrule *Gearhart*, several recent cases in Texas have held that gross negligence is the standard by which a noninterested director's conduct will be judged.¹⁹³ The first attempt to "redefine" the standard of liability in Texas is illustrated in *FDIC v. Brown*.¹⁹⁴ The *Brown* court went to great lengths to determine exactly what the business judgment rule is in Texas, disregarding rules that were defined only in previous courts' dicta and looking to public policy.¹⁹⁵ The court also reviewed a previous memorandum opinion, in which it held that "the *negligence* of a director, *no matter how unwise or imprudent*, does not constitute a breach of duty if the acts of the director were 'within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved.'"¹⁹⁶ After stating that this memorandum opinion was "erroneous to the extent that it barred claims for gross negligence against a disinterested corporate director," the court held that *ultra vires* and fraudulent conduct encompass gross negligence.¹⁹⁷ The court reasoned first that gross negligence, defined as a total or "entire want of care,"¹⁹⁸ fits inside a list of actions that are not protected: "injurious practices, abuse of power, and oppression on the part of the company or its controlling agency clearly subversive to the rights of the minority, or a shareholder."¹⁹⁹ Second, the *Brown* court reasoned that *ultra vires* and fraudulent conduct were aligned with "reckless mismanagement" in *Jewell v. Sal-O-Dent Laboratories Inc.*,²⁰⁰ and "reckless mismanagement . . . encompasses gross negligence."²⁰¹

192. *Gearhart Indus.*, 741 F.2d at 722; *Int'l Bankers Life Ins.*, 368 S.W.2d at 578.

193. See Roberts & Pivnik, *supra* note 7, at 49–50.

194. 812 F. Supp. 722 (S.D. Tex. 1992).

195. *Id.* at 723.

196. *Id.* at 722–24 (emphasis added) (quoting *Resolution Trust Corp. v. Holmes*, No. CIV A. H-92-0753, 1992 WL 533256 (Aug. 7, 1992).

197. *Brown*, 812 F. Supp. at 725–26.

198. *Id.* at 725 (quoting *Burk Royalty Co. v. Walls*, 616 S.W.2d 911, 920 (Tex. 1981)); *Missouri Pac. Ry. Co. v. Shuford*, 10 S.W. 408, 411 (Tex. 1888) (defining gross negligence as "that entire want of care which would raise the belief that the act or omission complained of was the result of a conscious indifference to the right or welfare of the person or persons to be affected by it").

199. *Brown*, 812 F. Supp. at 725 (quoting *Cates v. Sparkman*, 11 S.W. 846, 849 (Tex. 1889)).

200. 69 S.W.2d 544, 546 (Tex. Civ. App.—Eastland 1934, writ *ref'd*) (speaking in the context of conduct that would justify the appointment of a receiver).

201. *Brown*, 812 F. Supp. at 725–26.

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Another Texas court followed the *Brown* decision and added a third line of reasoning in support of the decision that directors should be held liable for gross negligence despite the business judgment rule: “[t]he Texas legislature gave added weight to the *Gearhart* standard of liability when it enacted House Bill 1076.”²⁰² The legislature stated that the goal of the bill was to clarify existing law in terms of the “proper standard of care for officers and directors of insured depository institutions.”²⁰³ This court interpreted the *Gearhart* decision as excluding grossly negligent acts from the protections of the business judgment rule,²⁰⁴ even though *Gearhart* only expressly imposed liability for *ultra vires* or fraudulent acts.²⁰⁵ To hold otherwise “essentially abolishes the duty of care, and imposes liability only for breach of the duty of loyalty or obedience.”²⁰⁶

While most of the recent decisions about the Texas business judgment rule have involved financial institutions,²⁰⁷ at least one case did not.²⁰⁸ In *Weaver v. Kellogg*, the directors of a petroleum and chemical trading corporation diverted funds for their own personal benefit prior to a corporate bankruptcy.²⁰⁹ The court held that the business judgment rule does not bar claims for gross negligence, and it defined gross negligence:

(1) viewed objectively from the standpoint of the actor, the act or omission must involve an extreme degree of risk, considering the probability and magnitude of the potential harm to others, and (2) the actor must have actual, subjective awareness of the risk involved, but nevertheless proceed in conscious indifference to the rights, safety, or welfare of others.²¹⁰

A director who abdicates his responsibilities and fails to exercise any judgment when making the decision also qualifies as grossly

202. *FDIC v. Harrington*, 844 F. Supp. 300, 305–07, n.8 (N.D. Tex. 1994). The section of House Bill 1076 that is referred to is now codified as Texas Finance Code § 31.006(a). TEX. FIN. CODE ANN. § 31.006(a) (Vernon 1998).

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

204. *Id.* at 306.

205. *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 721, 721 (5th Cir. 1984) (stating that “Texas courts to this day will not impose liability upon a noninterested corporate director unless the challenged action is *ultra vires* or is tainted by fraud”).

206. *Harrington*, 844 F. Supp. at 306.

207. *Roberts & Pivnik*, *supra* note 7, at 50 n.24.

208. *See Weaver v. Kellogg*, 216 B.R. 563, 568 (Bankr. S.D. Tex. 1997) (regarding a petroleum and chemical trading corporation).

209. *Id.* at 568–69.

210. *Id.* at 584 (quoting *Transp. Ins. Co. v. Moriel*, 879 S.W.2d 10 (Tex. 1994)).

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negligent.²¹¹ It appears that the Texas standard has been changed since *Gearhart*, so that only a grossly negligent director will not be protected from personal liability by the business judgment rule.

3. Shareholder Derivative Suits

One or more minority shareholders may bring a shareholder derivative suit on behalf of a corporation if the corporation elects not to pursue a cause of action.²¹² Generally, Texas does not permit majority shareholders to bring a derivative suit because majority shareholders can control the actions of the corporation.²¹³ Minority shareholders who wish to bring a shareholder derivative suit must first make a demand of the corporation's board of directors, in an attempt to cause them to pursue the claim.²¹⁴ The purpose of the demand is to give the directors "an opportunity to exercise their reasonable business judgment and 'waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right.'"²¹⁵

Additionally, the demand allows the board of directors to pursue remedies other than filing a lawsuit, which promotes judicial economy.²¹⁶ The demand requirement also hinders the use of strike suits by shareholders attempting to induce a settlement from the corporation.²¹⁷

TBCA article 5.14 lists only one procedural requirement for making a pre-suit demand,²¹⁸ and Texas courts have not addressed this issue at great length.²¹⁹ However, due to the

211. *Harrington*, 844 F. Supp. at 306 n.7; *FDIC v. Brown*, 812 F. Supp. 722, 726 (S.D. Tex. 1992).

212. See *Wise*, *supra* note 172, at 60 (detailing and discussing the requirements for bringing a shareholder derivative suit) (quoting HARRY G. HENN & JOHN R. ALEXANDER, *LAW OF CORPORATIONS* § 360, at 1045 (3d ed. 1983)). In Texas, under article 2.31(A) of the TBCA, "the powers of a corporation shall be exercised by or under the authority of, and the business and affairs of a corporation shall be managed under the direction of, the board of directors of the corporation." TEX. BUS. CORP. ACT ANN. art. 2.31(A) (Vernon Supp. 2003). Therefore, "[c]orporate litigation policy is clearly a part of the 'business and affairs' of a corporation to be managed by its directors[, and s]hareholder-derivative actions inherently encroach on the board of directors' power to manage the corporation's affairs." *Wise*, *supra* note 172, at 64.

213. *Wise*, *supra* note 172, at 60 n.1.

214. TEX. BUS. CORP. ACT ANN. art. 5.14(C)(1) (Vernon Supp. 2003).

215. *Wise*, *supra* note 172, at 66 (quoting *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 96 (1991)).

216. *Id.*

217. *Id.*

218. The shareholder must specifically explain in writing his effort to compel the board of directors to bring the suit. Art. 5.14(C)(1).

219. *Wise*, *supra* note 172, at 67; *Pace v. Jordan*, 999 S.W.2d 615, 621 (Tex. App.—

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similarity between article 5.14 and the comparable federal rule, shareholders can look to federal law for guidance.²²⁰ Where a shareholder has not made a proper demand, or where he has not allowed a reasonable and adequate period of time for the directors to take action before instituting a lawsuit, a shareholder's derivative action is subject to dismissal or a stay of proceedings until the board has had the opportunity to respond.²²¹ The demand requirement will be excused if the demand would be futile.²²²

In Texas, a shareholder's derivative suit must be brought to advance allegations against a director.²²³ One reason for this rule is that the "directors' duties of loyalty and care run to the corporation, not to individual shareholders or even to a majority of the shareholders."²²⁴ A cause of action for breach of a director's fiduciary duties belongs to the corporation and cannot be brought by a stockholder in his own right, nor can the shareholder directly prosecute the suit in the name of the corporation,²²⁵ but exceptions do exist to this general rule.²²⁶

4. Limiting Director Liability

Texas enacted a statute similar to Delaware's section 102(b)(7) in response to the Delaware *Van Gorkom* decision and "the director and officer liability insurance crisis of the 1980s."²²⁷ Under article 1302-7.06 of the Texas Miscellaneous Corporation Laws, a provision can be included in a Texas corporation's articles of incorporation to eliminate or reduce a director's liability for monetary damages caused by acts or omissions done

Houston [1st Dist.] 1999, pet. denied) (addressing the pre-suit demand requirement).

220. *Id.*; see also FED. R. CIV. P. 23.1.

221. TEX. BUS. CORP. ACT ANN. art. 5.14(D), (F) (Vernon 1992 & Supp. 2001); Wise, *supra* note 172, at 70. Article 5.14(C)(2) allows a shareholder to go forward with a derivative suit if ninety days have passed since filing his demand with no response from the board of directors. TEX. BUS. CORP. ACT ANN. art. 5.14(C)(2) (Vernon 1992 & Supp. 2001).

222. Wise, *supra* note 172, at 71-72 (stating that "[a] demand is 'futile' only if the directors' minds are closed to argument").

223. *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 721 (5th Cir. 1984).

224. See *Gearhart Indus.*, 741 F.2d at 721. An individual shareholder must have suffered a separate and distinct injury from other shareholders in order to sue the corporation directly." Wise, *supra* note 172, at 62.

225. Wise, *supra* note 172, at 62; *United States v. Palmer*, 578 F.2d 144, 145-46 (5th Cir. 1978) (per curiam).

226. *Gearhart Indus.*, 741 F.2d at 722 n.8 (noting that a shareholder may sue the corporation for committing an ultra vires act under article 2.04(B)(1) of the Texas Business Corporation Act, and that *Patton v. Nicholas*, 279 S.W.2d 848, 853 (Tex. 1955), allows for an additional exception).

227. Egan & Huff, *supra* note 8, at 272.

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the person's capacity as a director; only in certain situations will such a provision be disallowed.²²⁸ Article 1302-7.06 does not authorize the elimination or limitation of the liability of a director to the extent the director is found liable for:

- (1) a breach of the director's duty of loyalty to the corporation or its shareholders or members;
- (2) an act or omission not in good faith that constitutes a breach of duty of the director to the corporation or an act or omission that involves intentional misconduct or a knowing violation of the law;
- (3) a transaction from which the director received an improper benefit, whether or not the benefit resulted from an action taken within the scope of the director's office; or
- (4) an act or omission for which the liability of a director is expressly provided by an applicable statute.²²⁹

Texas' article 1302-7.06 serves to ensure that, for corporations who choose to include the optional provision in their articles of incorporation, their directors' monetary liability will be judged according to the standards of liability set forth in *Gearhart*.²³⁰ These corporations would be subject to the *Gearhart* standards even if gross negligence is finally determined to be the applicable standard.²³¹

For the most part, article 1302-7.06 is identical to Delaware's section 102(b)(7), as both statutes allow director liability to be reduced or eliminated in all but four situations: (i) when the duty of loyalty has been breached, (ii) when good faith is not exercised or there is "intentional misconduct or a knowing violation of law, (iii) when certain unlawful distributions occur, and (iv) in transactions where the director derives "an improper personal benefit."²³²

228. *Id.*; TEX. REV. CIV. STAT. ANN. art. 1302-7.06 (Vernon 1997 & Supp. 2003).

229. Art. 1302-7.06(B).

230. Egan & Huff, *supra* note 8, at 272.

231. *Id.*

232. *See id.* at 272-73 (quoting DEL. CODE ANN. tit. 8, § 102(b)(7) (2001)).

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VI. PIERCING THE CORPORATE VEIL

The term “piercing the corporate veil” is defined as “[t]he judicial act of imposing personal liability on otherwise immune corporate officers, directors, and shareholders for the corporation’s wrongful acts.”²³³ The “corporate veil” is a “legal assumption that the acts of a corporation are not the actions of its shareholders, so that the shareholders are exempt from liability for the corporation’s actions.”²³⁴ While it is generally thought that veil piercing is a rare occurrence,²³⁵ in cases where a corporation has one to three shareholders and depending on various factors, courts have been found to pierce the corporate veil in approximately one-third to one-half of the cases.²³⁶

A. *Delaware*

Delaware law is fairly underdeveloped in the area of corporate veil piercing,²³⁷ but generally, shareholders will be held liable for “(1) dominion or mere instrumentality; and (2) use of the corporation for the perpetration of a fraud.”²³⁸ While the Delaware Court of Chancery has the discretion to pierce a corporation’s veil,²³⁹ proving the required factors is burdensome.²⁴⁰

B. *Texas*

In comparison, Texas courts have no problem in looking beyond the corporate veil when the corporate shell “has been used as part of a basically unfair device to achieve an inequitable result.”²⁴¹ In response to *Castleberry v. Branscum*,²⁴² and with the

233. BLACK’S LAW DICTIONARY 1168 (7th ed. 1999).

234. *Id.* at 341.

235. Roberts & Pivnik, *supra* note 7, at 61.

236. Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1054–55 (1991).

237. See Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83, 148 (2002).

238. Roberts & Pivnik, *supra* note 7, at 62; see *Equitable Trust Co. v. Gallagher*, 99 A.2d 490, 493 (Del. 1953), *modified on reh’g on other grounds*, 102 A.2d 538 (Del. 1954); see also *Stauffer v. Standard Brands, Inc.*, 178 A.2d 311, 316 (Del. Ch. 1962) (finding no indication of fraudulent conduct on the part of corporate directors).

239. See *Sonne v. Sacks*, 314 A.2d 194, 197 (Del. 1973); Roberts & Pivnik, *supra* note 7, at 62 (noting that “despite its apparent strict approach, veil piercing in Delaware remains somewhat flexible because it is an equitable action taken at the discretion of the Court of Chancery”).

240. *Harco Nat’l Ins. Co. v. Green Farms, Inc.*, No. 1131, 1989 WL 110537, at *4 (Del. Ch. Sept. 19, 1989).

241. *Castleberry v. Branscum*, 721 S.W.2d 270, 271 (Tex. 1986); Roberts & Pivnik, *supra* note 7, at 62–63.

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goal of clarifying Texas law on veil piercing,²⁴³ Texas Business Corporation Act (“TBCA”) article 2.21(A)(2) was amended twice, in 1989 and 1993.²⁴⁴ Now, under TBCA article 2.21, the corporate veil may not be pierced except when the corporate form is used to “perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder, owner, subscriber, or affiliate.”²⁴⁵ Two Texas practitioners explain the current problem with veil piercing law:

By its own terms, article 2.21 of the TBCA applies only to contract cases. However, the comments to that section provide that the amendments should also be considered “by analogy” in the context of tort claims. Texas courts, on the other hand, seem to rely on the rationale that, while in contract cases the plaintiff has an opportunity to select the entity with which he deals, the plaintiff in a tort claim has no such chance. As a result, uncertainty remains regarding veil piercing in tort cases in the state of Texas.²⁴⁶

Another commenter has stated that “[t]he apparent intent of the revisions of Article 2.21 was to leave *Castleberry* intact regarding the piercing claims made in connection with tort actions against the corporation, but to limit grounds for piercing claims when the dispute stems from a contract dispute.”²⁴⁷ The alter ego and sham to perpetrate a fraud theories may no longer be valid grounds for piercing the corporate veil in contract

242. *Castleberry*, 721 S.W.2d at 270. In *Castleberry*, the Texas Supreme Court approved several grounds for corporate veil piercing, including: “(1) denuding; (2) alter ego; (3) sham to perpetrate a fraud; and (4) inadequate capitalization.” J. Thomas Oldham, *Piercing the Corporate Veil: Recent Developments in Texas Law*, 32 HOUS. LAW. 33, 33 (1995) (providing an overview of the *Castleberry* decision and discussing the concerns of the corporate bar and their clients after *Castleberry*); Roberts & Pivnik, *supra* note 7, at 63.

243. See Roberts & Pivnik, *supra* note 7, at 63.

244. TEX. BUS. CORP. ACT. ANN. art. 2.21 cmt. (Vernon Supp. 2003); see Oldham, *supra* note 241, at 33–36; Roberts & Pivnik, *supra* note 7, at 63.

245. TEX. BUS. CORP. ACT. ANN. art. 2.21(A)(2) (Vernon Supp. 2003); Oldham, *supra* note 241, at 35 (analyzing the amendments passed in 1993).

246. Roberts & Pivnik, *supra* note 7, at 64 (citations omitted). Professor Tom Oldham points out, though, that “[s]omewhat surprisingly, cases decided after the 1989 amendments [to TBCA article 2.21] have muddied the waters substantially regarding applicable standards for piercing the corporate veil in contract disputes.” Oldham, *supra* note 241, at 34.

247. Oldham, *supra* note 241, at 34.

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cases.²⁴⁸ Furthermore, it is also uncertain whether denuding or inadequate capitalization are still possible grounds.²⁴⁹

VII. CORPORATE TAKEOVER SITUATIONS

A. *Delaware*

Delaware case law regarding “defensive measures is, as expected, second to none.”²⁵⁰ In order to take defensive measures, (1) the board of “directors must show that they [have] reasonable grounds for believing that a danger to corporate policy and effectiveness exist[s]”; and (2) the measure that is taken “must be reasonable in relation to the threat posed.”²⁵¹ A board of directors may take steps “that have the effect of defeating a threatened change in corporate control, when those steps are taken advisedly, in good faith pursuit of a corporate interest, and are reasonable in relation to a threat.”²⁵² If, however, the board’s action is designed to cause a stockholder vote to be ineffective, the board may not take such steps, and the board will be required to show “a compelling justification for such action.”²⁵³

A board of directors may only consider the impact of an action on other constituencies if “it bears some reasonable relationship to general shareholder interests.”²⁵⁴ After the point at which it is clear that a breakup of the corporation will occur, the directors may not consider other constituencies.²⁵⁵ When it is clear a sale is inevitable, the board is charged with the duty of maximizing corporate value and shareholder benefit.²⁵⁶

248. *Id.* at 35–36.

249. *Id.* at 35.

250. Roberts & Pivnik, *supra* note 7, at 69.

251. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (noting that it is helpful to have the approval of outside independent directors when trying to show that good faith was used and that a reasonable investigation was conducted); Roberts & Pivnik, *supra* note 7, at 69–70 (discussing the two prongs from *Unocal* in detail).

252. *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988); *see* Roberts & Pivnik, *supra* note 7, at 70.

253. Roberts & Pivnik, *supra* note 7, at 70 (quoting *Blasius Indus.*, 564 A.2d at 661).

254. *Id.* at 69 (quoting *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1282 n.29 (Del. 1989) (identifying the proper factors a board may consider)).

255. *Id.* at 70; *Revlon, Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173, 182 (Del. 1986) (stating that “such concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder”).

256. Roberts & Pivnik, *supra* note 7, at 70; *Revlon*, 506 A.2d at 182.

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The problem with Texas case law and the TBCA on the issue of corporate takeovers has been described by two corporate attorneys:

In Texas, the TBCA contains no provision regarding antitakeover or defensive measures. No Texas case directly addresses the issue of a director's duties in a defensive posture to a takeover. The closest a Texas court has come to the issue is the unsupportable decision in *Texaco, Inc. v. Pennzoil, Co.*, in which the Texas Court of Appeals incorrectly applied New York law regarding a director's duties in the face of a tendered offer. No subsequent Texas case has ruled that there is a heightened degree of scrutiny to the garden variety business judgment rule. Texas law does not seem to draw a distinction between a director's duty in a defensive posture or otherwise. Thus, the uncertain standard is that courts will not question defensive tactics as long as a director exercises business judgment in good faith, with due care, and in the best interests of the corporation.²⁵⁷

These issues remain unresolved today, as no Texas cases have dealt with corporate takeover situations and the TBCA has not been amended to add a corporate takeover provision since the excerpt from the above article was written.

VIII. CONCLUSION

For many years, publicly held corporations have chosen Delaware as the state in which to incorporate due to its favorable corporate laws.²⁵⁸ Statistics from 1996 reflect that more than half of all corporations listed on major stock exchanges were incorporated in Delaware.²⁵⁹ In 2000, Delaware continued to break records, as 59,000 new companies established themselves

257. Roberts & Pivnik, *supra* note 7, at 71–72 (citations omitted) (citing 729 S.W.2d 768 (Tex. App.—Houston [1st Dist.] 1987, writ ref'd n.r.e.), *cert. dismissed*, 485 U.S. 994 (1988)).

258. EISENBERG, *supra* note 1, at 101.

259. *Id.*

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in Delaware.²⁶⁰ Texas has attempted in recent years to catch up with Delaware as a leader in the corporate world, mostly through revisions to the Texas Business Corporation Act.²⁶¹ However, Delaware has been focusing on corporations since its first general corporation laws were enacted in 1899.²⁶² It is this author's opinion that new legislation alone will not immediately result in a state becoming competitive with Delaware.

In Delaware, a large number of cases have been heard, allowing for predictability and consistency, and more written opinions exist because of the absence of juries in the Court of Chancery.²⁶³ Also, Delaware law is very formal,²⁶⁴ and the state has an express director-consent-to-service statute, allowing plaintiffs to obtain jurisdiction over important corporate representatives.²⁶⁵ Conversely, Texas case law is uncertain in several areas, including the standard for director liability, the standard for corporate veil piercing, and the duties of a director in defensive corporate takeover situations.²⁶⁶ Texas corporate disputes are handled in courts of general jurisdiction and are heard by juries,²⁶⁷ and it may be difficult for a plaintiff to obtain jurisdiction over important representatives of a Texas corporation.²⁶⁸

Texas also imposes a minimum capital requirement of \$1,000,²⁶⁹ whereas Delaware has no minimum capital requirement,²⁷⁰ and Delaware exempts certain corporations from paying its income taxes²⁷¹ in addition to allowing credits for certain types of corporations that are attempting to get established or expand.²⁷² While Texas is one of only four states that does not have a corporate state income tax,²⁷³ Texas franchise taxes have been analogized to the imposition of a corporate income tax.²⁷⁴

260. See Windsor, *supra* note 6.

261. See Roberts & Pivnik, *supra* note 7, at 46–48.

262. See Moore, *supra* note 12, at H–8.

263. See WOLFE & PITTENGER, *supra* note 47, § 1-3.

264. See Taylor, *supra* note 54, at 854.

265. DEL. CODE ANN. tit. 10, § 3114 (1999); see Ward, *supra* note 57, at 12.

266. See Roberts & Pivnik, *supra* note 7, at 47–49, 64.

267. See Egan & Huff, *supra* note 8, at 259.

268. See *supra* notes 81–82 and accompanying text.

269. TEX. BUS. CORP. ACT ANN. art. 3.05(A) (Vernon Supp. 2003).

270. See BALOTTI & FINKELSTEIN, *supra* note 94, at § 1.9.

271. DEL. CODE ANN. tit. 30, § 1902(b)(8) (Supp. 2002).

272. DEL. CODE ANN. tit. 30, § 2011 (1997).

273. See Roberts & Pivnik, *supra* note 7, at 79.

274. See Egan & Huff, *supra* note 8, at 252.

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It has been stated that “Delaware’s standard for director liability is as certain as the sun will rise each and every day.”²⁷⁵ The Delaware business judgment rule will protect a corporate director as long as that director “acted in good faith and with appropriate care in informing himself of all material information.”²⁷⁶ Texas courts, however, have applied differing tests in determining director liability and applying the business judgment rule, from *ultra vires* or fraudulent, to gross negligence, to less-than-gross negligence.²⁷⁷

While Delaware law is not as advanced in the area of corporate veil piercing,²⁷⁸ Texas law is uncertain as to the theories that may be set forth for piercing the corporate veil for both contract and tort claims.²⁷⁹ Finally, Delaware case law is well established on defensive measures to which corporations may resort in corporate takeover situations.²⁸⁰ The Texas Business Corporation Act, however, does not speak to “antitakeover or defensive measures,” and no Texas case addresses “directors’ duties in a defensive posture to a takeover.”²⁸¹

For these reasons, while Texas has made great strides in recent years to attract more corporations to the state, it is clear that Delaware has been and will continue to be a leader in corporate law into the future.

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275. See Roberts & Pivnik, *supra* note 7, at 48.

276. Egan & Huff, *supra* note 8, at 265 (citing *Brehm v. Eisner*, 746 A.2d 244, 259 (Del. 2000)).

277. See *supra* notes 172–177 and accompanying text.

278. Roberts & Pivnik, *supra* note 7, at 61.

279. See *id.* at 64; Oldham, *supra* note 241, at 34.

280. See Roberts & Pivnik, *supra* note 7, at 69.

281. See *id.* at 71–72.

