

SUBJECT: Revising the Texas Business Corporations Act and related laws

COMMITTEE: Business and Industry — committee substitute recommended

VOTE: 9 ayes — Giddings, Elkins, Kolkhorst, Bohac, Martinez Fischer, J. Moreno, Oliveira, Solomons, Zedler

0 nays

WITNESSES: For — Curtis Huff; J. Leon Lebowitz; Bradley L. Whitlock, Texas Business Law Foundation

Against — None

On — Carmen Flores, Secretary of State's Office

BACKGROUND: The Texas Business Corporations Act (TBCA) and the Texas Miscellaneous Corporation Laws Act (TMCLA), enacted in 1955 and 1961, respectively, govern the formation and internal management of various business entities, including for-profit and nonprofit corporations, limited liability companies, professional corporations, professional associations, real estate investment trusts (REITs), cooperative associations, lodges, and church benefit plans.

A registered agent is a person or entity that may be served with process in a lawsuit. TBCA, art. 2.09 requires a corporation to register an office, which need not be the same place that it does business, with the secretary of state. A registered agent may be a person who has the same business office as the registered office, a Texas corporation, or a foreign corporation authorized to do business in Texas with the same business office as the registered office.

TBCA, art. 2.14-1 authorizes a board of directors to create and issue shares of stock or other securities, subject to limitations in the articles of incorporation. Art. 2.22 allows a corporation's articles of incorporation, bylaws, or written agreements among shareholders to impose restrictions on the transfer or registration of transfer of the corporation's securities. This article sets forth examples of reasonable restrictions, including a restriction for the purpose of maintaining a tax advantage for the corporation.

Under Art 2.22-1, shareholders have preemptive rights unless an entity expressly denies them in its articles of incorporation. Preemptive rights enable shareholders to buy shares of stock whenever the entity issues more shares. Shareholders with such rights may buy a pro-rata portion of the new shares according to what they already own, provided that they do so within a certain time frame. For example, if a corporation issues 1,000 new shares of stock, a shareholder who owns 25 percent of the existing shares may buy up to 250 new shares.

Art. 2.24 requires that shareholder meetings occur in the place stated in or according to the bylaws, or, if not otherwise specified, at the registered office of the corporation. Art. 2.25 requires that shareholders receive written or printed notice of the place, date, and time of shareholder meetings.

Art. 2.27 requires that a list of all shareholders of a corporation who are entitled to vote be kept on file at the corporation's registered office or principal place of business and be subject to inspection by any shareholder during business hours for at least 10 days before any shareholder meeting.

Under Art. 2.29(D), cumulative voting is allowed unless the articles of incorporation specifically prohibit it. Cumulative voting rights enable minority shareholders to obtain representation on a board of directors. For example, if five director positions are open, a shareholder who owns 25 percent of the shares receives one vote per share owned for each director position. If 1,000 shares are outstanding, that person owns 250 shares and receives 1,250 votes. Under cumulative voting, that person may cast all 1,250 votes for one director candidate. Because directors are elected by plurality — that is, the five candidates who receive the most votes are elected — the minority shareholder is guaranteed to elect at least one director, because the other shareholders could not muster enough votes against that candidate and still elect the other four.

Under Art. 2.36, to form a corporation or REIT in Texas, an entity must have at least \$1,000 in stated capital.

Art. 5.01 requires entities that are merging to adopt a plan of merger, subject requirements specified in the statute.

DIGEST: CSHB 1165 would make various revisions to the TBCA and TMCLA concerning business corporations.

The bill would amend the TBCA to allow electronic transmission of documents for granting proxies, giving notice of shareholder meetings and conducting meetings, maintaining lists of shareholders with voting rights, and other purposes.

Entities other than corporations could be registered agents for service of process, so long as they were organized under Texas laws and had an office that generally was open during normal business hours to perform the duties of a registered agent.

The board of directors would have exclusive authority to grant, amend, redeem, extend, or replace shareholders' rights or options to buy or receive shares of securities, although the board would remain subject to any limitations in the articles of incorporation. The board could allow one or more officers to designate officers and employees to receive rights or options or to determine the number of rights or options to be received. The board would have to determine the total number of rights or options to be offered and could not allow officers to designate themselves as recipients.

CSHB 1165 would add two permissible restrictions on transfer or registration of transfer of a corporation's securities. It would authorize restrictions that would require the owner of a security to sell or transfer it back to the corporation or to another shareholder or that would require the automatic sale of restricted securities to the corporation or shareholders.

The bill would reverse the default rules on preemptive rights and cumulative voting rights to make these rights unavailable unless expressly provided for in the articles of incorporation. A corporation could amend its articles any time after September 1, 2003, to limit or deny cumulative voting rights.

CSHB 1165 would remove the requirement that an entity have \$1,000 in stated capital at the time of beginning business. It would authorize what is known as a "force the vote" provision, allowing shareholders to vote on a plan of merger even after the board of directors had determined that the merger was not in the corporation's best interest.

CSHB 1165 also would repeal various portions of the TBCA and TMCLA to conform with changes in other laws.

The bill would take effect September 1, 2003.

**SUPPORTERS
SAY:**

CSHB 1165 would amend the TBCA and TMCLA to bring them up to date with current technology. These statutes have not been amended significantly in the past six years and do not provide for the use of electronic technology, such as email and the Internet, which has become essential to doing business.

Electronic technology is vital for modern corporations to communicate with their shareholders. By authorizing the use of this technology, CSHB 1165 would save businesses money while giving shareholders easy and immediate access to corporate information. It would enable shareholders who otherwise could not attend shareholder meetings because of time constraints or the expense of travel to attend meetings in the comfort of their homes.

Allowing a board to delegate to officers the right to issue options, except to themselves, would give corporations more flexibility to offer competitive stock-option plans. As an added safeguard, a corporation could limit this right in its articles of incorporation. This change, which would be permissive, would reflect changes made in Delaware law several years ago. Allowing officers to exercise more control over stock plans would make sense, because officers have the best understanding of how to motivate employees to perform their best possible work and to remain with the corporation.

CSHB 1165 would allow corporations and other entities to add restrictions to the sale and transfer of their stock to help them preserve their tax advantages. A REIT places restrictions on the number of shareholders and how many shares each can own. It is legitimate to have an agreement in the articles of incorporation or with the shareholders that a person who violates these limits must sell the shares back to the corporation. Because the intent of the statute, when amended in 1989, was to allow entities to use restrictions to keep their tax advantages, businesses already use these types of agreements. This bill simply would codify existing practice.

Similarly, “force the vote” provisions already are common in merger practice, and CSHB 1165 would codify that practice. This would bring Texas in line with states like Delaware that are known for progressive business laws.

Many portions of CSHB 1165 also are contained in HB 1156 by Giddings, et al., adopting a new Business Organizations Code, also on today’s House calendar. However, the provisions of HB 1156 would not take effect until January 1, 2006, and thereafter, so CSHB 1165 would allow several needed provisions to take effect sooner, on September 1 of this year.

OPPONENTS
SAY:

Although allowing electronic transmission of corporate communications would be good for some shareholders, it could prevent others — especially those who do not have or do not know how to use a computer — from receiving vital information. Also, allowing a corporation to keep a list of its shareholders in electronic format could create privacy problems. The current system of having to go to corporate offices to obtain shareholder lists deters bad actors from procuring lists of private information. If this information were made available on the Internet, it could be used improperly and to the detriment of shareholders. The bill should require corporations to implement restrictions on obtaining these lists to preserve shareholder privacy and to allow shareholders to choose whether or not they want to be listed in an electronic database.

Allowing a board of directors to delegate stock-option planning power would not be good policy. Shareholders elect the board to oversee the corporation and to delegate day-to-day operations to the officers. Stock-option plans directly affect shareholders’ interests and should be subject to shareholders’ control. Shareholders do not elect or control the corporation’s officers, who may not have the same purview of the corporation’s interests as the board has because the officers interact less with the shareholders.

NOTES:

The committee substitute proposes changes to the TBCA and TMCLA in addition to those in the bill as filed. For example, the original bill did not address allowing a board of directors to delegate the right to issue stock options to officers, nor the “force the vote” provisions related to mergers. The substitute also would add authorization for electronic transmission of notice of shareholder meetings.

HB 1165
House Research Organization
page 6

The companion bill, SB 1544 by Janek, has been referred to the Senate Business and Commerce Committee.