THE TEXAS COURTS' ONGOING STRUGGLE TO HARMONIZE THE TEXAS BUSINESS ORGANIZATIONS CODE WITH THE TEXAS RULES OF CIVIL PROCEDURE IN DERIVATIVE SHAREHOLDER LITIGATION

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I. INTRODUCTION

In 1997, the Texas Legislature attempted to provide "Texas with modern and flexible business laws" to "attract and continue to retain businesses to incorporate and organize in Texas."[1] To accomplish these worthy goals, the legislature substantially rewrote the Texas Business Organizations Code and adopted, in large part, §§ 7.40–7.47 of the Model Business Corporation Act (MBCA).[2] The new Texas Business Organizations Code (the Texas Statute) governed all shareholder derivative lawsuits filed in the state.[3] At their core, these are lawsuits in which one or more shareholders attempt to wrestle control of decisions that are typically internal affairs of a corporation away from a corporation's board of directors.[4] Accordingly, these suits are potentially quite disruptive.

The rationale that motivated the legislature in 1997 is no less important today. Fifty-two of the Fortune 500 companies are now headquartered in Texas.[5] In 2012, the Texas gross domestic product was over $1.4 trillion, putting its economic output just above Spain's and above Mexico's 2013 gross domestic product.[6] Texas petroleum product exports in 2013 were valued at over $60 billion; the state produced nearly 950 million barrels of oil.[7] Texas's vast oil shale resources in the Eagle Ford Shale and the Permian Basin are currently among the world's most actively drilled fields.[8]

The manner in which Texas state and federal courts would interpret the Texas Statute was not known for years. In 2006, an article this commentator

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1. *Hearings on Tex. S.B. 555 Before the Senate Comm. on Econ. Dev.*, 75th Leg., R.S. (Apr. 8, 1997) (transcript available from Senate Staff Services Office).

2. *Compare* 2 MODEL BUS. CORP. ACT ANN. §§ 7.40–.47 (4th ed. 2013) (containing the sections pertaining to derivative proceedings), *with* TEX. BUS. ORGS. CODE ANN. §§ 21.551–.563 (West 2012) (containing the Texas sections pertaining to derivative proceedings).

3. BUS. ORGS. CODE § 21.562.

4. *See, e.g.*, Connolly v. Gasmire, 257 S.W.3d 831, 839–40 (Tex. App.—Dallas 2008, no pet.) (describing the basic nature of a shareholder derivative lawsuit).

5. Maria Halkias, *Texas Dominates 2014 Fortune 500 List with 52 Companies*, DALL. NEWS (June 2, 2014, 10:18 AM), http://bizbeatblog.dallasnews.com/2014/06/texas-dominates-2014-fortune-500-list-with-52-companies.html/.

6. *Compare Texas State Energy Profile*, U.S. ENERGY INFO. ADMIN., http://www.eia.gov/state/print.cfm?sid=TX (last updated Mar. 27, 2014) (showing that Texas's gross domestic product (GDP) was over $1.4 trillion in 2012), *with Gross Domestic Product 2013*, WORLD BANK 1 (Dec. 16, 2014), http://databank.worldbank.org/data/download/GDP.pdf (showing that Spain's GDP was over $1.3 trillion in 2013 and Mexico's was over $1.2 trillion).

7. *See Petroleum Products Manufacturing*, OFF. GOVERNOR, http://governor.state.tx.us/files/ecodev/profilepetroleumandcoal.pdf (last visited Nov. 12, 2014); Mark J. Perry, *The Remarkable Rise of Texas Crude Oil: The State Produced Nearly One Billion Barrels Last Year, and 34.5% of All US Crude*, AM. ENTERPRISE INST. (Feb. 28, 2014, 2:10 PM), http://www.aei.org/publication/the-remarkable-rise-of-texas-crude-oil-the-state-produced-nearly-one-billion-barrels-last-year-and-34-5-of-all-us-crude/.

8. *See Eagle Ford Shale Play*, EAGLE FORD SHALE, http://eaglefordshale.com (last visited Nov. 12, 2014); Russell Gold, *Permian Basin in Texas to Drive Down Oil Prices: Output, Already Exceeding Bakken Shale, Is Likely to Hit 2 Million Barrels a Day*, WALL ST. J. (Sep. 1, 2014, 7:21 PM), http://online.wsj.com/articles/permian-basin-in-texas-to-drive-down-oil-prices-1409613682.

coauthored[9] noted that in the first eight years of the Texas Statute's existence, only two appellate courts had addressed the procedural mechanism for evaluating a shareholder's standing to pursue derivative claims.[10] That article went on to address not only inconsistencies within the provisions of the new statute, but also the inherent uncertainties this new statute would face when courts attempted to harmonize its legal and procedural elements with the Texas Rules of Civil Procedure.[11]

In the eight years since 2006, the Fifth and Fourteenth Courts of Appeals, sitting in Dallas and Houston respectively, each issued two opinions applying the Texas Statute to the critical issues involving who has a right to control the claims asserted in a derivative lawsuit—the shareholder or the board of directors.[12] In these opinions, the courts were forced to answer critical procedural questions that the plain language of the Texas Statute did not adequately address. These critical questions were:

> (1) What procedure governs the threshold question of a shareholder's standing in the context of derivative action involving a foreign corporation? (2) What procedure governs an attempt by the corporation to regain control of derivative action through a special litigation committee or other independent decision maker when a majority of the board of directors is tainted by a conflict of interest?[13]

The Texas Supreme Court has not addressed any of these issues, and it seems unlikely it will have the chance to do so in the near future. Accordingly, uncertainty remains not only because of the way the courts answered these questions, but also because the decisions reached by the courts of appeals are not binding authority outside their respective districts.

This Article argues that the legislature should amend the Texas Statute to definitively answer these questions, while at the same time evaluating whether the courts of appeals' decisions sufficiently coincide with the larger body of corporate law outside of Texas.[14] The Delaware Court of Chancery made the

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9. Todd A. Murray & Lyndon F. Bittle, *Emerging Issues Raised by Derivative Shareholder Actions Involving Foreign Corporations Headquartered in Texas: Making Sense of the Interaction Between Texas Procedures and Substantive Law*, 39 TEX. TECH L. REV. 1, 5 (2006).

10. *See* Moonlight Invs., Ltd. v. John, 192 S.W.3d 890, 894 (Tex. App.—Eastland 2006, pet. denied) (holding that the special exceptions under Texas Rule of Civil Procedure 91 was the proper mechanism for challenging demand futility for a foreign corporation); Pace v. Jordan, 999 S.W.2d 615, 621 (Tex. App.—Houston [1st Dist.] 1999, pet. denied) (upholding the demand requirement for Texas corporations).

11. *See* Murray & Bittle, *supra* note 9, at 27–29.

12. *See In re* Platinum Energy Solutions, Inc., 420 S.W.3d 342, 348–50 (Tex. App.—Houston [14th Dist.] 2014, no pet.); *In re* Crown Castle Int'l Corp., 247 S.W.3d 349, 353–55 (Tex. App.—Houston [14th Dist.] 2008, pet. denied); Connolly v. Gasmire, 257 S.W.3d 831, 839–40 (Tex. App.—Dallas 2008, no pet.); Johnson *ex rel.* MAII Holdings, Inc. v. Jackson Walker, L.L.P., 247 S.W.3d 765, 772–74 (Tex. App.—Dallas 2008, pet. denied).

13. *See In re Platinum Energy Solutions*, 420 S.W.3d at 346–49; *In re Crown Castle*, 247 S.W.3d at 352–55; *Connolly*, 257 S.W.3d at 839–50; *MAII Holdings*, 247 S.W.3d at 772–77.

14. *See infra* Part IV.

peril of leaving Texas corporate law in an uncertain state abundantly clear in last year's *Boilermakers Local 154 Retirement Fund v. Chevron Corp* decision.[15] A dozen companies, including Chevron and FedEx, adopted bylaws —without stockholder votes—precluding their stockholders from filing a derivative action anywhere but Delaware.[16] Ten of the twelve corporations relented after lawsuits challenged the bylaws, but Chevron and FedEx forged on.[17] The opinion by Delaware Chancellor Strine (now a member of the Delaware Supreme Court) validated those companies' bylaws, holding them enforceable in the same manner a court would enforce any other forum selection clause.[18] "[T]he realities of institutional shareholder backlash or negative publicity" may impede a corporation's implementation of this approach.[19] Regardless of potential impediments, however, "the significance of the opinion cannot be overstated given its potential for changing the landscape of shareholder litigation."[20] Unless Texas corporate law becomes more predictable, corporations headquartered in Texas may decide to force their stockholders—and in many cases the citizens of Texas—to fly to Delaware to challenge corporate misconduct.[21]

This Article will begin by analyzing fundamental concepts in derivative litigation—shareholder standing, the demand requirement, and the ability of the corporation to regain control over the litigation if the board of directors as a whole has a disabling conflict.[22] This Article will next explore why Texas courts have struggled, and will likely continue to struggle, to apply the Texas Statute in its current form.[23] Finally, the Article will suggest ways the legislature may consider amending the statute to make derivative litigation more procedurally predictable.[24]

II. KEY CONCEPTS IN SHAREHOLDER DERIVATIVE LITIGATION

Normally, directors, not stockholders, decide whether to initiate and pursue litigation on a corporation's behalf, and directors' decisions generally fall under the broad discretion of the "business judgment rule."[25] A

15. *See generally* Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934 (Del. Ch. 2013) (concluding that a company's board of directors could unilaterally adopt enforceable forum selection bylaws).

16. *Id.* at 942, 945.

17. *Id.* at 945.

18. *Id.* at 963.

19. Todd A. Murray, *Update on Delaware Fiduciary Opinions Issued in 2013*, 36 TEX. BUS. LITIG. J., Spring 2014, at 1, http://texbuslit.org/SPRING2014deleware.pdf.

20. *Id.*

21. *See generally Boilermakers*, 73 A.3d 934 (enforcing corporate bylaws that selected Delaware as the sole forum for shareholder lawsuits).

22. *See infra* Part II.A–C.

23. *See infra* Part III.A–B.

24. *See infra* Part IV.

25. *See* DEL. CODE ANN. tit. 8, § 141(a) (West 2011); Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 366–67 (Del. 2006); Braddock v. Zimmerman, 906 A.2d 776, 784 (Del. 2006); Rales v.

stockholder, however, can file a derivative lawsuit seeking to temporarily suspend a board of directors' management powers when influence or interest prevents that board from deciding what is truly in the best interests of the corporation.[26] This creates a situation in which a shareholder, frequently a disgruntled one, is acting on a corporation's behalf.[27]

Delaware often has been in the vanguard of corporate law, and the vast majority of public companies have chosen to incorporate there.[28] The Delaware Court of Chancery, a non-jury trial court with original and exclusive equity jurisdiction, adjudicates all cases filed in Delaware involving shareholder derivative litigation.[29] Delaware corporate law has developed through a mix of statutory and common law.[30] The most prevalent alternative to Delaware law is the MBCA and Revised MBCA, a model set of laws prepared by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association.[31] It has been adopted in at least some form in forty-two states.[32] The Texas Statute is largely consistent with the MBCA.[33] As demonstrated in this Article, these two approaches address the same issues and have similar goals, but differ in material ways.

A. Shareholder Standing

A shareholder must demonstrate standing to step into the shoes of the board of directors and pursue litigation on behalf of the corporation.[34] Delaware law imposes the "continuous ownership" rule—the stockholder must continuously hold shares of the corporation's stock from the time of the alleged wrongful act and throughout the lawsuit.[35] In *Lewis v. Ward*, the Delaware Supreme Court reinforced this rule and affirmed yet again the Delaware rule that a shareholder loses his standing to pursue derivative claims if he loses his

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Blasband, 634 A.2d 927, 932–33 (Del. 1993); Aronson v. Lewis, 473 A.2d 805, 811–12 (Del. 1984), *overruled by* Brehm v. Eisner, 746 A.2d 244, 253 (Del. 2000) (determining the proper standard of review is de novo).

26. *See Aronson*, 473 A.2d at 814–15.

27. *See id.*

28. *In re* Aguilar, 344 S.W.3d 41, 47 (Tex. App.—El Paso 2011, no pet.) ("Delaware has been described as the Mother Court of corporate law." (quoting Kamen v. Kemper Fin. Servs., Inc., 908 F.2d 1338, 1343 (7th Cir. 1990), *rev'd on other grounds*, 500 U.S. 90 (1991)) (internal quotation marks omitted)).

29. *Judicial Officers of the Court of Chancery*, DEL. ST. CTS., http://courts.delaware.gov/chancery/judges.stm (last visited Nov. 14, 2014).

30. *A Short History of the Delaware Court of Chancery*, DEL. ST. CTS., http://courts.delaware.gov/chancery/history.stm (last visited Nov. 14, 2014).

31. *See* Murray & Bittle, *supra* note 9, at 13–14.

32. *See* D. Gordon Smith, *A Proposal to Eliminate Director Standards from the Model Business Corporation Act*, 67 U. CIN. L. REV. 1201, 1202 (1999).

33. *See supra* note 2 and accompanying text.

34. *See* DEL. CODE ANN. tit. 8, § 327 (West 2011); Lewis v. Anderson, 477 A.2d 1040, 1046 (Del. 1984).

35. *Anderson*, 477 A.2d at 1046.

status as a shareholder.[36] Only two exceptions exist.[37] The first allows a claim to survive a stock-divesting merger when fraud in the merger itself is the basis of the claim, and the second allows a claim when that merger is merely a reorganization.[38]

Under § 21.552 of the Texas Statute, the basic requirement is the same, but to this point, no exceptions have been recognized:

> **§ 21.552. Standing to Bring Proceeding**
> A shareholder may not institute or maintain a derivative proceeding unless:
> (1) the shareholder:
> (A) was a shareholder of the corporation at the time of the act or omission complained of; or
> (B) became a shareholder by operation of law from a person that was a shareholder at the time of the act or omission complained of; and
> (2) the shareholder fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.[39]

The First Court of Appeals held in *Somers ex rel. EGL, Inc. v. Crane* that the "plain language" meant what it said—a former stockholder, who was not a current shareholder, was not entitled to bring a derivative lawsuit.[40] Moreover, the Texas opinions that have addressed this requirement decided the issue on a plea to the jurisdiction under Texas Rule of Civil Procedure 85 (Texas Rule).[41] Faced with such a plea, a trial court may resolve factual issues in reaching its decision.[42]

B. The Demand Requirement and Pleading Demand Futility

The next critical issue in derivative litigation is whether the shareholder must ask the corporation's board of directors to file the lawsuit before the shareholder proceeds. Courts call this request a "demand."[43] The core difference between the Delaware approach and the Texas approach is that under the Delaware approach, a shareholder's demand concedes the board of directors' ability to properly consider the demand;[44] therefore, a shareholder of Delaware corporations is strategically disadvantaged if he tenders a demand to

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36. Lewis v. Ward, 852 A.2d 896, 904 (Del. 2004).

37. *Id.* at 902–06.

38. *Id.* at 904–06.

39. TEX. BUS. ORGS. CODE ANN. § 21.552 (West 2012).

40. Somers *ex rel.* EGL, Inc. v. Crane, 295 S.W.3d 5, 13–14 (Tex. App.—Houston [1st Dist.] 2009, pet. denied).

41. *See* TEX. R. CIV. P. 85; *see, e.g.*, *EGL*, 295 S.W.3d at 11, 13; Lewis v. CNL Rest. Props., Inc., 223 S.W.3d 784, 788 (Tex. App.—Dallas 2007, no pet.).

42. *EGL*, 295 S.W.3d at 10–11; *see CNL Rest. Props.*, 223 S.W.3d at 786.

43. *See* Scattered Corp. v. Chi. Stock Exch., Inc., 701 A.2d 70, 74–75 (Del. 1997), *overruled by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

44. *See id.*; *infra* Part II.B.2 (explaining that a demand does not concede the disinterestedness and independence of the board under the framework of the MBCA adopted by Texas).

the board of directors to pursue the claim.[45] Instead, a shareholder of Delaware corporations typically argues that making a demand would be "futile" because the board is conflicted.[46]

1. The Demand Requirement Under Delaware Law

Delaware's Chancery Court Rule 23.1 (Delaware Rule), which Delaware treats as a substantive standing requirement, prevents a shareholder from pursuing a derivative action on behalf of the corporation until he has made a demand on the board of directors to institute such an action and such demand has been wrongfully refused, or the shareholder has demonstrated, with particularity, that demand is excused because it would be futile.[47] The shareholder has the burden.[48] That burden "is not satisfied by conclusory statements or mere notice pleading."[49] The shareholder's allegations of demand futility "must comply with stringent requirements of factual particularity."[50]

To demonstrate demand futility, a shareholder must show that the directors are under an influence that sterilizes their discretion or that they are incapable of making an impartial decision.[51] There is a presumption, however, 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 was taken in the best interests of the corporation (i.e., a presumption that the directors are faithful to their fiduciary duties).[52] One of two Delaware decisions provides the standards for determining demand futility—either *Aronson v. Lewis* or *Rales v. Blasband*.[53]

When a shareholder's cause of action in a derivative suit arises from an affirmative business decision made by a corporation's board of directors, courts apply the two-part *Aronson* test.[54] Under the *Aronson* test, demand will be excused if the shareholder pleads particularized facts, which create a reasonable doubt that: "(1) the directors are disinterested and independent or (2) the challenged transaction was otherwise the product of a valid exercise of business

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45. *E.g.*, Beam *ex rel*. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1056 (Del. 2004) (stating that if discovery is required to properly plead futility, an action to obtain corporation records under § 220 of the Delaware Code before filing any derivative lawsuit is the most prudent course of action).

46. *Id.* at 1051–52.

47. *See* DEL. CH. CT. R. 23.1; Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 366–67 (Del. 2006); Braddock v. Zimmerman, 906 A.2d 776, 784 (Del. 2006); Spiegel v. Buntrock, 571 A.2d 767, 773 (Del. 1990); Aronson v. Lewis, 473 A.2d 805, 811–12 (Del. 1984), *overruled by Brehm*, 746 A.2d 244.

48. *See Stewart*, 845 A.2d at 1048–49; *Aronson*, 473 A.2d at 812.

49. *Brehm*, 746 A.2d at 254.

50. *Id.*; *AmSouth Bancorporation*, 911 A.2d at 367 n.9; *Aronson*, 473 A.2d at 811.

51. *See* Rales v. Blasband, 634 A.2d 927, 932 (Del. 1993); *Aronson*, 473 A.2d at 811; Kohls v. Duthie, 791 A.2d 772, 779 (Del. Ch. 2000).

52. *See Stewart*, 845 A.2d at 1048–49; *Aronson*, 473 A.2d at 812.

53. *Rales*, 634 A.2d at 932–33; *Aronson*, 473 A.2d at 814.

54. *See* Braddock v. Zimmerman, 906 A.2d 776, 784 (Del. 2006); *Aronson*, 473 A.2d at 814.

judgment."[55] These two parts of the *Aronson* test are disjunctive, so if either part is satisfied, demand is excused.[56]

Rales applies when a shareholder sues because the corporation's board of directors has failed to do something.[57] Demand is not excused unless the shareholder's allegations demonstrate why the board is incapable of considering a demand.[58] This test typically applies when the derivative lawsuit challenges (1) a decision made by the board of directors, but a majority of the directors who made the decision are no longer on the board;[59] (2) conduct that does not involve a business decision by the directors;[60] and (3) a decision by the board of directors of a different corporation.[61] Under the *Rales* test, demand is excused only where a shareholder creates reasonable doubt that the board of directors can properly exercise its independent and disinterested business judgment in responding to a demand.[62]

Under the first part of the *Aronson* and *Rales* tests, a shareholder must plead particularized facts that create reasonable doubt that a majority of the directors are disinterested and independent.[63] It is insufficient to allege that demand is futile because the directors would have to sue themselves or approve of the underlying transaction.[64] Under the *Rales* test, a shareholder can create reasonable doubt by asserting that the "directors face a substantial likelihood of liability."[65] A shareholder may assert that the directors face a substantial likelihood of liability because they failed to act in the face of a known duty to act.[66] This is also known as "oversight liability."[67] To adequately plead oversight liability, the shareholder must allege facts showing that the directors utterly failed to implement any system or controls (financial or otherwise) or consciously failed to monitor or oversee the operation of those controls.[68]

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55. *See Braddock*, 906 A.2d at 784 (quoting *Rales*, 634 A.2d at 933) (internal quotation marks omitted).

56. Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000).

57. *See Braddock*, 906 A.2d at 784–85.

58. *Rales*, 634 A.2d at 934 n.9; Kohls v. Duthie, 791 A.2d 772, 780 (Del. Ch. 2000); *see* Stone *ex rel*. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 367 (Del. 2006).

59. *See, e.g.*, Harris v. Carter, 582 A.2d 222, 228 (Del. Ch. 1990) (regarding a derivative suit filed after a change in control).

60. *Rales*, 634 A.2d at 934 n.9 (discussing a derivative suit alleging third-party breach of contract).

61. *Id.* at 933–34 (finding that demand was excused in a derivative suit by a shareholder of a consolidated company post-merger, alleging breach by directors of pre-merger acquired company).

62. *Id.* at 934; *Braddock*, 906 A.2d at 784.

63. Beam *ex rel*. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1049 (Del. 2004); Orman v. Cullman, 794 A.2d 5, 24 (Del. Ch. 2002).

64. Brehm v. Eisner, 746 A.2d 244, 257 n.34 (Del. 2000); Aronson v. Lewis, 473 A.2d 805, 817–18 (Del. 1984), *overruled by Brehm*, 746 A.2d 244; Kohls v. Duthie, 791 A.2d 772, 779 (Del. Ch. 2000).

65. Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 367 (Del. 2006) (internal quotation marks omitted); Ryan v. Gifford, 918 A.2d 341, 355 (Del. Ch. 2007); Forsythe v. ESC Fund Mgmt. Co. U.S., No. 1091-VCL, 2007 WL 2982247, at *6 (Del. Ch. 2007).

66. *See AmSouth Bancorporation*, 911 A.2d at 369.

67. *Id*.

68. *See id.* at 370; *Forsythe*, 2007 WL 2982247, at *6.

2. The Demand Requirement Under the Texas Statute

Under the Texas Statute, the demand requirement is universal, so a lawsuit may be summarily dismissed if the shareholder does not make a demand on the board before filing suit:

> **§ 21.553. Demand**
> (a) A shareholder may not institute a derivative proceeding until the 91st day after the date a written demand is filed with the corporation stating with particularity the act, omission, or other matter that is the subject of the claim or challenge and requesting that the corporation take suitable action.
> (b) The waiting period required by Subsection (a) before a derivative proceeding may be instituted is not required if:
> (1) the shareholder has been previously notified that the demand has been rejected by the corporation;
> (2) the corporation is suffering irreparable injury; or
> (3) irreparable injury to the corporation would result by waiting for the expiration of the 90-day period.[69]

The first decision applying the Texas Statute, *Pace v. Jordan*, had little difficulty simply concluding that "demand futility is no longer an option."[70] The Texas Supreme Court's 2009 decision *In re Schmitz* held that the demand itself must name the shareholder on whose behalf the demand is being made, as corporations "cannot be expected to incur the time and expense involved in fully investigating a demand without verifying that it comes from a valid source."[71] Note that neither § 21.553 nor § 21.558 suggest that a demand concedes the disinterestedness of the board.[72] Moreover, the official comment to § 7.44 of the MBCA, which is analogous to §§ 21.554 and 21.558 of the Texas Statute, states:

> Since section 7.42 requires demand in all cases, the distinction between demand-excused and demand-required cases does not apply. [Section 7.44 carries] forward that distinction, however, by establishing pleading rules and allocating the burden of proof depending on whether there is a majority of qualified directors on the board.[73]

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69. TEX. BUS. ORGS. CODE ANN. § 21.553 (West 2012).
70. Pace v. Jordan, 999 S.W.2d 615, 621 (Tex. App.—Houston [1st Dist.] 1999, pet. denied).
71. *In re* Schmitz, 285 S.W.3d 451, 456–57 (Tex. 2009).
72. TEX. BUS. ORGS. CODE ANN. § 21.554 (West 2012). For the statutory language *see infra* text accompanying note 206.
73. 2 MODEL BUS. CORP. ACT ANN. § 7.44 cmt. 2 (4th ed. 2013).

C. Regaining Control of Derivative Litigation: Special Litigation Committees

In 1981, the Delaware Supreme Court's decision in *Zapata Corp. v. Maldonado* created a procedure that allowed a corporation to regain control of a derivative claim if that corporation's board of directors was not in a position to disinterestedly evaluate the lawsuit.[74] Under this holding, a board of directors tainted by some conflict may delegate its powers to manage corporate litigation to a committee of disinterested directors.[75] The Texas Statute likewise sets forth a procedure under which a board of directors may regain control of a derivative claim.[76] This procedure is based on the MBCA and is roughly parallel to the approach initially adopted by *Auerbach v. Bennett*.[77]

Generally, the procedure for invoking *Zapata* or § 21.554 begins with the appointment and empowerment of the Special Litigation Committee (SLC), or another decision-making group, by the corporation's board.[78] After appointment, the decision-making group retains counsel and moves to stay discovery during the course of its intake investigation.[79] An investigation is conducted, frequently with the assistance of lawyers and other professionals.[80] After its review, the decision-making group issues a report containing its findings and ultimate conclusion to the board, the plaintiff, and the court.[81] Based on its recommendations, the decision-making group then either moves to permit the lawsuit to continue, adopt the claims and proceed in the lawsuit on the corporation's behalf, or moves to dismiss.[82] But beyond these generalities, the procedure and standards applied under *Zapata* and the Texas Statute differ in very material ways.[83]

1. Differences Between Zapata *and the Texas Statute*

A properly empowered group of disinterested directors known as an SLC can properly act under Delaware Code § 141 to investigate and determine the course of the derivative litigation.[84] If the group is a minority of the board of directors, they must be delegated by the board's full authority to determine the

74. Zapata Corp. v. Maldonado, 430 A.2d 779, 785–86 (Del. 1981).
75. *Id.* at 788.
76. TEX. BUS. ORGS. CODE ANN. §§ 21.553–.556, 21.558 (West 2012).
77. Auerbach v. Bennett, 393 N.E.2d 994, 1002–03 (N.Y. 1979).
78. BUS. ORGS. CODE § 21.554.
79. BUS. ORGS. CODE § 21.555.
80. BUS. ORGS. CODE § 21.556.
81. BUS. ORGS. CODE § 21.558; *see also* Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981).
82. BUS. ORGS. CODE § 21.558; *see also Zapata*, 430 A.2d at 788–89.
83. *See infra* Part II.C.1. *Compare* TEX. BUS. ORGS. CODE ANN. § 21.551–.563 (West 2012) (giving no power to courts to exercise their own business judgment), *with Zapata*, 430 A.2d at 788–79 (permitting courts to use their own business judgment in shareholder derivative lawsuits).
84. DEL. CODE ANN. tit. 8, § 141 (West 2011).

proper course of action.[85] As set forth in *Zapata*, the court must apply a two-step framework when deciding whether to grant the SLC's motion to dismiss.[86]

"First, the Court should inquire into the independence and good faith of the [SLC] and the bases supporting its conclusions."[87] In this inquiry, the committee has the burden of proof.[88] If the court is satisfied that the SLC "was independent and showed reasonable bases for good faith findings and recommendations, the [c]ourt may proceed . . . to the next step."[89]

Second, the court has the discretion, but not the obligation, to apply its own business judgment to determine whether the motion should be granted.[90] This step is designed "to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest."[91]

Alternatively, the SLC could decide to pursue the litigation or allow the plaintiff to do so.[92] If the SLC files a motion to dismiss, Delaware courts generally limit discovery to the issues relevant to the *Zapata* inquiry.[93]

The Texas Statute is markedly different from *Zapata* because it forbids courts from exercising their own business judgment, thereby "emasculat[ing] the business judgment doctrine."[94] This concept is apparent in § 21.558(a), which states:

> **§ 21.558. Dismissal of Derivative Proceeding**
> (a) A court shall dismiss a derivative proceeding on a motion by the corporation if the person or group of persons described by Section 21.554 determines in good faith, after conducting a reasonable inquiry and based on factors the person or group considers appropriate under the circumstances, that continuation of the derivative proceeding is not in the best interests of the corporation.[95]

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85. *Id.*
86. *Zapata*, 430 A.2d at 788.
87. *Id.*
88. *Id.* at 788–89.
89. *Id.* at 789.
90. *Id.* A court should apply its own business judgment under the second step only if the result reached by the SLC is "irrational" or "egregious." Carlton Invs. v. TLC Beatrice Int'l Holdings, Inc., No. Civ. A. 13950, 1997 WL 305829, at *2 (Del. Ch. 1997).
91. *Zapata*, 430 A.2d at 789.
92. *Id.* at 788.
93. *E.g.*, *Carlton*, 1997 WL 305829, at *2; Kaplan v. Wyatt, No. 6361, 1984 WL 8274, at *2–4 (Del. Ch. 1984).
94. *See* Auerbach v. Bennett, 393 N.E.2d 994, 1002 (N.Y. 1979).
95. TEX. BUS. ORGS. CODE ANN. § 21.558(a) (West 2012).

The plain text does not state, or even imply, that the court can evaluate the basis for the decision not to proceed, and the factors for dismissal are left solely to the discretion of the individuals making the decision.[96]

Other key differences between Delaware's *Zapata* approach and the Texas Statute are as follows: (1) a specific stay mechanism;[97] (2) specific discovery limitations;[98] (3) the option to request that a court appoint one or two non-directors to make the determination;[99] and (4) a mechanism for payment of attorneys' fees and expenses by the corporation if the proceeding resulted in substantial benefit, and by the plaintiff if the action was brought or maintained for an improper purpose.[100]

Only §§ 21.555 (Discovery), 21.560 (Discontinuance), and 21.561 (Payment of Expenses), "which are procedural provisions," apply to suits against foreign corporations maintained in Texas courts.[101] Otherwise, the statute states that a derivative proceeding brought in the name of a foreign corporation is governed by the laws of the jurisdiction of incorporation of the foreign corporation.[102]

2. Critical Issues Under Both Zapata *and the Texas Statute*

Under both *Zapata* and the Texas Statute, director independence is critical.[103] A director is independent when he is in a position to base his decision on the merits of the issue rather than being governed by extraneous considerations or influences.[104] When applying this standard to an SLC's decision to terminate derivative litigation, the court must examine the totality of the circumstances.[105] These circumstances include the following:

> (1) a committee member's status as a defendant, and potential liability; (2) a committee member's participation in or approval of the alleged wrongdoing; (3) a committee member's past or present business dealings with the corporation; (4) a committee member's past or present business or social

96. *See id*. Frequently, however, practitioners in this practice area have argued that the "good faith" inquiry invites a review of the reasonableness of the decision itself. *See id.* Thus far, courts have not given credence to this approach.

97. TEX. BUS. ORGS. CODE ANN. § 21.555 (West 2012).

98. *See* TEX. BUS. ORGS. CODE ANN. § 21.556 (West 2012).

99. *See* TEX. BUS. ORGS. CODE ANN. § 21.554 (West 2012).

100. *See* TEX. BUS. ORGS. CODE ANN. § 21.561 (West 2012).

101. TEX. BUS. ORGS. CODE ANN. § 21.562(a) (West 2012).

102. *Id.* These three procedural sections may provide tactical options to a corporation that in many cases may otherwise be unavailable if the suit had been brought in a different forum. *See id.*

103. *See* BUS. ORGS. CODE § 21.562; Zapata Corp. v. Maldonado, 430 A.2d 779, 788–89 (Del. 1981).

104. Kaplan v. Wyatt, 499 A.2d 1184, 1189 (Del. 1985).

105. Strougo *ex rel*. The Brazil Fund, Inc. v. Padegs, 27 F. Supp. 2d 442, 448 (S.D.N.Y. 1998) (applying Delaware law).

> dealings with individual defendants; (5) the number of directors on the committee; and (6) the "structural bias" of the committee.[106]

In addition, courts have indicated that the appointment of independent counsel is a factor supporting a finding of independence.[107] Independence, however, does not require the complete absence of any facts that might point to non-objectivity.[108]

In *Kaplan v. Wyatt*, the Delaware Supreme Court held that an oil corporation's two-member SLC acted independently, even though one of the members was on the corporation's board at the time the issue arose, had investments and affiliations with the companies conducting substantial business with the corporation, may have had a bias in favor of oil company executives, and worked directly with the corporation's officer when conducting the investigation.[109] The court sided with the SLC because the plaintiff failed to show how any of these factors prevented the committee member or the SLC from basing their decisions on the merits of the issues.[110]

The *Kaplan* court concluded that the mere fact that the committee member was on the board when the actions at issue occurred did not suggest that he did not make a disinterested judgment on whether the litigation should proceed.[111] The court noted that this non-presumption would apply even if the committee member originally approved the contested actions.[112] The court also reasoned that the committee member's affiliation with the entities transacting business with the corporation did not taint the process because there was no evidence that personal dealings between the committee members and the corporation influenced his judgment.[113] The court stated that the plaintiffs' general allegations of bias in favor of oil company executives were insufficient to show interest.[114] In addition, the court concluded that direct participation by corporate officers and counsel in the SLC's investigation did not prevent independence.[115] Although the court admitted the practice was less than ideal, it ultimately decided that the corporation's participation was not fatal because the plaintiff failed to show "that the presence of the corporate officers influenced those being interviewed, altered the outcome of the investigation, or impaired the independence of the Committee in making its report."[116]

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106. *In re* Oracle Sec. Litig., 852 F. Supp. 1437, 1441 (N.D. Cal. 1994) (citing *Kaplan*, 499 A.2d at 1189).
107. *E.g.*, *Brazil Fund*, 27 F. Supp. 2d at 451.
108. *In re Oracle Sec. Litig.*, 852 F. Supp. at 1442.
109. *Kaplan*, 499 A.2d at 1190.
110. *Id.*
111. *Id.* at 1189.
112. *Id.*
113. *Id.*
114. *Id.* at 1189–90.
115. *Id.* at 1190.
116. *Id.*

Other courts have followed *Kaplan*'s lead. In *Bach v. National Western Life Insurance Co.*, the Fifth Circuit held that there was no fact issue regarding the independence of an insurance company's two-person SLC, even though both members were executives of some other insurance companies, voted to reimburse directors for litigation expenses, and attended a semi-social meeting with interested parties at a resort.[117] In *Strougo ex rel. The Brazil Fund, Inc. v. Padegs*, the court held that a two-member SLC had acted independently despite the fact that one of the committee members had initially been a defendant, approved the transaction in question, arguably had personal or family ties with one of the defendants, and the other member had been recommended by an interested law firm.[118] In reaching its conclusion, the court noted that "if independent litigation committees are to be utilized, courts must accept the likelihood that its members will have experience similar to that of the defendant directors."[119]

Note that issues of privilege frequently become a focal point. For example, the SLC or other decision-making group may itself review highly sensitive and privileged information in the course of its work. It seems illogical that review of such material would operate as an absolute waiver of any privilege. But in the context of potential or pending shareholder litigation, the privilege is subject to the right of the shareholders to show cause why it should not be invoked in a particular instance.[120] But communications between the corporation's counsel and the decision-making group's counsel about the derivative lawsuit itself may not be privileged, especially prior to a decision to terminate the lawsuit.[121] It is not certain whether the joint-defense privilege applies at all to communications before there is a pending lawsuit.[122] Moreover, it is far from certain that the decision-making group and the corporation's board, management, and counsel would have similar interests prior to any determination.[123]

Interviews of key personnel are generally necessary in an investigation. These, like any communications with third-party witnesses, typically do not fall within the privilege.[124] Corporate clients cannot immunize the witness

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117. Bach v. Nat'l W. Life Ins. Co., 810 F.2d 509, 512–13 (5th Cir. 1987). *But see* Lewis v. Fuqua, 502 A.2d 962, 966–67 (Del. Ch. 1985) (holding that, when considered as a whole, the fact that the sole member of the SLC was a member of the board at the time the challenged actions occurred, was a defendant in the suit, had numerous financial and political dealings with the company's CEO, and was president of a university that had received substantial contributions from the company, raised a question of fact as to whether the member could act independently because "[i]f a single member committee is to be used, the member should, like Caesar's wife, be above reproach").

118. Strougo *ex rel.* The Brazil Fund, Inc. v. Padegs, 27 F. Supp. 2d 442, 449–51 (S.D.N.Y. 1998).

119. *Id.* at 449.

120. Wal-Mart Stores, Inc. v. Ind. Elec. Workers Pension Trust Fund IBEW, 95 A.2d 1264, 1278 (Del. 2014) (expressly adopting Garner v. Wolfinbarger, 430 F.2d 1093 (5th Cir. 1970)).

121. *See id.*

122. *Id.*

123. *Id.*

124. Methodist Home v. Marshall, 830 S.W.2d 220, 224 (Tex. App.—Dallas 1992, no writ).

statements by revealing them to the attorney.[125] Likewise, an attorney cannot protect a witness statement under the attorney–client privilege by relaying it to the client.[126] And in any event, the witness statements are not work product, even if made or prepared in anticipation of litigation or trial.[127]

An SLC or other decision-making group can consider a wide variety of factors in determining whether the suit is in the corporation's best interest. The factors considered include the following: (1) the merits of the derivative action (i.e., whether the complaint states a cause of action and is supported by substantial evidence); (2) the costs of litigation exacerbated by likely indemnification; (3) the waste of management's time and energy; (4) the extent of the injury resulting to the corporation from the acts or transactions giving rise to the lawsuit; (5) the damage to customer and supplier relations that will result from publicity from the trial; (6) the damage to employee morale; (7) the impairment of management's ability to run the ongoing business of the corporation; (8) the likelihood that similar acts or transactions will recur; and (9) the possibility of adverse consequences relating to the corporation's insurance coverage.[128]

Focusing on the burden of proof can be important.[129] Frequently, an investigation will evaluate related-party transactions that are ultimately governed by the "entire fairness" standard set forth in *Kahn v. Tremont Corp*.[130] Under Delaware law, a § 144 transaction challenged by its stockholder will be upheld if found to be entirely fair to the corporation.[131] The burden of showing fairness generally rests with the defendant.[132] In the context of an investigation, however, the inquiry is different.[133] There, the ultimate defendant may not have to "prove" the entire fairness of the transaction because the decision-making body's inquiry is not limited to the ultimate success of the litigation alone.[134] It is not only acceptable, but also appropriate, to consider business issues when determining whether to bring a claim or allow the plaintiff to proceed.[135]

This process presents unique discovery issues—both *Zapata* and the Texas Statute limit the discovery plaintiffs may obtain in order to contest any

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125. *Id.*

126. *See id.*

127. TEX. R. CIV. P. 192.3(h).

128. *See* Abella v. Universal Leaf Tobacco Co., 546 F. Supp. 795, 801 n.13 (E.D. Va. 1982); Genzer v. Cunningham, 498 F. Supp. 682, 695–96 (E.D. Mich. 1980); Maldonado v. Flynn, 485 F. Supp. 274, 284 n.35 (S.D.N.Y. 1980), *rev'd in part*, 671 F.2d 729 (2d Cir. 1982) (per curiam); Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981); Auerbach v. Bennett, 393 N.E.2d 994, 1002 (N.Y. 1979).

129. Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997) (en banc).

130. *Id.*

131. *See id.* at 429.

132. *Id.* at 428. The burden of proof, however, can shift to the plaintiff if the transaction is approved by a well-functioning and fully informed committee of independent directors. *Id.*

133. *But see id.*

134. *But see id.*

135. *See supra* note 128 and accompanying text.

recommendation issued by the decision-making group.[136] This discovery, however, generally includes the investigation report, depositions of members, documents relating to the creation and appointment of that body, communications between that group and the individual defendants, and witness interviews.[137] Plaintiffs typically cannot depose individuals interviewed in the course of their work or the decision-making group's counsel, nor can they obtain document discovery of all the items reviewed by decision-making group's counsel.[138]

D. A Note on Closely Held Corporations

The Texas Statute gives courts the discretion to give shareholders in closely held corporations relief from the demand requirement or the special committee process when it comes to their ability to bring what would otherwise be derivative claims against directors and management.[139] In this regard, § 21.563 provides:

> **§ 21.563. Closely Held Corporation**
> (a) In this section, "closely held corporation" means a corporation that has:
> (1) fewer than 35 shareholders; and
> (2) no shares listed on a national securities exchange or regularly quoted in an over-the-counter market by one or more members of a national securities association.
> (b) Sections 21.552–21.559 do not apply to a closely held corporation.
> (c) If justice requires:
> (1) a derivative proceeding brought by a shareholder of a closely held corporation may be treated by a court as a direct action brought by the shareholder for the shareholder's own benefit; and
> (2) a recovery in a direct or derivative proceeding by a shareholder may be paid directly to the plaintiff or to the corporation if necessary to protect the interests of creditors or other shareholders of the corporation.[140]

Despite this favorable treatment, several courts of appeals' decisions interpreted the word "oppressive" in the Texas receivership statute—Texas Business Organization Code § 11.404 and its predecessor, Article 7.05 of the Texas Business Corporations Act—as giving minority shareholders in closely

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136. *Compare* Carlton Invs. v. TLC Beatrice Int'l Holdings, Inc., No. Civ. A. 13950, 1997 WL 305829, at *2 (Del. Ch. 1997), *and* Kaplan v. Wyatt, No. 6361, 1984 WL 8274, at *2–4 (Del. Ch. 1984), *with* TEX. BUS. ORGS. CODE ANN. § 21.556 (West 2012) (limiting discovery to "(1) facts relating to whether the [SLC] is independent and disinterested; (2) the good faith of the inquiry and review by the [SLC]; and (3) the reasonableness of the procedures followed by the [SLC] in conducting the review").

137. *E.g.*, *Carlton Invs.*, 1997 WL 305829, at *2; *Kaplan*, 1984 WL 8274, at *2–4.

138. *See Carlton Invs.*, 1997 WL 305829, at *2; *Kaplan*, 1984 WL 8274, at *2–4.

139. TEX. BUS. ORGS. CODE ANN. § 21.563 (West 2012).

140. *Id.*

held corporations special treatment.[141] In particular, the 1988 decision *Davis v. Sheerin* held that the receivership statute authorized Texas courts to invoke their "general equity power[]" to award the oppressed stockholder a draconian buyout as a remedy.[142] The Texas Supreme Court foreclosed this possible remedy.

On February 26, 2014, the Texas Supreme Court issued its opinion in *Ritchie v. Rupe*, holding: (1) Texas does not recognize a "common-law cause of action for 'minority shareholder oppression,'" and (2) the "appointment of a rehabilitative receiver is the only remedy . . . for oppressive actions" by corporate management.[143]

Ann Caldwell Rupe, a minority shareholder in a closely held corporation, brought suit against the controlling shareholders, asserting claims for breach of fiduciary duty and oppressive conduct and seeking the appointment of a receiver to liquidate the corporation.[144] At trial, the jury found in Rupe's favor on essentially all of her claims and found the fair value of Rupe's stock to be $7.3 million.[145] The trial court found that the alleged oppressive conduct was likely to continue and that the most equitable remedy was to require the corporation to redeem Rupe's shares.[146] The court of appeals affirmed the finding of oppressive conduct but concluded the trial court had erred by instructing the jury not to discount the value of Rupe's shares for the lack of marketability and control.[147]

The Texas Supreme Court reversed and remanded.[148] The supreme court's opinion held that § 11.404 under the Texas Statute "creates a single cause of action with a single remedy: an action for appointment of a rehabilitative receiver."[149] In so holding, the court curtailed a minority shareholder's ability to use the threat of a court-ordered buyout to extract unwarranted value from majority shareholders.[150] Without a common-law cause of action, shareholders are limited to the confines of § 11.404(a)(1).[151] While the Texas Statute allows appointment of a receiver in response to oppressive conduct, the court also held that oppressive in this context means instances in which the majority abuses their authority with the intent to harm the interests of one or more shareholders in a manner that does not comport

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141. *See, e.g.*, Argo Data Res. Corp. v. Shagrithaya, 380 S.W.3d 249, 265 (Tex. App.—Dallas 2012, pet. denied).

142. Davis v. Sheerin, 754 S.W.2d 375, 379 (Tex. App.—Houston [1st Dist.] 1988, writ denied), *disapproved of by* Ritchie v. Rupe, 443 S.W.3d 856 (Tex. 2014); *see also Argo*, 380 S.W.3d at 265.

143. *Ritchie*, 443 S.W.3d at 876–77.

144. *Id.* at 860.

145. *Id.*

146. *Id.* at 862–63.

147. *Id.*

148. *Id.*

149. *Id.* at 872.

150. *See id.* at 876–78.

151. *See id.* at 879.

with the honest exercise of their business judgment.[152] In other words, the Texas Supreme Court has confirmed the standards for contesting corporate decisions in closely held corporations are the same as the standards for doing so in widely held corporations.

III. THE TEXAS COURTS' STRUGGLE TO INTERPRET §§ 21.562, 21.554, AND 21.558

Since 2006, Texas courts have wrestled with three of the most critical sections of the Texas Statute—§§ 21.562, 21.554, and 21.558. Section 21.562 identifies which parts of the statute are procedural and which are substantive.[153] Sections 21.554 and 21.558 created the Texas version of the SLC process.[154] All of these sections contain elements of procedure that are inconsistent with the Texas Rules of Civil Procedure that Texas courts are accustomed to applying.[155] These three sections, unfortunately, are not the model of clarity. This has forced courts to interpret a great deal.

A. Confusion Created by the Substantive Procedural Scheme in § 21.562 in Cases Involving Foreign Corporations

One particularly vexing part of the Texas Statute is the manner in which it describes the procedural and substantive elements of corporate affairs, particularly when it involves a foreign corporation.[156] Then, the threshold question becomes which aspects of the proceeding are procedural and which are substantive. At first blush, § 21.562, which purports to instruct courts which aspects of the proceeding the Texas Statute will govern and which aspects the jurisprudence of the foreign jurisdiction will govern, appears straightforward:

> **§ 21.562. Application to Foreign Corporations**
> (a) In a derivative proceeding brought in the right of a foreign corporation, the matters covered by this subchapter are governed by the laws of the jurisdiction of incorporation of the foreign corporation, except for Sections 21.555, 21.560, and 21.561, which are procedural provisions and do not relate to the internal affairs of the foreign corporation.
> (b) In the case of matters relating to a foreign corporation under Section 21.554, a reference to a person or group of persons described by that section

152. *Id.* at 876–77.

153. TEX. BUS. ORGS. CODE ANN. § 21.562 (West 2012).

154. *See* TEX. BUS. ORGS. CODE ANN. §§ 21.554, 21.558 (West 2012).

155. *See* BUS. ORGS. CODE §§ 21.562, 21.554, 21.558.

156. *See id.* The same problem arises when the business entity is not a creature of the TBO—a non-profit or an electric cooperative. *See* Denton Cnty. Elec. Coop., Inc. v. Hackett, 368 S.W.3d 765, 774–84 (Tex. App.—Fort Worth 2012, pet. denied) (grappling with issues under the Texas Electric Cooperative Corporation Act).

> refers to a person or group entitled under the laws of the jurisdiction of incorporation of the foreign corporation to review and dispose of a derivative proceeding. The standard of review of a decision made by the person or group to dismiss the derivative proceeding shall be governed by the laws of the jurisdiction of incorporation of the foreign corporation.[157]

But the last eight years has demonstrated that the proverbial devil is in the details.

The struggle posed by § 21.562 first manifested when the Eleventh Court of Appeals (sitting in Eastland) decided *Moonlight Investments, Ltd. v. John* in 2006.[158] In the trial court, the defendants moved to dismiss, arguing: (1) under the applicable Maryland law, the plaintiff failed to adequately allege demand futility; and (2) dismissal was the proper remedy based on the statute's use of "dismiss" in § 5.14(F) (now § 21.558).[159] The trial court granted the motion, dismissing without prejudice, and the plaintiff appealed.[160] The court of appeals first agreed that Maryland substantive law applied and the plaintiff failed to adequately allege demand futility.[161] But then the court was forced to grapple with the propriety of the remedy of dismissal.[162] The court noted that under the Texas Rules of Civil Procedure there was not, at the time, a motion to dismiss the petition per se.[163] Rather, a defendant must challenge a defective pleading by filing special exceptions under Texas Rule 91.[164] If the trial court finds the pleading defective, it cannot dismiss the lawsuit without first giving the plaintiff an opportunity to replead.[165]

Turning then to the issue at hand, the court of appeals' effort to apply the statute produced an unusual result. Indeed, the court observed how dismissal would have been the proper remedy *in Maryland* when a shareholder filed suit against a *Maryland corporation* before either making a demand or adequately pleading a proper excuse.[166] Given the clear wording of § 21.553, the court observed, dismissal would be the proper remedy *in Texas* if a shareholder filed suit against a *Texas corporation* before making a demand.[167] But, as the court observed, this was a suit *in Texas* against a *Maryland corporation*.[168] Since

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157. BUS. ORGS. CODE § 21.562.

158. *See generally* Moonlight Invs., Ltd. v. John, 192 S.W.3d 890 (Tex. App.—Eastland 2006, pet. denied) (involving a dispute between a shareholder, board members, officers, and auditors of a corporation).

159. *Id.* at 891–92. The defendants' request for dismissal specially excepted to the plaintiff's petition in the alternative. *Id.* at 893.

160. *Id.* at 890.

161. *Id.* at 893.

162. *Id.* at 893–94.

163. *Id.* at 893; *see* TEX. R. CIV. P. 91.

164. *Moonlight*, 192 S.W.3d at 893.

165. *Id.*; *see also* Ford v. Performance Aircraft Servs., Inc., 178 S.W.3d 330, 336 (Tex. App.—Fort Worth 2005, pet. denied) (holding that a "trial court may not dismiss a case after sustaining special exceptions without first giving the nonexcepting party an opportunity to amend its pleadings").

166. *Moonlight*, 192 S.W.3d at 893.

167. *Id.*

168. *See id.* at 891.

§ 21.562 did not list § 21.553 among the provisions applicable to foreign corporations, the trial court erred by not reverting back to Texas Rule 91 and failing to allow plaintiffs to replead prior to dismissing the lawsuit.[169] When compared with the express intent of the Texas Legislature to pass "modern" business laws, the result in *Moonlight* seems rather arcane.

Two years later, the Fourteenth Court of Appeals (sitting in Houston) had to grapple with the impact of *Moonlight* in a mandamus proceeding in a derivative shareholder suit filed against Crown Castle International Corp., a Delaware corporation.[170] In that case, the defendants filed special exceptions under Texas Rule 91, consistent with *Moonlight*, averring that the plaintiffs had neither made a demand nor alleged futility adequately.[171] The plaintiffs responded by serving discovery, and the corporation objected.[172] Rejecting the corporation's argument that it was not required under Delaware substantive law to produce discovery until after the plaintiffs had properly pleaded futility, the court ordered the corporation to provide the discovery.[173] The mandamus proceeding ensued to stop the discovery.[174]

The plaintiffs, citing *Moonlight*, argued that discovery was appropriate under Texas procedural rules despite pending special exceptions.[175] Further, it pointed to the fact that none of the procedural provisions identified in § 21.562 prevented discovery from proceeding under normal Texas rules.[176] Following the logic of *Moonlight*, one might have anticipated the plaintiffs would get the requested discovery. But the court of appeals applied different logic. It began by explaining that *Moonlight* held that dismissal would have been the proper remedy under the laws of the state of incorporation, and the proper procedure under Texas law was to sustain special exceptions and allow the plaintiffs the opportunity to replead.[177] The court noted that in this case, the trial court had followed that procedure and dismissed only after the plaintiffs had not done so.[178]

The court then turned to Delaware law, finding that its preclusion of discovery to demonstrate demand futility was substantive—not a "technical rule of pleading."[179] In reaching this result, the court relied on well-settled

169. *Id.* at 894.

170. *See generally In re* Crown Castle Int'l Corp., 247 S.W.3d 349 (Tex. App.—Houston [14th Dist.] 2008, pet. denied) (involving a shareholder derivative suit).

171. *See id.* at 351.

172. *Id.*

173. *See id.* at 352.

174. *See id.*

175. *See id.* at 354.

176. *See id.*

177. *See id.*

178. *Id.*

179. *Id.*

Delaware authority.[180] Construing the ability to replead as "procedural" but precluding discovery to amend that same pleading as "substantive" seems to be drawing a very fine line.[181] So a different court of appeals facing these same facts might conclude—quite logically—that discovery is, as it is in most instances, purely a procedural matter. Moreover, a court faced with substantive law of some state other than Delaware might reach a different result applying the same reasoning.

Later in 2008, the Fifth Court of Appeals (sitting in Dallas) issued its decision in *Connolly v. Gasmire*, which followed *Moonlight*'s reasoning.[182] *Connolly*, which involved a Delaware corporation, held that Texas Rule 91 was the correct procedural vehicle for challenging the adequacy of a shareholder derivative action's demand futility allegations.[183] But unlike in *Crown Castle*, the propriety of allowing a plaintiff to conduct post-petition discovery to amend and supplement demand futility allegations was not part of the court's holding.[184] Rather, the focus was simply on the adequacy of the allegations pleaded with particularity.[185] The trial court had allowed the plaintiff to replead, but the plaintiff declined.[186] The court found Delaware Chancery Rule 23.1 "a substantive right designed to assure a shareholder gives the corporation the opportunity to rectify an alleged wrong without litigation."[187] On this basis, the court of appeals upheld the trial court's motion to dismiss based on insufficient allegations showing why a demand on the board would have been futile.[188]

Early in 2014, the Fourteenth Court of Appeals faced the conundrum of discovery in a context different than what it faced in *Crown Castle*. *In re Platinum Energy Solutions, Inc.*, unlike *Crown Castle*, involved an SLC formed to investigate the allegations made in the lawsuit.[189] After investigating the plaintiff's contentions, the SLC filed a motion to dismiss under § 21.558.[190]

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180. *See id.* (relying on Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90 (1991); Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040 (Del. 2004); Haber v. Bell, 465 A.2d 353 (Del. Ch. 1983); Stotland v. GAF Corp., Civ. A. No. 6876, 1983 WL 21371 (Del. Ch. 1983)).

181. *See id.*

182. Connolly v. Gasmire, 257 S.W.3d 831, 839 (Tex. App.—Dallas 2008, no pet.).

183. *See id.*

184. *See id.*

185. *See id.* at 843–52.

186. *Id.* at 838.

187. *Id.* at 840 n.4.

188. *See id.* at 851–52.

189. *See In re* Platinum Energy Solutions, Inc., 420 S.W.3d 342, 344 (Tex. App.—Houston [14th Dist.] 2014, no pet.).

190. *Id.* Section 21.558 provides:

> **§ 21.558. Dismissal of Derivative Proceeding**
>
> (a) A court shall dismiss a derivative proceeding on a motion by the corporation if the person or group of persons described by Section 21.554 determines in good faith, after conducting a reasonable inquiry and based on factors the person or group considers appropriate under the circumstances, that continuation of the derivative proceeding is not in the best interests of the corporation.

The SLC believed this action triggered the very limited discovery constraints of § 21.556.[191] The plaintiff, however, argued that § 21.562 did not list § 21.558 as applicable to derivative suits involving a foreign corporation, so the plaintiff was entitled to the broader discovery available under Nevada law, which itself looked to Delaware law.[192]

The court of appeals recognized that this tension exists because § 21.556 applies "Chapter 21's discovery limits to 'domestic or foreign' corporations, while [§ 21.562] omits Chapter 21's discovery limits from the list of statutory provisions applicable to foreign corporations."[193] Going further, the court found the two sections were in outright conflict and was unable to harmonize the two provisions to give effect to both.[194] Some of the tension may result from § 21.556 not being part of the MBCA's basic structure.[195] The plaintiffs argued that § 21.556 must yield because the discovery at issue here dealt with the "internal affairs" of the corporation.[196] The court disagreed, finding § 21.556 controlling because it dealt with "the narrower topic of discovery in a proceeding on a motion to dismiss the derivative action."[197] But this reasoning

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(b) In determining whether the requirements of Subsection (a) have been met, the burden of proof shall be on:

(1) the plaintiff shareholder if:

(A) the majority of the board of directors consists of independent and disinterested directors at the time the determination is made;

(B) the determination is made by a panel of one or more independent and disinterested persons appointed under Section 21.554(a)(3); or

(C) the corporation presents prima facie evidence that demonstrates that the directors appointed under Section 21.554(a)(2) are independent and disinterested; or

(2) the corporation in any other circumstance.

TEX. BUS. ORGS. CODE ANN. § 21.558 (West 2012).

191. *In re Platinum Energy Solutions*, 420 S.W.3d at 344. Section 21.556 provides in relevant part:

§ 21.556. Discovery

(a) If a domestic or foreign corporation proposes to dismiss a derivative proceeding under Section 21.558, discovery by a shareholder after the filing of the derivative proceeding in accordance with this subchapter shall be limited to:

(1) facts relating to whether the person or group of persons described by Section 21.558 is independent and disinterested;

(2) the good faith of the inquiry and review by the person or group; and

(3) the reasonableness of the procedures followed by the person or group in conducting the review.

(b) Discovery described by Subsection (a) may not be expanded to include a fact or substantive matter regarding the act, omission, or other matter that is the subject matter of the derivative proceeding.

TEX. BUS. ORGS. CODE ANN. § 21.556 (West 2012).

192. *In re Platinum Energy Solutions*, 420 S.W.3d at 344. Note, however, that Delaware's discovery limits may not in fact be broader than those imposed by § 21.557. *See supra* notes 93–102 and accompanying text.

193. *In re Platinum Energy Solutions*, 420 S.W.3d at 347–48 (citing Murray & Bittle, *supra* note 9, at 26–27).

194. *Id.* at 348.

195. *See* 2 MODEL BUS. CORP. ACT ANN. §§ 7.40–.47 (4th ed. 2013) (showing the absence of discovery).

196. *In re Platinum Energy Solutions*, 420 S.W.3d at 349.

197. *Id.* at 348.

does not explain why it is appropriate that § 21.556 controls, rather than the broad discovery allowed by the Texas Rules of Civil Procedure. Clearly, if the court had applied the reasoning of *Moonlight*, that would seem to be the case.[198] Even more importantly, the Texas Statute's discovery limits are tailored to the Texas dismissal procedure in § 21.558; Delaware's dismissal standard under *Zapata* is fundamentally different, so the Texas limits would seem inappropriate.[199] Moreover, this reasoning seems inconsistent with the earlier decision in *Crown Castle* by the same court of appeals. Both decisions looked to Delaware substantive law, but *Crown Castle* held that Delaware law dictated what discovery was allowed, while *Platinum Energy* held that Texas law dictated what discovery was allowed.[200] For all these reasons, a different court of appeals may well reach a different result in future litigation.

A recent change in the Texas Rules of Civil Procedure adds additional confusion. Effective March 1, 2013, the Texas Supreme Court adopted Texas Rule 91a, which, for the first time, gives defendants the right to move to dismiss "on the grounds that [a cause of action] has no basis in law or fact."[201] It is unknown how the courts will apply this new rule in derivative lawsuits or how it will interplay with prior decisions interpreting the Texas Statute. As noted in the discussion above, *Moonlight* and *Crown Castle* both dictated that Texas Rule 91 was the proper mechanism to challenge a shareholder's failure to make a demand when the derivative suit involved a foreign corporation.[202] Both cases did so because a motion to dismiss was not procedurally proper under the Texas Rules of Civil Procedure.[203] Thus, it would seem possible that *Moonlight* and *Crown Castle* could have been decided differently had Texas Rule 91a been available at the time those cases were decided. Nonetheless, it is important to note that Texas Rule 91a is more akin to Federal Rule of Civil Procedure (Federal Rule) 12(b)(6) than it is to Federal Rule 23.1 and Delaware Rule of Civil Procedure (Delaware Rule) 23.1.[204] Both Federal Rule 23.1 and Delaware Rule 23.1 are procedural mechanisms expressly applicable to challenging shareholder standing and demand futility in derivative actions.[205] Accordingly, confusion remains.

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198. *See* Moonlight Invs., Ltd. v. John, 192 S.W.3d 890, 894 (Tex. App.—Eastland 2006, pet. denied) (reverting to the normal Texas Rules of Civil Procedure for a derivative suit involving a foreign corporation in Texas state court).

199. *See supra* notes 93–102 and accompanying text.

200. *See In re* Crown Castle Int'l Corp., 247 S.W.3d 349, 353–55 (Tex. App.—Houston [14th Dist.] 2008, pet. denied); *In re Platinum Energy Solutions*, 420 S.W.3d at 348–50.

201. TEX. R. CIV. P. 91a.1.

202. *See supra* notes 158–81 and accompanying text.

203. *See supra* text accompanying notes 169, 173.

204. *Compare* TEX. R. CIV. P. 91a.1 (providing that a party may move to dismiss when the cause of action has "no basis in law or fact"), *with* FED. R. CIV. P. 12(b)(6) (providing that a party may move to dismiss for "failure to state a claim"), FED. R. CIV. P. 23.1 (setting forth pleading requirements in "Derivative Actions"), *and* DEL. CH. CT. R. 23.1 (setting forth pleading requirements in "Derivative Actions").

205. FED. R. CIV. P. 23.1; DEL. CH. CT. R. 23.1.

B. Confusion Created by Unanswered Procedural Questions Involving a Determination Under § 21.554 and a Motion to Dismiss Pursuant to § 21.558

When a Texas corporation receives a demand from a shareholder detailing potential claims, § 21.554 supplies the procedure for responding to the demand. This section states:

> **§ 21.554. Determination by Directors or Independent Persons**
> (a) A determination of how to proceed on allegations made in a demand or petition relating to a derivative proceeding must be made by an affirmative vote of the majority of:
>
> (1) the independent and disinterested directors of the corporation present at a meeting of the board of directors of the corporation at which interested directors are not present at the time of the vote if the independent and disinterested directors constitute a quorum of the board of directors;
>
> (2) a committee consisting of two or more independent and disinterested directors appointed by an affirmative vote of the majority of one or more independent and disinterested directors . . . ; or
>
> (3) a panel of one or more independent and disinterested persons appointed by the court on a motion by the corporation . . . .[206]

If the result of this procedure is a determination that pursuing the claims in the demand or in the petition is not in the corporation's "best interests," the corporation can file a motion to dismiss pursuant to § 21.558.[207] The factors on which the decision is to be based are, according to the statute, within the sole discretion of the decision makers—what they consider "appropriate under the circumstances."[208] And § 21.558's use of "shall" indicates that a court may not substitute its judgment for the judgment of the persons making the decision.[209]

The Fifth Court of Appeals issued a detailed opinion affirming the trial court's application of this process in *Johnson ex rel. MAII Holdings, Inc. v. Jackson Walker, L.L.P.*[210] In *MAII Holdings*, the Texas corporation—MAII Holdings—filed a motion requesting that the trial court appoint a decision maker under § 21.554(a)(3).[211] The trial court granted the motion.[212] The ensuing investigation over the course of several months concluded that continuation of the litigation was not in the best interests of the

206. TEX. BUS. ORGS. CODE ANN. § 21.554 (West 2012).

207. TEX. BUS. ORGS. CODE ANN. § 21.558 (West 2012). For the exact statutory language of § 21.558, *see supra* note 190.

208. BUS. ORGS. CODE § 21.558.

209. *See id.*

210. Johnson *ex rel.* MAII Holdings, Inc. v. Jackson Walker, L.L.P., 247 S.W.3d 765, 780 (Tex. App.—Dallas 2008, pet. denied).

211. *Id.* at 769–70.

212. *Id.* at 770.

corporation.[213] Under the limited discovery rules set forth in § 21.556, the plaintiff obtained a copy of the report documenting the investigation and the determination, the appendices to the report, some correspondence, and the fee bills of the individual conducting the investigation.[214] The trial court also allowed the plaintiff to take the deposition of the individual conducting the investigation.[215] The trial court then held a hearing on MAII Holding's motion to dismiss, at which it allowed live testimony.[216] The trial court granted the motion, entered a judgment, and made findings of fact and conclusions of law.[217]

The court of appeals reviewed the trial court's findings of fact for legal and factual sufficiency of the evidence, noting those findings would be set aside "only if the evidence is so weak or if the finding is so against the great weight and preponderance of the evidence."[218] Under that standard, the court of appeals affirmed.[219] The plaintiff argued on appeal that the process itself was unconstitutional, violated due process, and violated the open courts and right to a jury trial provisions of the Texas Constitution.[220] Interestingly, when the court rejected the plaintiff's argument that the Texas Statute's procedure for resolving a motion to dismiss violated the right to a jury trial, the court relied on the venerable 1889 opinion by the Texas Supreme Court in *Cates v. Sparkman*.[221] The court in *MAII Holdings* held a derivative suit is "historically an equitable matter," so, the court reasoned, the plaintiff was not entitled to a jury trial.[222] The court of appeals found it was appropriate that the trial court was the trier of fact.[223] Moreover, the court of appeals' reasoning is consistent with the comments to § 7.42 of the MBCA, as well as other authorities, and is consistent with the practice in Delaware that is most familiar to corporations.[224]

Several issues from the case, however, remain unaddressed. The plaintiff did not raise on appeal whether the trial court itself should have applied a summary judgment standard under Texas Rule 166a—i.e., should have applied an absence of material fact rather than a preponderance of the evidence

213. *Id.*
214. *Id.* For the exact statutory language of § 21.558, *see supra* note 190.
215. *MAII Holdings*, 247 S.W.3d at 770.
216. *Id.*
217. *Id.*
218. *Id.* at 773.
219. *Id.*
220. *Id.* at 780.
221. *Id.* at 778 (citing Cates v. Sparkman, 11 S.W. 846, 849 (Tex. 1889)).
222. *Id.* at 780 (quoting Ross v. Bernhard, 396 U.S. 531, 538 (1970)) (internal quotation marks omitted).
223. *Id.* at 774.
224. *See Ross*, 396 U.S. at 538 (noting that the shareholder's right to sue is an equitable matter and that there is a right to a jury matter only with respect to the equitable claim); *In re* Consumers Power Co. Derivative Litig., 132 F.R.D. 455, 464 n.21 (E.D. Mich. 1990) ("[I]t is consistent with the pedigree of derivative actions that consideration of who can act for the corporation should first be resolved by a judge before a trial . . . ."); 2 MODEL BUS. CORP. ACT ANN. § 7.42 cmt. 4 (4th ed. 2013) ("[I]f the corporation . . . after a derivative proceeding has commenced, decides to assume control of the litigation, the shareholder's right to commence or control the proceeding ends . . . .").

standard.[225] Moreover, as noted above, Texas Rule 91a permits a motion to dismiss for failure to state a claim, much like Federal Rule 12(b)(6).[226] But nothing in Rule 91a suggests the court can hear evidence and resolve factual issues, which obviously should be the case with a § 21.558 motion.[227] The Texas Statute gives neither direction on what standard of proof applies, nor any hint on what procedure a court should apply when deciding the motion to "dismiss" described in § 21.558.[228]

If the trial court sits as a court in equity, then these questions are little more than academic curiosities.[229] A court sitting in equity can hear evidence, resolve factual issues, render a judgment, and make findings of fact and conclusions of law. This is the procedure in Delaware that has worked well for decades.

Whether future judicial decisions will agree with the reasoning of *MAII Holdings* is uncertain, particularly given Texas courts' historical resistance to taking litigation out of the hands of juries. If a different court of appeals (or a district court located in a different court of appeals' jurisdiction) does not follow *MAII Holdings* and sit in equity, summary judgment appears to be the only option. This seems a procedural quagmire.

IV. A PROPOSAL FOR CLARITY

The vast majority of the uncertainty created by the Texas Statute stems from its failure to identify the type of procedural vehicle the legislature intends a court to use when deciding whether to dismiss a derivative suit. Absent legislative action, confusion for courts, lawyers, and corporations will persist for years—until a sufficient number of these issues have reached the Texas Supreme Court for a ruling. As suggested by this Article, however, the better approach would be to amend the Texas Statute to clarify the most significant questions raised over the last eight years. These questions are:

1. Does it make sense that the procedure for dismissal based on failure to make demand is the same for a Texas corporation in Texas court as it is for a Delaware corporation in Delaware court, but different for a Delaware corporation in Texas court?
2. Does it makes sense that the discovery limits in § 21.556 are applied to proceedings involving foreign corporations when those limits are

225. *MAII Holdings*, 247 S.W.3d at 765.

226. *See supra* note 204.

227. *See* TEX. BUS. ORGS. CODE ANN. § 21.558 (West 2012); TEX. R. CIV. P. 91a.

228. BUS. ORGS. CODE § 21.558.

229. *E.g.*, Johnson v. Diversicare Afton Oaks, LLC, 597 F.3d 673, 676 (5th Cir. 2010) (noting that in a non-jury case, a court "has somewhat greater discretion to consider what weight it will accord the evidence" (quoting *In re* Placid Oil Co., 932 F.2d 394, 397 (5th Cir. 1991)) (internal quotation marks omitted)).

omitted from the procedural provisions applicable to foreign corporations set forth in § 21.558?

3. Does it make sense that courts may apply summary judgment standards to a motion to dismiss under § 21.558, leaving a jury to decide any material facts in dispute as to the independence, disinterestedness, and good faith of the persons deciding whether to pursue derivative claims?

This Article respectfully suggests the answer to all three questions is no.

First, it seems fundamentally inconsistent with the legislature's intent to modernize Texas corporation law by allowing a Texas corporation to move to dismiss for failure to make demand but requiring a foreign corporation to file special exceptions. Neither does it seem appropriate to give different, and somewhat less preferential, treatment to foreign corporations that are headquartered in Texas and employ Texas citizens. Moreover, given that Texas Rule 91a now provides a mechanism for dismissal, the inconsistent treatment of a foreign corporation in the derivative context seems even less rational.[230] The following amendment is one possible way to rectify this problem. Proposed amendments are bolded and underlined below:

> **§ 21.553. Demand**
> (a) A shareholder **of a Texas corporation** may not institute a derivative proceeding until the 91st day after the date a written demand is filed with the corporation [setting forth] with particularity the act, omission, or other matter that is the subject of the claim or challenge and requesting that the corporation take suitable action.
> (b) The waiting period required by Subsection (a) before a derivative proceeding may be instituted is not required if:
> (1) the shareholder has been previously notified that the demand has been rejected by the corporation;
> (2) the corporation is suffering irreparable injury; or
> (3) irreparable injury to the corporation would result by waiting for the expiration of the 90–day period.
> **(c) No shareholder of a foreign corporation may commence a derivative proceeding without complying with the substantive legal requirements of the state of incorporation.**
> . . . .
> **§ 21.562. Application to Foreign Corporations**
> (a) In a derivative proceeding brought in the right of a foreign corporation, the matters covered by this subchapter are governed by the laws of the jurisdiction of incorporation of the foreign corporation, except for Sections **21.553,** 21.555, 21.560, and 21.561, which are procedural provisions and do not relate to the internal affairs of the foreign corporation.
> (b) In the case of matters relating to a foreign corporation under Section 21.554, a reference to a person or group of persons described by that section

230. *See* TEX. R. CIV. P. 91a.

> refers to a person or group entitled under the laws of the jurisdiction of incorporation of the foreign corporation to review and dispose of a derivative proceeding. The standard of review of a decision made by the person or group to dismiss the derivative proceeding shall be governed by the laws of the jurisdiction of incorporation of the foreign corporation.[231]

Similarly, a rule could easily address the potential procedural landmines highlighted by *MAII Holdings* for a Texas corporation in §§ 21.554 and 21.558.[232] The *MAII Holdings* opinion provides a roadmap that is consistent with the vast majority of corporate law across the country.[233] Making its holding binding in all Texas jurisdictions would create consistency and predictability in future derivative suits. It also seems appropriate to clarify that proceedings involving foreign corporations will be handled consistently. The legislature could establish consistency by amending the statute as follows:

> **§ 21.558. Dismissal of Derivative Proceeding**
> (a) A court shall**, sitting in equity as the finder of fact,** dismiss a derivative proceeding on a motion by the corporation if the person or group of persons described by Section 21.554 determines in good faith, after conducting a reasonable inquiry and based on factors the person or group considers appropriate under the circumstances, that continuation of the derivative proceeding is not in the best interests of the corporation.
> (b) In determining whether the requirements of Subsection (a) have been met, the burden of proof shall be on:
> (1) the plaintiff shareholder if:
> (A) the majority of the board of directors consists of independent and disinterested directors at the time the determination is made;
> (B) the determination is made by a panel of one or more independent and disinterested persons appointed under Section 21.554(a)(3); or
> (C) the corporation presents prima facie evidence that demonstrates that the directors appointed under Section 21.554(a)(2) are independent and disinterested; or
> (2) the corporation in any other circumstances.
> . . . .
> **§ 21.562. Application to Foreign Corporations**
> . . . .
> (b) In the case of matters relating to a foreign corporation under Section 21.554, a reference to a person or group of persons described by that section refers to a person or group entitled under the laws of the jurisdiction of incorporation of the foreign corporation to review and dispose of a derivative

231. *See* TEX. BUS. ORGS. CODE ANN. §§ 21.553, 21.562 (West 2012).
232. *See supra* notes 215–24 and accompanying text.
233. *See* Johnson *ex rel.* MAII Holdings, Inc. v. Jackson Walker, L.L.P., 247 S.W.3d 765, 772–77 (Tex. App.—Dallas 2008, pet. denied); *supra* notes 210–28 and accompanying text.

> proceeding. **The court shall, sitting in equity as the trier of fact,** ~~The standard of~~ review ~~of~~ a decision made by the person or group to dismiss the derivative proceeding ~~shall be governed by~~ **in accordance with** the laws of the jurisdiction of incorporation of the foreign corporation.[234]

Finally, *Crown Castle* and *Platinum Energy* raise fundamental questions of what discovery courts will allow in a derivative suit involving a foreign jurisdiction and what law governs.[235] Given the number of significant foreign corporations headquartered in the state, these problems will likely arise again. Of the two decisions (by the same court of appeals), *Crown Castle* seems the better reasoned—whether a shareholder can use discovery to satisfy the heightened pleading requirements of a foreign jurisdiction is a core substantive matter.[236] Section 21.562 did not list § 21.556 (Discovery) as procedural.[237] Even more importantly, *Platinum Energy* does not seem to anticipate that discovery would be different across jurisdictions because the standard for dismissal would be different.[238] For example, the standard for dismissal under *Zapata* is fundamentally different than the standard under the Texas Statute.[239] Thus, this seems like a critical issue the legislature should address, which it could accomplish by incorporating the following language in § 21.556:

> **§ 21.556. Discovery**
> (a) If a domestic ~~or foreign~~ corporation proposes to dismiss a derivative proceeding under Section 21.558, discovery by a shareholder after the filing of the derivative proceeding in accordance with this subchapter shall be limited to:
> (1) facts relating to whether the person or group of persons described by Section 21.558 is independent and disinterested;
> (2) the good faith of the inquiry and review by the person or group; and
> (3) the reasonableness of the procedures followed by the person or group in conducting the review.
> (b) Discovery described by Subsection (a) may not be expanded to include a fact or substantive matter regarding the act, omission, or other matter that is the subject matter of the derivative proceeding. . . .
> . . . .
> **§ 21.562. Application to Foreign Corporations**
> (a) In a derivative proceeding brought in the right of a foreign corporation, the matters covered by this subchapter are governed by the laws of the jurisdiction of incorporation of the foreign corporation, except for Sections

234. *See* TEX. BUS. ORGS. CODE ANN. §§ 21.558, 21.562 (West 2012).
235. *See supra* notes 170–98 and accompanying text.
236. *In re* Crown Castle Int'l Corp., 247 S.W.3d 349, 354–55 (Tex. App.—Houston [14th Dist.] 2008, pet. denied).
237. *See* BUS. ORGS. CODE § 21.562.
238. *See In re* Platinum Energy Solutions, Inc., 420 S.W.3d 342, 348–49 (Tex. App.—Houston [14th Dist.] 2014, no pet.).
239. *See supra* Part II.C.

> 21.555, 21.560, and 21.561, which are procedural provisions and do not relate to the internal affairs of the foreign corporation.
> (b) In the case of matters relating to a foreign corporation**,** ~~under Section 21.554, a reference to a person or group of person described by that section refers to a~~ **the** person or group entitled under the laws of the jurisdiction of incorporation of the foreign corporation to review and dispose of a derivative proceeding**, the scope of permissible discovery shall be governed by the laws of the jurisdiction of incorporation of the foreign corporation.** The standard of review of a decision made by the person or group to dismiss the derivative proceeding shall be governed by the laws of the jurisdiction of incorporation of the foreign corporation.[240]

It is important to note that § 21.562(b) of the current statute refers to § 21.554, implying it is somehow procedural and thus applicable to foreign corporations, despite the fact that § 21.554 is not listed in § 21.562(a).[241] Thus, this Article proposes that this reference to § 21.554 adds confusion and should be eliminated, just like the reference to "or foreign" corporations in § 21.556 that *Platinum Energy* could not harmonize with § 21.562. This Article suggests that the person or group entitled to review, discovery, and the review of the court's decision should all be governed by the law of jurisdiction of the foreign corporation. This change would then align the Texas Statute with the structure of the MBCA, adding consistency and predictability.

Practitioners may devise other solutions to these issues, or they may propose adaptations to the process different from those proposed here. These solutions, however, attempt to clarify the statute in a manner that is largely consistent with modern corporate law and, where logical, conforms to existing decisions by the court of appeals.

V. CONCLUSION

As noted above, Texas is a dynamic state and an economic power. But the development of its corporate law in the last sixteen years does not appear to have been sufficient to create a predictable corporate law environment for either Texas or foreign corporations. The Supreme Court of Texas has not had the opportunity to weigh in on even the most fundamental issues arising under the modern Texas Statute. Texas is at risk if it allows such uncertainty to persist. Major corporations residing in the state may begin requiring stockholders—and in some cases Texas residents—to retain counsel, and pursue litigation, in other states. That result would be bad not only for Texas stockholders, but also for the Texas legal system.

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240. *See* TEX. BUS. ORGS. CODE. ANN. §§ 21.556, 21.562 (West 2012).
241. *See* TEX. BUS. ORGS. CODE. ANN. §§ 21.554, 21.562 (West 2012).