

Court Holds That Promissory Note Did Not Allow Partial Conversion To Equity

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In *Hotze v. In Mgmt., LLC*, family members sued each other over control of a family business. No. 14-18-00995-CV, 2021 Tex. App. LEXIS 5821 (Tex. App.—Houston [14th Dist.] July 22, 2021, no pet. history). Three of the brothers ended up with greatly increased control of the company after debt the company owed to a partnership formed by the three brothers was partially converted into company stock. *Id.* Two other brothers and other associated parties filed two lawsuits, bringing both individual and derivative claims, which were consolidated for trial. “A key issue in the case was whether the promissory note between Troika and CECO authorized a partial conversion of debt for stock.” *Id.* The trial court concluded that it did, and instructed the jury to that effect. The two brothers appealed.

The court of appeals reversed, holding that that note did not allow partial conversion:

Appellees assert that these provisions unambiguously authorized a partial conversion of the note. Appellants argue the note unambiguously authorized only a complete and not a partial conversion and that the trial court erred in instructing the jury otherwise. We agree with appellants. To begin with, the note does not use the phrase or refer to the concept of partial conversion. See Tex. Bus. Org. Code §21.168 (requiring that convertible debt terms must be set forth in the debt instrument). Instead, paragraph 7 authorizes the holder (Troika) to “convert the outstanding aggregate amount of principal of this Note and unpaid interest accrued thereon into . . . common stock.” The adjective “aggregate” means “total,” “combined,” “formed by the conjunction or collection of particulars into a whole mass or sum.” The Random House Unabridged Dictionary 29 (2d ed. 1994). In paragraph 7, it is used to indicate that Troika could convert the outstanding total or combined amount of principal and unpaid accrued interest. It does not suggest Troika could convert a partial amount of the debt. Additionally, the note requires that the note itself must be surrendered to effect conversion. Paragraph 7 states, “Upon conversion, the Holder shall surrender this Note at Maker’s principal office.” Paragraph 8 provides that “conversion shall be deemed to have been made at the close of business on the date that the Note has been surrendered for conversion.” The note contains no provision for issuing a new note in the event of a partial conversion. These provisions confirm that only a complete conversion is authorized by the note.

Id. The court also emphasized that the terms must be in the note, and that the parties could not imply rights:

The outside directors additionally postulate, without explanation or citation to authority, that “if a party has the right to convert all of a note, it has the right to convert part of it.” There is no reason for this to be true. As stated, convertible debt terms must be set forth in the debt instrument. See Tex. Bus. Org. Code §21.168. There may be many reasons a borrowing corporation would not want to permit any conversion unless the entirety of the connected debt is dissolved through such conversion.

Id. The court concluded that this error of law (instructing the jury that the note allowed partial conversion) required a remand for a new trial:

They also argue that the 2018 ratification vote authorized partial conversion, even if the note or the original board resolution did not. See generally Tex. Bus. Orgs. Code §§ 21.901-.917 (governing ratification of defective corporate acts and shares). The issue, however, is not just whether the board authorized a conversion of debt to stock or later ratified such action; the issue is whether, given that Troika had no right to demand a partial conversion, when the board created and gave to Troika (a partnership wholly owned by members of CECO’s board) stock that amounted to over 96% of the outstanding voting shares in CECO in exchange for cancellation of a relatively small amount of debt (\$38,503.56 in principal and \$203,194.44 in interest, leaving \$2,461,496.44 in principal owed), did the board members commit any torts or statutory violations? Because the jury was repeatedly instructed in the charge that the note authorized partial conversion, the jury never considered the board’s actions in light of the fact that the note did not give Troika a right of partial conversion. The trial court’s error in construing the note permeated the trial and the charge and rendered many of the jury’s findings meaningless. A remand is therefore necessary for proper consideration of the board’s actions.

Id.

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