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# Choice of Entity and Tax Considerations

## Texas Bar CLE Essentials of Business Law: Practical Considerations

**DISCLAIMER:**

This is not intended nor should it be used as a substitute for legal advice or opinion, which can be rendered only when related to specific fact situations.





# Byron F. Egan – Bio Information

**Practice:** Byron F. Egan is a partner of *Jackson Walker L.L.P.* in Dallas. He is engaged in a corporate, partnership, securities, mergers and acquisitions (“M&A”) and financing practice. Mr. Egan has extensive experience in business entity formation and governance matters, M&A and financing transactions in a wide variety of industries including energy, financial and technology. In addition to handling transactions, he advises boards of directors and their audit, compensation and special committees with respect to fiduciary duty and other corporate governance issues, the Sarbanes-Oxley Act, special investigation and other issues.

**Involvement:** Mr. Egan is Senior Vice Chair and Chair of Executive Council of the M&A Committee of the American Bar Association and served as Co-Chair of its Asset Acquisition Agreement Task Force, which wrote the *Model Asset Purchase Agreement with Commentary*. He has been Chair of the Texas Business Law Foundation, the Business Law Section of the State Bar of Texas and that section’s Corporation Law Committee. On behalf of these groups, he has been instrumental in the drafting and enactment of many Texas business entity and other statutes. He is also a member of the American Law Institute.

**Honors:** For more than twenty-five years, Mr. Egan has been listed in The Best Lawyers in America under Corporate, M&A or Securities Law. He is a 2018 recipient of the Texas Lawyer Lifetime Achievement Award, a 2018 recipient of the Distinguished Alumni Award of the Highland Park Independent School District, and the 2015 recipient of the Texas Bar Foundation’s Dan Rugeley Price Memorial Award, which is presented annually to a lawyer who has an unreserved commitment to clients and to the legal profession. A four-time winner of the Burton Award for distinguished legal writing, in 2009 his article entitled “Director Duties: Process and Proof” was awarded the Franklin Jones Outstanding CLE Article Award and an earlier version of that article was honored by the State Bar Corporate Counsel Section’s Award for the Most Requested Article in the Last Five Years. Mr. Egan has been recognized as one of the top corporate and M&A lawyers in Texas by a number of publications, including *Corporate Counsel Magazine*, *Texas Lawyer*, *Texas Monthly*, *The M&A Journal* (which profiled him in 2005) and *Who’s Who Legal*. See [www.jw.com](http://www.jw.com) for additional information regarding his civic and other activities.

**Education:** Mr. Egan received his B.A. and J.D. degrees from the University of Texas. After law school, he served as a law clerk for Judge Irving L. Goldberg on the United States Court of Appeals for the Fifth Circuit.

**Publications:** Mr. Egan writes and speaks about the areas in which his law practice is focused, and is a frequent author and lecturer regarding M&A, governance of corporations, partnerships and limited liability companies, securities laws, and financing techniques. He is the author of the 2018 treatise *EGAN ON ENTITIES: Corporations, Partnerships and Limited Liability Companies in Texas*, which addresses the formation, governance and sale of business entities, including an analysis of the fiduciary duties of their governing persons in a variety of situations. In addition, Mr. Egan has written or co-authored the following law journal articles: **Corporate Governance:** *Fiduciary Duties of Corporate Directors and Officers in Texas*, 43 Texas Journal of Business Law 45 (Spring 2009); *Responsibilities of Officers and Directors under Texas and Delaware Law*, XXVI Corporate Counsel Review 1 (May 2007); **Entity Choice and Formation:** *Joint Venture Formation*, 44 Texas Journal of Business Law 129 (2012); *Choice of Entity Decision Tree After Margin Tax and Texas Business Organizations Code*, 42 Texas Journal of Business Law 171 (Spring 2007); *Choice of Entity Alternatives*, 39 Texas Journal of Business Law 379 (Winter 2004); *Choice of State of Incorporation – Texas Versus Delaware: Is it Now Time to Rethink Traditional Notions*, 54 SMU Law Review 249 (Winter 2001); **M&A:** *Confidentiality Agreements are Contracts with Long Teeth*, 46 Texas Journal of Business Law 1 (Fall 2014); *Private Company Acquisitions: A Mock Negotiation*, 116 Penn St. L. Rev. 743 (2012); *Asset Acquisitions: Assuming and Avoiding Liabilities*, 116 Penn St. L. Rev. 913 (2012); *Asset Acquisitions: A Colloquy*, X U. Miami Business Law Review 145 (Winter/Spring 2002); **Securities Law:** *Major Themes of the Sarbanes-Oxley Act*, 42 Texas Journal of Business Law 339 (Winter 2008); *Communicating with Auditors After the Sarbanes-Oxley Act*, 41 Texas Journal of Business Law 131 (Fall 2005); *The Sarbanes-Oxley Act and Its Expanding Reach*, 40 Texas Journal of Business Law 305 (Winter 2005); *Congress Takes Action: The Sarbanes-Oxley Act*, XXII Corporate Counsel Review 1 (May 2003); and **Legislation:** *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 41 Texas Journal of Business Law 41 (Spring 2005); *Texas Chancery Courts – The Missing Link to More Texas Entities*, Texas Bar Journal, Opinion Section, February 2016 Issue.





# Publications

- Treatise by Byron F. Egan entitled EGAN ON ENTITIES: Corporations, Partnerships and Limited Liability Companies in Texas (First Edition 2016 and Second Edition 2018) (the Second Edition, “**EGAN ON ENTITIES**”). The Second Edition is available from Corporation Service Company and LexisNexis: <https://www.cscglobal.com/blog/csc-publishing-egan-on-entities/>
- *M&A After the Tax Reform Act*, TexasBarCLE & Business Law Section of State Bar of Texas Choice, Governance & Acquisition of Entities Course, San Antonio, May 18, 2018 (“***Acquisition Structure paper***”): <http://www.jw.com/wp-content/uploads/2018/05/Byron-Egan-MA-After-the-Tax-Reform-Act-with-Appendices.pdfwww.jw.com/>
- *Joint Venture Governance and Business Opportunity Issues*, University of Texas School of Law 11th Annual Mergers and Acquisitions Institute, Dallas, October 15, 2015 (“***Joint Venture paper***”): [www.jw.com/joint-venture-governance-and-business-opportunity-issues/](http://www.jw.com/joint-venture-governance-and-business-opportunity-issues/)





# Five Business Entity Forms in Both Texas and Delaware

- Corporation
- General Partnership
- Limited Partnership
- Limited Liability Partnership (“LLP”)
- Limited Liability Company (“LLC”)

This program focuses on LLCs in Texas and Delaware, but discusses other entities for comparison and because courts in LLC cases may refer to precedent regarding other entities.



# Texas Secretary of State — Statistical Information

## Certificates of Formation Filed for Calendar Year 2018

Domestic For-Profit Corporation	24,135
Domestic Limited Liability Company	192,284
Domestic Limited Partnership	4,599
Domestic Nonprofit Corporation	12,830
Domestic Professional Corporation	686
Domestic Professional Association	408

## Domestic Limited Liability Partnership Statistics for Calendar Year 2018

Registrations of Domestic Limited Liability Partnership	417
Domestic LLP Registrations Maintained	3,287





# Texas Secretary of State — Statistical Information

## MASTER FILE STATISTICS AS OF JANUARY 1, 2019

Entity Type	Active Entities
Domestic For-Profit Corporation	366,017
Domestic Limited Liability Company	1,042,532
Domestic Limited Partnership	129,878
Domestic Nonprofit Corporation	153,211
Domestic Professional Corporation	17,686
Domestic Professional Association	19,300





# Delaware Secretary of State — Statistical Information

## Certificates of Formation Filed for Calendar Year 2018

Domestic For-Profit Corporation	44,169
Domestic Limited Liability Company	157,142
Domestic Limited Partnership	12,383
Domestic Public Benefit Corporations	1,669

## Master File Statistics for December 31, 2018 (Est.)

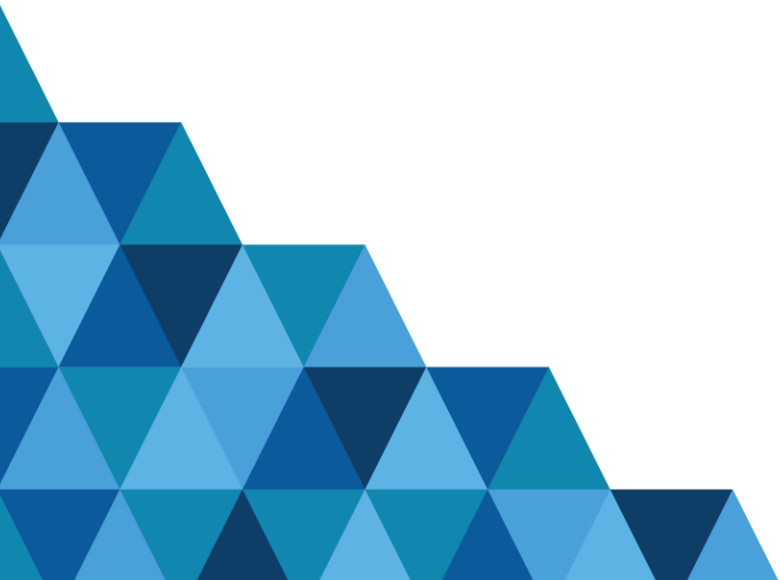
Entity Type	Active Entities
Domestic For-Profit Corporation	958,734
Domestic Limited Liability Company	983,734
Domestic Limited Partnership	101,818
Domestic Public Benefit Corporations	1,698



# Texas Business Organizations Code

- Enacted by the Texas Legislature in 2003.
- Referred to as "**TBOC**" or "**Code**".

See EGAN ON ENTITIES §1.3 (7-18)







# Texas Business Organizations Code

- Became effective for new entities formed under Texas law after January 1, 2006. **[TBOC §§ 1.002(20); 402.001]**
- After January 1, 2010, TBOC governs all Texas entities. **[TBOC § 402.005]**





# Texas Business Organizations Code

- TBOC codified source law.
- TBOC has been amended every Legislative Session in response to cases and other states' statutory changes.
- The TBOC spoke provisions principally applicable to LLCs are found in TBOC Title 3, Chapter 1, §§101.001 *et seq.* and the applicable hub provisions are principally in TBOC Title 1, Chapters 1-2.





# Delaware Limited Liability Company Act

- Delaware LLCs are formed under, and governed by, the Delaware Limited Liability Company Act (“DLLCA”).






# Federal Income Taxes

## Prior to Tax Cuts and Jobs Act of 2017

[EGAN ON ENTITIES Appendix A (621-643)]

- **“Check-the-Box”** Regulations [EGAN ON ENTITIES Appendix A 621-626]
- Corporations
  - Rates 15%-35%
  - Shareholders taxed on dividends at 20% plus 3.8% Unearned Income Medicare Contribution Tax (“net investment income tax”) on the lesser of (1) the taxpayer’s net investment income for the tax year or (2) the excess of modified adjusted gross income for the tax year over the threshold amount of \$200,000 (\$250,000 in the case of joint filers and surviving spouses, and \$125,000 in the case of a married taxpayer filing separately)
- Partnerships and LLC
  - “Flow thru” entities with no entity level tax
  - Tax at owner level





# Federal Income Taxes

## After Tax Cuts and Jobs Act of 2017 (the "Tax Act")

- Corporations
  - Flat tax rate: 21%
  - Immediate deduction of depreciable tangible assets, including assets acquired from a third party
  - Interest deduction limited to approximately 30% of EBITDA
- Partnerships and LLC
  - "Flow thru" entities with no entity level tax
  - Tax at owner level at individual rates ranging up to 37% plus 3.8% Medicare Contribution Tax on self-employment income (see prior slide)
  - Noncorporate investors in businesses (other than specified service businesses) conducted through partnerships and LLCs can deduct approximately 20% of their business income subject to income limits





# Texas Margin Tax

## [EGAN ON ENTITIES Appendix B (645-689)]

- Enacted in 2006
- Margin Tax Returns due May 15 for calendar year tax payers.
- Applies to all business entities.
  - Exceptions: (i) general partnerships which are not LLPs and all of whose partners are individuals and (ii) entities 90% of whose gross income is from narrowly defined passive income sources.
  - Does not apply to sole proprietorships.
- Margin Tax base is taxable entity's (or unitary group's) gross receipts after deductions for either:
  - Compensation, or
  - Cost of goods sold,
- Provided that the Margin Tax base may not exceed 70% of a business's total revenues.
- Looks like income tax, but in 2012 Texas Supreme Court in *Allcat* held not income tax.





# Texas Margin Tax – cont'd

## [EGAN ON ENTITIES Appendix B (645-689)]

- Apportionment to Texas: multiply the tax base by a fraction:  
$$\frac{\text{Texas gross receipts}}{\text{aggregate gross receipts}}$$
- Tax rate for 2019 applied to the Texas portion of the tax base is 0.75%.
  - Exception for retail and wholesale businesses which pay a 0.375% rate.
- Margin Tax changes the calculus for entity selections, but not necessarily the result.
  - LLC has become more attractive as it can elect to be taxed as a corporation or partnership for federal income tax purposes. [EGAN ON ENTITIES Appendix A (621-623; 635-638); Appendix C (671-681)]
  - Uncertainties as to an LLC's treatment for self employment purposes can restrict its desirability in some situations. [EGAN ON ENTITIES Appendix A (635-638)]





# Delaware Corporate Income Tax

The Delaware corporate income tax rate is **8.7%** which is higher than average for states in the US.

However, Sections 1902(b)(6) and (8) of the Delaware General Corporation Law specifically ***exempt*** a:

- “corporation maintaining a statutory corporate office in the State but not doing business within the State” and
- “corporation whose activities within the state are confined to the maintenance and management of their intangible investments.”







# Delaware Taxation of LLCs

Delaware's state income tax does not apply at the entity level to an LLC (unless the LLC has elected to be taxed as a corporation for federal income tax purposes). See Del. Code Ann. Section 1601.

Rather LLC members (or a partnership's partners) are generally subject to Delaware personal income tax with a highest marginal rate of **6.6%**. See Del. Code Ann. 30 §1102(a)(14).





# Delaware Taxation of LLC Members

However, ***nonresident*** individual members of an LLC or partnership are only taxable on their income attributable ***to sources in Delaware***. See Del. Code Ann. 30 §1623(a)

Thus, many out of state corporations, LLCs, and partnerships that are not resident in Delaware, and do not have any income from business in Delaware, can avoid material Delaware income tax liability.





# Alternative Entities

## LLCs and partnerships are called "alternative entities"

- Courts apply "contractarian" approach in considering their governing documents in measuring fiduciary duties of their governing persons.
- Texas LLC and partnership statutes allow modification (but not elimination) of common law fiduciary duties, but now allow limitation of governing person liability to the extent permitted for corporations (eliminate for breaches of duty of care but not duty of loyalty).
- Delaware allows partnership and LLC agreements to eliminate all fiduciary duties, but cannot be "coy" in wording and cannot eliminate the duty of good faith and fair dealing.





# Alternative Entities – Governing Documents

- Fiduciary duties of general partners [See EGAN ON ENTITIES §§3.5 (460-462); 4.6 (474-495); 5.4 (521-546)] are highest and include:
  - Care
  - Loyalty
  - Candor
- Fiduciary duties of managers of LLC are analogous to those of corporate directors (absent contractual definition or limitation); include the duties of care, loyalty and candor; and are discussed more fully below. [See EGAN ON ENTITIES §5.3 (519-521)].





# Delaware Law — Partnership and LLC Agreements Respected

- Unlike TBOC, Delaware statutes governing partnerships and LLCs provide that their policy is to give maximum effect to the principle of freedom of contract and to entity agreements
- Delaware statutes allow the elimination of fiduciary duties
- Delaware statutes do not allow elimination of contractual duty of good faith and fair dealing

See EGAN ON ENTITIES §§3.5 (460-462); 4.6 (474-495);  
5.4 (521-546)





# Delaware Law — Partnership and LLC Agreements Respected

- Several recent Delaware cases involving limited partnership reorganizations
- General partner or an affiliate was the survivor or acquiring party in each
- These cases can be viewed as a roadmap to wording, pitfalls and alternatives to be considered when structuring M&A transactions

See EGAN ON ENTITIES §§4.6.1 (474-481); 5.4.2 (527-546)





# Delaware Law — Partnership and LLC Agreements Respected

- In four cases, the Delaware Supreme Court gave effect to the elimination of common law fiduciary duties and their replacement with a provision authorizing related party transactions where a conflicts committee of independent directors of the general partner in good faith determined that the transactions were in the best interests of the partnership.





# Delaware Law — Partnership and LLC Agreements Respected

- Two other decisions applied the implied covenant of good faith and fair dealing (which cannot be eliminated) to hold for the plaintiff. *Gerber v. Enter. Prods. Hldgs., LLC*, 67 A.3d 400, 404 (Del. 2013), held that a fairness opinion was inadequate to support a transaction with the GP because it only covered the fairness of the entire transaction rather than fairness to the LPs. *Dieckman v. Regency GP LP*, 155 A.3d 358 (Del. 2017), held that facts surrounding a director's appointment to and service on the special committee demonstrated a lack of respect for the director independence requirement of the partnership agreement and the failure to disclose the director conflict (serving as a director of an affiliate of the GP for two days after going on the special committee and going back on the affiliate's board immediately after the merger closed) was such a fundamental disclosure failure as to negate the approval by the unaffiliated limited partners.







# Delaware Law — Partnership and LLC Agreements Respected

- In the seventh decision Vice Chancellor Laster in *El Paso Pipeline Partners, L.P. Derivative Litigation* awarded \$171 million to the plaintiff limited partners because he found that the conflicts committee of the Board of the general partner did not in fact believe in good faith that the transaction was in the best interests of the partnership because its analysis focused on whether the purchase would enable the partnership to increase its distributions rather than whether it was paying too much for the assets and they were simply going through the motions to approve a transaction they knew general partner wanted and tried to accommodate. The Delaware Supreme Court respected these findings, but reversed because the partnership merged with an unaffiliated entity before the lawsuit was finally adjudicated and the Supreme Court held that the plaintiffs no longer had standing to bring the action (to have derivative standing, the limited partner must have been such from the challenged action through final adjudication – the merger eliminated derivative standing). *El Paso Pipeline GP Company, L.L.C. v. Brinckerhoff*, 152 A.3d 1248 (Del. 2016)13





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## LLC Vocabulary – Texas

- The owners of a Texas LLC are called “Members,” and are analogous to shareholders in a corporation or limited partners of a limited partnership.
- The “Managers” of an LLC are generally analogous to directors of a corporation and are elected by the Members in the same manner as corporate directors are elected by shareholders.
- Under the TBOC, however, an LLC may be structured so that management shall be by the Members as in the case of a close corporation or a general partnership, and in that case the Members would be analogous to general partners in a general or limited partnership but without personal liability for the LLC’s obligations. Under the TBOC, any individual, corporation, partnership, LLC or other person may become a Member or Manager. Thus, it is possible to have an LLC with a corporation as the sole Manager just as it is possible to have a limited partnership with a sole corporate general partner.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## LLC Vocabulary – Delaware

- LLCs formed under Delaware law are governed by the Delaware Limited Liability Company Act (the “DLLCA”).
- As in Texas, the owners of a Delaware LLC are called Members and are analogous to stockholders of a Delaware corporation.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## LLC Formation and Governing Documents

- Certificate of Formation.
  - Texas.
    - A Texas LLC is formed when one or more persons file a certificate of formation with the Texas Secretary of State along with a filing fee.
    - The initial certificate of formation must contain: (1) the name of the LLC, (2) a statement that it is an LLC, (3) the period of its duration, unless such duration is perpetual, (4) its purpose, which may be any lawful purpose for which LLCs may be organized, (5) the address of its initial registered office and the name of its initial registered agent at that address, (6) if the LLC is to have a Manager or Managers, a statement to that effect and the names and addresses of the initial Manager or Managers, or if the LLC will not have Managers, a statement to that effect and the names and addresses of the initial Members, (7) the name and address of each organizer, (8) specified information if the LLC is to be a professional LLC, and (9) any other provisions not inconsistent with law.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## LLC Formation and Governing Documents

- Certificate of Formation.
  - Texas.
    - An LLC's existence as such begins when the Secretary of State files the certificate of formation, unless it provides for delayed effectiveness as authorized by the TBOC.
    - An LLC may also be formed pursuant to a plan of conversion or merger, in which case the certificate of formation must be filed with the certificate of conversion or merger, but need not be filed separately.
    - A Texas LLC may generally be formed to conduct any lawful business, subject to limitations of other statutes which regulate particular businesses, and generally it has all of the powers of a Texas corporation or limited partnership, subject to any restrictions imposed by statute or its governing documents.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## LLC Formation and Governing Documents

- Certificate of Formation.
  - Texas.
    - The name of an LLC must contain words or an abbreviation to designate the nature of the entity. The designation may be any of the following: the words “limited liability company,” “limited company,” or an abbreviation of either phrase. The name must not be the same as or deceptively similar to that of any domestic or foreign filing entity authorized to transact business in Texas unless the existing entity with the similar name consents in writing.
    - The TBOC provides that, except as otherwise provided in an LLC’s certificate of formation or Company Agreement, the affirmative vote, approval, or consent of all Members is required to amend its certificate of formation.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## LLC Formation and Governing Documents

- Certificate of Formation.
  - Delaware.
    - A Delaware LLC is formed by the filing of an executed certificate of formation with the Secretary of State of Delaware. The certificate of formation must include the name of the LLC, the address of its registered office, the name and address of the registered agent for service of process, and any other matters the members determine to include therein.
    - It is formed at the time of the filing of its certificate of formation with the Secretary of State.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## LLC Formation and Governing Documents

- Company Agreement.
  - Texas. Most of the provisions relating to the organization and management of a Texas LLC and the terms governing its securities are to be contained in the LLC's company agreement ("Company Agreement"), which will typically contain provisions similar to those in limited partnership agreements and corporate bylaws.
    - Under the TBOC, the Company Agreement controls the majority of LLC governance matters and generally trumps the default TBOC provisions relating to LLCs, but TBOC §101.054 provides certain provisions of the TBOC may not be waived or modified by Company Agreement.
    - For example, the TBOC provides that the Company Agreement or certificate of formation may only be amended by unanimous member consent, but if either document provides otherwise (such as for amendment by Manager consent), then it may be amended pursuant to its own terms.







# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## LLC Formation and Governing Documents

- Company Agreement.
  - Texas.
    - A Texas Company Agreement will ordinarily contain the capital account and other financial and tax provisions found in a typical limited partnership agreement, but the TBOC does not require that the Company Agreement ever be approved by the Members or be filed with the Secretary of State or otherwise made a public record.
    - Nevertheless it may be desirable for the Members to approve the Company Agreement and express their agreement to be contractually bound thereby as the Members' express agreement to be contractually bound by the Company Agreement should facilitate enforcement thereof and its treatment as a "partnership agreement" for federal income tax purposes.
    - Under the TBOC a Company Agreement is enforceable by or against an LLC regardless of whether the LLC has signed or otherwise expressly adopted the Company Agreement.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## LLC Formation and Governing Documents

- Company Agreement.
  - Texas.
    - Under the TBOC a Member has no right to withdraw, and cannot be expelled, from the company unless provision therefor is made in the Company Agreement.
    - TBOC §101.205 provides that a Member who validly exercises right to withdraw pursuant to a Company Agreement provision is entitled to receive the fair value (a term not defined in the TBOC) of the Member's interest within a reasonable time thereafter unless the Company Agreement otherwise provides.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## LLC Formation and Governing Documents

- Company Agreement.
  - Delaware.
    - In Delaware, the agreement which is referred to in Texas as the Company Agreement is referred to as the LLC agreement (“LLC Agreement”).
    - The term “limited liability company agreement” is broadly defined in DLLCA § 18-101(7) to be the principal governing document of a Delaware LLC and to encompass “any agreement ... written, oral or implied, of the member or members as to the affairs of a limited liability company or its business.”
    - Oral LLC Agreements, while expressly recognized by the DLLCA, are subject to the Delaware statute of frauds.
    - A member, manager or assignee of an LLC is bound by the LLC Agreement whether or not a signatory thereto.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## LLC Formation and Governing Documents

- Company Agreement.
  - Delaware.
    - Single member LLCs are expressly authorized.
    - An LLC Agreement may be amended as provided therein or, if the LLC Agreement does not provide for its amendment, an amendment requires approval of all of the members.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Management - Texas

- The business and affairs of an LLC with Managers are managed under the direction of its Managers, who can function as a board of directors and may designate officers and other agents to act on behalf of the LLC.
- A Manager may be an individual, corporation, or other entity, and it is possible to have an LLC which has a single Manager that is a corporation or other entity.
- The certification of formation or the Company Agreement, however, may provide that the management of the business and affairs of the LLC may be reserved to its Members. Thus an LLC could be organized to be run without Managers, as in the case of a close corporation, or it could be structured so that the day to day operations are run by Managers but Member approval is required for significant actions as in the case of many joint ventures and closely held corporations.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Management - Texas

- The Company Agreement should specify who has the authority to obligate the LLC contractually or to empower others to do so. It should dictate the way in which the Managers or Members, whichever is authorized to manage the LLC, are to manage the LLC's business and affairs.
- The Company Agreement should specify how Managers are selected, their terms of office and how they may be removed.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Management - Texas

The TBOC provides that the following are agents of an LLC: (1) any officer or other agent who is vested with actual or apparent authority; (2) each Manager (to the extent that management of the LLC is vested in that Manager); and (3) each Member (to the extent that management of the LLC has been reserved to that Member). Texas law also provides that an act (including the execution of an instrument in the name of the LLC) for the purpose of apparently carrying on in the usual way the business of the LLC by any of the persons named in TBOC section 101.254(a) binds the LLC unless (1) the person so acting lacks authority to act for the LLC and (2) the third party with whom the LLC is dealing is aware of the actor's lack of authority. Lenders and others dealing with an LLC can determine with certainty who has authority to bind the LLC by reference to its certificate of formation, Company Agreement, and resolutions, just as in the case of a corporation. In routine business transactions where verification of authority is not the norm in transactions involving corporations, the same principles of apparent authority should apply in the LLC context.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Management - Delaware

- The DLLCA provisions relating to management of LLCs are comparable to those of the TBOC and largely defer to the LLC Agreement.







# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Fiduciary Duties

- Texas.
  - The TBOC does not address specifically whether Manager or Member fiduciary or other duties exist or attempt to define them, but it implicitly recognizes that these duties may exist in statutory provisions which permit them to be expanded or restricted, and liabilities for the breach thereof to be limited or eliminated, in the Company Agreement.
  - The duty of Managers in a Manager-managed LLC and Members in a Member-managed LLC to the LLC is generally assumed to be fiduciary in nature, measured by reference to the fiduciary duties of corporate directors in the absence of modification in the Company Agreement. The fiduciary duties of Managers could also be measured by reference to partnership law or the law of agency.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Fiduciary Duties

- Texas.
  - By analogy to corporate directors, Managers would have the duties of obedience, care and loyalty and should have the benefit of the business judgment rule. Much like a corporate director who, in theory, represents all of the shareholders of the corporation rather than those who are responsible for his being a director, a Manager should be deemed to have a fiduciary duty to all of the Members. Whether Members owe a fiduciary duty to the other Members or the LLC will likely be determined by reference to corporate principles in the absence of controlling provisions in the certificate of formation or Company Agreement.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Fiduciary Duties

- Texas.
  - TBOC § 101.401 allows LLC Company Agreements to expand or restrict the duties (including fiduciary duties) and liabilities of Members, Managers, officers and other persons to the LLC or to Members or Managers of the LLC.
  - TBOC § 7.001 allows for the limitation or elimination of liability to the LLC or its owners or Members for breaches of fiduciary or other duties of its Managers and, in the case of an LLC managed by its Members, of those Members in a certificate of formation or Company Agreement except for a breach of the duty of loyalty, bad faith, a transaction in which the person received an improper personal benefit, or an act for which liability is provided by statute.
  - A Company Agreement provision restricting fiduciary duties and limiting liability for breaches thereof as permitted by TBOC §§ 7.001 and 101.401 could read as follows:





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Fiduciary Duties

- Texas.

This Agreement is not intended to, and does not, create or impose any fiduciary or other duty on any Member or Manager. Furthermore, each of the Members, the Managers and the Company hereby, to the fullest extent permitted by Applicable Law [defined to mean the TBOC and other applicable Texas and federal statutes and regulations thereunder], restricts, limits, waives and eliminates any and all duties, including fiduciary duties, that otherwise may be implied by Applicable Law and, in doing so, acknowledges and agrees that the duties and obligations of each Member or Manager to each other and to the Company are only as expressly set forth in this Agreement and that no Member or Manager shall have any liability to the Company or any other Member or Manager for any act or omission except as specifically provided by Applicable Law or in this Agreement or another written agreement to which the Member or Manager is a party. The provisions of this Agreement, to the extent that they restrict, limit, waive and eliminate the duties and liabilities of a Member or Manager otherwise existing at law or in equity, are agreed by the Members to replace such other duties and liabilities of such Members or Managers.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Fiduciary Duties

- Texas.

Notwithstanding anything to the contrary contained in this Agreement,

(1) the Managers shall not permit or cause the Company to engage in, take or cause any of the following actions except with the prior approval of a majority of the outstanding Units voting: *[list specific actions]*:

(2) the Members and Managers and each of their respective Affiliates are permitted to have, and may presently or in the future have, investments or other business relationships, ventures, agreements or arrangements (i) with entities engaged in the business of the Company, other than through the Company (an "Other Business") and (ii) with *[additional entity specifics]*; *[provided, that any transactions between the Company and an Other Business will be on terms no less favorable to the Company than would be obtainable in a comparable arm's length transaction]*; and

(3) there shall be a presumption by the Company that any actions taken in good faith by the Manager on behalf of the Company shall not violate any fiduciary or other duties owed by the Managers to the Company or the Members.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Fiduciary Duties

- Texas.
  - Provisions such as the foregoing are often subject to intense negotiations and some investors may not agree to the limitations on duties and liabilities that those in control propose.
  - Unlike Delaware, in Texas a common-law duty of good faith and fair dealing does not exist in all contractual relationships. Rather, the duty arises only when a contract creates or governs a special relationship between the parties. A “special relationship” has been recognized where there is unequal bargaining power between the parties and a risk exists that one of the parties may take advantage of the other based upon the imbalance of power, e.g., insurer-insured. The elements which make a relationship special are absent in the relationship between an employer and an employee.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Fiduciary Duties

- Texas.

While there are no reported Texas cases as to whether a contractual duty of good faith and fair dealing exists between Members in an LLC, or between Managers and Members in a Texas LLC, it is likely that the duty of good faith and fair dealing exists in those LLC relationships, just as fiduciary duties likely exist, except in each case to the extent that the duty has been restricted by contract as permitted by the TBOC.

- Although the TBOC, unlike its Delaware counterpart, does not include provisions that expressly emphasize the principles of freedom of contract and enforceability of LLC Company Agreements that expand, restrict or eliminate fiduciary duties, the legislative history and scope of LLC Act § 2.20B, the precursor to TBOC § 101.401, indicate that even before the 2013 Legislative Session (in which its current wording was added), there was more latitude to exculpate Managers and Members for conduct that would otherwise breach a fiduciary duty under the TBOC than under provisions of the TBOC relating specifically to corporations.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Fiduciary Duties

- Texas.
  - TBOC §101.255 provides that, unless the certificate of formation or Company Agreement provides otherwise, a transaction between an LLC and one or more of its Managers or officers, or between an LLC and any other LLC or other entity in which one or more of its Managers or officers are Managers, directors or officers or have a financial interest, shall be valid notwithstanding the fact that the Manager or officer is present or participates in the meeting of Managers, or signs a written consent, which authorizes the transaction or the Manager's votes are counted for such purpose, if any of the following is satisfied:
    - (i) The material facts as to the transaction and interest are disclosed or known to the governing authority, and the governing authority in good faith authorizes the transaction by the approval of a majority of the disinterested Managers or Members (as appropriate) even though the disinterested Managers or Members are less than a quorum; or







# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Fiduciary Duties

- Texas.
  - (ii) The material facts as to the transaction and interest are disclosed or known to the Members, and the transaction is approved in good faith by a vote of the Members; or
  - (iii) The transaction is fair to the LLC as of the time it is authorized, approved or ratified by the Managers or Members.
- In a joint venture, the duty of a Manager to all Members could be an issue since the Managers would often have been selected to represent the interests of particular Members. The issue could be addressed by structuring the LLC to be managed by Members who would then appoint representatives to act for them on an operating committee which would run the business in the name of the Members. In such a situation, the Members would likely have fiduciary duties analogous to partners in a general partnership.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Fiduciary Duties

- Delaware. The DLLCA does not codify Manager or Member fiduciary duties, but expressly permits the elimination of fiduciary duties in an LLC, although not all Delaware LLC Agreements effectively do so.
  - In *Auriga Capital Corp. v. Gatz Properties, LLC*, 40 A.3d 839 (Del. Ch. 2012), Delaware Chancellor (now Chief Justice) Strine, in finding for the minority investors who had challenged the merger of the LLC into an entity controlled by the Manager, held that the LLC Agreement contractually incorporated a core element of the traditional common law fiduciary duty of loyalty by providing that the Manager could enter into a self-dealing transaction (such as its purchase of the LLC) only if it proved that the terms were fair. The LLC Agreement provided that, without the consent of the holders of two-thirds of the interests not held by the Manager or its affiliates, the Manager would not be entitled to cause the LLC to enter into any transaction with an affiliate that is less favorable to the LLC than that which could be entered into with an unaffiliated third party.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Fiduciary Duties

- Delaware.

The LLC Agreement's exculpation provision provided that the Manager would not be liable to the LLC for actions taken or omitted by the Manager in good faith and without gross negligence or willful misconduct. As the LLC Agreement's exculpatory provision expressly did not excuse bad faith action, willful misconduct, or even grossly negligent action, by the LLC Manager, the Manager was liable for the losses caused by its flawed merger. The Chancellor mused that under traditional principles of equity applicable to an LLC and in the absence of a contrary LLC Agreement provision, a Manager of an LLC would owe to the LLC and its members the common law fiduciary duties of care and loyalty.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Fiduciary Duties

- Delaware.
  - The Delaware Supreme Court affirmed *Auriga* in *Gatz Properties, LLC v. Auriga Capital Corp.*, 59 A.3d 1206 (Del. 2012), holding that although the LLC Agreement did not use words such as “entire fairness” or “fiduciary duties,” there was nonetheless an explicit contractual assumption by the parties of an obligation on the part of the Manager and Members of the LLC to obtain a fair price for the LLC in transactions between the LLC and affiliates, but the Supreme Court expressly rejected the Chancellor’s conclusion that the fiduciary duties were “default” fiduciary duties.
  - While the Supreme Court opinion in *Gatz* did not resolve the issue of whether fiduciary duties would be implied in the absence of the contractual elimination or modification of fiduciary duties in the LLC Agreement, the Delaware Court of Chancery subsequently “considered the issue of default fiduciary duties and held that, subject to clarification from the Supreme Court, managers and managing members of an LLC do owe fiduciary duties as a default matter.”





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Fiduciary Duties

- Delaware.
  - DLLCA § 18-1104 has been amended, effective August 1, 2013, to provide that unless modified in an LLC's governing documents, common law fiduciary duties apply to LLCs.
  - DLLCA § 18-1101 aggressively adopts a "contractarian approach" (i.e., the bargains of the parties manifested in LLC Agreements are to be respected and rarely trumped by statute or common law). The DLLCA does not have any provision which itself creates or negates Member or Manager fiduciary duties, but instead allows modification or elimination of fiduciary duties by an LLC Agreement, but does not allow the elimination of "the implied contractual covenant of good faith and fair dealing."





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Fiduciary Duties

- Delaware.

An LLC Agreement eliminating fiduciary duties as permitted by DLLCA § 18-1101 could read as follows:

“Except as expressly set forth in this Agreement or expressly required by the Delaware Act, no Manager or Member shall have any duties or liabilities, including fiduciary duties, to the Company or any Member, and the provisions of this Agreement, to the extent that they restrict, eliminate or otherwise modify the duties and liabilities, including fiduciary duties, of any Manager or Member otherwise existing at law or in equity, are agreed by the Company and the Members to replace such other duties and liabilities of the Managers and Members; provided that nothing here shall be construed to eliminate the implied contractual covenant of good faith and fair dealing under Delaware law.”

- Provisions such as the foregoing are often subject to intense negotiations and some investors may not agree to the limitations on duties and liabilities that those in control propose.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Fiduciary Duties

- Delaware.
  - Provisions in LLC Agreements purporting to limit fiduciary duties need to be explicit and conspicuous as LLC Agreement coyness can lead to unenforceability. Language in an LLC Agreement to the effect that no member or manager shall be liable for any act or omission unless attributable to gross negligence, fraud or willful misconduct provides limited exculpation from monetary liabilities, but having used a bad faith limit on exculpation, has been held to assume (rather than eliminate) common law fiduciary duties. *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, C.A. No. 3658-VCS, 2009 WL 1124451, 2009 Del. Ch. LEXIS 54 (Del. Ch. April 20, 2009).
  - Persons who control Members can be held responsible for fiduciary duty breaches of the Members. A legal claim exists in Delaware for aiding and abetting a breach of fiduciary duty, whether arising under statute, contract, common law or otherwise.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Business Combinations - Texas

- TBOC Chapter 10 contains merger provisions that allow an LLC to merge with one or more LLCs or “other entities” (i.e. any corporation, limited partnership, general partnership, joint venture, joint stock company, cooperative, association, bank, insurance company or other legal entity) to the extent that the laws or constituent documents of the other entity permit the merger. A Texas LLC can merge with, or convert into, a Delaware LLC.
- The merger must be pursuant to a written plan of merger containing certain provisions, and the entities involved must approve the merger by the vote required by their respective governing laws and organizational documents.
- Under TBOC, a merger is effective when the entities file an appropriate certificate of merger with the Secretary of State, unless the plan of merger provides for delayed effectiveness.
- Unless the Company Agreement provides them, there are no appraisal rights afforded to dissenters under the TBOC in an LLC merger.







# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Business Combinations - Texas

- An LLC's merger with another entity must be approved by a majority of the LLC's members, unless its certificate of formation or Company Agreement specifies otherwise.
- The TBOC also authorizes an LLC to convert into another form of entity, or convert from another form of entity into an LLC, without going through a merger or transfer of assets, and has provisions relating to the mechanics of the adoption of a plan of conversion, owner approval, filings with the Secretary of State, and the protection of creditors.
- The TBOC allows the Company Agreement to provide whether, or to what extent, Member approval of sales of all or substantially all of the LLC's assets is required. In the absence of a Company Agreement provision, the default under the TBOC is to require Member approval for the sale of all or substantially all of the assets of an LLC.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Business Combinations - Delaware

- A Delaware LLC may merge or consolidate with a Delaware or foreign LLC, corporation, statutory trust, general or limited partnership or “other business entity,” subject to the provisions of its LLC Agreement, under DLLCA § 18-209.
- To effect a merger, the LLC should adopt a plan of merger setting forth the terms and conditions of the merger and, after it has been approved by its Managers and Members as required in its LLC Agreement (or in the absence of a governing LLC Agreement provision, by the holders of more than 50% of its Member percentage interests), and file a certificate of merger with the Delaware Secretary of State. Unlike a corporation, there are no Delaware statutory appraisal rights in an LLC merger, but DLLCA § 18-210 expressly authorizes contractual appraisal rights in an LLC Agreement or plan of merger.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Business Combinations - Delaware

- Any requirements for Member approval of a sale of all or substantially all of the assets of a Delaware LLC are left to the LLC Agreement.
- Under DLLCA § 18-214, a corporation, partnership or any other entity, or a foreign LLC, may convert into a Delaware LLC by following the procedures specified therein.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Indemnification - Texas

- A Texas LLC may (but is not required to) indemnify any of its Members, Managers, officers or other persons subject only to such standards and restrictions, if any, as may be set forth in the LLC's certificate of formation or Company Agreement.
- The restrictions on indemnification applicable to Texas for-profit corporations are not applicable to Texas LLCs.
- This approach increases the importance of having long form indemnification (see sample long-form indemnification provision in EGAN ON ENTITIES § 5.6) because a "to maximum extent permitted by law" provision may encompass things neither the drafter nor the client foresaw, which could lead courts to read in public policy limits or find the provision void for vagueness. The indemnification provisions should specify who is entitled to be indemnified for what and under what circumstances, which requires both thought and careful drafting.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Indemnification - Delaware

- The DLLCA provides that a Delaware LLC has broad power to indemnify and advance costs of defense to its Members, Managers and others, and leaves it to the LLC Agreement.
- A Delaware LLC is thus far not subject to the same statutory and public policy constraints as are applicable to a Delaware corporation.
- Thus, as in Texas it is incumbent on those drafting LLC Agreements to define therein what, if any, indemnification rights are to be granted by the Delaware LLC.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Capital Contributions

- In both Texas and Delaware the contribution of a Member may consist of any tangible or intangible benefit to the LLC or other property of any kind or nature, including a promissory note, services performed, a contract for services to be performed or other interests in or securities or other obligations of any other LLC or other entity. The Company Agreement in Texas, or LLC Agreement in Delaware, ordinarily would contain provisions relative to when and under what circumstances capital contributions are required, capital accounts and the allocation of profits and losses comparable to those in a limited partnership agreement.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Allocation of Profits and Losses; Distributions

- In both Texas and Delaware, allocations of profits and losses, and distributions of cash or other assets, of an LLC are made to the Members in the manner provided by the Company or LLC Agreement.
- A Member is not entitled to receive distributions from an LLC prior to its winding up unless specified in the Company Agreement.
- An LLC may not make a distribution to its Members to the extent that, immediately after giving effect to the distribution, all liabilities of the LLC, other than liabilities to Members with respect to their interests and non-recourse liabilities, exceed the fair value of the LLC assets. A Member who receives a distribution that is not permitted under the preceding sentence has no liability to return the distribution unless the Member knew that the distribution was prohibited. The limitations on distributions by an LLC do not apply to payments for reasonable compensation for past or present services or reasonable payments made in the ordinary course of business under a bona fide retirement or other benefits program.





# Owner Liability for Entity Obligations — “Piercing the Corporate Veil”

## LLC

See [EGAN ON ENTITIES §5.9 \(560-566\)](#)

- Legislative History of Texas LLC Statute:
  - Article 4.03. Liability to Third Parties. This Article provides except as provided in the regulations, that a member or manager is not liable to third parties, expresses the legislative intent that limited liability be recognized in other jurisdictions and states a member is not a proper party to a proceeding by or against a Limited Liability Company.
- Some cases suggest corporate veil piercing concepts apply to LLCs. TBOC §101.002 amended in 2011 to provide TBOC veil piercing limitations for corporations also apply to LLCs if veil piercing permitted.







# Owner Liability for Entity Obligations — “Piercing the Corporate Veil”

## LLC

See [EGAN ON ENTITIES §5.9 \(560-566\)](#)

The TBOC provides that, except as provided in the Company Agreement, a Member or Manager is not liable to third parties for the debts, obligations or liabilities of an LLC, although Members are liable for the amount of any contributions they agreed in writing to make.

- Members may participate in the management of the LLC without forfeiting this liability shield, but may be liable for their own torts.
- Since the Tex. LLC Stats. deal expressly with the liability of Members and Managers for LLC obligations, the principles of “piercing the corporate veil” should not apply to LLCs in Texas, although there are Texas Court of Appeals decisions to the contrary and the Supreme Court has not addressed the issue.





# Owner Liability for Entity Obligations — “Piercing the Corporate Veil”

## LLC

See [EGAN ON ENTITIES §5.9 \(560-566\)](#)

- In 2011 the TBOC was amended to clarify the standards for the piercing of the LLC statutory liability shield, if LLC veil piercing is determined to be available notwithstanding the express no personal liability provisions of TBOC § 101.114 (Liability for Obligations), by adding a new TBOC § 101.002 (Applicability of Other Laws) which provides that TBOC §§ 21.223 (Liability for Obligations), 21.224 (Preemption of Liability), 21.225 (Exceptions to Limitations) and 21.226 (Liability for Obligations) in respect of for-profit corporations apply to an LLC and its members, owners, assignees and subscribers, subject to the limitations contained in TBOC § 101.114 (Liability for Obligations). These TBOC provisions and related corporate case law mean that in Texas veil piercing should not be applicable except in the case of actual fraud. See [EGAN ON ENTITIES § 2.4\(85-90\)](#)





# Owner Liability for Entity Obligations — “Piercing the Corporate Veil”

## LLC

See EGAN ON ENTITIES §5.9 (560-566)

- Alter ego veil piercing principles similar to those applicable to Delaware corporations are applicable to Delaware LLCs, with the plaintiff having to demonstrate a misuse of the LLC form along with an overall element of injustice or unfairness.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Nature and Classes of Membership Interests

See EGAN ON ENTITIES §5.9 (566-573)

- A membership interest in an LLC is personal property. It does not confer upon the Member any interest in specific LLC property. A membership interest may be evidenced by a certificate if the Company Agreement so provides.
- The Company Agreement may establish classes of Members having expressed relative rights, powers and duties, including voting rights, and may establish requirements regarding the voting procedures and requirements for any actions including the election of Managers and amendment of the Certificate of Formation and Company Agreement. The Company Agreement could provide for different classes of Members, each authorized to elect a specified number or percentage of the Managers.
- Whether an LLC membership interest is considered a “security” for the purposes of the Securities Act of 1933, as amended, and state securities or blue sky laws turns on the rights of the Members as set forth in the Company Agreement and other governing documents and the ability of the investor to exercise meaningful control over his investment.





# LIMITED LIABILITY COMPANIES

## [EGAN ON ENTITIES Chapter 5]

### Assignment of Membership Interests

See EGAN ON ENTITIES §5.11 (573-578)

- Unless otherwise provided in an LLC's Company Agreement, a Member's interest in an LLC is assignable in whole or in part. An assignment of a membership interest does not of itself dissolve the LLC or entitle the assignee to participate in the management and affairs of the LLC or to become, or to exercise any of the rights of, a Member. An assignment entitles the assignee to be allocated income, gain, loss, deduction, credit or similar items, and receive distributions, to which the assignor was entitled to the extent those items are assigned and, for any proper purpose, to require reasonable information or account of transactions of the LLC and to make reasonable inspection of the books and records of the LLC. Until the assignee becomes a Member, the assignor continues to be a Member and to have the power to exercise any rights or powers of a Member, except to the extent those rights or powers are assigned. An assignee of a membership interest may become a Member if and to the extent that the Company Agreement so provides or all Members consent. Until an assignee is admitted as a Member, the assignee does not have liability as a Member solely as a result of the assignment.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Assignment of Membership Interests

- The Company Agreement would typically contain restrictions on the assignment of interests to facilitate compliance with applicable securities and tax laws. Membership interest transfer restrictions contained in the Company Agreement are enforceable.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Winding Up and Termination

See EGAN ON ENTITIES §5.12 (574-578)

The TBOC requires that an LLC commence winding up its affairs, and the LLC Act provided that an LLC is dissolved, upon the occurrence of any of the following events:

- (1) the expiration of the period (if any) fixed for its duration, which may be perpetual;
- (2) the action of the Members to dissolve the LLC (in the absence of a specific provision in its certificate of formation or Company Agreement, the vote will be by a majority of the Members);
- (3) any event specified in its certificate of formation or Company Agreement to cause dissolution, or to require the winding up or termination, of the LLC;





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Winding Up and Termination

- (4) the occurrence of any event that terminates the continued membership of the last remaining Member of the LLC, absent certain circumstances; or
  - (5) entry of decree of judicial dissolution under the Tex. LLC Stats.
- Under the TBOC, the bankruptcy of a Member does not dissolve an LLC, or require its winding up or termination, unless its certificate of formation or Company Agreement so provides. In Delaware, however, the bankruptcy of a Member dissolves the LLC unless its LLC Agreement otherwise provides.
- The DLLCA dissolution provisions (DLLCA §§ 18.801 et seq.) are comparable to the TBOC provisions.







# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Foreign LLCs

See EGAN ON ENTITIES §5.13 (578-579)

Both the TBOC and the DLLCA provide a mechanism by which a limited liability company formed under the laws of another jurisdiction can qualify to do business in Texas or Delaware, as the case may be, as a foreign limited liability company (a “Foreign LLC”) and thereby achieve the limited liability afforded to a domestic LLC.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Series LLC

See EGAN ON ENTITIES §5.12 (580-583)

- Subchapter M of TBOC Chapter 101 and DLLCA § 18-215 permit the formation of series LLCs ("Series LLC") which may establish series of Members, Managers, membership interests or assets to which different assets and liabilities may be allocated. The Texas Series LLC provisions are modeled after the Series LLC provisions in Delaware.
- Through appropriate provisions in the Company or LLC Agreement and certificate of formation, the assets of one series can be isolated from the liabilities attributable to a different series. These provisions allow considerable flexibility in structuring LLCs. The provisions of Subchapter M generally have concepts similar to the Delaware provisions, but in many instances the wording has been revised to conform to the other provisions of the TBOC governing LLCs, including in particular the provisions relating to winding-up and termination of the series.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Series LLC

- To form a Series LLC, the organizer must file a certificate of formation that expressly states that the entity is a Series LLC and contains a statement that the debts and liabilities of a series are of the series only and are enforceable only against the assets of that series; provided, that an LLC can enforce the debts and liabilities of the series against the company generally or another series if there is an express agreement to do so within the Company Agreement or other written agreement. The Series LLC's Company or LLC Agreement should also expressly state that the debts and liabilities of a series are of the series only and are enforceable only against the assets of that series and not any other series or the Series LLC.
- The records maintained for the Series LLC and each series must account separately for the assets of the Series LLC and each series.





# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Series LLC

- A series of a Series LLC is not a separate entity under the TBOC or the DLLCA, but is a “person.” Although a series is not a separate entity, a series may grant security interests in its assets and file Uniform Commercial Code financing statements in the name of the series rather than that of the Series LLC.
- In Texas each LLC series will have to file an assumed name certificate if it will have a name different from the LLC as will usually be the case.






# LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

## Diversity Jurisdiction

See EGAN ON ENTITIES §5.16 (583)

- The citizenship of an LLC for federal diversity jurisdiction purposes is determined by looking to the citizenship of its Members, and, like a partnership, an LLC is deemed a citizen of each state in which it has a Member.
- In *Americold Realty Trust v. Conagra Foods, Inc.*, 136 S. Ct. 1012 (2016), the U.S. Supreme Court, in a case involving a Maryland real estate investment trust, held: “While humans and corporations can assert their own citizenship, other entities take the citizenship of their members.”





# **Business Entity Acquisition Decision Tree** **[*Acquisition Structure* paper]**

## **Alternative Structures for Acquisitions of Businesses [*Acquisition Structure* paper pp 3-7]**

- There are three basic forms of business acquisitions:
  - Statutory business combinations (e.g., mergers, consolidations and share exchanges);
  - Purchases of shares; and
  - Purchases of assets.





# Alternative Structures for Acquisitions of Businesses – cont'd

- Statutory business combinations
  - Can merge one or more corporations, LLCs or partnerships pursuant to a single plan of merger.
  - Mergers and consolidations require a plan of merger approved by directors and shareholders of each entity, followed by filing certificate of merger with Secretary of State; results in the merging of one entity into another entity which ends up with assets and liabilities of both constituent entities
  - Can be structured to be taxable or non-taxable for federal income tax purposes
  - Reverse triangular merger (buyer forms subsidiary which merges into target with target surviving and results in buyer owning all of stock of target; in forward triangular merger, target merges into merger subsidiary which is the survivor; reverse triangular merger taxed as sale of stock but forward triangular merger taxed as sale of assets).





# Alternative Structures for Acquisitions of Businesses – cont’d

- **Divisive merger** – under TBOC § § 1.002(55)(A) and 10.001-10.008, an entity can merge itself creating two or more surviving entities (plan of merger can divide assets and liabilities among parties, but limited prejudice to rights of existing creditors)
- TBOC § 10.008(a) provides when a merger takes effect upon the filing of a certificate of merger with the Secretary of State, the separate existence of the constituent entities ceases, and all assets and liabilities of the constituent entities are vested in the surviving entity without “any transfer or assignment having occurred.” This means that all assets of constituent entities move in accordance with the plan of merger, but under TBOC a merger is not an “**assignment**” for purposes of provisions in contracts prohibiting assignment unless (1) the contract is an IP license (see *Cincom Systems, Inc. v. Novelis Corp.*, 581 F.3d 431 (6<sup>th</sup> Cir. 1009) discussed in note 15 on p 10 of *Acquisition Structure* paper) or (2) the contract provides that a merger is deemed to be an assignment or otherwise prohibits the merger. See note 13 on page 9 of *Acquisition Structure* paper for Delaware *Mezo Scale* holding that reverse triangular merger is not an assignment under certain contract provisions.







# Alternative Structures for Acquisitions of Businesses – cont’d

- Purchases of Shares
  - Can structure on a taxable or non-taxable basis
  - In a voluntary stock purchase, the acquiring corporation must generally negotiate with each selling shareholder individually
  - Statutory “share exchange” permitted by TBOC (but not DGCL) under which the vote of holders of the requisite percentage (but less than all) of shares can bind all of the shareholders to exchange their shares pursuant to the plan of exchange approved by such vote. Statutory share exchange particularly useful where regulatory requirements make stock purchase desirable, but entity has too many shareholders to expect 100% of shareholders will agree to stock purchase agreement or can be located.
  - Target’s liabilities unaffected





# Alternative Structures for Acquisitions of Businesses – cont’d

- Asset Purchases
  - Asset purchases feature the advantage of specifying the assets to be acquired and the liabilities to be assumed.
  - “C” corporation generally recognizes gain on a sale of assets even in connection with a complete liquidation; shareholders of the target are taxed as if they had sold their stock for the liquidation proceeds (less the target’s corporate tax liability).
  - As a general rule and subject to tax considerations, in the buyer’s best interests to purchase assets, but in the seller’s best interests to sell stock or merge.





# Alternative Structures for Acquisitions of Businesses – cont'd

- Asset transactions are typically more complicated and more time consuming than stock purchases and statutory combinations because transfer of the seller's assets to the buyer must be documented and separate filings or recordings may be necessary to effect the transfer (e.g., real property deeds, lease assignments, patent and trademark assignments, motor vehicle registrations, etc.).
- In contrast to a stock purchase, the buyer in an asset transaction will only acquire the assets described in the acquisition agreement (assets to be purchased are often described with specificity in the agreement and the transfer documents; often excluded are cash, accounts receivable, litigation claims or claims for tax refunds, personal assets and certain records pertaining only to the seller's organization; puts the burden on the seller to specifically identify the assets that are to be retained).
- Among the assets to be transferred will be the seller's rights under contracts pertaining to its business (often contractual rights cannot be assigned without the consent of other parties – e.g., leases of real property and equipment, IP licenses, and joint ventures or strategic alliances; many government contracts cannot be assigned and require a novation with the buyer after the transaction is consummated).





# Alternative Structures for Acquisitions of Businesses – cont'd

- Unlike a stock purchase or statutory combination, where the acquired corporation retains all of its liabilities and obligations, known and unknown, the buyer in an asset purchase has an opportunity to determine which liabilities of the seller it will contractually assume.
  - One of the most important issues to be resolved is what liabilities incurred by the seller prior to the closing are to be assumed by the buyer.
  - It is rare in an asset purchase for the buyer not to assume some of the seller's liabilities relating to the business (e.g., the seller's obligations under contracts for the performance of services or the manufacture and delivery of goods after the closing).
  - For unknown liabilities or liabilities that are imposed on the buyer as a matter of law, the solution is not so easy and lawyers spend significant time and effort dealing with the allocation of responsibility and risk in respect of such liabilities (many acquisition agreements provide that none of the liabilities of the seller, other than those specifically identified, are being assumed by the buyer and then give examples of the types of liabilities not being assumed (e.g. tax, products and environmental liabilities)).





# Alternative Structures for Acquisitions of Businesses – cont’d

- There are some recognized exceptions to a buyer’s ability to avoid the seller’s liabilities by the terms of the acquisition agreement, including the following:
  - Bulk sales laws permit creditors of a seller to follow the assets of certain types of sellers into the hands of a buyer unless specified procedures are followed.
  - Under fraudulent conveyance or transfer statutes, the assets acquired by the buyer can be reached by creditors of the seller under certain circumstances. Actual fraud is not required and a statute may apply merely where the purchase price is not deemed fair consideration for the transfer of assets and the seller is, or is rendered, insolvent.
  - Liabilities can be assumed by implication, which may be the result of imprecise drafting or third-party beneficiary arguments that can leave a buyer with responsibility for liabilities of the seller.
  - Some state tax statutes provide that taxing authorities can follow the assets to recover taxes owed by the seller; often the buyer can secure a waiver from the state or other accommodation to eliminate this risk.
  - Under some environmental statutes and court decisions, the buyer may become subject to remediation obligations with respect to activities of a prior owner of real property.
  - In some states, courts have held buyers of manufacturing businesses responsible for tort liabilities for defects in products manufactured by a seller while it controlled the business. Similarly, some courts hold that certain environmental liabilities pass to the buyer that acquires substantially all the seller’s assets, carries on the business and benefits from the continuation.
  - The purchaser of a business may have successor liability for the seller’s unfair labor practices, employment discrimination, pension obligations or other liabilities to employees.
  - In certain jurisdictions (not Texas), the purchase of an entire business where the shareholders of the seller become shareholders of the buyer can cause a sale of assets to be treated as a “*de facto merger*.” This theory would result in the buyer assuming all of the seller’s liabilities.





# Alternative Structures for Acquisitions of Businesses – cont'd

- Many state and local jurisdictions impose sales, documentary or similar transfer taxes on the sale of certain categories of assets.
- A sale of assets may yield more employment or labor issues than a stock sale or statutory combination, because the seller will typically terminate its employees who may then be employed by the buyer (perhaps on different terms) or have to seek other employment.





# Alternative Structures for Acquisitions of Businesses – cont'd

- Common Threads in any Acquisition Agreement: Although the actual form of the agreement for the sale of a business can involve many variations, there are many common threads involved for the draftsman. The principal segments of a typical agreement for the sale of a business include:
  - Introductory material (i.e., opening paragraph and recitals);
  - The price and mechanics of the business combination;
  - Representations and warranties of the buyer and seller;
  - Covenants of the buyer and seller;
  - Conditions to closing;
  - Indemnification;
  - Termination procedures and remedies; and
  - Miscellaneous (boilerplate) clauses.





# Joint Ventures

- A joint venture is a relationship typically between two or three entities to accomplish a defined objective, and may take form of a contract or an entity. EGAN ON ENTITIES §1.5 (28-36).
- Traditionally, a joint venture was thought of as limited purpose general partnership—but today a JV more likely an LLC. *Joint Venture* paper pp 5-9.







# Joint Ventures

- Contributions to a joint venture can range from an established business unit with people and knowledge to cash or a license of IP (perhaps technology which one party has and needs funds and marketing muscle of other to develop; could be two parents putting together under-performing units to generally get off balance sheet).
- Expectations range from development of a product or project to a stand-alone business where the exit strategy is an IPO or sale of the joint venture. The exit strategy could also be dissolution of joint venture and distribution to partners.





# Joint Ventures

- A joint venture may be contractual relationship or an entity.
- In the US, the LLC is now the entity of choice for joint ventures (principally limited liability with flexibility to be taxed as corporation or partnership and ability to limit fiduciary duties).
- *Dernick Resources Inc. v. Wilstein*, 312 S.W.3d 864 (Tex. App.—Houston [1st Dist.] 2009, no pet.), illustrates the dangers of using the term “joint venture” in contractual arrangements.

See EGAN ON ENTITIES §1.5 (28-36)





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