

CHOICE OF ENTITY DECISION TREE

By

BYRON F. EGAN
Jackson Walker L.L.P.
901 Main Street, Suite 6000
Dallas, Texas 75202-3797
began@jw.com



Choice and Acquisition of Entities in Texas 2013

San Antonio, TX (live) – May 24, 2013
Houston, TX (video) – June 28, 2013
Dallas, TX (video) – July 12, 2013

Sponsored By: TexasBarCLE and the Business Law Section of the State Bar of Texas

Copyright© 2013 by Byron F. Egan. All rights reserved.

Byron F. Egan
Biographical Information

Jackson Walker L.L.P.
901 Main Street, Suite 6000
Dallas, Texas 75202

Phone: (214) 953-5727
Email: began@jw.com
www.jw.com

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, 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* (2001). He is Chair of the Texas Business Law Foundation; is a former Chair of the Business Law Section of the State Bar of Texas and former Chair of that section’s Corporation Law Committee; and on behalf of these groups, 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.

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, corporations, partnerships, limited liability companies, securities laws, and financing techniques. 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: *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).

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.

Honors: For over ten years, Mr. Egan has been listed in *The Best Lawyers in America* under Corporate, M&A or Securities Law. He won the Burton Award for Legal Achievement in 2005, 2006, 2008 and 2009. 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*. In 2009, his paper 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.

TABLE OF CONTENTS

I.	GENERAL.....	1
A.	Introduction.....	1
B.	Statutory Updating.....	3
C.	Texas Business Organizations Code.....	6
1.	Background.....	6
2.	Source Law Codified.....	6
3.	Hub and Spoke Organization of Code.....	7
4.	Effective Date.....	8
5.	Changes Made By the TBOC.....	8
(a)	Vocabulary.....	8
(b)	Certificate of Formation.....	9
(c)	Filing procedures.....	9
(d)	Entity Names.....	10
(e)	Governance.....	10
(f)	Construction.....	11
(g)	Transition Rules.....	11
D.	TBOC Amendments Made in 2011 Legislative Session.....	11
1.	Technical TBOC Changes.....	11
2.	Other TBOC Amendments.....	12
(a)	LLP Insurance Requirement Eliminated.....	12
(b)	LLP Liability Shield Improved.....	12
(c)	Charging Orders for General Partnerships.....	12
(d)	Reasonable Restrictions on Access to Books and Records.....	12
(e)	Disenters Rights.....	12
(f)	Corporate Veil Piercing Limits Application to LLCs.....	12
E.	Amendments to Texas Business & Commerce Code in 2011 Legislative Session.....	13
1.	Choice of Law.....	13
(a)	Negotiations From Chosen Jurisdiction.....	15
(b)	Internal Affairs.....	15
(c)	\$25 Million Syndicated Loans.....	15
(d)	Reasonable Relationship Determined at Time of Transaction.....	15
2.	Uniform Commercial Code Article 9.....	16
F.	Federal “Check-the-Box” Tax Regulations.....	16
1.	Classification.....	16
2.	Check-the-Box Regulations.....	16
(a)	Eligible Entities.....	17
(b)	The Default Rules.....	17
(c)	The Election Rules.....	18
(d)	Existing Entities.....	18
3.	Former Classification Regulations.....	19
(a)	Continuity of Life.....	19
(b)	Centralization of Management.....	20
(c)	Limited Liability.....	20

(d)	Free Transferability of Interest.....	20
G.	Texas Entity Taxation.....	21
1.	Corporations and LLCs, but not Partnerships, Subject to Former Franchise Tax .	21
2.	Franchise Tax Change Proposals.....	21
3.	Margin Tax.....	23
(a)	Who is Subject to Margin Tax	24
(b)	Passive Entities.....	27
(c)	LLPs	28
(d)	Prior Chapter 171 Exemptions	28
(e)	Small Business Phase-In	29
(f)	Basic Calculation.....	29
(g)	Gross Revenue Less (x) Compensation or (y) Cost of Goods Sold.....	30
(h)	Gross Revenue.....	30
(i)	The Compensation Deduction.....	32
(j)	The Cost of “Goods” Sold Deduction	33
(k)	Transition and Filing	33
(l)	Unitary Reporting.....	33
(m)	Combined Reporting	34
(n)	Apportionment	36
(o)	Credits / NOLs	36
(p)	Administration and Enforcement	37
(q)	Effect of Margin Tax on Choice of Entity Decisions.....	37
4.	Constitutionality of Margin Tax Upheld in Allcat.....	37
5.	Classification of Margin Tax Under GAAP	39
6.	Internal Partnerships Will Not Work Under Margin Tax	40
7.	Conversions.....	41
8.	2011 Legislative Tax Changes.....	42
(a)	General Administrative Provisions	42
(1)	Record Retention	42
(2)	Late Filing Penalty.....	42
(3)	Enhanced Enforcement	42
(b)	Tax Speed Up Provisions	43
(c)	Margin Tax.....	43
(d)	Sales Tax	43
(1)	Nexus	43
(2)	Sale for Resale	44
(e)	Property Tax.....	44
H.	Business Combinations and Conversions	44
1.	Business Combinations Generally	44
(a)	Merger	44
(b)	Share Exchange.....	44
(c)	Asset Sale	45
2.	Conversions.....	48
(a)	General	48
(b)	Texas Statutes.....	48

(c)	Federal Income Tax Consequences.....	51
(1)	Conversions of Entities Classified as Partnerships.....	51
(2)	Conversions of Entities Classified as Corporations.....	52
(d)	Effect on State Licenses.....	53
I.	Use of Equity Interests to Compensate Service Providers.....	53
J.	Choice of Entity.....	53
II.	CORPORATIONS.....	54
A.	General.....	54
B.	Taxation.....	54
1.	Taxation of C-Corporations.....	55
2.	Taxation of S-Corporations.....	56
(a)	Effect of S-Corporation Status.....	56
(b)	Eligibility for S-Corporation Status.....	57
(c)	Termination of S-Corporation Status.....	57
(d)	Liquidation or Transfer of Interest.....	57
3.	Contributions of Appreciated Property.....	58
4.	Texas Entity Taxes.....	58
5.	Self-Employment Tax.....	58
C.	Owner Liability Issues.....	58
D.	Management.....	62
E.	Fiduciary Duties.....	65
1.	General.....	65
2.	Business Judgment Rule.....	66
3.	Overcoming Business Judgment Rule.....	66
4.	Corporate Opportunities Renunciation.....	66
5.	Interested Director Transactions.....	67
6.	Limitation of Director Liability.....	70
F.	Ability to Raise Capital.....	72
G.	Transferability of Ownership Interests.....	72
1.	Restrictions on Transfer of Shares.....	72
2.	Securities Law Restrictions.....	73
3.	Beneficial Owners.....	73
4.	No Bearer Shares.....	74
H.	Continuity of Life.....	74
I.	Formation.....	74
J.	Operations in Other Jurisdictions.....	76
K.	Business Combinations; Conversions.....	76
L.	Anti-Takeover.....	77
III.	GENERAL PARTNERSHIP.....	77
A.	General.....	77
1.	Definition of “Person”.....	78
2.	Factors Indicating Partnership.....	79
3.	Factors Not Indicative of Partnership.....	79
4.	Oral Partnerships.....	81
5.	Joint Ventures.....	81

B.	Taxation	82
1.	General Rule	82
2.	Joint Venture/Tax Implications.....	82
3.	Contributions of Appreciated Property.....	82
4.	Texas Entity Taxes.....	83
5.	Self-Employment Tax.....	83
C.	Owner Liability Issues	83
D.	Management.....	85
E.	Fiduciary Duties.....	85
1.	General.....	85
2.	Loyalty	86
3.	Care	86
4.	Candor.....	86
5.	Liability.....	87
6.	Effect of Partnership Agreement	87
F.	Ability To Raise Capital	87
G.	Transferability of Ownership Interests	87
1.	Generally.....	87
2.	Partnership Interests as Securities.....	88
H.	Continuity of Life	89
I.	Formation.....	89
J.	Operations in Other Jurisdictions.....	90
K.	Business Combinations.....	91
IV.	LIMITED PARTNERSHIP	91
A.	General.....	91
B.	Taxation	91
1.	Federal Income Taxation	91
2.	Contributions of Appreciated Property.....	91
3.	Texas Entity Taxes.....	92
4.	Self-Employment Tax.....	92
C.	Owner Liability Issues	93
D.	Distributions.....	95
E.	Management.....	96
F.	Fiduciary Duties.....	96
G.	Indemnification	104
H.	Flexibility In Raising Capital.....	105
I.	Transferability of Ownership Interests	106
J.	Continuity of Life	106
K.	Formation.....	108
L.	Operations in Other Jurisdictions.....	109
M.	Business Combinations.....	109
V.	LIMITED LIABILITY COMPANY	110
A.	General.....	110
B.	Taxation	111
1.	Check the Box Regulations.....	111

2.	Other Tax Issues Relating to LLCs.....	112
(a)	Texas Entity Taxes.....	112
(b)	Flexible Statute.....	112
(c)	One Member LLC.....	113
(d)	Contributions of Appreciated Property.....	113
(e)	Self-Employment Tax.....	114
C.	Members; Managers.....	116
D.	Purposes and Powers.....	117
E.	Formation.....	117
F.	Company Agreement.....	118
G.	Management.....	121
H.	Fiduciary Duties.....	123
I.	Indemnification.....	141
J.	Capital Contributions.....	141
K.	Allocation of Profits and Losses; Distributions.....	141
L.	Owner Limited Liability Issues.....	142
M.	Nature and Classes of Membership Interests.....	147
N.	Assignment of Membership Interests.....	153
O.	Dissolution.....	153
P.	Merger; Conversion.....	156
Q.	TLLCA Relationship to TBCA and TMCLA.....	157
R.	Foreign LLCs.....	158
S.	Professional LLCs.....	159
T.	Diversity Jurisdiction.....	160
VI.	LIMITED LIABILITY PARTNERSHIP.....	161
A.	General.....	161
B.	Evolution of the LLP in Texas.....	161
1.	First LLP in 1991 in Texas.....	161
2.	LLP Now Nationwide.....	162
3.	1997 Amendment to Limit Contract Liabilities.....	163
4.	Insurance Requirement.....	164
5.	TBOC Prior to 2011 S.....	166
C.	Liability Shielded After 2011 S.B. 748.....	170
1.	LLP Shield.....	171
2.	Limits to LLP Shield.....	172
3.	Burden of Proof.....	172
4.	LLP Status Does Not Affect Liability of Partnership.....	172
5.	Shielded vs.....	172
6.	Other State LLP Statutes.....	173
D.	Post 2011 S.B. 748 Requirements for LLP Status.....	173
1.	Name.....	173
2.	Filing with the Secretary of State of Texas.....	174
E.	Taxation.....	175
1.	Federal Tax Classification.....	175
2.	Texas Entity Taxes.....	175

3.	Self-Employment Tax	175
F.	Other Issues	175
1.	Advertisement of LLP Status	175
2.	Assumed Name Certificate	176
3.	Time of Compliance	176
4.	Effect on Pre-LLP Liabilities	177
5.	Limited Partnership as LLP	177
6.	Indemnification and Contribution	178
7.	Inconsistent Partnership Agreement Provisions	178
8.	Fiduciary Duties	180
9.	Foreign LLP Qualification	180
10.	Bankruptcy	182
11.	Federal Diversity Jurisdiction	183
VII.	EXTRATERRITORIAL RECOGNITION OF LLC AND LLP LIMITED LIABILITY	183
A.	General	183
B.	Texas Statutes	183
C.	Texas Cases	184
D.	Decisions in Other States	186
E.	Qualification as Foreign Entity and Other Ways to Reduce Extraterritorial Risk.....	189
VIII.	DECISION MATRIX	190
IX.	TAX COSTS IN CHOICE OF ENTITY DECISION.....	193
A.	Assumptions in Following Chart	193
B.	Unearned Income Medicare Contribution Tax	193
X.	CONCLUSION.....	195

APPENDIX A – Entity Comparison Chart

APPENDIX B – Basic Texas Business Entities and Federal/State Taxation Alternatives Chart

APPENDIX C – Texas Business Organizations Code Table of Contents As of September 1, 2011

APPENDIX D – An Introduction to the Texas Business Law Foundation

APPENDIX E – Legislation Sponsored by the Texas Business Law Foundation in the
2011 Legislative Session

APPENDIX F – Egan on Entities

CHOICE OF ENTITY DECISION TREE

BY

BYRON F. EGAN*

I. GENERAL.

A. **Introduction.** In selecting a form of business entity in which to engage in business in Texas the organizer or initial owners should consider the following five business entity forms:

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

The form of business entity most advantageous in a particular situation depends on the objectives of the business for which the entity is being organized. In most situations, the choice of entity focus continues to be on how the entity and its owners will be taxed and the extent to which the entity will shield the owners of the business from liabilities arising out of its activities. Appendix A at the back of this paper is an Entity Comparison Chart that compares key characteristics of the available Texas business entities, and Appendix B compares the tax attributes of the respective entities.

Until the 1990s, the spectrum of business entity forms available in Texas was not as broad as it is today. In 1991, the Texas Legislature passed the world’s first LLP statute permitting a general partnership to significantly limit the individual liability of its partners for certain acts of other partners by the partnership making a specified filing with the Secretary of State of Texas (the “Secretary of State”) and complying with certain other statutory requirements.¹ The Texas LLP statute was later amended to extend its LLP shield to contracts.

* Copyright © 2013 by Byron F. Egan. All rights reserved.

Byron F. Egan is a partner of Jackson Walker L.L.P. in Dallas, Texas. Mr. Egan is Senior Vice Chair and Chair of the Executive Council of the ABA Business Law Section’s Mergers & Acquisitions Committee and former Chair of its Asset Acquisition Agreement Task Force, and a member of the American Law Institute. Mr. Egan is Chairman of the Texas Business Law Foundation and is also former Chairman of the Business Law Section of the State Bar of Texas and of that Section’s Corporation Law Committee. *See “Egan on Entities”* attached as Appendix F.

The author wishes to particularly acknowledge the contribution of Steven D. Moore of Jackson Walker L.L.P. in Austin in preparing the Margin Tax discussions in this paper. The contributions of the following are also acknowledged: Alexandra E. Hanson, Nelson H. Hunt, William H. Hornberger, Michael L. Laussade and Monica Pace Messick of Jackson Walker L.L.P. in Dallas.

¹ Act of May 9, 1961, 57th Leg., R.S., ch. 158, 1961 Tex. Gen. Laws 289; Act of May 17, 1979, 66th Leg., R.S., ch. 723, § 5, 1979 Tex. Gen. Laws 1782; Act of May 9, 1985, 69th Leg., R.S., ch. 159, § 76, 1985 Tex. Gen. Laws 692; Act of May 9, 1991, 72d Leg., R.S., ch. 901, §§ 83–85, 1991 Tex. Gen. Laws 3234–35; Act of May 31, 1993, 73d Leg., R.S., ch. 917, § 2, 1993 Tex. Gen. Laws 3912–13 (expired Jan. 1, 1999); *see* Susan

Also in 1991, Texas became the fourth state to adopt a statute providing for the creation of an LLC, which limits the personal liability of LLC interest owners for LLC obligations at least as much as the liability of corporate shareholders is limited for corporate obligations. Today, all fifty states and the District of Columbia have adopted LLP and LLC statutes.²

The Texas Legislature enacted the Texas Business Organizations Code (the “TBOC”) to codify the Texas statutes relating to business entities referenced above, together with the Texas statutes governing the formation and operation of other for-profit and non-profit private sector entities.³ The TBOC is applicable to entities formed or converting under Texas law after January 1, 2006. Entities in existence on January 1, 2006 could continue to be governed by the Texas source statutes until January 1, 2010, after which time they must conform to the TBOC,⁴ although they could elect to be governed by the TBOC prior to that time.⁵

Federal and state taxation of an entity and its owners for entity income is a major factor in the selection of the form of entity for a particular situation. Under the United States (“U.S.”) Internal Revenue Code of 1986, as amended (the “IRC”), and the “Check-the-Box” regulations promulgated by the Internal Revenue Service (“IRS”), an unincorporated business entity may be classified as an “association” taxable as a corporation subject to income taxes at the corporate level ranging from 15% to 35% of taxable net income, absent a valid S-corporation status election, which is in addition to any taxation which may be imposed on the owner as a result of distributions from the business entity.⁶ Alternatively, the entity may be classified as a partnership, a non-taxable “flow-through” entity in which taxation is imposed only at the ownership level. Although a corporation is classified only as a corporation for IRC purposes, an LLC or partnership may elect whether to be classified as a partnership. A single-owner LLC is disregarded as a separate entity for federal income tax purposes unless it elects otherwise. In addition to federal tax laws, an entity and its advisors must comply with federal anti money laundering and terrorist regulations.⁷

Texas does not have a state personal income tax. The Texas Legislature has replaced the Texas franchise tax on corporations and LLCs with a novel business entity tax called the “Margin Tax,” which is imposed on all business entities other than general partnerships wholly

S. Fortney, *Professional Responsibility and Liability Issues Related to Limited Liability Law Partnerships*, 39 S. TEX. L. REV. 399, 402 (1998).

² J. William Callison, *Changed Circumstances: Eliminating the Williamson Presumption that General Partnership Interests Are Not Securities*, 58 BUS. LAW. 1373, 1382 (2003).

³ A detailed Table of Contents for the TBOC showing this organization appears in Appendix C.

⁴ TBOC § 402.005.

⁵ TBOC § 402.003.

⁶ *See infra* notes 91-105 and related text.

⁷ An entity and its advisors are charged with reviewing and complying with the Specially Designated Nationals List (“SDN List”) maintained by the Office of Foreign Assets Control (“OFAC”) within the United States (“U.S.”) Department of Treasury. U.S. citizens and companies (subject to certain exclusions typically conditioned upon the issuance of a special license) are precluded from engaging in business with any individual or entity listed on the SDN List. The SDN List and OFAC guidance are available on the OFAC website at <http://www.ustreas.gov/offices/enforcement/ofac/>.

owned by individuals and certain “passive entities.”⁸ Essentially, the calculation of the Margin Tax is based on a taxable entity’s, or unitary group’s, gross receipts after deductions for either (x) compensation or (y) cost of goods sold, provided that the “tax base” for the Margin Tax may not exceed 70% of the entity’s total revenues. This “tax base” is apportioned to Texas by multiplying the tax base by a fraction of which the numerator is Texas gross receipts and the denominator is aggregate gross receipts. The tax rate applied to the Texas portion of the tax base is 1% for all taxpayers, except a narrowly defined group of retail and wholesale businesses that will pay a ½ of 1% rate. For calendar year taxpayers, the Margin Tax is payable annually on May 15 of each year based on entity income for the year ending the preceding December 31.

The enactment of the Margin Tax changed the calculus for entity selections, but not necessarily the result. The LLC became more attractive as it can elect to be taxed as a corporation or partnership for federal income tax purposes, but the uncertainties as to an LLC’s treatment for self-employment purposes continue to restrict its desirability in some situations.⁹

B. Statutory Updating.

Texas’ entity statutes are continually being updated and improved through the efforts of the Texas Business Law Foundation¹⁰ and the Business Law Section of the State Bar of Texas¹¹ in an effort to make Texas a more attractive jurisdiction for the organization of entities.¹² This updating process commenced in 1950 with the organization of the State Bar’s Corporation Law Committee, which was succeeded in 1953 by what is now the Business Law Section and was later enhanced by the organization of the Texas Business Law Foundation.¹³ Continuing this tradition, the 75th Session of the Texas Legislature (the “1997 Legislative Session”), which adjourned *sine die* on June 2, 1997, brought Senate Bill 555 (“1997 S.B. 555”), which became effective September 1, 1997, making numerous changes in Texas’ business entity statutes, some of which were quite innovative.¹⁴ The changes effected in 1999 and 2001 were relatively limited; however in the 78th Session of the Texas Legislature (the “2003 Legislative Session”), which convened January 14, 2003 and adjourned *sine die* on June 2, 2003, the TBOC was

⁸ See *infra* notes 126-231 and related text.

⁹ See *infra* notes 609-621 and related text.

¹⁰ See *An Introduction to the Texas Business Law Foundation* attached as Appendix D.

¹¹ See Alan R. Bromberg, *Texas Business Organization and Commercial Law—Two Centuries of Development*, 55 SMU L. REV. 83, 113–14 (2002); Alan R. Bromberg, Byron F. Egan, Dan L. Nicewander, and Robert S. Trotti, *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 31 BULL. BUS. L. SEC. ST. B. TEX. 1 (1994); see generally Alan R. Bromberg, Byron F. Egan, Dan L. Nicewander, and Robert S. Trotti, *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 41 TEX. J. BUS. L. 41 (2005) (displaying the continually changing statutes).

¹² Cf. Jens Dammann & Matthias Schuëndeln, *The Incorporation Choices of Privately Held Corporations*, 27 J.L. ECON. & ORG. 79 (Apr. 2011).

¹³ See Bromberg, *supra* note 7, at 113–14; Bromberg et al., *Role of Business-Original*, *supra* note 7, at 1; Bromberg et al., *Role of Business-Updated*, *supra* note 7, at 44.

¹⁴ Tex. S.B. 555, 75th Leg., R.S. (1997); Curtis W. Huff, *The New Business Organization Laws: Changes Made in the 75th Legislature to Address Modern Business Practices*, 34 TEX. J. BUS. L. 1 (1997).

passed,¹⁵ and significant changes were made to Texas' other entity statutes.¹⁶ In the 79th Session of the Texas Legislature (the "2005 Legislative Session"), which convened January 11, 2005 and adjourned *sine die* on May 30, 2005, changes were again made to the Texas entity statutes,¹⁷ including the TBOC.¹⁸ In the 80th Session of the Texas Legislature (the "2007 Legislative Session"), which convened January 9, 2007 and adjourned *sine die* on May 28, 2007, further changes were made to the TBOC and other Texas statutes affecting business entities.¹⁹ Additional changes were made to the TBOC and other Texas statutes affecting business entities in the 81st Session of the Texas Legislature (the "2009 Legislative Session"), which convened on January 13, 2009 and adjourned *sine die* June 1, 2009.²⁰ This tradition of updating Texas' entity statutes through the efforts of the Business Law Section and the Texas Business Law Foundation continued in the 82nd Texas Legislature, 2011 Regular Session (the "2011 Legislative Session"), which convened on January 11, 2011 and adjourned on May 30, 2011.²¹ This tradition is

¹⁵ Tex. H.B. 1156, 78th Leg., R.S. (2003) by Rep. Helen Giddings, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=78R&Bill=HB1156> ("2003 H.B. 1156"). The "Revisor's Report" for the TBOC is available at both www.texasbusinesslaw.org and on the Texas Legislative Council website at http://www.tlc.state.tx.us/legal/bocode/bo_revisors_report.html. The interim report from the House Sub-Committee studying the TBOC, which contains a side-by-side comparison of the TBOC and its source law, is available at <http://www.house.state.tx.us>.

¹⁶ See Tex. H.B. 1165, 78th Leg., R.S. (2003) by Rep. Burt R. Solomons, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=78R&Bill=HB1165> ("2003 H.B. 1165"); see also Tex. H.B. 1637, 78th Leg., R.S. (2003) by Rep. Rene Oliveira, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=78R&Bill=HB1637> ("2003 H.B. 1637").

¹⁷ Tex. H.B. 1507, 79th Leg., R.S. (2005) by Rep. Burt Solomons, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=79R&Bill=HB1507> ("2005 H.B. 1507"); Tex. H.B. 1154, 79th Leg., R.S. (2005) by Rep. Gary Elkins, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=79R&Bill=HB1154>; Tex. H.B. 1319, 79th Leg., R.S. (2005) by Rep. Helen Giddings, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=79R&Bill=HB1319> ("2005 H.B. 1319").

¹⁸ 2005 H.B. 1319.

¹⁹ See Tex. H.B. 1737, 80th Leg., R.S. (2007) by Rep. Helen Giddings, available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=80R&Bill=HB1737> ("2007 H.B. 1737"), which became effective September 1, 2007; Daryl B. Robertson, *2007 Amendments to the Texas Business Organizations Code*, 42 TEX. J. BUS. L. 257 (Fall 2007).

²⁰ See Rick Tulli & Daryl Robertson, *2009 Legislative Update on Texas Business Organizations Code Amendments*, 43 TEX. J. BUS. L. 571 (Winter 2009); Byron F. Egan, *Choice of Entity Alternatives* (May 28, 2010), available at <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1396>, which at Appendix D describes (i) S.B. 1442 by Sen. Troy Fraser (generally updating the TBOC), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=SB1442> ("2009 S.B. 1442"), and (ii) H.B. 1787 by Rep. Burt Solomons (amending TBOC provisions pertaining to the designation of registered agents for service of process), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB1787> ("2009 H.B. 1787").

²¹ The TBOC was amended in the 2011 Legislative Session by the following bills, which were sponsored by the Texas Business Law Foundation, to be effective September 1, 2011:

S.B. 748 ("2011 S.B. 748") by Sen. John J. Carona was a 58-page package of amendments to the corporation, non-profit corporation, partnership and LLC provisions of the TBOC to address issues that have arisen in recent experience under the TBOC and to make the statute more user friendly for Texas entities, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB748>.

continuing in the 83rd Texas Legislature, 2013 Regular Session (the “2013 Legislative Session”), which convened on January 11, 2013 and will adjourn on May 27, 2013.²²

S.B. 323 (“2011 S.B. 323”) by Sen. John J. Carona amended the TBOC to provide that the TBOC provisions that limit the liability of shareholders of Texas corporations apply to managers and members of Texas LLCs if LLC “veil piercing” becomes recognized in Texas, *available at* <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB323>.

S.B. 1568 (“2011 S.B. 1568”) by Sen. Craig Estes clarified that a derivative plaintiff must own stock at the time of filing the derivative action and continuously to the completion of the action, *available at* <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB1568>.

The Texas Business Law Foundation also sponsored the following legislation in the 2011 Legislative Session:

H.B. 2991 (“2011 H.B. 2991”) by Rep. Joe Deshotel amended chapter 271 of the Texas Business and Commerce Code effective September 1, 2011 to add additional safe harbors for choosing the law of a particular jurisdiction to govern large transactions, *available at* <http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=82R&Bill=HB2991>.

S.B. 782 (“2011 S.B. 782”) by Sen. John Carona amended Texas Business and Commerce Code Chapter 9 effective July 1, 2013 to adopt changes to Uniform Commercial Code Article 9 approved and recommended by the National Conference of Commissioners on Uniform State Laws for enactment in all states (the majority of the changes are in the nature of language adjustments for clarity or to update Article 9 to reflect advances in technology or business practices), *available at* <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB782>.

Further information regarding each of the five bills referenced above appears in Appendix E (*Legislation Sponsored by the Texas Business Law Foundation in the 2011 Legislative Session*).

22

The legislation which the Texas Business Law Foundation has endorsed and is actively supporting in the 2013 Legislative Session includes:

1. Business Organizations Code Updating [HB 1929 (Olivera)/SB 847 (Corona)]: Amends the TBOC to update its provisions relating to corporations, partnerships and limited liability companies (“LLCs”), including (i) simplification of the required contents for amended and restated certificates of formation, (ii) requiring limited partnerships to give winding up notices to potential claimants much like corporations are currently required to do, (iii) clarifying that the governing documents of partnerships and LLCs may eliminate monetary liability of their governing persons to the same extent that a corporate certificate of formation can do so for directors and to the further extent permitted by the specific partnership and LLC provisions of the TBOC, (iv) clarification that partnership agreements and LLC company agreements may provide rights to persons who are not parties thereto (e.g., officers, managers or creditors), and (v) clarification of the powers of an LLC series and that a series is not a separate entity; the same bill also amends Section 24.003 of the Texas Business and Commerce Code (“*TB&CC*”) to eliminate a subsection that provided that a general partner’s nonpartnership assets are considered in determining the solvency of the partnership for fraudulent transfer purposes.
2. Social Purpose Corporations [HB 1928 (Olivera)/SB 849 (Carona)]: Amends the TBOC to allow for-profit corporations to include “social purposes” in their certificates of formation and to specify that their governing persons are entitled to consider those social purposes in making decisions on behalf of the corporations.
3. Finance Code [HB 1979 (Villarreal)/SB 952 (Carona)]: Amends Section 306.003 of the Finance Code to allow parties to commercial loans to agree that (i) interest is to be computed on the basis of actual days over a year of 360 days or twelve 30-day months, (ii) accrued interest may be paid on a periodic basis (not more often than monthly) by adding it to the principal balance of the loan, and (iii) confirm that the

C. Texas Business Organizations Code.

1. Background. In the 2003 Legislative Session, the TBOC, which was previously introduced and not passed in the 1999²³ and 2001 Legislative Sessions, was again introduced and finally passed.²⁴ The TBOC prior to the 2011 Legislative Session²⁵ included amendments made during the 2005 Legislative Session, the 2007 Legislative Session and the 2009 Legislative Session.²⁶ Additional amendments were made to the TBOC in 2011 including those discussed below under “D. Amendments Made in 2011 Legislative Session” and in Appendix E – Legislation Sponsored by the Texas Business Law Foundation in the 2011 Legislative Session. The TBOC is still a work in progress, and will be amended in subsequent Legislative Sessions as gaps and ambiguities are discovered, and as business organization practices and needs evolve. The TBOC provides considerable flexibility to organizations in establishing their capital structures, effecting business combination transactions and governing their internal affairs. It is a model for future statutes nationwide and solidifies Texas’ position as a leader in corporate law.

2. Source Law Codified. The TBOC is principally a codification of the existing Texas statutes governing non-profit and for-profit private-sector entities, rather than

provisions in Chapter 306 are meant to be safe harbors and do not create a negative implication for other transactions.

4. Amendments to Section 4A.108, Texas Business & Commerce Code [HB 702 (Deshotel)/SB 230 (Carona)]: Amends TB&CC Section 4A.108 so that international consumer wire transfers will remain covered by TB&CC Section 4A.108; the amendment is necessitated by an amendment to the federal Electronic Funds Transfer Act effected by the Dodd-Frank Wall Street Reform and Consumer Protection Act that would have removed the statutory framework for such transfers.

5. Amendments to Section 9.516(b), Texas Business & Commerce Code [HB 1970 (Villarreal)/SB 474 (Carona)]: Technical change to TB&CC Section 9.516(b) to eliminate organization information from financing statements that is not otherwise required by the TB&CC.

6. Uniform Trade Secrets Act [HB 1894 (Elkins)/SB 953 (Carona)]: The proposed Uniform Trade Secrets Act (“*UTSA*”) generally modernizes existing Texas common law relating to misappropriation of trade secrets, but makes the following changes from the *UTSA*: (i) does not require that information have been in “continuous use”, resulting in a broader class of trade secrets, (ii) provides that injunctive relief is a proper remedy, (iii) provides that attorneys’ fees are available to a plaintiff where misappropriation was willful and malicious, and are available to a defendant where a claim of misappropriation was made in bad faith, and (iv) provides that damages for misappropriation can include both actual loss and unjust enrichment, or alternatively imposition of a reasonable royalty, plus exemplary damages not exceeding twice any damage award. The *UTSA* has been adopted in 46 other states.

See *An Introduction to the Texas Business Law Foundation* attached as Appendix D.

²³ Thomas F. Blackwell, *The Revolution is Here: The Promise of a Unified Business Entity Code*, 24 J. CORP. L. 333, 359 (1999).

²⁴ 2003 H.B. 1156. The Revisor’s Report for the TBOC is available at both www.texasbusinesslaw.org and on the Texas Legislative Council website at http://www.tlc.state.tx.us/legal/bocode/bo_revisors_report.html. The interim report from the House Subcommittee studying the TBOC, which contains a side-by-side comparison of current and proposed law, is available at www.house.state.tx.us.

²⁵ TEX. BUS. ORGS. CODE. ANN. (Vernon 2011), available at <http://tlo2.tlc.state.tx.us/statutes/bo.toc.htm> (hereinafter “TBOC”).

²⁶ 2005 H.B. 1319, 2007 H.B. 1737, 2009 S.B. 1442 and 2009 H.B. 1787.

substantive modifications to existing law.²⁷ These statutes consist of the following: the Texas Business Corporation Act (the “TBCA”),²⁸ the Texas Non-Profit Corporation Act (the “TNPCA”),²⁹ the Texas Miscellaneous Corporation Laws Act (the “TMCLA”),³⁰ the Texas Limited Liability Company Act (the “LLC Act”),³¹ the Texas Revised Partnership Act (the “TRPA”),³² the Texas Revised Limited Partnership Act (the “TRLPA”),³³ the Texas Real Estate Investment Trust Act (the “TREITA”),³⁴ the Texas Uniform Unincorporated Nonprofit Associations Act (the “TUUNA”),³⁵ the Texas Professional Corporation Act (the “TPCA”),³⁶ the Texas Professional Associations Act (the “TPAA”),³⁷ the Texas Cooperative Associations Act (the “TCAA”),³⁸ and other existing provisions of Texas statutes governing private entities. Banks, trust companies, savings associations, insurance companies, railroad companies, cemetery organizations, and certain abstract or title companies organized under other special Texas statutes are not “domestic entities”³⁹ under the TBOC; therefore, they are governed by the TBOC only to the extent that the special Texas statute or its source laws incorporate the TBOC by reference or the TBOC is not inconsistent with the special statute.⁴⁰ Generally entities organized under Texas special statutes prior to January 1, 2006 were subject to the transition rules applicable to other Texas entities and continued to generally reference the source law rather than the TBOC until January 1, 2010, after which all Texas entities are governed by the TBOC.⁴¹

3. Hub and Spoke Organization of Code. The TBOC adopts a “hub and spoke” organizational approach under which provisions common to all entities are included in a central “hub” of the TBOC found in Title 1. These common provisions include, for example, the primary sections governing purposes and powers of entities, filings, meetings and voting, liability, indemnification of directors and partners, and mergers among entities. Outside of Title 1, separate “spokes” contain provisions governing different types of entities which are not

²⁷ Ad Hoc Codification Committee, *Report of the Codification Committee of the Section of Business Law of the State Bar of Texas on the Proposed Business Organizations Code*, Apr. 16, 2002, at 55, available at http://www.texasbusinesslaw.org/608127_6_date_12262000.pdf (hereinafter “Codification Comm. Report”).

²⁸ TEX. BUS. CORP. ACT ANN. arts. 1.01 *et. seq.* (Vernon Supp. 2011) (hereinafter “TBCA”).

²⁹ TEX. REV. CIV. STAT. ANN. art. 1396-1 (Vernon Supp. 2011) (hereinafter “TNPCA”).

³⁰ TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon Supp. 2011) (hereinafter “TMCLA”).

³¹ TEX. REV. CIV. STAT. ANN. art. 1528n (Vernon Supp. 2011) (hereinafter “LLC Act”).

³² TEX. REV. CIV. STAT. ANN. art. 6132b (repealed 1999) (hereinafter “TRPA”).

³³ TEX. REV. CIV. STAT. ANN. art. 6132a-1 (Vernon Supp. 2011) (hereinafter “TRLPA”).

³⁴ TEX. REV. CIV. STAT. ANN. art. 6138A (Vernon Supp. 2011) (hereinafter “TREITA”).

³⁵ TEX. REV. CIV. STAT. ANN. art. 1396-1B (Vernon Supp. 2011) (hereinafter “TUUNA”).

³⁶ TEX. REV. CIV. STAT. ANN. art. 1528e (Vernon Supp. 2011) (hereinafter “TPCA”).

³⁷ TEX. REV. CIV. STAT. ANN. art. 1528f (Vernon Supp. 2011) (hereinafter “TPAA”).

³⁸ TEX. REV. CIV. STAT. ANN. art. 1396-1A (Vernon Supp. 2011) (hereinafter “TCAA”).

³⁹ TBOC § 2.003.

⁴⁰ TBOC § 23.001.

⁴¹ TBOC § 402.005. Note that the Texas Finance Code has been amended by 2007 H.B. 1962 to provide that bank associations and trust companies organized after January 1, 2006 are governed by the TBOC. Tex. H.B. 1962, §§ 12 and 68, 80th Leg., R.S. (2007), available at <http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=80R&Bill=HB1962> (“2007 H.B. 1962”).

common or similar among the different entities. To determine applicable law for a given business entity, one should look first to the general provisions in Title 1, and then to the entity-specific provisions containing additions and modifications to the general rules. However, where a direct conflict exists between a provision of Title 1 and a provision of any other Title, the other Title will govern the matter.⁴²

4. Effective Date. The TBOC became effective on January 1, 2006 and applies to all domestic entities either organized in Texas or resulting from a conversion that takes effect on or after that date.⁴³ Domestic entities already in existence on January 1, 2006 continued to be governed by then existing entity statutes until January 1, 2010,⁴⁴ at which time the source laws were repealed and all domestic entities became subject to the TBOC. However, such entities could elect to be governed by the TBOC prior to that date by making a filing with the Secretary of State of Texas and amending their governing documents as necessary.⁴⁵

5. Changes Made By the TBOC. The TBOC, which had been under development since 1995, was a joint project of the Business Law Section of the State Bar of Texas, the office of the Texas Secretary of State and the Texas Legislative Council,⁴⁶ and was passed with the endorsement and strong support of the Texas Business Law Foundation. In the codification process, the general objective was not to make substantive revisions to the existing Texas statutes. However, the TBOC did change the form and procedures of many of the existing provisions, and some substantive changes did occur. Some of the more general changes, as well as basic transition and construction provisions, are summarized below. Other changes that are more entity-specific are addressed in the appropriate sections of this article.

(a) Vocabulary. In an effort to streamline laws that govern business entities, the TBOC uses new terms to denote concepts and filings that previously were common to many different entity types but under different names. For example, each entity typically has a particular person or set of persons which govern that type of entity. For limited partnerships, that person is the general partner; for corporations, it is the board of directors; and for LLCs, it is either the managers or members, as specified in the LLC's formation documents. The TBOC replaces all those different terms and simply refers to the persons or entities that control the entity as that entity's "governing authority."⁴⁷ Similarly, the name of the document a filing entity must file with the Secretary of State to be duly organized under Texas law is now simply called a "certificate of formation," whereas previously each entity had its own name for such document.⁴⁸ One other significant vocabulary change is that the Regulations of a limited liability

⁴² TBOC § 1.106(c).

⁴³ TBOC § 402.001(a).

⁴⁴ TBOC § 402.005.

⁴⁵ TBOC § 402.003.

⁴⁶ Revisor's Report, *supra* note 15. The Bar Committee was primarily responsible for drafting the TBOC in collaboration with the Secretary of State and the Texas Legislative Council.

⁴⁷ TBOC § 1.002(35).

⁴⁸ TBOC § 1.002(6). Comparable documents under pre-TBOC law include a corporation's Articles of Incorporation, an LLC's Articles of Organization, and a limited partnership's Certificate of Limited Partnership.

company are now referred to as its “Company Agreement.”⁴⁹ Other changes include the shift in the titles of filings from “Application for Certificate of Authority to Transact Business”⁵⁰ to “Application for Registration,”⁵¹ from “Articles of Amendment”⁵² to “Certificate of Amendment,”⁵³ and from “Articles of Dissolution”⁵⁴ to “Certificate of Termination.”⁵⁵ Under the TBOC, a “domestic entity” is a corporation, partnership, LLC or other entity formed under the TBOC or whose internal affairs are governed by the TBOC,⁵⁶ and a “foreign entity” is an organization that is formed under and the internal affairs are governed by the laws of a jurisdiction other than Texas.⁵⁷ A Texas entity that is formed by a filing with the Secretary of State is called a “filing entity” and includes a corporation, LP, LLC, professional association and a real estate investment trust.⁵⁸ “Person” was initially defined by reference to § 311.005 of the Government Code, and is now defined in TBOC § 1.002(69-b).⁵⁹

(b) Certificate of Formation. In addition to changing the name of the formation document required of entities organizing in Texas, the TBOC has made small alterations to its required contents as well. For example, previously such a document had to state the entity’s period of duration. The TBOC eliminates this requirement, except for entities that will not exist perpetually.⁶⁰ However, it adds the requirement that the document state what type of entity shall be formed upon its filing.⁶¹ Other requirements differ slightly for each entity.⁶²

(c) Filing procedures. In addition to changing the form of the document required to organize a Texas business entity, the TBOC streamlined the filing fees for a number of documents.⁶³ For example, the filing fees for a certificate of formation for all domestic entities are now set forth in TBOC Chapter Four, Subchapter D.⁶⁴ Additionally, the TBOC now authorizes a filing fee of \$50 for the pre-clearance of any document, whereas before,

⁴⁹ See TBOC § 101.052.

⁵⁰ See TBCA art. 8.01.

⁵¹ See TBOC § 9.004.

⁵² See TBCA art. 4.04.

⁵³ See TBOC § 3.053.

⁵⁴ See TBCA art. 6.06.

⁵⁵ See TBOC § 11.101.

⁵⁶ TBOC § 1.002(18).

⁵⁷ TBOC § 1.002(28).

⁵⁸ TBOC § 1.002(22).

⁵⁹ TBOC § 1.002(69-b) defines “person” as follows:

(69-b) “Person” means an individual or a corporation, partnership, limited liability company, business trust, trust, association, or other organization, estate, government or governmental subdivision or agency, or other legal entity.

⁶⁰ TBOC §§ 3.003, 3.005, and the related Revisor’s Report, *supra* note 15.

⁶¹ TBOC § 3.005 and the related Revisor’s Report, *supra* note 15.

⁶² TBOC § 3.005 provides the minimum requirements for all Certificates of Formation, and the sections immediately thereafter specify the additional information required for each type of entity.

⁶³ See TBOC Chapter 4, Subchapter D.

⁶⁴ See *id.* and the related Revisor’s Report, *supra* note 15.

the Secretary of State was only authorized to charge such fee for pre-clearance of limited partnership documents.⁶⁵ Another procedural change is that previously, when certain entities sent in their formation document (i.e., articles of incorporation for a regular corporation), the Secretary of State would send back an official document in response (i.e., a certificate of incorporation).⁶⁶ Now, however, upon receipt of a certificate of formation, the Secretary of State may simply return a written acknowledgement of the filing, and is not required to issue any additional certificates or documents.⁶⁷ Filings are generally effective when filed, not when the Secretary of State acknowledges them.⁶⁸ Additionally, documents with delayed effective dates may now be abandoned at any time prior to effectiveness.⁶⁹

(d) Entity Names. The TBOC relaxes the requirements for indicating the business entity form in the entity's official name further than even the most recent revisions to pre-TBOC law. A business's name must still indicate the business's entity form, but with greater flexibility regarding placement and abbreviation thereof than was previously permitted.⁷⁰ For example, previously, a limited partnership had to include in its name "limited," "limited partnership," "L.P.," or "Ltd.," and the name could not contain the name of a limited partner except under limited circumstances.⁷¹ Now, however, limited partnerships need only contain "limited," "limited partnership," or "an abbreviation of that word or phrase" in their names, without any restrictions on the inclusion of a limited partner's name.⁷² Under the TBOC an LLP is called a limited liability partnership rather than a "registered" limited liability partnership as it was known under TRPA.⁷³

(e) Governance. Subject to contrary provisions in an entity's governing documents, the TBOC now permits the removal of officers with or without cause, doing away with the requirement in much of the source law that such removal must be in the entity's best interests.⁷⁴ Also, the TBOC extends to all types of domestic entities the right for officers and directors to rely on opinions, reports, and statements given by certain people in the execution of their duties.⁷⁵ Further, it clarifies, as a default rule, that governing persons of domestic entities, other than limited partnerships, have the right to inspect the entity's books and records in connection with their duties.⁷⁶

⁶⁵ TBOC § 4.151 and the related Revisor's Report, *supra* note 15.

⁶⁶ *See* TBCA art. 3.03.

⁶⁷ *See* TBOC § 4.002 the related Revisor's Report, *supra* note 15.

⁶⁸ TBOC § 4.051.

⁶⁹ TBOC § 4.057.

⁷⁰ *See* TBOC §§ 5.054-5.063.

⁷¹ TRLPA § 1.03.

⁷² TBOC §§ 5.055, 153.102 and the related Revisor's Report, *supra* note 15.

⁷³ TRPA § 3.08; TBOC §§ 1.002(48) and 152.801-152.805.

⁷⁴ TBOC § 3.104; TBCA art. 2.43; TNPCA art. 1396-2.21.

⁷⁵ TBOC § 3.102. This default right previously existed for certain entities (*see, e.g.*, TBCA art. 2.41D and TNPCA art. 1396-2.28(B)), but not for partnerships or LLCs. *See* TBOC § 3.102 and the related Revisor's Report, *supra* note 15.

⁷⁶ TBOC § 3.152 and the related Revisor's Report, *supra* note 15.

Additionally, the TBOC expands the permissible methods of holding required meetings to encompass the broad spectrum of technology now available by which such meetings may be conducted.⁷⁷ Moreover, it adds safeguards that must be followed when using such technology to assure that only authorized persons are able to vote at such meetings.⁷⁸

(f) Construction. The TBOC incorporates the provisions of the Code Construction Act⁷⁹ to assist in its interpretation.⁸⁰ The Code Construction Act includes such useful aids as definitions of commonly used terms, basic rules of construction, the order of authority for conflicting statutes, and statutory savings provisions. The rules of the Code Construction Act are general in nature, and are intended to fill in any gaps left by the more specific rules of construction provided within the TBOC applicable to particular entity types.

(g) Transition Rules.⁸¹ As previously stated, during the transition period between January 1, 2006 and January 1, 2010, entities which were formed in Texas prior to the TBOC's effective date but not opting in to TBOC governance continued to be governed by the old Texas statutes. During that period, such entities could continue to make filings with the Texas Secretary of State in the same manner as before the TBOC effective date, without any need to conform to the new filing requirements of the TBOC or adjust the nomenclature used.⁸² However, limited liability partnerships were only entitled to continue following the registration requirements of the TRPA and TRLPA until their existing registrations expired,⁸³ at which point they were required to renew under the TBOC (although until January 1, 2010 they continued to be substantively governed by the TRPA and TRLPA).

D. TBOC Amendments Made in 2011 Legislative Session. In the 2011 Legislative Session, both technical and substantive changes were made to the TBOC to be effective September 1, 2011.⁸⁴ Those changes are described in Appendix E – Legislation Sponsored by the Texas Business Law Foundation in the 2011 Legislative Session and elsewhere below.

1. Technical TBOC Changes. Important technical amendments from the 2011 Legislative Session that make explicit what is implicit in existing law include the following: (1) clarifying how a membership interest in a limited liability company is treated on the divorce of a member or the death of a member or member's spouse, based on similar provisions for partnerships; (2) clarifying the effects in governing documents of references to

⁷⁷ See TBOC § 6.002.

⁷⁸ TBOC § 6.002.

⁷⁹ TEX. GOV'T CODE ANN. § 311 (Vernon Supp. 2011).

⁸⁰ TBOC § 1.051.

⁸¹ For more detailed rules governing the transition period, see TBOC Title 8.

⁸² To illustrate, a corporation that was incorporated in Texas prior to January 1, 2006 could still amend its Articles of Incorporation by filing Articles of Amendment to its Articles of Incorporation, rather than a Certificate of Amendment until January 1, 2010. The Articles of Amendment would only need to conform to the current version of the TBCA until January 1, 2010.

⁸³ TBOC § 402.001(b).

⁸⁴ See generally Daryl B. Robertson, *2011 Legislative Update: Amendments to the Texas Business Organizations Code and Texas Business and Commerce Code*, XXX CORP. COUNS. REV. 159 (Nov. 2011).

prior law and synonymous terms; (3) clarifying that certain provisions in Chapter 101 which specify the requirements for establishment of a series limited liability company may not be waived by the company agreement; (4) clarifying the power to reinstate an entity pursuant to the Code if the entity was formed as a domestic entity or registered as a foreign entity under prior law; (5) clarifying that a director, officer or member that has a conflict of interest in a transaction or due to a relationship cannot be subject to a claim for breach of duty if the director, officer or member follows the statutory procedure for approval of the conflict of interest transaction or relationship; and (b) clarifying that a plaintiff in a corporate derivative lawsuit must have been a shareholder at the time of filing suit through completion of the proceedings.

2. Other TBOC Amendments.

(a) LLP Insurance Requirement Eliminated. Eliminating the antiquated requirement for liability insurance or posting of a cash deposit or bond as a condition to the registration of an LLP, thereby conforming to the Uniform Partnership Act (1997) and the respective laws of most other states.

(b) LLP Liability Shield Improved. Conforming the vicarious liability provisions relating to limited liability partnerships to the approach taken in the Uniform Partnership Act (1997) and the trend in other states.

(c) Charging Orders for General Partnerships. Adding charging order provisions for partnership interests in general partnerships that are similar to the charging order provisions applicable to partnership interests in limited partnerships and membership interests in LLCs.

(d) Reasonable Restrictions on Access to Books and Records. Allowing the company agreement of an LLC and the partnership agreement of a limited partnership to reasonably to restrict access by a member or limited partner, respectively, to the entity's books and records.

(e) Disenters Rights. Amending the time periods for certain notices and other actions in the dissenters' rights provisions to make them more uniform and, like the historical pattern in the source provisions of the TBCA, to establish a time limit on the procedure before recourse to a court.

(f) Corporate Veil Piercing Limits Application to LLCs. TBOC § 101.114 provides that a member or manager is not liable for the debts, obligations or liabilities of an LLC, except as and to the extent the company agreement or regulations specifically provide otherwise. This language prohibits a court from holding the members or managers liable for the debts, obligations and liabilities of an LLC. However, some recent judicial opinions have applied corporate veil piercing principles to LLCs, causing uncertainty as to the proper standards to be applied if LLC veil piercing is to be recognized. Of note, some Texas opinions have

applied corporate veil piercing standards in disregarding the statutory liability shield.⁸⁵ When applying corporate veil piercing standards to limited liability companies, these courts recognized that the provisions of TBCA Article 2.21, which are carried over in TBOC §§ 21.223 through 21.226, were controlling with respect to such standards. 2011 S.B. 323 clarified the standards for the piercing of the LLC statutory liability shield by adding a new TBOC § 101.002 which provides that TBOC §§ 21.223, 21.224, 21.225 and 21.226 apply to an LLC and its members, owners, assignees and subscribers, subject to the limitations contained in TBOC § 101.114.

E. Amendments to Texas Business & Commerce Code in 2011 Legislative Session.

1. **Choice of Law.** A “choice of law” clause is a contract provision stating that any dispute arising under the contract shall be handled in accordance with the law of the particular jurisdiction specified in the contract. Prior to September 1, 1993, Texas relied on two principles for determining the enforceability of a choice of law provision in a contract: (i) the Uniform Commercial Code (“UCC”) § 1.301 (formerly UCC § 1.105) governed transactions covered by the UCC and required a “reasonable relationship” between the parties and the chosen jurisdiction to exist for that jurisdiction’s law to be applied⁸⁶ and (ii) all remaining transactions were governed by the common law Restatement (Second) of Conflict of Laws, Section 187,

⁸⁵ See, e.g., *McCarthy v. Wani Venture, A.S.*, 251 S.W.3d 573, (Tex. App.—Houston [1st Dist.] 2007, pet. denied); *In re JNS Aviation, LLC (Nick Corp. v. JNS Aviation, Inc.)*, 376 B.R. 500 (Bankr. N.D. Tex. 2007), amended in part by 2008 WL 686159 (Bankr. N.D. Tex. March 7, 2008).

⁸⁶ UCC § 1.301 as adopted in Texas appears in Texas Business and Commerce Code (“TB&CC”) § 1.301. TB&CC § 1.301 (as in effect both before and after the 2011 Legislative Session) provides as follows:

Sec. 1.301. TERRITORIAL APPLICATION OF THE TITLE; PARTIES’ POWER TO CHOOSE APPLICABLE LAW. (a) Except as provided hereafter in this section, when a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties. Failing such agreement this title applies to transactions bearing an appropriate relation to this state.

(b) Where one of the following provisions of this title specifies the applicable law, that provision governs and a contrary agreement is effective only to the extent permitted by the law (including the conflict of laws rules) so specified:

Rights of creditors against sold goods. Section 2.402.

Applicability of the chapter on Leases. Sections 2A.105 and 2A.106.

Applicability of the chapter on Bank Deposits and Collections. Section 4.102.

Governing law in the chapter on Funds Transfers. Section 4A.507.

Letters of Credit. Section 5.116.

Applicability of the chapter on Investment Securities. Section 8.110.

Law governing perfection, the effect of perfection or nonperfection, and the priority of security interests and agricultural liens. Sections 9.301-9.307.

(c) If a transaction that is subject to this title is a “qualified transaction,” as defined in Section 271.001, then except as provided in Subsection (b) of this section, Chapter 271 governs the effect of an agreement by the parties that the law of a particular jurisdiction governs an issue relating to the transaction or that the law of a particular jurisdiction governs the interpretation or construction of an agreement relating to the transaction or a provision of the agreement.

which provided that, with certain exceptions, a contractual choice of law will be enforced unless there is no reasonable basis for the choice.

Effective September 1, 1993, Section 35.51 (now located in Chapter 271) was added to the Texas Business and Commerce Code (“TB&CC”) to govern certain choice of law provisions. Under this provision, with certain exceptions, the parties to a transaction involving more than \$1 million (a “qualified transaction”) may agree that the law of a particular jurisdiction governs a particular issue relating to the transaction, including the validity or the enforceability of an agreement relating to the transaction or a provision of the agreement. If the transaction bears a reasonable relation to the chosen jurisdiction, then the laws of that jurisdiction (other than conflict laws rules) shall govern the particular issue. In addition, the statute contains specific factual criteria or “safe harbors,” the presence of any one of which will satisfy the “reasonable relation” test.

In the 2011 Legislative Session, TB&CC Chapter 271 (Rights of Parties to Choose Law Applicable to Certain Transactions) was updated to reflect modern business practices in large transactions by 2011 H.B. 2991⁸⁷ to add additional safe harbors for choosing the law of a particular jurisdiction to govern transactions involving at least \$1 million.⁸⁸ The

⁸⁷ Available at <http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=82R&Bill=HB2991>.

⁸⁸ 2011 H.B. No. 2991 amended TB&CC § 271.004, effective for transactions entered into on or after September 1, 2011, by amending Subsection (b) and adding Subsection (c) to read as follows:

(b) A transaction bearing [bears] a reasonable relation to a particular jurisdiction includes [if]:

(1) a transaction in which:

(A) a party to the transaction is a resident of that jurisdiction;

(B) [~~2~~] a party to the transaction has the party’s place of business or, if that party has more than one place of business, the party’s chief executive office or an office from which the party conducts a substantial part of the negotiations relating to the transaction, in that jurisdiction;

(C) [~~3~~] all or part of the subject matter of the transaction is located in that jurisdiction;

(D) [~~4~~] a party to the transaction is required to perform in that jurisdiction a substantial part of the party’s obligations relating to the transaction, such as delivering payments; [~~or~~]

(E) [~~5~~] a substantial part of the negotiations relating to the transaction occurred in or from that jurisdiction and an agreement relating to the transaction was signed in that jurisdiction by a party to the transaction; or

(F) all or part of the subject matter of the transaction is related to the governing documents or internal affairs of an entity formed under the laws of that jurisdiction, such as:

(i) an agreement among members or owners of the entity, an agreement or option to acquire a membership or ownership interest in the entity, and the conversion of debt or other securities into an ownership interest in the entity; and

(ii) any other matter relating to rights or obligations with respect to the entity’s membership or ownership interests; and

(2) a transaction in which:

(A) all or part of the subject matter of the transaction is a loan or other extension of credit in which a party lends, advances, borrows, or receives, or is obligated to lend or advance or entitled to borrow or receive, money or credit with an aggregate value of at least \$25 million;

(B) at least three financial institutions or other lenders or providers of credit are parties to the transaction;

2011 changes to TB&CC Chapter 271 related to (a) transactions in which a substantial part of the negotiations were conducted from the chosen jurisdiction; (b) agreements governing the internal affairs of an entity; (c) agreements for multi-lender financing transactions involving at least \$25 million; and (d) whether there is a qualifying reasonable relationship to the law chosen is to be determined at time of transaction and is not affected by subsequent events:

(a) Negotiations From Chosen Jurisdiction. TBOC § 271.004(b)(1)(E) was amended to provide that a transaction bears a reasonable relation to the chosen jurisdiction if a substantial part of the negotiations relating to the transaction occurred from the chosen jurisdiction, as well as in the chosen jurisdiction or an agreement relating to the transaction was signed in that jurisdiction by a party to the transaction.

(b) Internal Affairs. TB&CC § 271.004(b)(1) was amended to add a new subsection (F) providing that a transaction bears a reasonable relation to the chosen jurisdiction if “all or part of the subject matter of the transaction is related to the governing documents or internal affairs of an entity formed under the laws of that jurisdiction, such as: (i) an agreement among members or owners of the entity, an agreement or option to acquire a membership or ownership interest in the entity, and the conversion of debt or other securities into an ownership interest in the entity; and (ii) any other matter relating to rights or obligations with respect to the entity’s membership or ownership interests.”

(c) \$25 Million Syndicated Loans. TB&CC § 271.004(b) was amended to add a new subsection (2) providing that a transaction bears a reasonable relation to the chosen jurisdiction if (A) all or part of the subject matter of the transaction is a loan or other extension of credit in which a party lends, advances, borrows, or receives, or is obligated to lend or advance or entitled to borrow or receive, money or credit with an aggregate value of at least \$25 million; (B) at least three financial institutions or other lenders or providers of credit are parties to the transaction; (C) the particular jurisdiction is in the United States; and (D) a party to the transaction has more than one place of business and has an office in that particular jurisdiction.”

(d) Reasonable Relationship Determined at Time of Transaction. TB&CC § 271.004 was further amended to add a new subsection (c) providing: “If a transaction bears a reasonable relation to a particular jurisdiction at the time the parties enter into the transaction, the transaction shall continue to bear a reasonable relation to that jurisdiction regardless of: (1) any subsequent change in facts or circumstances with respect to the

(C) the particular jurisdiction is in the United States; and

(D) a party to the transaction has more than one place of business and has an office in that particular jurisdiction.

(c) If a transaction bears a reasonable relation to a particular jurisdiction at the time the parties enter into the transaction, the transaction shall continue to bear a reasonable relation to that jurisdiction regardless of:

(1) any subsequent change in facts or circumstances with respect to the transaction, the subject matter of the transaction, or any party to the transaction; or

(2) any modification, amendment, renewal, extension, or restatement of any agreement relating to the transaction.

transaction, the subject matter of the transaction, or any party to the transaction; or (2) any modification, amendment, renewal, extension, or restatement of any agreement relating to the transaction.”

2. Uniform Commercial Code Article 9. TB&CC Chapter 9 (Secured Transactions) is the body of law that controls secured transactions, including security agreements for real and personal property, and related agreements between creditors and debtors. Since the current version of Chapter 9 took effect in 2001, a number of its provisions have proven cumbersome or problematic. 2011 S.B. 782⁸⁹ amended TB&CC Chapter 9 to adopt changes to UCC Article 9 approved and recommended by the National Conference of Commissioners on Uniform State Laws for enactment in all states. The majority of the 2011 amendments are in the nature of language adjustments for clarity or to update UCC Article 9 to reflect advances in technology or business practices and become effective July 1, 2013.

F. Federal “Check-the-Box” Tax Regulations.

1. Classification. Under the IRC and the Treasury regulations promulgated thereunder, an unincorporated business entity may be classified as an “association” taxable as a corporation and subject to income taxes at the corporate level ranging from 15% to 35% of taxable net income (absent a valid S-corporation status election) in addition to any taxation which may be imposed on the owner as a result of distributions from the business entity. Alternatively, the entity may be classified as a partnership, a non-taxable “flow-through” entity in which taxation is imposed only at the ownership level. Finally, if it is a single-owner LLC or LP, it may be disregarded as a separate entity for federal income tax purposes.⁹⁰

For many years, the IRS classified business entities for purposes of federal income taxation by determining whether an organization had more corporate characteristics than non-corporate characteristics. Thus, if an entity possessed more than two of the corporate characteristics of continuity of life, centralization of management, limited liability, and free transferability of interest, it would be classified as a corporation for purposes of federal income taxation. Effective January 1, 1997, the IRS adopted “the Check-the-Box” Regulations discussed below, which effectively allow a partnership or LLC to elect whether to be taxed as a corporation.

2. Check-the-Box Regulations. On December 18, 1996 the IRS issued Treasury Regulations §§ 301.7701-1, -2 and -3 (the “Check-the-Box Regulations”), which became effective January 1, 1997 and completely replaced the former classification regulations.⁹¹ Entities now have the assurance of either partnership or corporate classification

⁸⁹ Available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB782>.

⁹⁰ Rev. Rul. 2004-77, 2004-2 C.B. 119 (July 29, 2004) (“If an eligible entity has two members under local law, but one of the members of the eligible entity is, for federal tax purposes, disregarded as an entity separate from the other member of the eligible entity, then the eligible entity cannot be classified as a partnership and is either disregarded as an entity separate from its owner or an association taxable as a corporation”).

⁹¹ T.D. 8697, 1997-1 C.B. 215, corrected by T.D. 8697, 1997 WL 108762 (IRS TD Mar 13, 1997).

under a set of default rules or the ability to make an election to obtain the desired classification.⁹² Although the four factor technical analysis of the IRS' former classification regulations ("Former Classification Regulations") has been completely replaced, the IRS still requires certain prerequisites to be fulfilled prior to qualifying under the default rules or making a valid election:⁹³

(a) Eligible Entities. Initially, the entity must be a "business entity" that is separate from its owners for federal income tax purposes. A business entity is defined, in part, as any entity recognized for tax purposes that is not classified as a trust under Treas. Reg. § 301.7701-4 or otherwise subject to special treatment under the IRC, e.g., real estate mortgage investment conduits ("REMICs").⁹⁴ The Check-the-Box Regulations do not provide a test for determining when a separate entity exists. Rather, the Check-the-Box Regulations merely state that a separate entity may be created by a joint venture or other contractual arrangement if the participants carry on a trade or business and divide the resulting profits.⁹⁵ Additionally, to be eligible for partnership classification, the business entity must not be automatically classified as a corporation under the Check-the-Box Regulations (e.g., domestic incorporated entities, life insurance companies and most entities whose interests are publicly traded).⁹⁶ Among the entities that the Check-the-Box Regulations automatically classify as corporations are over 85 specific types of foreign business entities.⁹⁷ A business entity that meets the foregoing requirements is an "eligible entity" that need not make an election if the entity meets the requirements of the default rules.⁹⁸

(b) The Default Rules. The default rules under Treas. Reg. § 301.7701-3(b)(1) provide that a domestic eligible entity (an entity organized in the U.S. that is not classified as a corporation) is a partnership if it has two or more members and is disregarded as a separate entity if it has a single owner (i.e., treated as a sole proprietorship or division of the owner). Under Treas. Reg. § 301.7701-3(b)(2), a foreign eligible entity is (i) a partnership if it has two or more members and at least one member has unlimited liability (as determined solely by reference to the law under which the entity is organized),⁹⁹ (ii) an association taxable as a

⁹² Treas. Reg. § 301.7701-3(a) (as amended in 2006).

⁹³ *Id.*

⁹⁴ *Id.* §§ 301.7701-2(a), 301.7701-4.

⁹⁵ *Id.* § 301.7701-1(a)(2).

⁹⁶ *Id.* § 301.7701-2.

⁹⁷ Treas. Reg. § 301.7701-2(b)(8).

⁹⁸ *Id.* § 301.7701-3(a).

⁹⁹ Treas. Reg. § 301.7701-3(b)(2)(ii) provides:

[A] member of a foreign eligible entity has limited liability if the member has no personal liability for the debts of or claims against the entity by reason of being a member. This determination is based solely on the statute or law pursuant to which the entity is organized, except that if the underlying statute or law allows the entity to specify in its organizational documents whether the members will have limited liability, the organizational documents may also be relevant. For purposes of this section, a member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such. A member has personal liability for purposes of this paragraph even if the member makes an

corporation if no member has unlimited liability, or (iii) disregarded as a separate entity if it has a single owner with unlimited liability.

(c) The Election Rules. An eligible entity that desires to obtain a classification other than under the default classification rules, or desires to change its classification, may file an election with the IRS on Form 8832 (Entity Classification Election).¹⁰⁰ For example, an election will be necessary if a domestic LLC with two or more members qualifies as an eligible entity and the owners desire corporate classification rather than the default partnership classification. The Treasury Regulations require that each member of an entity, or any officer, manager or member of the entity who is authorized to make the election and who so represents under penalty of perjury, sign Form 8832.¹⁰¹

(d) Existing Entities. Under the Check-the-Box Regulations, the classification of eligible entities in existence prior to the effective date of the regulations will be respected by the IRS for all periods prior to January 1, 1997 if (i) the entity had a reasonable basis¹⁰² for its claimed classification, (ii) the entity and all of the entity's members or partners recognized the federal income tax consequences of any change in the entity's classification within the 60 months prior to January 1, 1997, and (iii) neither the entity nor any member had been notified in writing on or before May 8, 1996 that the entity's classification was under examination by the IRS.¹⁰³ Therefore, unless an existing eligible entity elected to change the classification claimed prior to January 1, 1997, the entity will be "grandfathered" and will not be required to make an election to protect its classification. However, the one exception to this rule is when a single owner entity previously claimed to be classified as a partnership.¹⁰⁴ The single owner entity will be disregarded as an entity separate from its owner and thus will be treated as a sole proprietorship, or a branch or division of the owner.¹⁰⁵ If an entity elects to change its classification, there can be severe adverse consequences and tax counsel should be consulted.

agreement under which another person (whether or not a member of the entity) assumes such liability or agrees to indemnify that member for any such liability.

¹⁰⁰ *Id.* § 301.7701-3(c).

¹⁰¹ *Id.* § 301.7701-3(g)(2).

¹⁰² The term "reasonable basis" has the same meaning as under I.R.C. § 6662, which addresses the accuracy-related penalties. Treas. Reg. § 301.7701-3(h)(2)(i). The "reasonable basis" standard is defined in Treas. Reg. § 1.6662-3(b)(3) as follows:

Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in [Treas. Reg.] § 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in [Treas. Reg.] § 1.6662-4(d)(2).

See American Bar Association Section of Taxation Committee on the Standards of Tax Practice, *Standards of Tax Practice Statement*, 54 TAX LAW. 185, 189 (2000).

¹⁰³ Treas. Reg. § 301.7701-3(h)(2).

¹⁰⁴ *Id.* § 301.7701-3(b)(3).

¹⁰⁵ *Id.* § 301.7701-3(f)(2).

3. Former Classification Regulations. Prior to January 1, 1997, under former Treasury Regulation section 301.7701-2¹⁰⁶ (the “Former Classification Regulations”), an unincorporated organization would have been treated by the IRS as an “association” (taxable as a corporation) if the organization had more corporate characteristics than non-corporate characteristics. Thus, if an entity possessed more than two of the four corporate characteristics, it would have been classified as a corporation for purposes of federal income taxation and, if it had two or less of the corporate characteristics, it would be classified as a partnership. These four characteristics are still relevant today for the limited purpose of understanding older partnership and LLC agreements in which they may be embodied and they may still be encountered in drafts of new documents based on outdated precedent for years to come, which in each case may unnecessarily (from a tax perspective) restrict the current business objectives of the parties. The following sections discuss the four corporate characteristics:

(a) Continuity of Life. An organization does not have continuity of life if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member would cause dissolution of the organization (hereinafter, “Dissolution Event”).¹⁰⁷ If the occurrence of a Dissolution Event causes a dissolution of the organization, continuity of life does not exist, even if the remaining members have the ability to opt, by unanimous or majority consent, to continue the business.¹⁰⁸ Some states (including Texas) allow the partners of a partnership or members of an LLC to provide in the partnership agreement or company agreement that the business will continue in the event of a Dissolution Event.¹⁰⁹ Despite the fact that such an agreement constitutes the agreement of a majority of the members of the organization, the use of any prior agreement to continue the business, by eliminating the possibility of dissolution upon a Dissolution Event, may have created continuity of life and would have jeopardized the

¹⁰⁶ Former Treas. Reg. § 301.7701-2 (1967) (codifying *Morrissey v. Comm’r*, 296 U.S. 344, 357–58 (1935)); see BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 2.02 (5th ed. 1987) (discussing the classification of associations as corporations for federal income tax purposes).

¹⁰⁷ Former Treas. Reg. § 301.7701-2(b). A general or limited partnership formed under a statute corresponding to the Uniform Partnership Act or the Uniform Limited Partnership Act was considered by the IRS to lack continuity of life under Former Treas. Reg. § 301.7701-2(b).

¹⁰⁸ Former Treas. Reg. § 301.7701-2(b). Until 1993, the Former Classification Regulations indicated that such a partnership would avoid continuity of life only if a Dissolution Event resulted in either automatic dissolution or dissolution unless *all* of the remaining partners agreed to continue the business. Thus, it was assumed that a partnership *would* have the corporate characteristic of continuity of life if an agreement of a *majority* of the remaining partners were sufficient to save the partnership from dissolution upon the occurrence of a Dissolution Event. This belief was reinforced by Private Letter Ruling 90-100-27, in which the IRS, considering an LLC’s tax status, ruled that “[b]ecause dissolution under the Act may be avoided by a majority vote of members, rather than unanimous agreement, L possesses the corporate characteristic of continuity of life.” I.R.S. Priv. Ltr. Rul. 90-10-027 (March 9, 1990). The IRS should have based its ruling on the Regulations governing the LLC instead of the statute under which the LLC was formed, regardless of whether a majority vote to continue the business was insufficient to preclude continuity of life. Ultimately, the Former Classification Regulations were amended effective June 14, 1993 to allow “a majority in interest,” rather than “all remaining members,” of a partnership to elect to continue the business after a Dissolution Event. See Rev. Rul. 93-91, 1983-2 C.B. 316; Rev. Proc. 95-10, 1995-1 I.R.B. 20 (confirming the applicability of this standard to LLCs).

¹⁰⁹ See, e.g., LLC Act §§ 3.02(9), 6.01(B); TBOC § 101.052.

classification of the entity as a partnership for federal income tax purposes.¹¹⁰ Because continuity of life is no longer relevant to determining whether an entity may be classified as a partnership for federal income tax purposes, attorneys should consider whether Dissolution Events are consistent with the business objectives of the parties and, if they are not, consider means for negating them in partnership and LLC agreements.

(b) Centralization of Management. For this corporate characteristic to be present, the exclusive and continuing power to make necessary management decisions must be concentrated in a managerial group (composed of less than all the members) that has the authority to act on behalf of the organization independently of its members.¹¹¹ The key to this characteristic is the group's ability to bind the entity in its role as a representative of the organization, as opposed to its role as an owner.

(c) Limited Liability. An organization has the corporate characteristic of limited liability if under local law no member is personally liable for the debts or obligations of the organization when the organization's assets are insufficient to satisfy such debts or obligations.¹¹² In the case of a limited partnership, the IRS deemed the entity to have limited liability where the general partner has no substantial assets (other than his interest in the partnership) that could be reached by creditors of the entity and the general partner is merely a "dummy" acting as agent of the limited partners.¹¹³ To negate such an IRS assertion under the Former Classification Regulations, tax lawyers advised that the general partner should have substantial assets that could be reached by creditors. The capitalization of the general partner is of reduced importance from a tax standpoint under the Check-the-Box Regulations.¹¹⁴

(d) Free Transferability of Interest. The characteristic of free transferability of interest does not exist in a case where a member can, without the consent of other members, assign only his right to a share in the profits but cannot assign his rights to participate in the management of the organization.¹¹⁵ Free transferability does not exist if, under

¹¹⁰ See I.R.S. Priv. Ltr. Rul. 90-30-013 (Apr. 25, 1990) (explaining "no right to continue the business of X upon a [Dissolution Event] is stated in the articles of organization apart from continuance of X's business upon the consent of all the remaining members. Therefore, if a member of X ceases to be a member of X for any reason, the continuity of X is not assured, because all remaining members must agree to continue the business. Consequently, X lacks the corporate characteristic of continuity of life."); see also I.R.S. Priv. Ltr. Rul. 90-29-019 (Apr. 19, 1990); I.R.S. Priv. Ltr. Rul. 89-37-010 (June 16, 1989); Former Treas. Reg. § 301.7701(b)(1) (explaining "[a]n organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization."). Arguably, if the members have a preexisting agreement providing that such Dissolution Events will not cause a dissolution, then the organization has continuity of life. It would appear that there must be some uncertainty about the continuation of the business at the time of the Dissolution Event in order to avoid a finding of continuity of life.

¹¹¹ Rev. Proc. 95-10, 1995-1 I.R.B. 20; Rev. Rul. 93-6, 1993-1 C.B. 229; see also BITTKER & EUSTICE, *supra* note 106, at § 2.02.

¹¹² Former Treas. Reg. § 301.7701-2(d)(1).

¹¹³ Former Treas. Reg. § 301.7701-2(d)(2).

¹¹⁴ In contrast to the Former Classification Regulations and Rev. Proc. 89-12, 1989-7, I.R.B. 22, the Check-the-Box Regulations do not focus on the capitalization of the general partner.

¹¹⁵ Former Treas. Reg. § 301.7701-2(e)(1); see also Act of May 9, 1961, 57th Leg., R.S., ch. 158, 1961 Tex. Gen. Laws 289; Act of May 17, 1979, 66th Leg., R.S., ch. 723, § 5, 1979 Tex. Gen. Laws 1782; Act of May 9,

local law, the transfer of a member's interest results in the dissolution of the old entity and the formation of a new entity.¹¹⁶ Partnership and LLC agreements traditionally have contained provisions intended to negate free transferability by giving a general partner or manager the discretion to decide whether to approve a proposed transfer.¹¹⁷ These provisions are no longer appropriate except to the extent necessary to achieve the party's business objectives or to facilitate compliance with securities laws.

G. Texas Entity Taxation.

1. Corporations and LLCs, but not Partnerships, Subject to Former Franchise Tax. Through December 31, 2006, corporations and LLCs were subject to the former version of the Texas franchise tax,¹¹⁸ which was equal to the greater of (i) 0.25% of "taxable capital" (generally owners' equity) and (ii) 4.5% of "net taxable earned surplus." "Net taxable earned surplus" was computed by determining the entity's reportable federal taxable income and adding to that amount the compensation of officers and directors. The add-back was not required if (x) the corporation had not more than 35 shareholders or was an S-corporation for federal tax purposes with no more than 75 shareholders,¹¹⁹ or (y) the LLC had not more than 35 members.¹²⁰ The result was apportioned to Texas based on the percentage of its gross receipts from Texas sources. Although labeled a "franchise tax," the tax on "net taxable earned surplus" was really in most cases a 4.5% income tax levied at the entity level.

Limited and general partnerships (including the LLP) were not subject to the former franchise tax in deference to article 8, Section 24(a) of The Texas Constitution.¹²¹ The Texas Comptroller of Public Accounts ("Comptroller") had issued private letter rulings stating that it would honor the state law classification of an entity as a partnership, despite any Check-the-Box election by the partnership to be treated as a corporation for federal income tax purposes.¹²²

2. Franchise Tax Change Proposals. Efforts to reduce Texas' dependence on property taxes to fund public schools led the 1997 through 2005 Texas Legislatures to consider, but not adopt, proposed changes in the Texas tax system which would subject partnerships to the

1985, 69th Leg., R.S., ch. 159, § 76, 1985 Tex. Gen. Laws 692; Act of May 9, 1991, 72d Leg., R.S., ch. 901, §§ 83–85, 1991 Tex. Gen. Laws 3234-35; Act of May 31, 1993, 73d Leg., R.S., ch. 917, § 2, 1993 Tex. Gen. Laws 3912-13 (expired Jan. 1, 1999).

¹¹⁶ Former Treas. Reg. § 301.7701-2(d)(2).

¹¹⁷ In contrast to the Former Classification Regulations and Revenue Procedure 89-12, the Check-the-Box Regulations do not focus on the capitalization of the general partner.

¹¹⁸ TEX. TAX CODE § 171.001 (Vernon 2002 & Supp. 2004).

¹¹⁹ TEX. TAX CODE § 171.110(b) (Vernon 2002 & Supp. 2004).

¹²⁰ 34 TEX. ADMIN. CODE § 3.558(b)(10) (2002) (Public Finance, Franchise Tax, Earned Surplus: Officer and Director Compensation).

¹²¹ Commonly referred to as the "Bullock Amendment" and prohibiting income based taxes on a person's share of partnership income.

¹²² See, e.g., Comptroller Taxpayer Response Letter Accession No. 9811328L (Nov. 30, 1998).

franchise tax.¹²³ The 2005 Texas Legislature also proposed: (i) a payroll based tax; and (ii) an extension of the Texas franchise tax to foreign corporations earning Texas source income from Texas based partnerships. In 2006, property tax reform efforts were primarily motivated by the Texas Supreme Court's decision in *Neeley v. West Orange-Cove Consolidated Independent School District*.¹²⁴ The Court in *West Orange-Cove* held that the property tax rate cap then in effect of \$1.50 per \$1,000 of valuation violated Article VIII, Section 1-e of the Texas Constitution, which prohibits the imposition of a statewide property tax. The Court directed the Texas Legislature to cure the defect by June 1, 2006. In anticipation of a Supreme Court decision in *West Orange-Cove*, on November 4, 2005, Governor Rick Perry appointed a 24-member Texas Tax Reform Commission and former Comptroller John Sharp as its Chairman (the "Sharp Commission") to study and make recommendations on how to reform Texas' business tax structure and provide significant property tax relief and also to later address court-mandated changes in how Texas funds its schools. On November 21, 2005 (the day before the Supreme Court decision in *West Orange-Cove*), the Sharp Commission held the first of a series of public hearings at which various affected parties testified as to what should be changed. On March 29, 2006, the Sharp Commission released its report (the "Sharp Commission Report") which recommended that (1) the Legislature should cut school district property taxes for maintenance and operations substantially (with many districts setting rates at or near \$1.50 per \$100 of valuation, the Sharp Commission recommended that the property tax rate should be lowered to \$1 per \$100 and permanently re-capped at no more than \$1.30 per \$100 by the 2007 tax year and reductions for the 2006 tax year sufficient to comply with the Supreme Court's mandate to be provided immediately) and (2) the Legislature should reform the state's franchise

¹²³ See Tex. H.B. 3146, 78th Leg., R.S. (2003), available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=78R&Bill=HB3146> ("2003 H.B. 3146"). 2003 H.B. 3146 in the 2003 Legislative Session, by Representative Ron Wilson, attempted to amend the Texas Tax Code to define "corporation" for franchise purposes as "every corporation, limited liability company, limited partnership, business trust, real estate investment trust, savings and loan association, banking corporation, and any other entity for which any of the owners have limited liability" and exclude, in the case of a partnership, the distributive share of the partnership's income or loss attributable to natural persons. See also Tex. H.B. 3, 79th Leg. R.S. (2005), available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=79R&Bill=HB3>. House Bill 3, as passed by the House on March 14, 2005, would have enacted a Reformed Franchise Tax which would have applied to most business entities, including most corporations, LLCs and partnerships, and allow them to elect either (i) 1.15% tax on Texas employee wages with no ceiling or (ii) the existing franchise tax at the rate of 4.5% of net taxable earned surplus. In the event an unincorporated entity owned wholly or partially by natural persons elects to be subject to the franchise tax, H.B. 3 required that the business and those natural persons agree pursuant to an election form that the taxable earned surplus of the business shall be calculated without regard to any exclusion, exemption or prohibition set forth in Article 8, Section 24(a), of the Texas Constitution (the "*Bullock Amendment*"), which effectively recognizes the applicability of the Bullock Amendment to any form of income tax imposed on an unincorporated entity in which an interest is owned by a natural person. On May 11, 2005, the Senate passed C.S. H.B. 3, which, like H.B. 3, would have included most corporations, LLCs and partnerships as "taxable entities" and would have allowed the entities to elect to be subject to either (1) a 1.75% tax on Texas employee wages up to a cap of \$1,500 per employee or (2) a 2.5% business activity tax which is similar to the current franchise tax plus all compensation exceeding \$30,000 per employee; in each case subject to a minimum tax of 0.25% of Texas gross receipts. Both the House and Senate bills included additional sales and other consumption taxes, although there were significant differences in the two bills. This tax legislation died in a Conference Committee at the end of the 2005 Legislative Session.

¹²⁴ 176 S.W.3d 746 (Tex. 2005).

tax by (a) broadening the base of businesses that pay into the system to include most entities whose owners are generally protected from the entities' liabilities, (b) cutting the franchise tax rate from 4.5% to 1%, (c) basing the franchise tax on a business' margin by allowing each business to choose between deducting either the cost of goods sold or employee or partner compensation (including health insurance, pensions and other benefits) from its total revenue, and (d) increasing the small-business exemption from \$150,000 to \$300,000 in total revenue and exempting sole proprietors and "non-corporate general partnerships."¹²⁵ The Sharp Commission Report also recommended raising the tax on cigarettes by \$1 per pack.

3. Margin Tax. In a Special Session which convened on April 17, 2006 and adjourned *sine die* on May 15, 2006, the Texas Legislature passed House Bill 3 ("2006 H.B. 3").¹²⁶ Texas Tax Code Chapter 171¹²⁷ was amended by 2006 H.B. 3 to replace the current franchise tax on corporations and LLCs with a new and novel business entity tax called the "Margin Tax" herein. In the 2007 Legislative Session the Margin Tax provisions of the Texas Tax Code were amended by 2007 H.B. 3928.

In the 2009 Texas Legislative Session, only three bills that passed amended Chapter 171 of the Texas Tax Code. One of the bills clarified the method that banks may use to apportion income related to loans and securities to be consistent with prior Texas Comptroller policy.¹²⁸ This change clarified that FASB 115 "trading securities" must be treated as inventory items and that the aggregate proceeds from trading shall be included in a lending institution's apportionment formula. The second bill raised the small business threshold for Margin Tax payers from \$300,000 of gross revenue up to \$1,000,000 of gross revenue for the 2010 and 2011 tax years.¹²⁹ The third bill,¹³⁰ 2009 S.B. 636, allowed "destination management companies" to

¹²⁵ A draft of the legislation proposed by the Sharp Commission can be found at http://www.governor.state.tx.us/priorities/tax_reform/TTRC_report/files/tax_reform_bill.pdf.

¹²⁶ Tex. H.B. 3, 79th Leg., 3d C.S. (2006) ("2006 H.B. 3"); the text of 2006 H.B. 3 can be viewed in its entirety at the following link: <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=793&Bill=HB3>. See Ira A. Lipstet, *Franchise Tax Reformed: The New Margin Tax Including 2007 Legislative Changes and Final Comptroller Rules*, 42 TEX. J. BUS. L. 1 (2007).

¹²⁷ Chapter 171 of the Texas Tax Code was modified and largely replaced by the provisions of 2006 H.B. 3. References in the following footnotes to the "Texas Tax Code" are references to Chapter 171 of the Texas Tax Code as amended in 2006 by 2006 H.B. 3 and in 2007 by H.B. 3928. 2007 H.B. 3928 by Rep. Jim Keffer, 80th Leg., R.S. (2007) ("2007 H.B. 3928"), available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=80R&Bill=HB3928>.

¹²⁸ H.B. 4611 by Rep. Rene Oliveira (D-Brownsville), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB4611> ("2009 H.B. 4611"). 2009 H.B. 4611 clarified that "lending institutions" (defined in § 171.0001(10) of the Texas Tax Code) shall include gross proceeds (rather than net proceeds) from the sale of trading securities (as defined in FASB 115) in gross receipts for apportionment purposes. A similar interpretation had been applied under § 171.105(a) of the former Texas franchise tax.

¹²⁹ H.B. 4765 by Rep. Rene Oliveira (D-Brownsville), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB4765> ("2009 H.B. 4765") (increased the small business exemption from the franchise tax from \$300,000 to \$1 million for 2010 and 2011 tax years, contingent on the passage of an increase in the smokeless tobacco tax; the increased exemption would have expired on December 31, 2011; thereafter, the exemption would be reduced from \$1 million to \$600,000 absent future amendments; the reduction was made contingent on the passage of an increase in the smokeless tobacco tax; 2009 H.B. 4765 is effective January 1, 2010); H.B. 2154 Rep. Al

exclude “payments made to other persons to provide services, labor, or materials in connection with the provision of destination management services” from gross receipts in calculating their Texas Margin Tax liability. The travel agent industry was one of the industries hardest hit by the lack of a deduction for pass-through expenses under the Margin Tax, and 2009 S.B. 636 provided some relief by excluding certain pass-through payments from gross receipts.

No bills were passed in the 2011 Legislative Session or the subsequent Special Session which convened on May 31, 2011 and adjourned June 30, 2011 (the “2011 Special Session”) which drastically altered the current Texas Margin Tax regime. The large budget shortfall predicted for the 2012 to 2013 biennium dominated the attention of the Legislators. In the April 5, 2011 edition of *The Quorum Report*,¹³¹ Senator Steve Ogden, Chair of the Senate Finance Committee was quoted as saying:

The state’s tax system needs to be uniform and equitable with a rate as low as possible . . . The biggest component of that problem is the failure of the business margins tax. The tax needs to be fixed sooner rather than later, and . . . a constitutional amendment to return to a franchise tax [is] one potential fix.”

Chairman Ogden was presumably referring to modifying the Bullock Amendment to allow for an income based tax on the income earned by or allocated from state-law liability protected active trades or businesses. The 2011 Texas Supreme Court decision in *In re Allcat Claims Service, L.P. and John Weakley vs. Susan Combs, Texas Comptroller of Public Accounts and Gregg Abbott, Attorney General for the State of Texas*¹³² alleviates the need to amend the Texas Constitution in order to impose an income based tax on business entities, including limited liability partnerships.

(a) Who is Subject to Margin Tax. The Margin Tax is imposed on all businesses except (i) sole proprietorships, (ii) general partnerships “the direct ownership of which is entirely composed of natural persons,” and (iii) certain “passive” entities.¹³³ Thus,

Edwards (D-Houston), *available at* <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB2154> (“2009 H.B. 2154”) (provided the smokeless tobacco tax required by 2009 H.B. 4765).

¹³⁰ S.B. 636 by Sen. Kel Seliger (R-Amarillo), *available at* <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=SB636> (“2009 S.B. 636”). The bill adds a new subsection 171.1011(g-6) to the Texas Tax Code.

¹³¹ See <http://www.quorumreport.com>.

¹³² No. 11-0589, 2011 WL 6091134 (Tex. Nov. 28, 2011).

¹³³ Texas Tax Code § 171.0002 defines “taxable entity” as follows:

Sec. 171.0002. DEFINITION OF TAXABLE ENTITY. (a) Except as otherwise provided by this section, “taxable entity” means a partnership, limited liability partnership, corporation, banking corporation, savings and loan association, limited liability company, business trust, professional association, business association, joint venture, joint stock company, holding company, or other legal entity. The term includes a combined group. A joint venture does not include joint operating or co-ownership arrangements meeting the requirements of Treasury Regulation Section 1.761-2(a)(3) that elect out of federal partnership treatment as provided by Section 761(a), Internal Revenue Code.

(b) “Taxable entity” does not include:

corporations, limited partnerships, certain general partnerships, LLPs, LLCs, business trusts and professional associations are subject to the Margin Tax.¹³⁴ The Margin Tax is not imposed on sole proprietorships, general partnerships that are owned 100% by natural persons or the estate of a natural person,¹³⁵ certain narrowly defined passive income entities¹³⁶ (including certain real

-
- (1) a sole proprietorship;
 - (2) a general partnership:
 - (A) the direct ownership of which is entirely composed of natural persons; and
 - (B) the liability of which is not limited under a statute of this state or another state, including by registration as a limited liability partnership;
 - (3) a passive entity as defined by Section 171.0003; or
 - (4) an entity that is exempt from taxation under Subchapter B.
- (c) “Taxable entity” does not include an entity that is:
- (1) a grantor trust as defined by Sections 671 and 7701(a)(30)(E), Internal Revenue Code, all of the grantors and beneficiaries of which are natural persons or charitable entities as described in Section 501(c)(3), Internal Revenue Code, excluding a trust taxable as a business entity pursuant to Treasury Regulation Section 301.7701-4(b);
 - (2) an estate of a natural person as defined by Section 7701(a)(30)(D), Internal Revenue Code, excluding an estate taxable as a business entity pursuant to Treasury Regulation Section 301.7701-4(b);
 - (3) an escrow;
 - (4) a real estate investment trust (REIT) as defined by Section 856, Internal Revenue Code, and its “qualified REIT subsidiary” entities as defined by Section 856(i)(2), Internal Revenue Code, provided that:
 - (A) a REIT with any amount of its assets in direct holdings of real estate, other than real estate it occupies for business purposes, as opposed to holding interests in limited partnerships or other entities that directly hold the real estate, is a taxable entity; and
 - (B) a limited partnership or other entity that directly holds the real estate as described in Paragraph (A) is not exempt under this subdivision, without regard to whether a REIT holds an interest in it;
 - (5) a real estate mortgage investment conduit (REMIC), as defined by Section 860D, Internal Revenue Code;
 - (6) a nonprofit self-insurance trust created under Chapter 2212, Insurance Code, or a predecessor statute;
 - (7) a trust qualified under Section 401(a), Internal Revenue Code; or
 - (8) a trust or other entity that is exempt under Section 501(c)(9), Internal Revenue Code.
- (d) An entity that can file as a sole proprietorship for federal tax purposes is not a sole proprietorship for purposes of Subsection (b)(1) and is not exempt under that subsection if the entity is formed in a manner under the statutes of this state, another state, or a foreign country that limit the liability of the entity.

¹³⁴ Texas Tax Code Ann. § 171.0002(a).

¹³⁵ Since an LLP is classified under both the TRPA and the TBOC as a species of general partnership, under a literal reading of 2006 H.B. 3 the Margin Tax would not have been applicable to an LLP composed solely of natural persons. Various statements by the Sharp Commission and the offices of the Governor and the Comptroller suggested that the Margin Tax was generally intended to apply to any entity that afforded limited liability to its owners, which would include the LLP. 2007 H.B. 3928 resolved this issue by amending Texas Tax Code § 171.0002 to expressly provide that an LLP is subject to the Margin Tax.

¹³⁶ Texas Tax Code Ann. § 171.0003 defines “passive entity” as follows:

Sec. 171.0003. DEFINITION OF PASSIVE ENTITY. (a) An entity is a passive entity only if:

- (1) the entity is a general or limited partnership or a trust, other than a business trust;
- (2) during the period on which margin is based, the entity's federal gross income consists of at least 90 percent of the following income:

(A) dividends, interest, foreign currency exchange gain, periodic and nonperiodic payments with respect to notional principal contracts, option premiums, cash settlement or termination payments with respect to a financial instrument, and income from a limited liability company;

(B) distributive shares of partnership income to the extent that those distributive shares of income are greater than zero;

(C) capital gains from the sale of real property, gains from the sale of commodities traded on a commodities exchange, and gains from the sale of securities; and

(D) royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests; and

- (3) the entity does not receive more than 10 percent of its federal gross income from conducting an active trade or business.

(a-1) In making the computation under Subsection (a)(3), income described by Subsection (a)(2) may not be treated as income from conducting an active trade or business.

(b) The income described by Subsection (a)(2) does not include:

(1) rent; or

(2) income received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is a member of an affiliated group and another member of that group is the operator under the same joint operating agreement.

As used in the definition of "passive entity," Texas Tax Code § 171.0004 defines "conducting active trade or business" as follows:

Sec. 171.0004. DEFINITION OF CONDUCTING ACTIVE TRADE OR BUSINESS. (a) The definition in this section applies only to Section 171.0003.

(b) An entity conducts an active trade or business if:

(1) the activities being carried on by the entity include one or more active operations that form a part of the process of earning income or profit; and

(2) the entity performs active management and operational functions.

(c) Activities performed by the entity include activities performed by persons outside the entity, including independent contractors, to the extent the persons perform services on behalf of the entity and those services constitute all or part of the entity's trade or business.

(d) An entity conducts an active trade or business if assets, including royalties, patents, trademarks, and other intangible assets, held by the entity are used in the active trade or business of one or more related entities.

(e) For purposes of this section:

(1) the ownership of a royalty interest or a nonoperating working interest in mineral rights does not constitute conduct of an active trade or business;

(2) payment of compensation to employees or independent contractors for financial or legal services reasonably necessary for the operation of the entity does not constitute conduct of an active trade or business; and

(3) holding a seat on the board of directors of an entity does not by itself constitute conduct of an active trade or business.

estate investment trusts (“REITs”),¹³⁷ grantor trusts,¹³⁸ estates of a natural person, an escrow,¹³⁹ or a REMIC. Effective January 1, 2012, the Margin Tax does not apply to certain unincorporated political action committees.¹⁴⁰ Political action committees formed as Texas non-profit corporations are still subject to the Texas franchise tax.¹⁴¹

(b) Passive Entities. In order to be exempt in any given tax year, a “passive entity” must receive at least 90% of its gross income, for federal income tax purposes,¹⁴² from partnership allocations from downstream non-controlled flow through entities, dividends, interest, royalties, or capital gains from the sale of (i) real estate,¹⁴³ (ii) securities or (iii) commodities. Real estate rentals, as well as other rent and income from working mineral interests, are not passive income sources unless they are classified as “royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests.”¹⁴⁴ In addition, only non-business trusts, general partnerships and limited partnerships can qualify as passive entities. LLCs and corporations (including S-corps) cannot qualify as passive entities, even if 90% of their income is from qualifying passive sources.

A limited partnership that has income from real estate rents, as well as dividends and interest, may want to consider whether the entity could be split in two in order to

¹³⁷ The REIT exclusion is limited to REITs that do not directly own property (other than the real estate that the REIT occupies for business purposes) and qualified REIT subsidiaries (which do not include partnerships). Tex. Tax Code Ann. § 171.0002(c)(4).

¹³⁸ An interpretative question under 2006 H.B. 3 is what types of “trusts” other than grantor trusts, might be considered to be a “legal entity” as that term is used in connection with the definition of “taxable entity.” The Texas Trust Code applies only to “express trusts.” An “express trust” is defined in the Texas Trust Code as “a fiduciary relationship” with respect to property which arises as a manifestation by the settlor of an intention to create the *relationship* and which subjects the person holding title to the property to equitable duties to deal with the property for the benefit of another person.” Recently, the Texas Supreme Court confirmed previous decisions that a trust is not an entity but a relationship. *See, e.g., Huie v. DeShazo*, 922 S.W.2d 920, 926 (Tex. 1996) (holding that “[t]he term ‘trust’ refers not to a separate legal entity but rather to the fiduciary relationship governing the trustee with respect to the trust property[,]” and that treating trust rather than trustee as attorney’s client “is inconsistent with the law of trusts”). There is at least a negative implication in the wording of 2006 H.B. 3, however, that trusts other than “grantor trusts” are taxable entities. Further, a trust is an entity for federal income tax purposes (when a trust applies for a taxpayer identification number, the name of the entity is the name of the trust – not the name of the trustee; the taxpayer name used on a trust’s Form 1041 is the trust’s name).

¹³⁹ Tex. Tax Code Ann. § 171.0002(c).

¹⁴⁰ Article 45 of Senate Bill 1 (“2011 S.B. 1”) passed in 2011 Special Session.

¹⁴¹ *See Texas Tax Policy News* (Tex. Comptroller of Pub. Acts. Oct. 2011).

¹⁴² 34 Texas Administrative Code § 3.582 (2008) (Public Finance, Franchise Tax, Margin: Passive Entities) defines federal gross income as: “Gross income as defined in Internal Revenue Code, §61(a).”

¹⁴³ There is some pending discussion of what definition of “real estate” will be used for this purpose. While the Texas Comptroller has long standing definitions for “real estate” under the sales tax chapters of the Texas Tax Code, there is some informal indication that the Internal Revenue Code’s definition of real estate is more appropriate for this purpose. *See, e.g., Treas. Reg. 1-897-1(b)(1)*.

¹⁴⁴ Tex. Tax Code Ann. § 171.0003(a)(2)(D); *see also* § 171.0003(b)(2) (passive income includes “income received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is [not] a member of an affiliated group and another member of that group is the operator under the same joint operating agreement”).

isolate the passive income sources into an entity that will qualify as a tax exempt passive entity.¹⁴⁵

Comptroller Rule 3.582 mandates that an entity must be the type of entity that may qualify to be passive (i.e., a partnership or trust, and not an LLC) for the entire tax year at issue in order to qualify as passive for such year.¹⁴⁶ So for example, if an LLC with substantial real estate rents plans to convert to an LP for a year in which it will liquidate a real estate asset, achieve a major capital gain, and possibly qualify as a passive entity, the LLC will need to complete the conversion to an LP prior to January 1 of such year.

Passive entities are not part of combined groups, and the owners of passive entities are not allowed to exclude income allocations from the passive entity.¹⁴⁷ Rather, if the owners of a passive entity are otherwise “taxable entities,” they will have to re-test to determine their own passive status. The income the owners receive from such a downstream passive entity may qualify as passive source income,¹⁴⁸ but the passive entity owner will still have to independently pass the 90% passive source test. Caution and care should be taken with respect to passive entity planning, and one rule of thumb is that passive entity status will not be of any benefit to the extent that there are intermediary taxable entities (i.e. corporations or LLCs) between a passive entity and its ultimate natural person owners.

(c) LLPs. In 2007 the Texas Legislature in 2007 H.B. 3928 “clarified” (or expanded) the scope of the Margin Tax to apply to LLPs.¹⁴⁹ Also, the Comptroller has determined that LLPs can qualify to be passive entities if they otherwise meet the 90% test for passive revenue.¹⁵⁰

(d) Prior Chapter 171 Exemptions. The Margin Tax preserves the exemptions previously available under the Texas franchise tax for “an entity which is not a

¹⁴⁵ 2006 H.B. 3 § 22 raised some historical questions about whether or to what extent partnership divisions could be honored. For example, 2006 H.B. 3 § 22(f) provides that when a partnership is divided into two or more partnerships, the resulting partnerships are treated as a “continuation of the prior partnership.” This does not apply to partnerships owned 50% or less by the partners of the former partnership. *See* 2006 H.B. 3 § 22.

¹⁴⁶ 34 TEX. ADMIN. CODE § 3.582(g) (stating the “[r]eporting requirement for a passive entity. If an entity meets all of the qualifications of a passive entity **for the reporting period**, the entity will owe no tax; however, the entity must file information to verify that the passive entity qualifications are met each year.”) (*emphasis added*).

¹⁴⁷ 34 TEX. ADMIN. CODE § 3.587(c)(4) (2008) (Public Finance, Franchise Tax, Margin: Total Revenue) (stating the total revenue reporting requirements for a passive entity that “[a] taxable entity will include its share of net distributive income from a passive entity, but only to the extent the net income of the passive entity was not generated by any other taxable entity”).

¹⁴⁸ 34 TEX. ADMIN. CODE § 3.582(c)(2)(B) (stating the income qualifications for a passive entity as “[passive income includes] distributive shares of partnership income”).

¹⁴⁹ 2007 H.B. 3928 § 2 amended TEX. TAX CODE ANN. § 171.0002(a) to add “limited liability partnership” to the statutory definition of “taxable entity.”

¹⁵⁰ 34 TEX. ADMIN. CODE § 3.582(c)(1)(C).

corporation but that because of its activities, would qualify for a specific exemption ... if it were a corporation” to the extent it would qualify if it were a corporation.¹⁵¹

(e) Small Business Phase-In. In the 2009 Legislative Session, the Tax Code was amended so that, for tax years 2010 and 2011, if a taxable entity¹⁵² had total revenue of \$1 million or less, it was not required to pay any Texas franchise tax for that year.¹⁵³ Article 37 of 2011 S.B. 1 from the 2011 Special Session extended the \$1 million threshold to December 31, 2013. The threshold is subject to a CPI index, and is set at \$1,030,000 for the report due May 15, 2013. For reports due on or after January 1, 2014, the small business exemption will be reduced to \$600,000 if the statute is not amended in the 2013 Texas Legislative Session, which is widely expected to occur.¹⁵⁴ These threshold tax amounts do not function as a deduction. A business with gross revenue in excess of the applicable threshold amount calculates its tax liability on its entire gross receipts.

(f) Basic Calculation. In a nutshell, the calculation of the Margin Tax is based on a taxable entity’s (or unitary group’s) gross receipts after making an election to deduction either (x) compensation or (y) cost of goods sold (“COGS”). Initially, the election to use COGS or compensation as the deduction had to be made on or before the due date of the return and such election could not be amended thereafter.¹⁵⁵ In a rare reversal of policy, the Texas Comptroller has reversed its position and now allows post-due date amendments to the COGs vs. compensation deduction.¹⁵⁶ An affiliated group must choose one type of deduction to apply to the entire group. The “tax base” is apportioned to Texas using a single-factor gross receipts apportionment formula with no throwback rule – Texas gross receipts divided by aggregate gross receipts. The tax rate applied to the Texas portion of the tax base is 1% for all taxpayers except a narrowly defined group of retail and wholesale businesses which pay a 0.5% rate.¹⁵⁷ There is a safety net so that the “tax base” for the Margin Tax may not exceed 70% of a

¹⁵¹ See, e.g., TEX. TAX CODE ANN. § 171.088.

¹⁵² A taxable entity includes a combined group for this \$1 million threshold. 34 T.A.C. 3.581(b)(13).

¹⁵³ 2009 H.B. 4765 by Rep. Rene Oliveira (D-Brownsville), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB4765> (increased the small business exemption from the franchise tax from \$300,000 to \$1 million for 2010 and 2011 tax years, contingent on the passage of an increase in the smokeless tobacco tax; the increased exemption sunsets on December 31, 2011; thereafter, the exemption was reduced from \$1 million to \$600,000 and the reduction was made contingent on the passage of an increase in the smokeless tobacco tax; 2009 H.B. 4765 was effective January 1, 2010); 2009 H.B. 2154 Rep. Al Edwards (D-Houston), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB2154> (provided the smokeless tobacco tax required by 2009 H.B. 4765, which was intended to raise new revenue by increasing tobacco taxes to offset some of the fiscal impact of 2009 H.B. 4765). In addition there is a staggered phase-in of the Margin Tax for taxpayers with annual revenues greater than \$600,000 and less than \$900,000.

¹⁵⁴ See, e.g., H.B. 213, 83rd Tex. Legislature, introduced by Rep. Hilderbran, permanently setting the Texas franchise tax applicability threshold at \$1 million, indexed to inflation.

¹⁵⁵ See, e.g., Texas Comptroller of Public Accounts Hearing 104,076 (Accession No. 201102012H, Feb. 23, 2011).

¹⁵⁶ www.window.state.us/tax_info/franchise/cog-compensation.html.

¹⁵⁷ Article 51 of 2011 S.B. 1 from the 2011 Special Session extended the .5% rate to “apparel rental activities classified as Industry 5999 or 7299” of the 1987 SIC Manual. Tex. Tax Code § 171.0001(12)(B) (effective January 1, 2012).

business's total revenues.¹⁵⁸ However, it is possible for an entity to owe Margin Tax in any given year even if it is reporting a loss for federal income tax purposes and has a negative cash flow. There is also an alternative "EZ" calculation based on a .575% tax rate, with no deductions for taxpayers with less than \$10,000,000 in gross revenue.¹⁵⁹

Entities would pay the Margin Tax on a "unitary combined basis" (i.e., affiliated groups of entities would in effect be required to pay taxes on a consolidated basis). Thus, the internal partnership structure described below under the heading "6. Internal Partnerships Will Not Work Under Margin Tax" would no longer work as described.¹⁶⁰

(g) Gross Revenue Less (x) Compensation or (y) Cost of Goods Sold. For purposes of the Margin Tax, a taxable entity's total revenue is generally total income as reported on IRS Form 1120 (for corporate entities),¹⁶¹ or IRS Form 1065 (for partnerships and other pass-through entities),¹⁶² plus dividends, interest, gross rents and royalties, and net capital gain income,¹⁶³ minus bad debts, certain foreign items, and income from related entities to the extent already included in the margin tax base.¹⁶⁴

(h) Gross Revenue. 2006 H.B. 3 includes a very short and specific list of "flow through" items which are excluded from gross receipts: (A) flow-through funds that are mandated by law or fiduciary duty to be distributed to other entities (such as sales and other taxes collected from a third party and remitted to a taxing authority);¹⁶⁵ (B) the following flow-through funds that are required by contract to be distributed to other entities: (i) sales commissions paid to non-employees (including split-fee real estate commissions);¹⁶⁶ (ii) subcontracting payments for "services, labor, or materials in connection with the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of the boundaries of real property";¹⁶⁷ and (iii) law firms may exclude the amounts they are obligated to pay over to clients and referring attorneys, matter specific expenses, and pro-bono out-of-pocket expenses not to exceed \$500 per case;¹⁶⁸ (C) the federal tax basis of

¹⁵⁸ See *id.* § 171.101.

¹⁵⁹ *Id.* § 171.1016.

¹⁶⁰ See *infra* note 232 and related text.

¹⁶¹ *Id.* § 171.1011(c)(1).

¹⁶² *Id.* § 171.1011(c)(2).

¹⁶³ *Id.* § 171.1011(c)(1)(A).

¹⁶⁴ *Id.* § 171.1011(c)(1)(B).

¹⁶⁵ *Id.* § 171.1011(f).

¹⁶⁶ *Id.* § 171.1011(g)(1).

¹⁶⁷ *Id.* § 171.1011(g)(3). Payments to subcontractors (apart from very limited express exclusions) are not excludable from gross receipts for Margin Tax calculations. Thus, if a client specifically engaged an accounting firm in Texas to hire other accounting firms and pay for tax filings in other states or countries and include the amount in the Texas accountant's bill as a reimbursable expense, the expense reimbursement would be included in the Texas accounting firm's gross receipts. The consequence is the Texas firms will increasingly ask their clients to pay significant out of pocket expenses directly.

¹⁶⁸ Texas Tax Code § 171.1011(g-3) allows legal service providers to exclude flow-through receipts as follows:

(g-3) A taxable entity that provides legal services shall exclude from its total revenue:

securities and loans underwritten or sold;¹⁶⁹ (D) lending institutions may exclude loan principal repayment proceeds;¹⁷⁰ (E) dividends and interest received from federal obligations;¹⁷¹ (F) reimbursements received by a “management company”¹⁷² for specified costs incurred in its conduct of the active trade or business of a managed entity, including wages and compensation; and (G) payments received by a staff leasing services company from a client company for wages, payroll taxes on those wages, employee benefits, and workers’ compensation benefits for the assigned employees of the client company.¹⁷³

Health care providers¹⁷⁴ may generally exclude payments received under the Medicaid, Medicare, Children’s Health Insurance Program (“CHIP”), workers’ compensation, the TRICARE military health system, the Indigent Health Care and Treatment Act, as well as the actual costs of “uncompensated care.”¹⁷⁵ Health care institutions¹⁷⁶ may

(1) to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), the following flow-through funds that are mandated by law, contract, or fiduciary duty to be distributed to the claimant by the claimant’s attorney or to other entities on behalf of a claimant by the claimant’s attorney:

- (A) damages due the claimant;
- (B) funds subject to a lien or other contractual obligation arising out of the representation, other than fees owed to the attorney;
- (C) funds subject to a subrogation interest or other third-party contractual claim; and
- (D) fees paid an attorney in the matter who is not a member, partner, shareholder, or employee of the taxable entity;

(2) to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), reimbursement of the taxable entity’s expenses incurred in prosecuting a claimant’s matter that are specific to the matter and that are not general operating expenses; and

(3) \$500 per pro bono services case handled by the attorney, but only if the attorney maintains records of the pro bono services for auditing purposes in accordance with the manner in which those services are reported to the State Bar of Texas.

¹⁶⁹ Tex. Tax Code §§ 171.1011(g)(2) and 171.1011(g-2).

¹⁷⁰ *Id.* § 171.1011(g-1).

¹⁷¹ *Id.* § 171.1011(m). “Federal obligations” are defined in Texas Tax Code § 171.1011(p)(1) to include stocks and other direct obligations of, and obligations unconditionally guaranteed by, the United States government and United States government agencies.

¹⁷² *Id.* § 171.1011(m)(1). “Management company” is defined in Texas Tax Code § 171.0001(11) as any limited liability entity that conducts all or part of the active trade or business of another entity in exchange for a management fee and reimbursement of specified costs.

¹⁷³ “Staff leasing services company” for these purposes has the meaning set forth in § 91.001 of the Texas Labor Code. TEX. LAB. CODE ANN. § 91.001 (Vernon 2010).

¹⁷⁴ “Health care providers” are defined in Texas Tax Code § 171.1011(p)(3) as “a taxable entity that participates in the Medicaid program, Medicare program, Children’s Health Insurance Program (CHIP), state workers’ compensation program, or TRICARE military health system as a provider of health care services.”

¹⁷⁵ Tex. Tax Code § 171.1011(n).

¹⁷⁶ *Id.* § 171.1011(p)(2). “Health care institutions” are defined to include ambulatory surgical centers; assisted living facilities licensed under Chapter 247 of the Health and Safety Code; emergency medical service providers; home and community support services agencies; hospices; hospitals; hospital systems; certain intermediate care facilities for mentally retarded persons; birthing centers; nursing homes; end stage renal disease facilities; or pharmacies.

exclude 50%¹⁷⁷ of the public reimbursement program revenues described above. Rulemaking by the Comptroller will be important with respect to these exclusions, because there are currently no means by which to trace Medicare funds to the actual service providers.

Any taxable entity may exclude revenues received from oil or gas produced during dates certified by the Comptroller from (1) an oil well designated by the Railroad Commission of Texas or similar authority of another state whose production averages less than 10 barrels a day over a 90-day period; and (2) a gas well designated by the Railroad Commission of Texas or similar authority of another state whose production averages less than 250 mcf a day over a 90-day period.¹⁷⁸ The Comptroller is required to certify dates during which the monthly average closing price of West Texas Intermediate crude oil is below \$40 per barrel and the average closing price of gas is below \$5 per MMBtu, as recorded on the New York Mercantile Exchange (NYMEX).¹⁷⁹

Article 45 of 2011 S.B. 1 from the 2011 Special Session allows certain “live event promotion company[ies]” to exclude payments to artists.¹⁸⁰ Article 45 also allows qualified “courier and logistics company[ies]” to exclude certain subcontracting payments to non-employees performing delivery services.¹⁸¹

(i) The Compensation Deduction. For purposes of the Margin Tax, “compensation” includes “wages and cash compensation” as reported on the Medicare wages and tips box of IRS Form W-2. Section 171.101(a)(1) allows a taxpayer to include in the “compensation” deduction the cost of all benefits to the extent deductible for federal income tax purposes.¹⁸² It also includes “net distributive income” from partnerships, limited liability companies, and S Corporations to natural persons,¹⁸³ plus stock awards and stock options as well as workers compensation benefits, health care, and retirement to the extent deductible for federal income tax purposes.¹⁸⁴ The deduction for wages and cash compensation for the return due May 15, 2012 may not exceed \$330,000 plus benefits that are deductible for federal income tax purposes for any single person.¹⁸⁵ Compensation apparently does not include social security or Medicare contributions, and such amounts apparently are not otherwise deductible for Margin Tax purposes.

¹⁷⁷ *Id.* § 171.1011(o).

¹⁷⁸ *Id.* § 171.1011(r).

¹⁷⁹ *Id.* § 171.1011(s).

¹⁸⁰ *Id.* § 171.1011(g-5) (effective January 1, 2012).

¹⁸¹ *Id.* § 171.1011(g-7) (effective January 1, 2012).

¹⁸² *See Winstead, P.C. vs. Susan Combs, Comptroller of Public Accounts of the State of Texas, and Greg Abbott, Attorney General of the State of Texas*, Cause No. D-1-GN-12-000141 (Dist. Ct. of Travis County, 201st Judicial Dist. of Texas, Feb. 7, 2013) (finding certain limitations in Comptroller Rule 3.589(c)(2) invalid).

¹⁸³ *Id.* § 171.1013(a)(1) & (2).

¹⁸⁴ *Id.* § 171.1013(a)(3).

¹⁸⁵ *Id.* § 171.1013(c).

(j) The Cost of “Goods” Sold Deduction. Under the Margin Tax, “goods” means real or tangible personal property sold in the ordinary course of business;¹⁸⁶ the term does not include provision of services. As a result, most service businesses (e.g., accounting, law and engineering firms) will not have a cost of goods sold and are relegated to sole reliance on the compensation deduction.

The term “cost of goods sold” is defined to include the direct costs of acquiring or producing goods, including labor costs, processing, assembling, packaging, inbound transportation, utilities, storage, control storage licensing and franchising costs, and production taxes.¹⁸⁷ Certain indirect costs for production facilities, land and equipment, such as depreciation, depletion, intangible drilling and dry hole costs, geological and geophysical costs, amortization, renting, leasing, repair, maintenance, research, and design are also included.¹⁸⁸ The “cost of goods sold” definition does not include selling costs, advertising, distribution and outbound transportation costs, interest or financing costs, income taxes or franchise taxes.¹⁸⁹ Up to 4% of administrative and overhead expenses may be included in “cost of goods sold” to the extent they are allocable to the costs of acquiring or producing goods.¹⁹⁰ The “cost of goods sold” must be capitalized to the extent required by I.R.C. § 263A.¹⁹¹

(k) Transition and Filing. The Margin Tax was phased in commencing on January 1, 2007. The Texas franchise tax remained in place for 2006, with the May 2007 tax payment based on business in 2006. The Margin Tax was effective January 1, 2007 and applies to business done after that date; however, the May 2007 franchise tax payment was based on the old franchise tax for business in 2006. The Margin Tax payments due in 2008 and subsequent years are based on business in the preceding calendar year.

Regular annual Margin Tax returns are due on May 15¹⁹² of each year, and are based on financial data from the previous calendar year. The first Margin Tax returns were originally due on May 15, 2008, but on April 22, 2008, the Comptroller extended that date for 30 days in recognition of the complexity of the Margin Tax and the newness of enhanced electronic reporting methods.¹⁹³ The Margin Tax returns are based on financial data for the preceding calendar year.

(l) Unitary Reporting. In another change from the franchise tax which did not provide for consolidated tax reporting, the Margin Tax requires Texas businesses to file

¹⁸⁶ *Id.* § 171.1012(a)(1).

¹⁸⁷ *Id.* § 171.1012(c).

¹⁸⁸ *Id.* § 171.1012(c) and (d).

¹⁸⁹ *Id.* § 171.1012(e).

¹⁹⁰ *Id.* § 171.1012(f).

¹⁹¹ *Id.* § 171.1011(g).

¹⁹² *Id.* § 171.151(c).

¹⁹³ See 2006 H.B. 3, § 22; Texas Comptroller of Public Accounts press release issued April 22, 2008, available at <http://www.window.state.tx.us/news2008/080422-ftaxextension.html>.

on a unitary and combined basis. An affiliated group of entities in a “unitary business”¹⁹⁴ must file a combined return including all taxable entities within the group.¹⁹⁵ The unitary group includes all affiliates¹⁹⁶ with a common owner (i.e., greater than 50% owned),¹⁹⁷ and the group includes entities with no nexus in Texas.¹⁹⁸

(m) Combined Reporting. The Margin Tax statute literally applies its combined reporting standard of greater than 50% ownership to one or more “common owner or owners.”¹⁹⁹ The application of this standard proved unworkable, and the Comptroller’s Rule 3.590²⁰⁰ now limits the application of the combined reporting requirement to entities with greater than 50% ownership or control held directly or indirectly by a single owner. The only attribution rule applies to interests owned or controlled by a husband and wife.²⁰¹

Comptroller Rule 3.590 includes the following examples of determining the scope of an affiliated group:

(i) Corporation A owns 10% of Corporation C and 60% of Corporation B, which owns 41% of Corporation C. Corporation A has a controlling interest in Corporation B and a controlling interest in Corporation C of 51% of stock ownership because it has control of the stock owned by Corporation B.

(ii) Corporation A owns 10% of Limited Liability Company C and 15% of Corporation B, which owns 90% of Limited Liability Company C. Corporation A does not have controlling interest in Limited Liability Company C and does not have a controlling interest in Corporation B. Corporation B has a controlling interest in Limited Liability Company C.

(iii) Individual A owns 100% of 10 corporations, each of which owns 10% of Partnership B. Individual A has a controlling interest in each of the ten corporations and in Partnership B.

¹⁹⁴ Texas Tax Code § 171.0001(17) defines a “unitary business” as “a single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts.”

¹⁹⁵ *Id.* § 171.1014.

¹⁹⁶ Section 171.0001(1) of the Texas Tax Code defines an “affiliated group” as “a group of one or more entities in which a *controlling interest* is owned by a common owner or owners, *either corporate or noncorporate*, or by one of more of the member entities.” [*emphasis added*]

¹⁹⁷ *Id.* § 171.0001(8).

¹⁹⁸ *See id.* § 171.1014(c).

¹⁹⁹ *Id.* § 171.0001(1).

²⁰⁰ 34 TEX. ADMIN. CODE § 3.590 (Public Finance, Margin: Combined Reporting) (Effective January 1, 2008).

²⁰¹ *Id.* § 3.590 (b)(4)(E).

(iv) Corporation A holds a 70% interest in Partnership B that owns 60% of Limited Liability Company C. Corporation A owns the remaining 40% of Limited Liability Company C. Corporation A owns a controlling interest in Partnership B and a 100% controlling interest in Limited Liability Company C.²⁰²

The Comptroller's Rule 3.590 defines "controlling interest" for determining the combined reporting standard for a corporation as, "either more than 50%, owned directly or indirectly, of the total combined voting power of all classes of stock of the corporation, or more than 50% owned directly or indirectly, of the beneficial ownership interest in the voting stock of the corporation."²⁰³ This test is clearly based on control. In contrast, with respect to a partnership or trust, Comptroller Rule 3.590 defines controlling interest as, "more than 50%, owned, directly or indirectly, of the capital, profits, or beneficial interest in the partnership, association, trust, or other entity."²⁰⁴ The controlling interest standard for partnerships and trusts appears to be more focused on economic or beneficial ownership rather than control. The Comptroller Rule 3.590 goes on to state that with respect to a limited liability company, controlling interest means "either more than 50%, owned directly or indirectly, of the total membership interest of the limited liability company or more than 50%, owned directly or indirectly, of the beneficial ownership interest in the membership interest of the limited liability company."²⁰⁵

One issue raised by Comptroller Rule 3.590 is which party to a trust agreement (settlor, trustee, or beneficiary) should be considered to hold the "beneficial interest" for purposes of the controlling interest standard. One might conclude under state law that the "beneficiary" holds the "beneficial interest." But, one must consider that in other contexts the term beneficial interest refers to control rather than economic ownership.²⁰⁶ The Comptroller may well be inclined to take the position that "controlling interest" should be determined by control rather than mere economic ownership.

The combined group does not include entities with 80% or more of their property and payroll outside the United States.²⁰⁷ Passive entities or exempt entities are not part of the group.²⁰⁸

²⁰² *Id.* § 3.590.

²⁰³ 34 T.A.C. § 3.590(b)(4)(A)(i).

²⁰⁴ 34 T.A.C. § 3.590(b)(4)(A)(ii).

²⁰⁵ 34 T.A.C. § 3.590(b)(4)(A)(iii).

²⁰⁶ *See* Rule 13d-3(a) promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended, which provides as follows:

(a) For the purposes of sections 13(d) and 13(g) of the Act a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares:

(1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or,

(2) Investment power which includes the power to dispose, or to direct the disposition of, such security.

²⁰⁷ Tex. Tax Code § 171.1014(a).

The affiliated group is a single taxable entity for purposes of filing the Margin Tax return, and the combined return is designed to be the sum of the returns of the separate affiliates. The group must make an election to choose either the (i) cost of goods sold deduction; or (ii) the compensation deduction for all of its members.²⁰⁹ In order to avoid double taxation the combined group may exclude items of total revenue received from a member of the group to the extent such revenue is already in the tax base of an upper tier group member.²¹⁰

(n) Apportionment. The Margin Tax is apportioned using a single-factor gross receipt formula (Texas gross receipts divided by aggregate gross receipts).²¹¹ Receipts that are excluded from the tax base must also be excluded from gross receipts for apportionment purposes.²¹²

Texas gross receipts include receipts from the sale of tangible personal property delivered or shipped to a buyer in this state, services performed in this state (regardless of customer location), the use of a patent, copyright, trademark, franchise, or license in this state, sale of real property in this state (including royalties from minerals) and other business done in this state.²¹³ Only Texas gross receipts from those entities within the group which have nexus in Texas are included in the calculation of Texas receipts (this is sometimes referred to as the “Joyce” rule).²¹⁴ Sales to states in which the seller is not subject to an income tax are not deemed to be a Texas receipt (i.e., no throwback rule).²¹⁵

Aggregate gross receipts include the gross receipts (as described above) of each taxable entity in the combined group without regard to whether an individual entity has nexus with Texas.²¹⁶ If a taxable entity sells an investment or capital asset, the taxable entity’s gross receipts from its entire business for taxable margin includes only the net gain from the sale.²¹⁷

(o) Credits / NOLs. Comptroller Rule 3.594 (effective January 1, 2008) describes the limited ability of a taxpayer to utilize its net business operating loss carryforwards (“NOLs”) as a credit against the Texas margin tax.²¹⁸ One initial qualification is that any business losses upon which NOLs are based must have been used to offset any positive amount of earned surplus even in years when no tax was due.²¹⁹ In addition, taxpayers must submit a notice of intent to preserve the right to claim the temporary credit for business loss

²⁰⁸ 34 T.A.C. § 3.590(b)(2)(B) & (F).

²⁰⁹ *Id.* § 171.1014(d).

²¹⁰ *Id.* § 171.1014(c)(3).

²¹¹ *Id.* § 171.106(a).

²¹² *Id.* § 171.1055(a).

²¹³ *Id.* § 171.103(a).

²¹⁴ *Id.* § 171.103(b).

²¹⁵ *See* deletion from former TEX. TAX CODE ANN. § 171.103(a)(1) (amended 2006).

²¹⁶ *Id.* § 171.105(c).

²¹⁷ *Id.* § 171.105(b).

²¹⁸ 34 TEX. ADMIN. CODE § 3.594 (2007) (Public Finance, Franchise Tax, Margin: Temporary Credit).

²¹⁹ *Id.*

carryforwards with the first report due from a taxable entity after January 1, 2008, on a form prescribed by the Comptroller.²²⁰ A taxable entity may only claim the credit if the entity was subject to franchise tax on May 1, 2006.²²¹ The of the right to claim the NOL credit may not be transferred to another entity and changes to the membership of a combined group can prejudice the right to utilize the NOL credit.²²²

“The election to claim the credit shall be made on each report originally due on or after January 1, 2008 and before September 1, 2027.”²²³ If a taxpayer is eligible to use its NOLs as a Margin Tax credit, then for report years 2008–2017, the credit is the business loss carryforward amount x 2.25% x 4.5%.²²⁴ For report years 2018–2027, the credit for the business loss carryforward amount x 7.75% x 4.5%.²²⁵

(p) Administration and Enforcement. The Comptroller has rulemaking authority with respect to the Margin Tax and has prepared a worksheet illustrating the calculation of taxable margin on a separate entity basis.²²⁶

(q) Effect of Margin Tax on Choice of Entity Decisions. The enactment of the Margin Tax changes the calculus for entity selections, but not necessarily the result. The LLC has become more attractive for all business that are not likely to ever qualify as exempt “passive entities” because an LLC can elect to be taxed as a corporation or partnership for federal income tax purposes. However, the uncertainties as to an LLC’s treatment for self-employment purposes can restrict its desirability in some situations.²²⁷

4. Constitutionality of Margin Tax Upheld in *Allcat*. On November 28, 2011, the Texas Supreme Court reported its *Allcat* decision²²⁸ that the Texas franchise, tax does not does not violate the Texas Constitution’s so-called “Bullock Amendment” which prohibits “a tax on the net incomes of natural persons.”²²⁹ *Allcat Claims Service, L.P.*, and one of its individual partners, John Weakly, filed their case on July 29, 2011 asserting that the margin tax

²²⁰ *Id.*

²²¹ *Id.*

²²² *Id.*

²²³ *Id.*

²²⁴ *Id.*

²²⁵ *Id.*

²²⁶ The Comptroller’s Margin Tax calculation worksheet is called “Franchise Tax Online Calculator” on the Comptroller’s website and may be found at <http://www.window.state.tx.us/taxinfo/taxforms/HB3Calc.pdf>.

²²⁷ See *infra* notes 609-621 and related text.

²²⁸ *In re Allcat Claims Service, L.P.*, No. 11-0589, 2011 WL 6091134 (Tex. Nov. 28, 2011).

²²⁹ The Bullock Amendment to Texas Constitution article 8, section 24(a),²²⁹ provides:

A general law enacted by the legislature that imposes ***a tax on the net incomes of natural persons, including a person’s share of partnership and unincorporated association income***, must provide that the portion of the law imposing the tax not take effect until approved by a majority of the registered voters voting in a statewide referendum held on the question of imposing the tax. The referendum must specify the rate that will apply to taxable income as defined by law. [Emphasis added]

was effectively a personal income tax as it applied to the income of partnerships owned by natural persons. Relying heavily on the separate legal entity status of partnerships under Texas law, the Texas Supreme Court ruled that the franchise tax is a tax **on business entities**, not on natural persons, and consequently that the margin tax does not violate the “Bullock Amendment.” Prior to *Allcat*, many commentators and public officials considered the Margin Tax to be an income tax, particularly in the case of a partnership providing professional services (e.g., accounting, engineering, law or medical).²³⁰

²³⁰ See Nikki Laing, *An Income Tax by Any Other Name is Still an Income Tax: The Constitutionality of the Texas “Margin” Tax as Applied to Partnerships and Other Unincorporated Associations*, 62 BAYLOR L. REV. 1 (2010). Former Comptroller Carole Keeton Strayhorn in a May 2, 2006 letter to Texas Governor Rick Perry, which can be found at <http://www.cpa.state.tx.us/news/60502taxplan.pdf>, wrote that portions of 2006 H.B. 3 are unconstitutional: “Taxing income from partnerships is strictly prohibited by the Texas Constitution, and I believe when this portion of H.B. 3 is challenged in court, the State will lose.” In a letter (dated April 21, 2006) (on file with author) to the Attorney General of Texas requesting a formal opinion whether 2006 H.B. 3 requires voter approval under the Bullock Amendment, Comptroller Strayhorn wrote:

The literal wording of the Bullock Amendment is that a tax on the net income of natural persons, including a person’s share of partnership or unincorporated association income, must include a statewide referendum. The phrase “a person’s share” logically modifies the words “income of natural persons” and read literally and as an average voter would understand it, this provision would mean that, unless approved by the voters, no tax may be levied on any income that a person receives from any unincorporated association. That interpretation is entirely consistent with the caption and ballot language of SJR 49, which refer to a prohibition against a “personal income tax.”

“A person’s share” of the income of an unincorporated association, whether it be a limited partnership or a professional association, is determined first by the agreement between the principals, and absent one, is governed by the statutes that apply to those entities. The “share” does not have to be predicated on the “net income” of the unincorporated association. However calculated or derived, the share received by the natural person that becomes a part of his or her “net income” cannot be taxed without voter approval, period.

An alternative interpretation of the partnership/unincorporated association proviso for which supporters of the legislation may contend would read into the proviso the word “net” so that, they would say, to trigger the referendum the tax would have to be on a person’s share of partnership or unincorporated association “net income.” In other words, under this much more restrictive interpretation, only a tax on the net income of a partnership or unincorporated association, from which a natural person received a share, would trigger the required referendum. Interpolation of words into a constitutional provision should not be utilized where it would defeat the overriding intent evidenced by the provision. *Mauzy v. Legislative Redistricting Board*, 471 S. W. 2d 570 (Tex. 1971). Interpolation of the word “net” in this proviso materially changes its meaning and would not be consistent with the caption and ballot language. The electorate voted on whether a personal income tax was to be approved by the Legislature without voter approval, and nothing suggests that it is only taxation of “net income” of the unincorporated association that was so objectionable as to require further voter approval.

* * *

This provision means that if the tax is determined by deducting from gross income any items of expense that are not specifically and directly related to transactions that created the income, it is an income tax. And, if it is an income tax, it is within the Bullock Amendment. Proposed Section 171.1012 (relating to the cost of goods sold deduction) and 171.1013 (relating to the compensation deduction) clearly include indirect and overhead costs of production and/or

The *Allcat* decision affords Texas lawmakers more flexibility to analyze what types of taxes would be permissible under the Bullock Amendment and additional latitude in crafting revisions to address continuing complaints about the margin tax. For example, applying the 1991 franchise tax base to most types of business entities, even if expressly linked to net income as reported for federal income tax purposes, should be permissible under the *Allcat* standard.

Because the franchise tax exclusion for partnerships was a factor to be considered in deciding whether to form a corporation, LLC or partnership, the enactment of the Margin Tax is a material consideration in the entity selection analysis and removes one factor favoring partnerships in a choice of entity analysis.

5. Classification of Margin Tax Under GAAP. The Margin Tax is classified as an income tax in financial statements prepared in accordance with GAAP.²³¹ The minutes of

compensation that make the margin tax an income tax under this preexisting Texas definition found in Chapter 141, thereby invoking the Bullock Amendment.

* * *

Certainly it is the case that not all expenses are deducted under the margin tax concept, and thus under some technical accounting definitions the margin tax would not be on “net income” as that term is sometimes used in accounting parlance (i.e., the concluding item on an income statement). But the amendment contains no link to accounting standards or definitions and it hardly could be said that an average voter in 1993 knew about, or cared about, the technicalities of accounting definitions—no tax on his or her net income, including on income that is received from partnerships or unincorporated associations, was what was being prohibited, technicalities aside.

Proponents of the margin tax will no doubt assert that the margin tax does not invoke Article VIII, Sec. 24(a) because the tax would be assessed against entities, not against individuals, and particularly entities that under the law provide liability insulating protection to their owners or investing principals just like corporations. But as noted, the partnership/unincorporated association proviso of the Bullock Amendment refers plainly and simply to “a person’s share” of the income of an unincorporated association as triggering the referendum. Whether the tax is directly on an entity is irrelevant if the only inquiry is whether there is ultimately a tax levied on “a person’s share” of some distribution.

* * *

I believe the proposed margin tax would likewise require a referendum under Article VIII, Sec. 24(a), precluding any adoption absent voter approval.

I also seek your opinion of whether the disparate tax rates found in this legislation as proposed are permissible. As presently conceived, retailers and wholesalers would pay the margin tax at the rate of ½ of 1 percent on their chosen tax base, and all other taxable entities would pay at the rate of 1 percent.

An obvious issue is whether any rational basis exists for taxing retailers and wholesalers at a rate substantially different from the rate that would apply to all other businesses. I question whether this approach is valid based on fundamental principles of equal treatment under the law.

²³¹ See Peggy Fikac, *‘Income tax’ is a loaded label for business levy - Perry opponents get fired up after accounting board calls it just that*, HoustonChronicle.com -- <http://www.HoustonChronicle.com> | Section: Houston & Texas (August 10, 2006), <http://search.chron.com/chronicle/archiveSearch.do> (Type “Peggy Fikac” in the Author search box, then select date range of “August 10, 2006 to August 10, 2006”):

A board that sets national accounting standards stirred up the Texas governor’s race by saying the state’s new business tax is an income tax for reporting purposes. The decision

FASB's August 2, 2006 meeting reflect that FASB decided not to add a project to its agenda that would provide guidance on whether the Margin Tax is an income tax that should be accounted for in accordance with FASB Statement No. 109, *Accounting for Income Taxes*, "because the tax is based on a measure of income." These minutes further reflect FASB's TA&I Committee had "concluded that the [Margin] Tax was an income tax that should be accounted for under Statement 109 and that there would not be diversity in the conclusions reached by preparers, auditors, and regulators on whether the [Margin] Tax was an income tax.

6. Internal Partnerships Will Not Work Under Margin Tax. Many Texas based corporations (whether or not incorporated in Texas) have utilized internal limited partnerships to isolate liabilities and reduce franchise taxes. Because the Texas franchise/income tax prior to the effectiveness of the Margin Tax was based upon federal taxable income (computed on a separate company basis, for there has been no consolidation for Texas franchise tax purposes), the corporate partner was subject to franchise taxes to the extent that its distributive share of the partnership's income (whether or not distributed) was Texas-sourced.²³² If the limited partnership were structured such that the Texas parent was a 1% general partner and the 99% limited partner was incorporated in a state without an income tax (assume Nevada) and did not otherwise do business or pay franchise taxes in Texas (the ownership of a limited partner interest in a limited partnership doing business in Texas did not alone require the Nevada corporate limited partner to qualify in Texas as a foreign corporation or to pay Texas franchise taxes on its distributive share of the partnership's income), the income attributable to the 99% limited partnership interest would not be subject to the Texas franchise/income tax. If the Nevada subsidiary subsequently dividended its income from the limited partnership to its Texas parent, then that dividend income would not be subjected to the Texas franchise/income tax because either the dividend was deducted in arriving at federal taxable income or it was a non-Texas receipt for franchise tax purposes. The foregoing is a simplification of a common internal limited partnership structure; the actual analysis, of course, was very fact specific and

by the Financial Accounting Standards Board embraced a label rejected by backers, including Republican Gov. Rick Perry, who championed the expanded business tax to lower local school property taxes. The designation gives fresh fodder to Perry challengers independent Carole Keeton Strayhorn, the state comptroller; independent Kinky Friedman; and Democrat Chris Bell. Strayhorn spokesman Mark Sanders said the ruling makes Perry the first governor in Texas history to sign into law an income tax. Bell spokesman Jason Stanford said Perry managed 'to pass not only the biggest tax increase in state history but also apparently a state income tax with the singular achievement of making sure that not one red cent will go to our public schools.' Friedman campaign director Dean Barkley added a call for litigation, saying, 'We urge the business people of Texas to take this issue to the courts and test its legality.' The Texas Constitution bars a tax on people's income without a statewide vote. Perry spokeswoman Kathy Walt and former state Comptroller John Sharp, a Democrat who headed the blue-ribbon panel that recommended the tax, dismissed the significance of the board's decision. 'It is merely an instruction to accountants on how to fill out a form,' said Walt, adding that Attorney General Greg Abbott 'has ruled that it's not an income tax. I'm going to take the attorney general's ruling, not the shrill tirade of the comptroller.' Abbott's top assistant, Barry McBee, Perry's former chief of staff, said in an April letter that the tax didn't conflict with the state constitution. Strayhorn was unsuccessful in seeking a formal opinion from Abbott."

²³² TEX. TAX CODE ANN. § 171.1032(c) (Vernon 2002 & Supp. 2004); Tex. S.B. 1125, 77th Leg., R.S. (2001).

there were a number of structure variations available depending upon the objectives and the source of the income. Since the Margin Tax applies on a unitary and combined basis, the use of internal partnerships has become less effective as an alternative for reducing Texas entity level taxes.

7. Conversions. Though largely irrelevant for state tax purposes under the Margin Tax, transforming a corporate entity into a limited partnership structure previously was an expensive and time consuming procedure for reducing Texas franchise taxes because it required actual asset conveyances and liability assumptions, multiple entities (typically including a Delaware or Nevada entity that must avoid nexus with Texas), and consents of lenders, lessors and others. A simpler “conversion” method evolved utilizing the Check-the-Box Regulations and the conversion procedures in the TBCA, the TRLPA and the TRPA.²³³ The conversion method required converting an existing corporate entity subject to Texas franchise tax to a Texas limited partnership or LLP. The converted entity then filed a Check-the-Box election to continue to be classified as a corporation for federal income tax purposes. For federal income tax purposes, the conversion should qualify as a nontaxable “F” reorganization. Thus, the entity ceased to be subject to Texas franchise tax when the conversion became effective, but continued to be treated as the same corporate entity for federal income tax purposes. The conversion method was suitable primarily for closely held corporations.

In Private Letter Ruling 2005 48021 (Dec. 2, 2005), the IRS found that an S corporation to LLC conversion did not create a second class of stock because the operating agreement for the LLC conferred identical rights on the members both as to distributions and liquidation.

Revenue Procedure 99-51, released by the IRS in December 1999 and reconfirmed by the IRS in Revenue Procedure 2013-3 issued in January 2011,²³⁴ added an additional note of caution to the practice of using Texas’ conversion statutes to convert an existing corporation (with a valid S-corporation election but subject to Texas franchise taxes pre-conversion) into a limited partnership (with a Check-the Box election to be treated as a corporation for federal tax purposes but not subject to Texas franchise taxes post-conversion). The issue was whether the converted entity’s prior S-corporation election remains valid after its metamorphosis into a state law limited partnership due to the IRC’s requirement that an electing S-corporation may have only one class of stock. In at least one private letter ruling issued by the IRS prior to the publication of Revenue Procedure 99-51, the IRS sanctioned an S-corporation’s conversion under state law to a limited partnership and acquiesced in continued S-corporation election treatment where the taxpayer represented that general and limited partners had identical rights under the partnership agreement to distributions and liquidating proceeds.²³⁵ However, in Revenue Procedure 99-51 and Revenue Procedure 2013-3 the IRS stated that (i) the IRS will no longer rule on the single class of stock requirement in the limited partnership context until it studies the matter extensively and issues further published administrative guidance and (ii) the

²³³ See *infra* notes 252-256 and related text.

²³⁴ Rev. Proc. 99-51, 1999-52 I.R.B. 761 (December 27, 1999) (superceded); Rev. Proc. 2013-3, 2013-1 I.R.B. 111 (December 31, 2012).

²³⁵ See, e.g., I.R.S. Priv. Ltr. Rul. 99-42-009 (July 16, 1999).

IRS will treat any request for an advance ruling on whether a state law limited partnership is eligible to elect S-corporation status as a request for a ruling on whether the entity has a single class of stock. Failure to continue a valid S-corporation election for a state law corporation converting to a state law limited partnership taxed as a corporation for federal tax purposes would be treated for tax purposes as a termination of the S election, which is effective as of the end of the day preceding the date of conversion. Until the IRS no-ruling policy is superseded, practitioners dealing with the conversion of existing S-corporations to partnerships in order to avoid Texas entity taxes may want to consider the alternative of using a subsidiary LLP (i.e., Checking-the-Box to be taxed as a corporation) in lieu of a limited partnership, and specifically drafting equal, pro rata treatment of the partners in the partnership agreement to overcome the single class of stock concern.

The applicability of the Margin Tax to limited partnerships removes conversions of corporations to limited partnerships as a means of reducing Texas entity taxes. Conversions to general partnerships, all of whose partners are individuals, remains a way to reduce Texas entity taxes, but this possible tax savings comes with the cost of personal liability.

8. 2011 Legislative Tax Changes. Neither the 2011 Legislative Session nor the subsequent Special Session which convened on May 31, 2011 and ended on June 30, 2011 (the “2011 Special Session”) generated any new material Texas taxes. There were, however, several important administrative and timing provisions²³⁶ which are described below.

(a) General Administrative Provisions.

(1) Record Retention. Article 4 of 2011 S.B. 1 from the 2011 Special Session²³⁷ (“2011 S.B. 1”) amended the Texas Occupations Code and the Texas Tax Code to extend the amount of time that taxpayers must keep records including electronically stored documents. Section 111.0041 of the Texas Tax Code was amended to extend the time to at least four years that taxpayers are required to maintain records to substantiate and verify a claim regarding taxes, penalties, and interest. Longer holding periods are required if administrative or judicial proceedings involving the records are pending.

(2) Late Filing Penalty. Article 14 of 2011 S.B. 1 added a \$50 late filing penalty for a person who fails to file reports required under Texas Tax Code Chapter 151 (*sales tax*); Chapter 152 (*motor vehicle tax*); 156 (*hotel occupancy tax*); 162 (*motor fuels tax*); 171 (*franchise tax*); or Chapter 183 (*mixed beverage tax*). The penalty is in addition to any other penalty and without regard to whether the taxpayer subsequently files the report or whether any taxes or fees were due. The article takes effect October 1, 2011.

(3) Enhanced Enforcement. Senate Bill 934,²³⁸ passed during the 2011 Legislative Session, expanded the Texas Comptroller’s ability to investigate and

²³⁶ There are other changes to the Texas Tax Code that are not included in this paper due to their application to a more limited scope of taxpayer.

²³⁷ <http://www.capitol.state.tx.us/BillLookup/Text.aspx?LegSess=821&Bill=SB1>.

²³⁸ <http://www.capitol.state.tx.us/BillLookup/Text.aspx?LegSess=82R&Bill=SB934>.

prosecute tax fraud. It increased criminal penalties for certain fraudulent sales tax nonpayment and concealing resale certificate information. For example, under the new law it is a first degree felony to collect and fail to remit sales tax in excess of \$200,000.²³⁹ It also added money laundering and organized criminal activities to existing tax fraud violations in the Texas Code of Criminal Procedure. The new law also tolls the limitations period during any criminal proceeding.

(b) Tax Speed Up Provisions. 2011 S.B. 1 required certain taxes that are collected from customers and that would otherwise be payable to the State in September of 2013 (i.e., the first month of next biennium) to have to be paid in August of 2013 (i.e., the last month of the 2011 biennium).

Article 9 of 2011 S.B. 1 required a prepayment of 25% *motor fuel* taxes otherwise payable in September 2013.

Article 10 of 2011 S.B. 1 required a prepayment of 25% certain *alcoholic beverage* taxes otherwise payable in September 2013.

Article 13 of 2011 S.B. 1 required monthly electronic *sales* tax-filers to pay 125% of their August 2013 return amount by August 30, 2013, and allows a credit for the 25% prepayment in the following monthly return.

(c) Margin Tax. Article 37 of 2011 S.B. 1 extended the small business Margin Tax threshold amount of \$1,000,000 through 2012 and 2013.

Effective January 1, 2012, Article 45 of 2011 S.B. 1 exempted political action committees from the Margin Tax. Article 45 also adds limited Margin Tax revenue exclusions for certain “live event promotion companies” and “courier services.”

Article 51 of 2011 S.B. 1 amended the definition of “retail trade” that can qualify for the lower .5% Margin Tax rate to include certain apparel rental businesses. The provision takes effect on January 1, 2012.

(d) Sales Tax.

(1) Nexus. Article 30 of 2011 S.B. 1 amended Texas Tax Code Section 151.008(b) to provide that the terms “seller” and “retailer” include a person who by agreement with an owner of tangible personal property has been entrusted with possession of and authority to sell, lease, or rent the property without additional action on the part of the owner.

Article 30 also amended Texas Tax Code Section 151.107 to provide that a “retailer engaged in business in this state” includes a retailer that (1) holds a substantial ownership (i.e. at least 50% direct or indirect) in a person who maintains a business location in this state if the retailer sells substantially the same product line and does so under

²³⁹ Tex. Tax Code Section 151.7032 (b)(7).

substantially the same business name as the related retailer or if the facilities or employees of the related person in this state are used to advertise, promote, or facilitate sales by the retailer or are used to maintain a marketplace in this state for the retailer, exchanging returned merchandise; *or* (2) holds a substantial ownership in, or is owned in whole or substantial part by, a person that maintains a distribution center, warehouse, or similar location in this state that delivers property sold by the retailer.

House Bill 1841 from the 2011 Legislative Session²⁴⁰ added a new Section 151.108 to the Texas Tax Code that provides that a person is not engaged in business in Texas for state tax nexus purposes if its only in-state activity is the use of an “Internet hosting” service.

(2) Sale for Resale. Article 12 of 2011 S.B. 1 amended Section 151.006 of the Texas Tax Code to more clearly prevent taxpayers that are providing nontaxable services from buying property or services associated with their services in exempt “sale[s] for resale.” Certain exceptions are made for purchases made by federal government contractors. The intent of the new provision is that a nontaxable service provider can only purchase items or services under the resale exemption if they actually sell such items or services in a taxable transaction to their customers.

(e) Property Tax. Senate Bill 1505 from the 2011 Legislative Session amended Section 23.175 of the Texas Property Tax Code to require Chief Appraisers to adjust the oil and gas price used to value mineral interests for the current appraisal year using a price forecast by the U.S. Energy Information Association and limits annual increases or decreases to the average annual percentage change in the Producer Price Index published by the Bureau of Labor and Statistics from 1982 to current.

H. Business Combinations and Conversions.

1. Business Combinations Generally. A business combination involves one entity or its owners acquiring another entity, its assets or ownership interests. A business combination can be effected by a merger, acquisition of shares or other ownership interests, or an acquisition of the assets of the acquired entity.

(a) Merger. Texas law allows corporations, LLCs and partnerships to merge with each other (e.g., a limited partnership can merge into a corporation).²⁴¹ Detailed provisions appearing in the TBOC and its predecessor statutes provide the mechanics of adopting a plan of merger, obtaining owner approval, filing with the Secretary of State, and protecting creditors.

(b) Share Exchange. A business combination may be effected by a transfer of shares or other ownership interests in which either (i) all of the owners agree to the sale or exchange of their interests or (ii) there is a statutory share or interest exchange pursuant to

²⁴⁰ <http://www.capitol.state.tx.us/BillLookup/Text.aspx?LegSess=82R&Bill=HB1841>.

²⁴¹ TBCA art. 5.01, § A; LLC Act § 10.01, § A; TRLPA § 2.11; TRPA § 9.02; TBOC § 10.001.

a plan of exchange approved by the vote of the owners, which may be less than unanimous but is binding on all, pursuant to statute or the entity documents.²⁴² The TBOC and its respective predecessor entity statutes – the TBCA, the LLC Act, the TRLPA and the TRPA – each have provisions providing the mechanics of adopting a plan of exchange, obtaining owner approval and filing with the Secretary of State.²⁴³

(c) Asset Sale. A sale or exchange of all or substantially all of the assets of an entity may require approval of the owners, depending on the nature of the transaction, the entity’s organization documents and applicable state law.²⁴⁴ In most states, shareholder approval of an asset sale has historically been required when a corporation is selling all or substantially all of its assets. The Delaware courts have used both “qualitative” and “quantitative” tests in interpreting the phrase “substantially all,” as it is used in Section 271 of the Delaware General Corporation Law (“DGCL”), which requires stockholder approval for a corporation to “sell, lease or exchange all or substantially all of its property and assets.”²⁴⁵

²⁴² TBCA art. 5.02 § A; LLC Act §§ 10.01, 10.06; TRLPA § 2.11; TRPA § 9.03; TBOC § 10.051.

²⁴³ TBCA art. 5.02 § A; LLC Act §§ 10.01, 10.06; TRLPA § 2.11; TRPA § 9.03; TBOC §§ 10.151-10.153.

²⁴⁴ See TBCA arts. 5.09 and 5.10; TBOC § 10.251. See also Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation - Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 287-288 (Winter 2001); Byron F. Egan and Amanda M. French, *1987 Amendments to the Texas Business Corporation Act and Other Texas Corporation Laws*, 25 Bull. of Section on Corp., Banking & Bus. L. 1, 11-12 (No. 1, Sept. 1987).

²⁴⁵ See *Gimbel v. Signal Co., Inc.*, 316 A.2d 599 (Del. Ch. 1974) (assets representing 41% of net worth but only 15% of gross revenues held not to be “substantially all”); *Katz v. Bregman*, 431 A.2d 1274 (Del. Ch. 1981) (51% of total assets, generating approximately 45% of net sales, held to be “substantially all”); and *Thorpe v. CERBCO, Inc.*, 676 A.2d 436 (Del. 1996) (sale of subsidiary with 68% of assets, which was primary income generator, held to be “substantially all”); Court noted that seller would be left with only one operating subsidiary, which was marginally profitable). See also *Hollinger Inc. v. Hollinger Int’l, Inc.*, 858 A.2d 342 (Del. Ch. 2004), *appeal refused*, 871 A.2d 1128 (Del. 2004), in which (A) the sale of assets by a subsidiary with approval of its parent corporation (its stockholder), but not the stockholders of the parent, was alleged by the largest stockholder of the parent to contravene DGCL § 271; (B) without reaching a conclusion, the Chancery Court commented in dicta that “[w]hen an asset sale by the wholly owned subsidiary is to be consummated by a contract in which the parent entirely guarantees the performance of the selling subsidiary that is disposing of all of its assets and in which the parent is liable for any breach of warranty by the subsidiary, the direct act of the parent’s board can, without any appreciable stretch, be viewed as selling assets of the parent itself” (the Court recognized that the precise language of DGCL § 271 only requires a vote on covered sales by a corporation of “its” assets, but felt that analyzing dispositions by subsidiaries on the basis of whether there was fraud or a showing that the subsidiary was a mere alter ego of the parent as suggested in *Leslie v. Telephonics Office Technologies, Inc.*, 1993 WL 547188 (Del. Ch., Dec. 30, 1993) was too rigid); and (C) examining the consolidated economics of the subsidiary level sale, the Chancery Court held (1) that “substantially all” of the assets should be literally read, commenting that “[a] fair and succinct equivalent to the term ‘substantially all’ would be ‘essentially everything’, notwithstanding past decisions that have looked at sales of assets around the 50% level, (2) that the principal inquiry was whether the assets sold were “quantitatively vital to the operations of” seller (the business sold represented 57.4% of parent’s consolidated EBITDA, 49% of its revenues, 35.7% of the book value of its assets, and 57% of its asset values based on bids for the two principal units of the parent), (3) that the parent had a remaining substantial profitable business after the sale (the Chancery Court wrote: “if the portion of the business not sold constitutes a substantial, viable, ongoing component of the corporation, the sale is not subject to Section 271,” quoting BALOTTI AND FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, §10.2 at 10-7 (3rd ed. Supp. 2004), and (4) that the

Difficulties in determining when a shareholder vote is required in Delaware led Texas to adopt a bright line test. TBCA articles 5.09 and 5.10 provided, in essence, that shareholder approval is required under Texas law only if it is contemplated that the corporation will cease to conduct any business following the sale of assets.²⁴⁶ Under TBCA article 5.10, a sale of all or substantially all of a corporation's property and assets must be approved by the shareholders (and shareholders who voted against the sale could perfect appraisal rights). TBCA article 5.09(A) provided an exception to the shareholder approval requirement if the sale is "in the usual and regular course of the business of the corporation," and a 1987 amendment added section B to article 5.09 providing that a sale is

in the usual and regular course of business if, [after the sale,] the corporation shall, directly or indirectly, either continue to engage in one or more businesses or apply a portion of the consideration received in connection with the transaction to the conduct of a business in which it engages following the transaction.²⁴⁷

"qualitative" test of *Gimbel* focuses on "factors such as the cash-flow generating value of assets" rather than subjective factors such as whether ownership of the business would enable its managers to have dinner with the Queen. See Morton and Reilly, *Clarity or Confusion? The 2005 Amendment to Section 271 of the Delaware General Corporation Law*, X Deal Points – The Newsletter of the Committee on Negotiated Acquisitions 2 (Fall 2005); see also Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 Bus. Law. 843, 855-58 (2005); BALOTTI AND FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS*, §10.2 (3rd ed. Supp. 2009). To address the uncertainties raised by dicta in Vice Chancellor Strine's opinion in *Hollinger*, DGCL § 271 was amended effective August 1, 2005 to add a new subsection (c) which provides as follows:

(c) For purposes of this section only, the property and assets of the corporation include the property and assets of any subsidiary of the corporation. As used in this subsection, "subsidiary" means any entity wholly-owned and controlled, directly or indirectly, by the corporation and includes, without limitation, corporations, partnerships, limited partnerships, limited liability partnerships, limited liability companies, and/or statutory trusts. Notwithstanding subsection (a) of this section, except to the extent the certificate of incorporation otherwise provides, no resolution by stockholders or members shall be required for a sale, lease or exchange of property and assets of the corporation to a subsidiary.

This amendment answered certain questions raised by *Hollinger*, but raised or left unanswered other questions (e.g., (i) whether subsection (c) applies in the case of a merger of a subsidiary with a third party even though literally read DGCL § 271 does not apply to mergers, (ii) what happens if the subsidiary is less than 100% owned, and (iii) what additional is meant by the requirement that the subsidiary be wholly "controlled" as well as "wholly owned"). See Morton and Reilly, *Clarity or Confusion? The 2005 Amendment to Section 271 of the Delaware General Corporation Law*, X Deal Points – The Newsletter of the Committee on Negotiated Acquisitions 2 (Fall 2005); cf. *Weinstein Enterprises, Inc. v. Orloff*, 870 A.2d 499 (Del. 2005) for a discussion of "control" in the context of a DGCL § 220 action seeking inspection of certain documents in the possession of a publicly held New York corporation of which the defendant Delaware corporation defendant was a 45.16% stockholder.

²⁴⁶ See Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation --Texas versus Delaware: Is it Now Time to Rethink Traditional Notions?*, 54 SMU L. REV. 249, 287-290 (Winter 2001).

²⁴⁷ In *Rudisill v. Arnold White & Durkee, P.C.*, 148 S.W.3d 556 (Tex. App.—Houston [14th Dist.] 2004, no pet.), the 1987 amendment to art. 5.09 was applied literally. The *Rudisill* case arose out of the combination

TBOC sections 21.451 and 21.455 carry forward TBCA articles 5.09 and 5.10.

The Texas partnership statutes do not contain any analogue to TBCA articles 5.09 and 5.10 and the parallel TBOC provisions applicable to corporations. They leave any such requirement to the partnership agreement or another contract among the owners of the entity.²⁴⁸ The Texas LLC Statutes reach a similar result, but under the TBOC it would be necessary to affirmatively provide that no owner vote is required to approve a sale of all or substantially all of the assets of the LLC.²⁴⁹

An important reason for structuring an acquisition as an asset transaction is the desire on the part of a buyer to limit its responsibility for liabilities of the seller, particularly unknown or contingent liabilities. 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. In certain other jurisdictions, 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 common law “*de facto merger*,” which would result in the buyer becoming responsible as a matter of law for seller liabilities which the buyer did not contractually assume.²⁵⁰

of Arnold White & Durkee, P.C. (“AWD”) with another law firm, Howrey & Simon (“HS”). The combination agreement provided that all of AWD’s assets other than those specifically excluded (three vacation condominiums, two insurance policies and several auto leases) were to be transferred to HS in exchange for a partnership interest in HS, which subsequently changed its name to Howrey Simon Arnold & White, LLP (“HSAW”). In addition, AWD shareholders were eligible individually to become partners in HSAW by signing its partnership agreement, which most of them did.

For business reasons, the AWD/HS combination was submitted to a vote of AWD’s shareholders. Three AWD shareholders submitted written objections to the combination, voted against it, declined to sign the HSAW partnership agreement, and then filed an action seeking a declaration of their entitlement to dissenters’ rights or alternate relief. The court accepted AWD’s position that these shareholders were not entitled to dissenters’ rights because the sale was in the “usual and regular course of business” as AWD continued “to engage in one or more businesses” within the meaning of TBCA art. 5.09B, writing that “AWD remained in the legal services business, at least indirectly, in that (1) its shareholders and employees continued to practice law under the auspices of HSAW, and (2) it held an ownership interest in HSAW, which unquestionably continues directly in that business.” The court further held that AWD’s obtaining shareholder approval when it was not required by TBCA art. 5.09 did not create appraisal rights, pointing out that appraisal rights are available under the statute only “*if special authorization of the shareholders is required.*” See Subcommittee on Recent Judicial Developments, *ABA Negotiated Acquisitions Committee, Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 Bus. Law. 843, 855-60 (2005).

²⁴⁸ See TBOC § 153.152.

²⁴⁹ TBOC § 1.002(32) defines “fundamental business transaction” to include a “sale of all or substantially all of the entity’s assets” and TBOC § 101.356 requires a member vote to approve any fundamental business transaction, although TBOC § 101.052 would allow the parties to include in the company agreement provisions that trump this TBOC requirement.

²⁵⁰ See *Knapp v. N. Amer. Rockwell Corp.*, 506 F.2d 361 (3d Cir. 1974); *Philadelphia Electric Co. v. Hercules, Inc.*, 762 F.2d 303 (3d Cir. 1985); *SmithKline Beecham Corp. v. Rohm and Haas Corp.*, 89 F.3d 154 (3d Cir. 1996); *Cargo Partner AG v. Albatrans Inc.*, 352 F.3d 41 (2d Cir. 2003).

Texas legislatively repealed the *de facto* merger doctrine in TBCA article 5.10B, which provides in relevant part that “[a] disposition of any, all, or substantially all, of the property and assets of a corporation . . . (1) is not considered to be a merger or conversion pursuant to this Act or otherwise; and (2) except as otherwise expressly provided by another statute, does not make the acquiring corporation, foreign corporation, or other entity responsible or liable for any liability or obligation of the selling corporation that the acquiring corporation, foreign corporation, or other entity did not expressly assume.”²⁵¹ TBOC section 10.254 carries forward TBCA article 5.10B and makes it applicable to all domestic entities.

2. Conversions.

(a) General. Texas law allows corporations, LLCs and partnerships to convert from one form of entity into another without going through a transfer of assets or merger.²⁵² A conversion is not a combination of entities; rather, it is only a change in the statutory form and nature of an existing entity. Additionally, a conversion involves only one entity and does not involve any change in the ownership of that entity, although it may change the rights of the owners.²⁵³ The TBOC and its source Texas entity statutes each have provisions relating to the mechanics of adopting a plan of conversion, obtaining owner approval, filing with the Secretary of State, and protecting creditors. Those Texas statutes and the federal income tax consequences of conversions are summarized below.

(b) Texas Statutes. Under the conversion provisions of Texas law,²⁵⁴ a Texas corporation may convert into another corporation or other entity if (i) the conversion is

²⁵¹ In *C.M. Asfahl Agency v. Tensor, Inc.*, 135 S.W.3d 768, 780-81 (Tex.App.—Houston [1st Dist.] 2004), a Texas Court of Civil Appeals, quoting TBCA art. 5.10(B)(2) and citing two other Texas cases, wrote:

This transaction was an asset transfer, as opposed to a stock transfer, and thus governed by Texas law authorizing a successor to acquire the assets of a corporation without incurring any of the grantor corporation’s liabilities unless the successor expressly assumes those liabilities. [citations omitted] Even if the Agency’s sales and marketing agreements with the Tensor parties purported to bind their ‘successors and assigns,’ therefore, the agreements could not contravene the protections that article 5.10(B)(2) afforded Allied Signal in acquiring the assets of the Tensor parties unless Allied Signal expressly agreed to be bound by Tensor parties’ agreements with the Agency.

See Byron F. Egan & Curtis W. Huff, *Choice of State of Incorporation --Texas versus Delaware: Is it Now Time to Rethink Traditional Notions*, 54 SMU Law Review 249, 287-290 (Winter 2001).

²⁵² TBCA Part Five; TBOC Chapter 10, Subchapter C; cf. ABA Committee on Corporate Laws, *Changes in the Model Business Corporation Act Relating to Domestication and Conversion – Final Adoption*, 58 Bus. Law 219 (Nov. 2002).

²⁵³ See *Grohman v. Kahlig*, 318 S.W.3d 882 (Tex. 2010), in which the Texas Supreme Court held that the conversion of two corporations into limited partnerships did not violate the terms of a security agreement covering shares of stock in the corporations that required the pledgor not to “sell, transfer, lease or otherwise dispose of the Collateral or any interest therein” without the pledgor’s consent, and not to “allow the Collateral to become wasted or destroyed,” because the pledged shares of stock were converted to limited partnership units and the definition of “Collateral” in the security agreement encompassed “all replacements, additions, and substitutions,” and the shares of stock that were canceled in the conversion were first replaced with limited partnership units that represented the same interest in the businesses; thus, the Collateral was not transferred, and the pledgee’s security interest was not impaired.

²⁵⁴ TBCA arts. 5.17, 5.18, 5.19 and 5.20; TBOC §§ 10.101-10.151, 10.154-10.203.

approved by its shareholders in the same manner as a merger in which the corporation is not the surviving entity would be approved; (ii) the conversion is consistent with the laws under which the resulting entity is to be governed; (iii) shareholders will have a comparable interest in the resulting entity unless a shareholder exercises his statutory dissenter's rights or otherwise agrees; (iv) no shareholder will become personally liable for the obligations of the resulting entity without his consent; and (v) the resulting entity is a new entity formed as a result of the

conversion rather than an existing entity (which would be a merger).²⁵⁵ Partnerships, limited partnerships, and LLCs are afforded comparable rights.²⁵⁶

Under the TBOC a converting entity may elect to continue its existence in its current organizational form and jurisdiction of formation in connection with its conversion under TBOC Chapter 10.²⁵⁷ This election, which is intended to afford foreign entities a means to

²⁵⁵ TBOC § 10.101. Under TBOC § 10.106, when a conversion takes effect upon the filing of a certificate of conversion with the Secretary of State after following the above procedures:

- (1) the converting entity shall continue to exist, without interruption, but in the organizational form of the converted entity rather than in its prior organizational form;
- (2) all rights, titles, and interests to all real estate and other property owned by the converting entity shall continue to be owned by the converted entity in its new organizational form without reversion or impairment, without further act or deed, and without any transfer or assignment having occurred, but subject to any existing liens or other encumbrances thereon;
- (3) all liabilities and obligations of the converting entity shall continue to be liabilities and obligations of the converted entity in its new organizational form without impairment or diminution by reason of the conversion;
- (4) all rights of creditors or other parties with respect to or against the prior interest holders or other owners of the converting entity in their capacities as such in existence as of the effective time of the conversion will continue in existence as to those liabilities and obligations and may be pursued by such creditors and obligees as if the conversion had not occurred;
- (5) a proceeding pending by or against the converting entity or by or against any of its owners or members in their capacities as such may be continued by or against the converted entity in its new organizational form and by or against the prior owners or members without any need for substitution of parties;
- (6) the ownership or membership interests in the converting entity that are to be converted into ownership or membership interests in the converted entity as provided in the plan of conversion shall be so converted, and the former holders of ownership or membership interests in the converting entity shall be entitled only to the rights provided in the plan of conversion or rights of dissent and appraisal under the TBOC;
- (7) if, after the effectiveness of the conversion, an owner or member of the converted entity would be liable under applicable law, in such capacity, for the debts or obligations of the entity, such owner or member shall be liable for the debts and obligations of the entity that existed before the conversion takes effect only to the extent that such owner or member: (a) agreed in writing to be liable for such debts or obligations, (b) was liable under applicable law, prior to the effectiveness of the conversion, for such debts or obligations, or (c) by becoming an owner or member of the converted entity becomes liable under applicable law for existing debts and obligations of the converted entity; and
- (8) if the converted entity is one not governed by the TBOC, then it is considered (a) to have appointed the Texas Secretary of State as its registered agent for purposes of enforcing any obligations or dissenters' rights and (b) to have agreed to promptly pay the dissenting members or owners of the converting entity any amounts owed under the TBOC.

See also TBCA art. 5.20.

²⁵⁶ *See* TBOC § 10.101. The comparable provisions for such entities governed by pre-TBOC law are found for LLCs at LLC Act §§ 10.08-10.11, for limited partnerships at TRLPA § 2.15, and for general partnerships at TRPA §§ 9.01, 9.05 and 9.06.

²⁵⁷ TBOC § 10.1025 as added in the 2009 Legislative Session by 2009 S.B. 1442 §§ 15-18. In a conversion and continuance transaction under new TBOC § 10.109, the converting entity continues to exist both in its

do business in the U.S. while avoiding adverse foreign tax consequences, is only available to a domestic entity of one organizational form that is converting into a non-U.S. entity of the same organizational form or a non-U.S. entity of one organizational form converting into a domestic entity of the same organizational form. The permitted election must be adopted and approved as part of the plan of conversion for the converting entity and permitted by, or not prohibited by or inconsistent with, the laws of the applicable non-U.S. jurisdiction.²⁵⁸

(c) Federal Income Tax Consequences. As in the case of organizational choice of entity determinations and business combinations, a conversion transaction should not be undertaken without a thorough analysis of the federal and state income tax consequences of the conversion. The following sections provide a brief summary of some of the federal income tax consequences of certain conversion transactions.²⁵⁹

(1) Conversions of Entities Classified as Partnerships. There generally should be no adverse federal income tax consequences arising from a properly structured conversion of an entity classified as a domestic partnership for federal income tax

current organizational form and jurisdiction of formation and in the same organizational form in the new jurisdiction of formation, and as a single entity subject to the laws of both jurisdictions. The property interests, liabilities and obligations of the entity remain unchanged. For a conversion and continuance transaction, the certificate of conversion must be titled a “certificate of conversion and continuance” and must include a statement certifying that the converting entity is electing to continue its existence in its current organizational form and jurisdiction of formation. See Byron F. Egan, *Choice of Entity Alternatives* (May 28, 2010), available at <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1396>, which at Appendix D describes (i) 2009 S.B. 1442 by Sen. Troy Fraser (generally updating the TBOC), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=SB1442>, and (ii) 2009 H.B. 1787 by Rep. Burt Solomons (amending TBOC provisions pertaining to the designation of registered agents for service of process), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB1787>.

Delaware General Corporation Law (“DGCL”) § 388 allows non-U.S. corporations and other entities to move to Delaware by filing a certificate of domestication, together with a certificate of incorporation with the Delaware Secretary of State. Upon filing these documents, the corporation becomes “domesticated” in Delaware, which means that the corporation becomes a Delaware corporation subject to all the provisions and entitled to all the benefits of the Delaware law governing corporations. A domesticated corporation is deemed to have been in existence since the beginning of its existence in the jurisdiction in which it was first formed, rather than the time it domesticated in Delaware. DGCL § 388 contemplates the movement of a corporation or other entity to Delaware on a permanent basis. DGCL § 388 contemplates a continuation, as opposed to a rebirth. DGCL § 388(e) specifically provides that a domestication “shall not be deemed to affect any obligations or liabilities of the non-United States entity incurred prior to its domestication.”

²⁵⁸ Even though the converting entity continues to exist in the non-U.S. jurisdiction (as well as in Texas), the entity would not be required to qualify to do business as a foreign entity under TBOC Chapter 9 (Foreign Entities) after its conversion and continuance. TBOC § 10.1025 as added in the 2009 Legislative Session by 2009 S.B. 1442 §§ 15-18. See Byron F. Egan, *Choice of Entity Alternatives* (May 28, 2010), available at <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1396>, which at Appendix D describes (i) 2009 S.B. 1442 by Sen. Troy Fraser (generally updating the TBOC), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=SB1442>, and (ii) 2009 H.B. 1787 by Rep. Burt Solomons (amending TBOC provisions pertaining to the designation of registered agents for service of process), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB1787>.

²⁵⁹ See Monte A. Jackel and Glen E. Dance, *Selected Federal Income Tax Aspects of Changing the Tax Status of Business Entities*, 3 PLI/Tax Strategies 255 (1997).

purposes (e.g., general partnerships, LLPs, limited partnerships and LLCs) into another entity classified as a domestic partnership for federal income tax purposes, provided that the owners' capital and profit interests and shares of entity liabilities do not change as a result of the conversion and the entity's business and assets remain substantially unchanged.²⁶⁰ These transactions are viewed as tax-free contributions under Section 721 of the IRC that do not cause the existing entity to terminate under Section 708, and do not cause the taxable year of the existing entity to close with respect to any or all of the partners or members. A new taxpayer identification number is not required. Careful attention should be paid to determining the partners' or members' correct share of the entity's liabilities before and after the conversion because a decrease in a partner's or member's share of those liabilities that exceeds the partner's or member's adjusted basis in its interest will result in recognition of gain.

The conversion of an entity classified as a partnership to an entity that is ignored for federal income tax purposes will occur if such entity only has a single member. For example, if one member of a two member LLC purchases the other member's interest, the partnership is deemed to make a liquidating distribution of all of its assets to the members, with the purchasing member treated as acquiring the assets distributed to the selling member. However, the selling member is treated as selling a partnership interest.²⁶¹ Partnership liquidations generally do not result in recognition of gain by the partners except to the extent that the amount of cash (marketable securities are in certain cases treated as cash) actually or constructively received by a partner exceeds the partner's adjusted basis in his partnership interest.²⁶² Note that distributions of property contributed to the partnership within seven years of the date of the deemed distribution may result in gain recognition pursuant to I.R.C. §§ 704(c)(1)(B) and 737.²⁶³

Conversion of an entity classified as a partnership into a corporation will generally be analyzed as a liquidating transaction with respect to the partnership and an incorporation transaction with respect to the corporation, either of which can result in recognition of gain by the owners of the converted entity.²⁶⁴ Nevertheless, with careful planning, most conversions of this type can be accomplished without recognition of gain.²⁶⁵

(2) Conversions of Entities Classified as Corporations.

Conversion of an entity classified as a corporation into an entity classified as a partnership or an entity ignored for federal income tax purposes will generally be treated as a taxable liquidating transaction with respect to the corporation and, in the case of conversion to a partnership entity, a contribution transaction with respect to the partnership entity.²⁶⁶ A corporation cannot be

²⁶⁰ See e.g., Rev. Rul. 95-37, 1995-17 I.R.B.10; Rev. Rul. 86-101, 1986-2 C.B. 94; Rev. Rul. 84-52, 1984-1 C.B. 157.

²⁶¹ Rev. Rul. 99-6, 1999-1 C.B. 432.

²⁶² See I.R.C. § 731 (1997); I.R.C. § 736 (1993); I.R.C. § 751(b) (2004); Treas. Reg. § 301.7701-3(g) (2006); Priv. Ltr. Rul. 201214014 (April 6, 2012).

²⁶³ See I.R.C. § 704(c)(1)(B) (2004); I.R.C. § 737 (1997).

²⁶⁴ See, e.g., I.R.C. § 751(b) (2004); I.R.C. § 351 (2005).

²⁶⁵ See Rev. Rul. 84-111, 1984-2 C.B. 88; Treas. Reg. § 301.7701-3(g) (2006).

²⁶⁶ Treas. Reg. § 301.7701-3(g)(1)(ii), (iii).

converted into an entity classified as a partnership or sole proprietorship in a tax free transaction. In the case of a C-corporation (other than one that is owned 80% or more by another corporation) the liquidation potentially may be subject to tax at both the corporate and shareholder levels. The corporation will recognize gain or loss equal to the difference between the fair market value of each tangible and intangible asset of the corporation and the corporation's adjusted basis in each respective asset.²⁶⁷ The shareholders will recognize gain or loss equal to the difference between the fair market value of the assets deemed distributed to them and their adjusted basis in the corporation's shares.²⁶⁸ Contrary to "common wisdom" that an S-corporation is taxed like a partnership, the same taxable liquidation rules apply to an S-corporation and its shareholders except that the corporate level gain realized by the S-corporation on the deemed liquidation generally flows through to the individual returns of the shareholders thereby increasing their adjusted bases in their stock and eliminating or decreasing the amount of shareholder level gain.²⁶⁹ In order to comply with the single-class-of-stock requirement, careful tax analysis should be undertaken when converting a corporation with an otherwise valid pre-conversion S-corporation election into partnership form electing post-conversion Check-the-Box treatment as a corporation.

(d) Effect on State Licenses. The Texas Attorney General has issued an opinion to the effect that "[w]hen a corporation converts to another type of business entity in accordance with the TBCA, as a general rule a state license held by the converting corporation continues to be held by the new business entity . . . subject to the particular statutory requirements or regulations of the specific state entity that issued the license."²⁷⁰

I. Use of Equity Interests to Compensate Service Providers. A corporation may compensate service providers using employee stock ownership plans ("ESOPs"), restricted stock, non-qualified stock options and incentive stock options; however, incentive stock options and ESOPs are not available in other forms of organization. The grant of equity interests or options to acquire equity interests to service providers in an entity taxed as a partnership creates a number of tax uncertainties.²⁷¹

J. Choice of Entity. To facilitate the entity choice analysis, the following information is provided below: (1) a summary comparison of the respective business entities; (2) a Decision Matrix in Part VIII; (3) an Entity Comparison Chart in Appendix A; and (4) a Basic Texas Business Entities and Federal/State Taxation Alternatives Chart in Appendix B.

²⁶⁷ I.R.C. § 336 (1988).

²⁶⁸ I.R.C. § 331(a) (1982).

²⁶⁹ I.R.C. § 1371(a) (2007); *see also* I.R.C. § 1363(a) (2007); *cf.* I.R.C. § 1374 (1989) (imposing a tax on built-in gains).

²⁷⁰ Op. Tex. Att'y Gen. No. JC-0126 (1999).

²⁷¹ *See* William H. Hornberger and James R. Griffin, Stock Options and Equity Compensation, Address at the 47th Annual Texas CPA Tax Institute (Nov. 14-16, 2000), *available at* <http://www.jw.com/site/jsp/publicationinfo.jsp?id=56>.

II. CORPORATIONS.

A. **General.** The primary advantages of operating a business as a corporation are generally considered to include:

- Limited liability of shareholders
- Centralization of management
- Flexibility in capital structure
- Status as a separate legal entity

The primary disadvantages of operating a business as a corporation are generally considered to be as follows:

- Expense of formation and maintenance
- Statutorily required formalities
- Tax treatment—double taxation for the C-corporation and restrictions on the S-corporation; state franchise taxes

Prior to January 1, 2006, Texas business corporations were organized under, and many are still governed by, the TBCA,²⁷² which was amended in 1997 by 1997 S.B. 555,²⁷³ in 2003 by 2003 H.B. 1165, in 2005 by 2005 H.B. 1507 and in 2007 by 2007 H.B. 1737. However, corporations formed after January 1, 2006 are organized under and governed by the TBOC. For entities formed before January 1, 2006, only the ones voluntarily opting into the TBOC, or converting to a Texas entity on or after January 1, 2006, were governed by the TBOC until January 1, 2010; from and after January 1, 2010, all Texas corporations are governed by the TBOC.²⁷⁴

The TBOC provides that the TBOC provisions applicable to corporations (TBOC Titles 1 and 2) may be officially and collectively known as “Texas Corporation Law.”²⁷⁵ However, because until 2010 some Texas for-profit corporations were governed by the TBCA and others by the TBOC, and because the substantive principles under both statutes are generally the same, the term “Tex. Corp. Stats.” is used herein to refer to the TBOC and the TBCA (as supplemented by the TMCLA) collectively, and the particular differences between the TBCA and the TBOC are referenced as appropriate.

B. **Taxation.** Federal taxation of a corporation in the United States depends on whether the corporation is a regular C-corporation, or has instead qualified for and elected S-corporation tax status.

²⁷² TBCA arts. 1.01 *et. seq.*

²⁷³ Tex. S.B. 555, 75th Leg., R.S. (1997).

²⁷⁴ All foreign entities which initially register to do business in Texas after January 1, 2006 are subject to the TBOC, regardless when formed. TBOC § 402.001(a)(13).

²⁷⁵ TBOC § 1.008(b).

1. Taxation of C-Corporations. C-corporations are separately taxable entities under the IRC. Thus, C-corporation earnings are subject to double taxation--first at the corporate level and again at the shareholder level upon distribution of dividends. Like the personal income tax, corporate tax rates vary depending on the level of income generated.

The taxable income of a C-corporation is subject to federal income tax at graduated rates ranging from 15% to 35%.²⁷⁶ The tax rate schedule for a C-corporation is as follows:²⁷⁷

If taxable income is:			
Over--	But not over--	Tax is:	Of the amount over--
\$0	\$50,000	15%	-0-
\$50,000	\$75,000	\$7,500 + 25%	\$50,000
\$75,000	\$100,000	\$13,750 + 34%	\$75,000
\$100,000	\$335,000	\$22,250 + 39% ²⁷⁸	\$100,000
\$335,000	\$10,000,000	\$113,900 + 34%	\$335,000
\$10,000,000	\$15,000,000	\$3,400,000 + 35%	\$10,000,000
\$15,000,000	\$18,333,333	\$5,150,000 + 38% ²⁷⁹	\$15,000,000
\$18,333,333	--	35%	-0-

Under the IRC, the capital gains of a corporation are generally taxed at the same rates as ordinary income.²⁸⁰

A C-corporation's shareholders must pay individual income taxes on any corporate profits that are distributed to them as dividends. A corporation may reduce its taxable income by paying salaries to its officers, directors or employees, which may help to minimize the effects of double taxation; however, unreasonable compensation may be recharacterized by the IRS as a constructive dividend, which is not deductible by the corporation and is also taxed as income to the officer, director or employee.²⁸¹ There can also be corporate level taxes on excessive accumulations of earnings.

²⁷⁶ I.R.C. §§ 11(a), 11(b).

²⁷⁷ I.R.C. § 11(a).

²⁷⁸ The tax rate for a C corporation with taxable income in excess of \$100,000 is increased by the lesser of (i) 5% of such excess, or (ii) \$11,750. I.R.C. §§ 11(a), 11(b). This essentially means that an additional 5% of tax is imposed on taxable income between \$100,000 and \$335,000.

²⁷⁹ The tax rate for corporations with taxable income in excess of \$15,000,000 is increased by the lesser of (i) 3% of such excess, or (ii) \$100,000. I.R.C. §§ 11(a), 11(b). This essentially means that an additional 3% of tax is imposed on taxable income between \$15,000,000 and \$18,333,333.

²⁸⁰ See I.R.C. § 1201(a).

²⁸¹ See *Pediatric Surgical Associates, P.C. v. Comm'r*, 81 T.C.M. (CCH) 1474 (2001), in which the Tax Court disallowed claimed deductions for salaries paid to shareholder surgeons because it found that the salaries exceeded reasonable allowances for services actually rendered and were disguised nondeductible dividends.

Because a C-corporation is a separately taxable entity, there is no flow-through of income, deductions (including intangible drilling costs and depletion allowances), NOLs or capital losses to a C-corporation's shareholders, although a C-corporation's shareholders are not subject to self-employment tax on distributions they receive. Additionally, a C-corporation can carry forward unused losses and credits, subject to specified limitations. If a C-corporation distributes appreciated assets to its shareholders, it will recognize a taxable gain. Furthermore, a C-corporation will generally recognize gain or loss on its liquidation (except for certain liquidations into a parent corporation),²⁸² and a shareholder will recognize taxable gain or loss on his or her interest in the corporation upon the corporation's liquidation or the shareholder's disposition thereof. However, both S- and C-corporations may be parties to a tax-free reorganization in which neither the corporation nor its shareholders are subject to taxation.

2. Taxation of S-Corporations.

(a) Effect of S-Corporation Status. S-corporation status is achieved by an eligible C-corporation making an election to be so treated. All shareholders, including their spouses if their stock is community property, must consent to such election. Generally, the result of electing S-corporation status is that no corporate level tax is imposed on the corporation's income. Instead, corporate level income is treated as having been received by the shareholders, whether or not such income was actually distributed, and is taxed at the shareholder level. An S-corporation that was previously a C-corporation is subject to a corporate level tax (i) if it realizes a gain on the disposition of assets that were appreciated (i.e., the fair market value exceeded the tax basis) on the date the S election became effective and the disposition occurs within 10 years of that date (subject to certain temporary exceptions enacted in 2009 and 2010)²⁸³ (subject to certain very limited exceptions reducing the 10-year recognition period for certain taxpayers in the 2009, 2010, 2011, 2012 and 2013 tax years),²⁸⁴ and (ii) on its excess net passive income (subject to certain limits and adjustments) if it has subchapter C earnings and profits and more than 25% of its gross receipts for the year is passive investment income.²⁸⁵

A shareholder's deduction for S-corporation losses is limited to the sum of the amount of the shareholder's adjusted basis in his stock and in the corporation's indebtedness

²⁸² See I.R.C. § 336 (1998); I.R.C. § 337 (1988).

²⁸³ I.R.C. § 1374 (1989); Treas. Reg. § 1.1374-1 (2005); *but see* temporary exceptions in Sec. 2014 of Small Business Jobs Act of 2010, P.L. 111-240; Sec. 1251 of American Recovery and Reinvestment Act of 2009, P.L. 111-5.

²⁸⁴ See I.R.C. § 1374(d)(7)(B) (enacted as part of P.L. 111-5 (American Recovery and Reinvestment Act of 2009) and P.L. 111-240 (Creating Small Business Jobs Act of 2010)) (providing exceptions for (i) in the case of any tax year beginning in 2009 and 2010 if the 7th tax year in the recognition period preceded such year; and (ii) in the case of any tax year beginning in 2011, if the 5th year in the recognition period preceded such tax year). See I.R.C. § 1374(d)(7)(C) (providing that for purposes of determining the net recognized built-in gain for tax years beginning in 2012 or 2013, a five-year recognition period applies in lieu of the otherwise applicable 10-year recognition period. See American Taxpayer Relief Act of 2012, P.L. 112-240, § 326.

²⁸⁵ I.R.C. § 1374 (1989).

to him.²⁸⁶ To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year.²⁸⁷

(b) Eligibility for S-Corporation Status. To be eligible for S-corporation status, a corporation must (i) be a domestic corporation (i.e., organized under the laws of a state of the United States),²⁸⁸ (ii) have no more than 100 shareholders (for this purpose, stock owned by a husband and wife is treated as owned by one shareholder and all family members can elect to be treated as one shareholder),²⁸⁹ (iii) have no more than one class of stock²⁹⁰ and (iv) have no shareholders other than individuals who are residents or citizens of the U.S. and certain trusts, estates or exempt organizations (e.g., qualified employee benefit plans and I.R.C. § 501(c)(3) organizations).²⁹¹ S-corporations may have a C-corporation as a subsidiary (even if the S-corporation owns 80% or more of the C-corporation). Additionally, an S-corporation may now own a qualified subchapter S subsidiary (“QSSS”). A QSSS includes any domestic corporation that qualifies as an S-corporation and is owned 100% by an S-corporation that elects to treat its subsidiary as a QSSS.²⁹² A QSSS is not treated as a corporation separate from the parent S-corporation; and all of the assets, liabilities, and items of income, deduction and credit are treated as though they belong to the parent S-corporation. For purposes of the requirement that an S-corporation have only one class of stock, indebtedness may be treated as a second class of stock unless it meets the requirements of the safe harbor rule for “straight debt”, the definition of which was expanded under the Small Business Job Protection Act of 1996. Certain options may also constitute a prohibited second class of stock. In order for the election of S-corporation status to be effective, the election must be made by all shareholders of the corporation.

(c) Termination of S-Corporation Status. Once an S-corporation election has been made, the election continues in effect until (i) it is voluntarily terminated by holders of more than one-half of the outstanding shares, (ii) the corporation ceases to meet the eligibility requirements specified above, or (iii) the corporation has subchapter C earnings and profits at the close of three consecutive taxable years and has gross receipts for each of such taxable years more than 25% of which are passive investment income.²⁹³

(d) Liquidation or Transfer of Interest. An S-corporation and its shareholders are treated in a manner similar to the way a C-corporation and its individual

²⁸⁶ I.R.C. § 1366(d)(1) (2007); I.R.C. § 1367(b)(2)(A) (2007).

²⁸⁷ I.R.C. § 1366(d)(2)(A) (2007).

²⁸⁸ I.R.C. § 1361(b)(1); I.R.C. § 1361(c).

²⁸⁹ I.R.C. § 1361(b)(1)(A) (2005) (as amended by The American Jobs Creation Act of 2004).

²⁹⁰ I.R.C. § 1361(b)(1)(D) (2005); *see supra* notes 233-235 and related text.

²⁹¹ I.R.C. §§ 1361(b)(1)(B) and (C) and 1361(c)(6) (2005).

²⁹² Paul G. Klug and Jay Nathanson, *Small Business Job Protection Act of 1996 Increases the Attractiveness of S Corporations*, 53 J. Mo. B. 219, 221 (1997).

²⁹³ I.R.C. § 1362(d)(1)-(3) (2005).

shareholders are treated when a shareholder disposes of its interest or the S-corporation is liquidated (except no double tax in most cases) or is a party to a nontaxable reorganization.²⁹⁴

3. Contributions of Appreciated Property. Owners of an S- or a C-corporation will generally recognize a taxable gain on appreciated property contributed to the corporation in exchange for shares in the corporation, unless the owners who contribute property will control²⁹⁵ at least 80% of the total combined voting power of all classes of voting stock and at least 80% of the total number of shares of all other classes of stock of the corporation immediately after the transfer.²⁹⁶

4. Texas Entity Taxes. Effective for tax years beginning on or after January 1, 2007, the Margin Tax replaces the Texas franchise tax and is applicable to all corporations.²⁹⁷ As discussed in more detail in Part I(E)(3) above, the tax is generally 1% of a statutorily defined gross receipts calculation, less either: (i) compensation or (ii) cost of goods sold.²⁹⁸

5. Self-Employment Tax. Shareholders of an S-corporation are generally not subject to self-employment tax on their share of the net earnings of trade or business income of the S-corporation if reasonable compensation is paid to the shareholders active in the business.²⁹⁹

C. Owner Liability Issues. Limited liability is one of the most important advantages of doing business as a corporation. In corporate law, it is fundamental that shareholders, officers, and directors are ordinarily protected from personal liability arising from the activities of the corporation.³⁰⁰ This insulation from personal liability is said to be the natural consequence of the incorporation process, and is supported by the theory or “fiction” that incorporation results in the creation of an “entity” separate and distinct from the individual shareholders.³⁰¹ While this general rule of nonliability is given great deference by the courts,

²⁹⁴ See BITTKER & EUSTICE, *supra* note 106, at § 6.04.

²⁹⁵ For these purposes, I.R.C. § 368(c) defines “control” as follows:

[O]wnership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

²⁹⁶ I.R.C. § 351(a) (2005); I.R.C. § 358(a) (2002); I.R.C. § 362(a) (2007); I.R.C. § 368(c) (1999).

²⁹⁷ See *supra* notes 126-227 and related text.

²⁹⁸ Tex. Tax Code Ann. § 171.001 (Vernon 2010). See *supra* note 158 and related text.

²⁹⁹ Rev. Rul. 59-221, 1959-1 C.B. 225; see also Priv. Ltr. Rul. 87-16-060 (Jan. 21, 1987) (ruling that S-corporation shareholders do not conduct the corporation’s business); Burgess J. W. Raby and William L. Raby, *Attempting to Avoid FICA and Self-Employment Tax*, 93 TAX NOTES 803, 803-06 (2001).

³⁰⁰ *Willis v. Donnelly*, 199 S.W.3d 262, 271 (Tex. 2006) (“A bedrock principle of corporate law is that an individual can incorporate a business and thereby normally shield himself from personal liability for the corporation’s contractual obligations.”); see Elizabeth S. Miller, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 TEX. J. BUS. L. 405, 406-416 (Fall 2009).

³⁰¹ *Delaney v. Fid. Lease Ltd.*, 517 S.W.2d 420, 423 (Tex. Civ. App.—El Paso 1974), *aff’d in part and rev’d in part on other grounds*, 526 S.W.2d 543 (Tex. 1975); *Sutton v. Reagan & Gee*, 405 S.W.2d 828 (Tex. Civ. App.—San Antonio 1966, writ ref’d n.r.e.).

there are circumstances under which personal liability may be imposed on the shareholders, officers, or directors of a corporation.

Generally, shareholders of a corporation will not be personally liable for debts and obligations of the corporation in excess of the shareholder's investment in the corporation. In exceptional situations, a court will "pierce the corporate veil" or "disregard the corporate entity" to find a shareholder personally liable for the activities of the corporation. In *Castleberry v. Branscum*,³⁰² the Texas Supreme Court enumerated circumstances under which the corporate entity may be disregarded, including, among others, (1) when the corporate fiction is used as a means of perpetrating fraud, (2) where a corporation is organized and operated as a mere tool or business conduit (the "alter ego") of another corporation (or person), (3) where the corporate fiction is resorted to as a means of evading an existing legal obligation, (4) where the corporate fiction is used to circumvent a statute, and (5) where the corporate fiction is relied upon as a protection of crime or to justify wrong. TBCA article 2.21 was subsequently amended to overrule *Castleberry* and define the circumstances under which a court may pierce the corporate veil in contract cases.³⁰³

Under TBCA article 2.21, as amended, as well as the parallel provision in TBOC section 21.223, no shareholder, or affiliate of the shareholder or the corporation, may be held liable for (i) any contractual obligation of the corporation on the basis that the shareholder or affiliate is or was the alter ego of the corporation or on the basis of actual or constructive fraud, a sham to perpetuate a fraud or a similar theory, unless it is shown that the shareholder used the corporation for the purpose of perpetrating, and did perpetrate, an actual fraud, primarily for the personal benefit of the shareholder or affiliate or (ii) any obligation (whether contractual, tort or other) on the basis that the corporation failed to observe any corporate formality (e.g., maintaining separate offices and employees, keeping separate books, holding regular meetings of shareholders and board of directors, keeping written minutes of such meetings, etc.).³⁰⁴ Several Texas cases have

³⁰² *Castleberry v. Branscum*, 721 S.W.2d 270, 272 (Tex. 1986).

³⁰³ *Castleberry* was cited by the Texas Supreme Court in *In re Smith*, 192 S.W.3d 564, 568-69 (Tex. 2006), which held that the *alter ego theory* was relevant in a post-judgment proceeding for determining a defendant's net worth for the purposes of determining the amount of security required to suspend enforcement of a judgment (under Texas law the security required may not exceed the lesser of 50% of the judgment debtor's net worth or \$25 million):

Because "[a]lter ego applies when there is such unity between corporation and individual that the separateness of the corporation has ceased," *Castleberry v. Branscum*, 721 S.W.2d 270, 272 (Tex.1986), an alter ego finding is relevant to the determination of the judgment debtor's net worth. * * *

Although the trial court did not abuse its discretion by considering the alter ego theory, that does not mean that the trial court's alter ego finding may be used to hold R.A. Smith & Company, Inc. or any other nonparty liable for the judgment. A judgment may not be amended to include an alter ego that was not named in the suit. *Matthews Const. Co., Inc. v. Rosen*, 796 S.W.2d 692, 693 (Tex.1990). Therefore, an alter ego finding in a post-judgment net worth proceeding may not be used to enforce the judgment against the unnamed alter ego or any other non-judgment debtor, but only to determine the judgment debtor's net worth for the purposes of Rule 24.

³⁰⁴ TBCA art. 2.21 (emphasis added). Some courts continue to ignore TBCA art. 2.21, perhaps because the litigants fail to bring it to the attention of the court, and cite *Castleberry* as authority. See, e.g., *Cementos de*

confirmed that TBCA article 2.21 is the exclusive means for piercing the corporate veil of a Texas corporation for the types of cases referenced and that actual fraud is a prerequisite thereunder.³⁰⁵

On November 14, 2008, *Castleberry* was explained and further limited by the Texas Supreme Court in *SSP Partners and Metro Novelties, Inc. v. Gladstrong Investments (USA) Corp.*³⁰⁶ As a result of the Texas Supreme Court's holding and teachings in *SSP*, *Castleberry* is no longer an authoritative statement of the Texas veil piercing common law. *SSP* was a products liability case in which a five-year-old boy was killed in a house fire started by a disposable butane lighter with a defective child-resistant mechanism sold by the defendant. In *SSP*, the Texas Supreme Court held that corporations cannot be held liable for each other's tort obligations merely because they are part of a single business enterprise.³⁰⁷ *SSP* rejects the single

Chihuahua, S.A. de C.V. v. Intermodal Sales Corp., 162 S.W.3d 581, 586-87 (Tex. App.—El Paso 2005, no pet.).

³⁰⁵ *S. Union Co. v. City of Edinburg*, 129 S.W.3d 74 (Tex. 2003) (the Texas Supreme Court repudiated the single business enterprise doctrine, and held that “[s]ince 1993 . . . section A of Article 2.21 is the exclusive means for imposing liability on a corporation for the obligations of another corporation in which it holds shares,” actual fraud is required to be plead and proved in a veil piercing case based on a contract claim); *Menetti v. Chavers*, 974 S.W.2d 168, 174 (Tex. App.—San Antonio 1998) (the Court of Appeals reversed a judgment against defendant shareholders of a construction company in a faulty home construction case, holding that “the trial court erred in finding the [defendants] individually liable for the acts of their corporation[,] because there was legally insufficient evidence to show actual fraud,” and that, following the 1996 amendments to the TBCA, “the actual fraud requirement should be applied, by analogy, to tort claims, especially those arising from contractual obligations”); *Signal Peak Enter. of Texas, Inc. v. Bettina Inv., Inc.*, 138 S.W.3d 915, 925 (Tex. App.—Dallas 2004) (the court applied a two-step approach, first relying on *Castleberry* to establish that the corporation in question was merely the alter ego of its controlling shareholder, then finding that the defendant's conduct did not constitute actual fraud as required by TBCA art. 2.21: “Once alter ego is found to exist, the plaintiff must then show that the person on whom liability is sought to be imposed caused the corporation to be used for the purpose of perpetrating, and perpetrated an actual fraud on the obligee for the direct benefit of the person on whom liability is sought to be imposed.”); *Country Village Homes, Inc. v. Patterson*, 236 S.W.3d 413, 430 (Tex. App.—Houston [1st Dist.] 2007) (in a judgment later vacated by agreement, the court was willing to treat both the single business enterprise theory and the alter ego theory as viable paths to disregarding the corporate entity; the court then recognized that, after *Southern Union*, TBCA art. 2.21 controls all veil-piercing claims, and “that a finding of actual fraud is required in order to prove a theory of Single Business Enterprise”); and *Rutherford v. Atwood*, 2003 WL 22053687 (Tex. App.—Houston [1st Dist.] 2003) (the court (citing both *Menetti v. Chavers*, *supra*, and *Farr v. Sun World Sav. Ass'n*, 810 S.W.2d 294 (Tex. App.—El Paso 1991)) held that not only was a showing of actual fraud required in order to pierce the corporate veil, but that the fraud must (i) “relate to the transaction at issue” and (ii) be primarily for the defendant's direct personal benefit).

³⁰⁶ 275 S.W.3d 444 (Tex. 2008).

³⁰⁷ In explaining and limiting *Castleberry*, the Supreme Court in *SSP* wrote:

Abuse and injustice are not components of the single business enterprise theory The theory applies to corporations that engage in any sharing of names, offices, accounting, employees, services, and finances. There is nothing abusive or unjust about any of these practices in the abstract. Different entities may coordinate their activities without joint liability.

Creation of affiliated corporations to limit liability while pursuing common goals lies firmly within the law and is commonplace. We have never held corporations liable for each other's obligations merely because of centralized control, mutual purposes, and

business enterprise liability theory, and adopts the approach taken by the Legislature in TBCA article 2.21 as the embodiment of public policy in Texas. Additionally, because it was a pure products liability case, *SSP* should be interpreted as applying the public policy of TBCA article 2.21 to all tort cases, not just those arising out of contracts. *SSP* is now the definitive statement of the Texas law of veil piercing for all cases, whether arising out of contracts, torts or otherwise.³⁰⁸

Officers and other agents of a corporation are not covered by TBCA article 2.21 or TBOC § 21.223 because the various veil-piercing theories are applicable only to shareholders and have never been used by a Texas court to hold an officer as such liable for the obligations of the entity.³⁰⁹ There are causes of action for holding an officer personally liable for the officer's

shared finances. There must also be evidence of abuse, or as we said in *Castleberry*, injustice and inequity. By "injustice" and "inequity" we do not mean a subjective perception of unfairness by an individual judge or juror; rather, these words are used in *Castleberry* as shorthand references for the kinds of abuse, specifically identified, that the corporate structure should not shield - fraud, evasion of existing obligations, circumvention of statutes, monopolization, criminal conduct, and the like. Such abuse is necessary before disregarding the existence of a corporation as a separate entity. Any other rule would seriously compromise what we have called a "bedrock principle of corporate law" that a legitimate purpose for forming a corporation is to limit individual liability for the corporation's obligations.

* * *

In *Castleberry*, we held that the corporate structure could be disregarded on a showing of constructive fraud, even without actual fraud. 721 S.W.2d at 273. The Legislature has since rejected that view in certain cases. Article 2.21 of the Texas Business Corporation Act takes a stricter approach to disregarding the corporate structure: [text of TBCA art. 2.21 omitted]

* * *

The single business enterprise liability theory is fundamentally inconsistent with the approach taken by the Legislature in Article 2.21.

Accordingly, we hold that the single business enterprise liability theory . . . will not support the imposition of one corporation's obligations on another.

(emphasis added). *SSP*, 275 S.W.3d at 454-456.

For additional authority for the proposition that TBCA art. 2.21 is the exclusive means for piercing the corporate veil of a Texas corporation and that actual fraud is a prerequisite thereunder, see Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation – Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. REV. 249, 301-302 (Winter 2001); see also Alan R. Bromberg, Byron F. Egan, Dan L. Nicewander and Robert S. Trotti, *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 41 TEX. J. BUS. L. 41, 64, 67 and 72 (Spring 2005); Alan R. Bromberg, Byron F. Egan, Dan L. Nicewander and Robert S. Trotti, *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 31 BULL. OF BUS. L. SEC. OF THE ST. B. OF TEX. 1, 2, 19, 22 (June 1994).

³⁰⁸ See *Tryco Enterprises, Inc. v. Robinson*, 390 S.W.3d 497 (Tex. App.—Houston [1stDist.] 2012) (actual fraud found where controllers caused corporation to transfer its assets to an entity they owned to avoid paying a judgment and to forfeit its charter for failure to pay franchise taxes).

³⁰⁹ Directors and officers are personally liable to creditors under the Tex. Tax Code for debts of a corporation whose charter is forfeited for failure to pay franchise taxes if the debts were incurred after the date the report, tax or penalty was due and before the corporate privileges are reinstated. Tex. Tax Code section 171.255 provides in relevant part:

own wrongful conduct, for an individual is liable for his own torts although a corporation may assume the liability pursuant to an indemnification arrangement.³¹⁰

D. Management. The corporation form of business entity allows for an efficient and flexible management structure. The traditional management structure of a corporation is centralized.³¹¹ Shareholders elect directors, who are given the power to manage the affairs of the corporation generally, as well as to formulate policies and objectives.³¹² Shareholders retain the power to vote on certain major matters.³¹³ Directors appoint officers, who are delegated the

-
- (a) If the corporate privileges of a corporation are forfeited for the failure to . . . pay a tax or penalty, each director or officer of the corporation is liable for each debt of the corporation that is created or incurred in this state after the date on which the report, tax, or penalty is due and before the corporate privileges are revived. The liability includes liability for any tax or penalty imposed by this chapter on the corporation that becomes due and payable after the date of the forfeiture.
 - (b) The liability of a director or officer is in the same manner and to the same extent as if the director or officer were a partner and the corporation were a partnership.
 - (c) A director or officer is not liable for a debt of the corporation if the director or officer shows that the debt was created or incurred:
 - (1) over the director's objection; or
 - (2) without the director's knowledge and that the exercise of reasonable diligence to become acquainted with the affairs of the corporation would not have revealed the intention to create the debt.

Tex. Tax Code Ann. § 171.255 (Vernon 2012).

³¹⁰ See TBOC §§ 8.001 et seq.

³¹¹ Douglas K. Moll, *Shareholder Oppression & Reasonable Expectations: Of Change, Gifts, and Inheritances in Close Corporation Disputes*, 86 MINN. L. REV. 717, 724 (2002).

³¹² *Capital Bank v. Am. Eyewear, Inc.*, 597 S.W.2d 17, 20 (Tex. App.—Dallas 1980, no writ) (declaring that “the authority to manage a corporation’s affairs is vested in its board of directors.”). A Certificate of Formation may grant corporate directors different voting rights, whether or not elected by separate classes or series of shares. TBOC § 21.406(a) as amended in the 2009 Legislative Session by 2009 S.B. 1442 § 36.

³¹³ TBCA art. 2.28 and TBOC § 21.358 provide that the general requirement for a quorum of shareholders at a meeting of shareholders will be the holders of a majority of the outstanding shares entitled to vote at the meeting. This requirement may be increased or decreased to as few as one-third of the holders of the outstanding shares if so provided in the articles of incorporation or certificate of formation. Once there is a quorum of shareholders at a meeting of shareholders, there is a quorum for all matters to be acted upon at that meeting. Electronic meetings of shareholders are permitted by TBCA art. 2.24 if authorized in the articles of incorporation or bylaws. TBOC § 6.002 permits electronic meetings, subject to an entity’s governing documents.

The vote required for approval of certain matters varies depending on the matter requiring action. The vote required for the election of directors is a plurality of votes cast unless otherwise provided in the charter or bylaws of the corporation. TBCA art. 2.28; TBOC § 21.359. The vote required for approval of fundamental corporate transactions, such as charter amendments, mergers, and dissolutions, is the holders of at least two-thirds of the outstanding shares entitled to vote on the matter unless otherwise provided in the charter of the corporation. TBCA arts. 4.02A(3), 5.03E and 6.03A(3); TBOC § 21.364. The articles of incorporation or certificate of formation may increase this voting requirement, or reduce it to not less than the holders of a majority of the voting power entitled to vote on the matter. TBCA art. 2.28D; TBOC § 21.365(a).

Unless otherwise provided in the corporation’s articles of incorporation, certificate of formation, or bylaws, the general vote requirement for shareholder action on matters other than the election of directors and extraordinary transactions is a majority of the votes cast “for,” “against” or “expressly abstaining” on the matter. TBCA art. 2.28(B); TBOC § 21.363.

authority to manage the corporation's day to day affairs and to implement the policies and objectives set by the directors.

Most corporate statutes, including the TBCA, the TBOC and the Delaware General Corporation Law (the "DGCL"), also provide for "close corporations" which may be managed by the shareholders directly.³¹⁴ A Texas corporation elects "close corporation" status by including a provision to such effect in its articles of incorporation or certificate of formation, and may provide in such document or in a shareholder agreement, which can be similar to a partnership agreement, that management will be by a board of directors or by the shareholders.³¹⁵ Under the Tex. Corp. Stats., any Texas corporation (except a corporation whose shares are publicly traded) may modify how the corporation is to be managed and operated, in much the same way as a close corporation, by an agreement set forth in (1) the certificate of formation or the bylaws approved by all of the shareholders or (2) a written agreement signed by all of the shareholders.³¹⁶ Thus, the management structure of corporations is generally flexible enough to

In corporations formed prior to September 1, 2003, unless expressly prohibited by the articles of incorporation, shareholders have the right to cumulate their votes in the election of directors if they notify the corporation at least one day before the meeting of their intent to do so; for corporations formed on or after September 1, 2003 and for those formed earlier but voluntarily opting in to the TBOC, shareholders do not have the right to cumulative voting unless the articles of incorporation or certificate of formation expressly grants that right. TBCA art. 2.29D; TBOC §§ 21.360, 21.362.

Each outstanding share is entitled to one vote unless otherwise provided in the corporation's articles of incorporation or certificate of formation. TBCA art. 2.29(A)(1); TBOC § 21.366(a). Furthermore, unless divided into one or more series, shares of the same class are required to be identical. TBCA art. 2.12(A); TBOC § 21.152(c). Limitations on the voting rights of holders of the same class or series of shares are permitted, depending on the characteristics of the shares. TBCA art. 2.29(A)(2); TBOC § 21.153.

The voting of shares by proxy is permitted. TBCA art. 2.29; TBOC § 21.367(a). However, no proxy will be valid eleven months after execution unless otherwise provided in the proxy. TBOC § 21.368. Proxies may be made irrevocable if coupled with an interest and may be in the form of an electronic transmission. TBCA art. 2.29(C); TBOC §§ 21.367(b), 21.369(b).

TBOC Chapter 3F, as added in the 2009 Legislative Session by 2009 S.B. 1442 § 4, provides that an entity's governing documents may provide for alternative governance processes in the event of a catastrophic event by which the entity's governing persons can act during the continuance of the emergency.

³¹⁴ See J. Leon Lebowitz, *Texas Close Corporation Law*, 44 TEX. B.J. 51 (1981); Robert W. Hamilton, *Corporations and Partnerships*, 36 SW. L.J. 227, 228-34 (1982).

³¹⁵ TBCA arts. 12.11, 12.13, 12.31; TBOC §§ 3.008, 21.703, 21.713.

³¹⁶ TBCA art. 2.30-1 and TBOC § 21.101 in effect extend close corporation flexibility to all corporations that are not publicly traded by authorizing shareholders' agreements that modify and override the mandatory provisions of the TBCA or the TBOC relating to operations and corporate governance. The agreement must be set forth in either (i) the articles of incorporation or bylaws and approved by all shareholders or (ii) in an agreement signed by all shareholders and made known to the corporation. TBCA art. 2.30-1(B)(1); TBOC § 21.101(b). The agreement is not required to be filed with the Secretary of State unless it is part of the articles of incorporation. TBCA arts. 2.30-1(B), 3.03; TBOC §§ 21.101(b), 4.002. An agreement so adopted may:

- (1) restrict the discretion or powers of the board of directors;

-
- (2) eliminate the board of directors and permit management of the business and affairs of the corporation by its shareholders, or in whole or in part by one or more of its shareholders, or by one or more persons not shareholders;
 - (3) establish the natural persons who shall be the directors or officers of the corporation, their term of office or manner of selection or removal, or terms or conditions of employment of any director, officer, or other employee of the corporation, regardless of the length of employment;
 - (4) govern the authorization or making of distributions, whether in proportion to ownership of shares, subject to the limitations in TBCA art. 2.38 (or TBOC § 21.303, as the case may be), or determine the manner in which profits and losses shall be apportioned;
 - (5) govern, in general or in regard to specific matters, the exercise or division of voting power by and between the shareholders, directors (if any), or other persons or by or among any of them, including use of disproportionate voting rights or director proxies;
 - (6) establish the terms and conditions of any agreement for the transfer or use of property or the provision of services between the corporation and any shareholder, director, officer or employee of the corporation, or other person or among any of them;
 - (7) authorize arbitration or grant authority to any shareholder or other person as to any issue about which there is a deadlock among the directors, shareholders or other person or persons empowered to manage the corporation to resolve that issue;
 - (8) require dissolution of the corporation at the request of one or more of the shareholders or upon the occurrence of a specified event or contingency in which case the dissolution of the corporation shall proceed as if all the shareholders had consented in writing to dissolution of the corporation as provided in TBCA art. 6.02 or TBOC §§ 21.501-21.504; or
 - (9) otherwise govern the exercise of corporate powers or the management of the business and affairs of the corporation or the relationship among the shareholders, the directors and the corporation, or among any of them, as if the corporation were a partnership or in a manner that would otherwise be appropriate only among partners, and is not contrary to public policy.

TBCA art. 2.30-1(A); TBOC § 21.101(a). The existence of an art. 2.30-1 or TBOC § 21.101 agreement must be conspicuously noted on the certificates representing the shares or on the information statement required for uncertificated shares. TBCA art. 2.30-1(C); TBOC §§ 21.103(a), (b). A purchaser who acquires shares of a corporation without actual or deemed knowledge of the agreement will have a right of rescission until the earlier of (i) 90 days after obtaining such knowledge or (ii) two years after the purchase of the shares. TBCA art. 2.30-1(D); TBOC § 21.105. An agreement permitted under Article 2.30-1 or TBOC § 21.101 will cease to be effective when shares of the corporation become listed on a national securities exchange, quoted on an interdealer quotation system of a national securities association or regularly traded in a market maintained by one or more members of a national or affiliated securities association. TBCA art. 2.30-1(E); TBOC § 21.109.

An art. 2.30-1 or § 21.101 agreement that limits the discretion or powers of the board of directors or supplants the board of directors will relieve the directors of, and impose upon the person or persons in whom such discretion or powers or management of the business and affairs of the corporation are vested, liability for action or omissions imposed by the TBCA, the TBOC, or other law on directors to the extent that the discretion or powers of the directors are limited or supplanted by the agreement.

Art. 2.30-1(G) and TBOC § 21.107 provide that the existence or performance of an art. 2.30-1 or § 21.101 agreement will not be grounds for imposing personal liability on any shareholder for the acts or obligations of the corporation by disregarding the separate entity of the corporation or otherwise, even if the agreement or its performance (i) treats the corporation as if it were a partnership or in a manner that otherwise is appropriate only among partners, (ii) results in the corporation being considered a partnership for purposes of taxation, or (iii) results in failure to observe the corporate formalities otherwise applicable to the matters governed by the agreement. Thus, TBCA art. 2.30-1 and TBOC § 21.107 provide protection beyond TBCA art. 2.21 and TBOC § 21.223 on shareholder liability.

allow both centralized management and decentralized management, depending on the needs of the corporation's owners.

E. Fiduciary Duties.

1. General. Directors of a corporation owe fiduciary duties of care, loyalty and obedience to the corporation.³¹⁷ The duty of care requires directors to exercise the degree of care that an ordinarily prudent person would exercise under similar circumstances.³¹⁸ The duty of loyalty dictates that a director must act in good faith and must not allow personal business interests to prevail over the interests of the corporation.³¹⁹ In general, a director will not be permitted to derive a personal profit or advantage at the expense of the corporation and must act solely with an eye to the best interest of the corporation, unhampered by any pecuniary interest of his own.³²⁰ The duty of obedience requires directors to obey the law and the articles of incorporation.³²¹ The fiduciary duty of loyalty requires controlling shareholders to deal fairly with the minority shareholders.³²² In Texas (but not in Delaware) minority shareholders may have an additional cause of action against controlling shareholders who engage in unfairly oppressive conduct that harms minority shareholders even if no fiduciary duty or statutory breach is found.³²³

³¹⁷ *Gearhart Industries, Inc. v. Smith Intern. Inc.*, 741 F.2d 707 (5th Cir. 1984); see Byron F. Egan, *Fiduciary Duties of Corporate Directors and Officers in Texas*, 43 TEX. J. BUS. LAW 45 (Spring 2009), available at <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1230>; Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, University of Texas School of Law 35th Annual Conference on Securities Regulation and Business Law (Feb. 8, 2013), available at <http://www.jw.com/publications/article/1830>; Byron F. Egan & Curtis W. Huff, *Choice of State of Incorporation - Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 259-270 (Winter 2001).

³¹⁸ *Gearhart*, 741 F.2d at 720.

³¹⁹ *Id.* at 719 (holding that the good faith of a director will be determined by whether the director acted with an intent to confer a benefit to the corporation); *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235 (Del. 2009); *Stone v. Ritter*, 911 A.2d 362 (Del. 2006); see *Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 578 (Tex. 1963) (holding that whether there exists a personal interest by the director will be a question of fact; cf. Lyman Johnson, *After Enron: Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27 (2003).

³²⁰ See *A. Copeland Enters., Inc. v. Guste*, 706 F. Supp. 1283, 1291 (W.D. Tex. 1989); *Milam v. Cooper Co.*, 258 S.W.2d 953, 956 (Tex. Civ. App.—Waco 1953, writ ref'd n.r.e.); see also TBCA art. 2.35-1(A) and TBOC § 21.418 (validating director transactions if (1) disinterested directors, after disclosure, approve the transaction; (2) shareholders of the corporation, after disclosure, approve the transaction; or (3) the transaction is otherwise fair); cf. *In re Mi-Lor Corp.*, 348 F.3d 294, 303 (1st Cir. 2003) (holding that a duty of full disclosure is imposed on directors in cases of self dealing). See generally John T. Kendrick, Jr., *The Interested Director in Texas*, 21 SW. L.J. 794 (1967).

³²¹ *Gearhart*, 741 F.2d at 719.

³²² See *In re Pure Res., Inc.*, 808 A.2d 421, 433 (Del. Ch. 2002).

³²³ See Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, University of Texas School of Law 35th Annual Conference on Securities Regulation and Business Law (Feb. 8, 2013) at pages 394-407, available at <http://www.jw.com/publications/article/1830>.

2. Business Judgment Rule. The business judgment rule provides a degree of protection to decisions made by corporate directors. Under the business judgment rule, directors are presumed to have satisfied their fiduciary duties in making a business decision.³²⁴ Under Delaware law, for the business judgment rule to apply, a decision must be made by disinterested directors who act in good faith after reasonable investigation and who honestly and reasonably believe that the decision will reasonably benefit the corporation.³²⁵ Under Texas law, the business judgment rule appears to be more favorable to directors than under Delaware law, since directors' actions are presumed to be valid if no conflict of interest exists and the action is not *ultra vires* or tainted by fraud.³²⁶

3. Overcoming Business Judgment Rule. The business judgment rule is only a presumption that protects directors from liability arising out of business decisions made for the corporation. If the presumption created by the business judgment rule is overcome or shown not to apply, then the burden shifts to the director to justify the fairness of the transaction to the corporation.³²⁷

4. Corporate Opportunities Renunciation. Generally the duty of loyalty prohibits a director from usurping business opportunities that otherwise might be pursued by the corporation.³²⁸ Both Texas and Delaware law permit a corporation to renounce any interest in business opportunities presented to the corporation or one or more of its officers, directors or shareholders in its certificate of formation or by action of its board of directors.³²⁹ While this allows a corporation to specifically forgo individual corporate opportunities or classes of opportunities, the type of judicial scrutiny applied to the decision to make any such renunciation

³²⁴ See *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986).

³²⁵ *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985). See Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, University of Texas School of Law 35th Annual Conference on Securities Regulation and Business Law (Feb. 8, 2013), available at <http://www.jw.com/publications/article/1830>; Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation - Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 263-270 (Winter 2001).

³²⁶ See *Gearhart*, 741 F.2d at 719-21; Byron F. Egan and Curtis W. Huff, *supra*, 54 SMU L. Rev. at 260-263.

³²⁷ *Gearhart*, 741 F.2d at 720.

³²⁸ The basic framework of the corporate opportunity doctrine was laid down by the Delaware Supreme Court in *Guth v. Loft, Inc.*, as follows:

[I]f there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, is, from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of his corporation, the law will not permit him to seize the opportunity for himself.

Guth v. Loft, Inc., 5 A.2d 503, 511 (Del. 1939); see also *Kohls v. Duthie*, 791 A.2d 772, 783-85 (Del. Ch. 2000).

³²⁹ TBCA art. 2.02(20), TBOC § 2.101(21); DGCL § 122(17).

of corporate opportunities will generally be governed by a traditional common law fiduciary duty analysis.³³⁰

5. Interested Director Transactions. Both Texas and Delaware have embraced the principle that a transaction or contract between a director and the director's corporation is presumed to be valid and will not be void or voidable solely by reason of the director's interest as long as certain conditions are met.

DGCL § 144 provides that a contract between a director and the director's corporation will not be voidable due to the director's interest if (i) the transaction or contract is approved in good faith by a majority of the disinterested directors after the material facts as to the relationship or interest and as to the transaction or contract are disclosed or known to the directors; (ii) the transaction or contract is approved in good faith by shareholders after the material facts as to the relationship or interest and as to the transaction or contract is disclosed or known to the shareholders; or (iii) the transaction or contract is fair to the corporation as of the time it is authorized, approved, or ratified by the directors or shareholders of the corporation.³³¹ In *Fliegler v. Lawrence*, however, the Delaware Supreme Court held that where the votes of directors, qua stockholders, were necessary to garner stockholder approval of a transaction in which the directors were interested, the taint of director self-interest was not removed, and the transaction or contract may still be set aside and liability imposed on a director if the transaction is not fair to the corporation.³³² The question remains, however, whether approval by a majority of disinterested stockholders will, pursuant to DGCL § 144(a)(2), cure any invalidity of director actions and, by virtue of the stockholder ratification, eliminate any director liability for losses from such actions.³³³

In 1985, Texas followed Delaware's lead in the area of interested director transactions and adopted TBCA article 2.35-1,³³⁴ the predecessor to TBOC § 21.418. In general,

³³⁰ R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* § 2.1 (2d ed. 1997); *see generally id.* at § 4.36.

³³¹ DGCL § 144(a).

³³² *Fliegler v. Lawrence*, 361 A.2d 218, 222 (Del. 1976).

³³³ *See Michelson v. Duncan*, 407 A.2d 211, 219 (Del. 1979). In *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009), the Delaware Supreme Court found that stockholder approval of a going private stock reclassification proposal did not effectively ratify or cleanse the transaction for two reasons:

First, because a shareholder vote was required to amend the certificate of incorporation, that approving vote could not also operate to "ratify" the challenged conduct of the interested directors. Second, the adjudicated cognizable claim that the Reclassification Proxy contained a material misrepresentation, eliminates an essential predicate for applying the doctrine, namely, that the shareholder vote was fully informed.

* * *

[T]he scope of the shareholder ratification doctrine must be limited to its so-called "classic" form; that is, to circumstances where a fully informed shareholder vote approves director action that does not legally require shareholder approval in order to become legally effective. Moreover, the only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve. With one exception, the "cleansing" effect of such a ratifying shareholder vote is to subject the challenged director action to business judgment review, as opposed to "extinguishing" the claim altogether (i.e., obviating all judicial review of the challenged action).

³³⁴ TBOC § 21.418; TBCA art. 2.35-1.

these Texas Corporate Statutes provide that a transaction between a corporation and one or more of its directors or officers will not be voidable solely by reason of that relationship if the transaction is approved by shareholders or disinterested directors after disclosure of the interest, or if the transaction is otherwise fair.³³⁵ Because TBCA art. 2.35-1, as initially enacted, was essentially identical to DGCL § 144, some uncertainty on the scope of TBCA art. 2.35-1 arose because of *Fliegler*'s interpretation of DGCL § 144. This imposition of a fairness gloss on the Texas statute rendered the effect of the safe harbor provisions in TBCA article 2.35-1 uncertain.

In 1997, TBCA article 2.35-1 was amended to address the ambiguity created by *Fliegler* and to clarify that contracts and transactions between a corporation and its directors and officers or in which a director or officer has a financial interest are valid notwithstanding that interest as long as any one of the following are met: (i) the disinterested directors of the corporation approve the transaction after disclosure of the interest, (ii) the shareholders of the corporation approve the transaction after disclosure of the interest or (iii) the transaction is fair.³³⁶ TBOC § 21.418 mirrors these clarifications.³³⁷ Under the Texas Corporate Statutes, if any one of these conditions is met, the contract will be considered valid notwithstanding the fact that the director or officer has an interest in the transaction.³³⁸ These provisions rely heavily on the statutory definitions of “disinterested” contained in TBCA art. 1.02 and TBOC § 1.003. Under these definitions, a director will be considered “disinterested” if the director is not a party to the contract or transaction or does not otherwise have a material financial interest in the outcome of the contract.³³⁹

Article 2.35-1 also changed the general approach of the statute from a mere presumption that a contract is not voidable by reason of the existence of an affiliated relationship if certain conditions are met to an absolute safe harbor that provides that an otherwise valid contract will be valid if the specified conditions are met, a change that was retained by TBOC § 21.418. Although the difference between the Texas and Delaware constructions is subtle, the distinction is significant and provides more certainty as transactions are structured.

Effective September 1, 2011, TBOC § 21.418 was amended by 2011 S.B. 748 to read in its entirety as follows:

Sec. 21.418. CONTRACTS OR TRANSACTIONS INVOLVING INTERESTED DIRECTORS AND OFFICERS. (a) This section applies to a contract or transaction between a corporation and:

(1) one or more directors or officers, or one or more affiliates or associates of one or more directors or officers, of the corporation; or

³³⁵ *Id.*; TBOC § 21.418; *see Landon v. S & H Mktg. Group, Inc.*, 82 S.W.3d 666 (Tex. App.—Eastland 2002).

³³⁶ TBCA art. 2.35-1.

³³⁷ TBOC § 21.418(d), as amended in the 2011 Legislative Session by 2011 S.B. 748, provides that an interested director may participate in the board authorization of the transaction in which the director has an interest or sign a unanimous written consent of the directors approving it.

³³⁸ *Id.* art. 2.35-1(A); TBOC § 21.418(b).

³³⁹ *Id.*

(2) an entity or other organization in which one or more directors or officers, or one or more affiliates or associates of one or more directors or officers, of the corporation:

(A) is a managerial official; or

(B) has a financial interest.

(b) An otherwise valid and enforceable contract or transaction described by Subsection (a) is valid and enforceable, and is not void or voidable, notwithstanding any relationship or interest described by Subsection (a), if any one of the following conditions is satisfied:

(1) the material facts as to the relationship or interest described by Subsection (a) and as to the contract or transaction are disclosed to or known by:

(A) the corporation's board of directors or a committee of the board of directors and the board of directors or committee in good faith authorizes the contract or transaction by the approval of the majority of the disinterested directors or committee members, regardless of whether the disinterested directors or committee members constitute a quorum; or

(B) the shareholders entitled to vote on the authorization of the contract or transaction, and the contract or transaction is specifically approved in good faith by a vote of the shareholders; or

(2) the contract or transaction is fair to the corporation when the contract or transaction is authorized, approved, or ratified by the board of directors, a committee of the board of directors, or the shareholders.

(c) Common or interested directors of a corporation may be included in determining the presence of a quorum at a meeting of the corporation's board of directors, or a committee of the board of directors, that authorizes the contract or transaction.

(d) A person who has the relationship or interest described by Subsection (a) may:

(1) be present at or participate in and, if the person is a director or committee member, may vote at a meeting of the board of directors or of a committee of the board that authorizes the contract or transaction; or

(2) sign, in the person's capacity as a director or committee member, a unanimous written consent of the directors or committee members to authorize the contract or transaction.

(e) If at least one of the conditions of Subsection (b) is satisfied, neither the corporation nor any of the corporation's shareholders will have a cause of action against any of the persons described by Subsection (a) for breach of duty with respect to the making, authorization, or performance of the contract or transaction because the person had the relationship or interest described by Subsection (a) or took any of the actions authorized by Subsection (d).

The changes to TBOC § 21.418 by 2011 S.B. 748 were intended to clarify what was already intended. TBOC § 21.418(a) was amended to clarify that it also applies to affiliates or associates of directors or officers that have the conflicting relationship or interest. TBOC § 21.418(b) was further amended to clarify that the contract or transaction is not void or voidable, and is valid and enforceable, notwithstanding the conflicting relationship or interest if the requirements of the Section are satisfied. Provisions formerly located in TBOC § 21.418(b) permitting the execution of a consent of directors, or the presence, participation or voting in the meeting of the board of directors, by the director or officer having the conflicting relationship or interest were moved to a new TBOC § 21.418(d). Finally, a new TBOC § 21.418(e) was added specifying that neither the corporation nor any of its shareholders have any cause of action against any of the conflicted officers or directors for breach of duty in respect of the contract or transaction because of such relationship or interest or the taking of any actions described by TBOC § 21.418(d).

6. Limitation of Director Liability. Both the DGCL and the Texas Corporate Statutes allow corporations to provide limitations on (or partial elimination of) director liability in relation to the duty of care in their certificates of incorporation.³⁴⁰ DGCL § 102(b)(7) in effect permits a corporation to include a provision in its certificate of incorporation limiting or eliminating a director's personal liability for monetary damages for breaches of the duty of care.³⁴¹ The liability of directors may not be so limited or eliminated, however, in connection with breaches of the duty of loyalty, the failure to act in good faith, intentional misconduct,

³⁴⁰ DGCL § 102(b)(7) reads as follows:

102 CONTENTS OF CERTIFICATE OF INCORPORATION.

* * *

(b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:

* * *

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer (x) to a member of the governing body of a corporation which is not authorized to issue capital stock, and (y) to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with § 141(a) of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.

³⁴¹ DGCL § 102(b)(7).

knowing violations of law, obtaining improper personal benefits, or paying dividends or approving stock repurchases in violation of DGCL § 174.³⁴² Delaware courts have routinely enforced DGCL § 102(b)(7) provisions and held that, pursuant to such provisions, directors cannot be held monetarily liable for damages caused by alleged breaches of the fiduciary duty of care.³⁴³

The Texas Corporate Statutes contain provisions which are comparable to DGCL § 102(b)(7), and permit a corporation to include a provision in its charter limiting or eliminating a director's personal liability for monetary damages for breaches of the duty of care.³⁴⁴ Like the DGCL, the Texas Corporate Statutes do not authorize the limitation of liability of an officer or a director acting in the capacity of an officer.³⁴⁵

³⁴² DGCL § 102(b)(7); *see also Zirn v. VLI Corp.*, 621 A.2d 773, 783 (Del. 1993) (DGCL § 102(b)(7) provision in corporation's certificate did not shield directors from liability where disclosure claims involving breach of the duty of loyalty were asserted); *Burtch v. Seaport Capital, LLC (In re Direct Response Media, Inc.)*, 466 B.R. 626 (D. Del. 2012) (noting that the Delaware Supreme Court has held that when a duty of care breach is not the exclusive claim, a court may not dismiss solely on an exculpatory provision).

³⁴³ A DGCL § 102(b)(7) provision does not operate to defeat the validity of a plaintiff's claim on the merits, rather it operates to defeat a plaintiff's ability to recover monetary damages. *Emerald Partners v. Berlin*, 787 A.2d 85, 92 (Del. 2001). In determining when a DGCL § 102(b)(7) provision should be evaluated by the Court of Chancery to determine whether it exculpates defendant directors, the Delaware Supreme Court has distinguished between cases invoking the business judgment presumption and those invoking entire fairness review (these standards of review are discussed below). *Id.* at 92-3. The Court determined that if a stockholder complaint unambiguously asserts solely a claim for breach of the duty of care, then the complaint may be dismissed by invocation of a DGCL § 102(b)(7) provision. *Id.* at 92. The Court held, however, that "when entire fairness is the applicable standard of judicial review, a determination that the director defendants are exculpated from paying monetary damages can be made only *after the basis* for their liability has been decided." *Id.* at 94. In such a circumstance, defendant directors can avoid personal liability for paying monetary damages only if they establish that their failure to withstand an entire fairness analysis was exclusively attributable to a violation of the duty of care. *Id.* at 98.

³⁴⁴ The Texas analogue to DGCL § 102(b)(7) is TBOC § 7.001, which provides in relevant part:

(b) The certificate of formation or similar instrument of an organization to which this section applies [generally, corporations] may provide that a governing person of the organization is not liable, or is liable only to the extent provided by the certificate of formation or similar instrument, to the organization or its owners or members for monetary damages for an act or omission by the person in the person's capacity as a governing person.

(c) Subsection (b) does not authorize the elimination or limitation of the liability of a governing person to the extent the person is found liable under applicable law for:

- (1) a breach of the person's duty of loyalty, if any, to the organization or its owners or members;
- (2) an act or omission not in good faith that:
 - (A) constitutes a breach of duty of the person to the organization; or
 - (B) involves intentional misconduct or a knowing violation of law;
- (3) a transaction from which the person received an improper benefit, regardless of whether the benefit resulted from an action taken within the scope of the person's duties; or
- (4) an act or omission for which the liability of a governing person is expressly provided by an applicable statute.

TMCLA art. 1302-7.06 provides substantially the same.

³⁴⁵ *See* TBOC § 7.001(b) ("The certificate of formation . . . may provide that a governing person of the organization is not liable, or is liable only to the extent provided by the certificate of formation or similar

F. Ability to Raise Capital. The corporation provides as much financing flexibility as any type of business entity. Corporations are given the authority in their statutes and governing documents to use any number of various devices to raise capital.³⁴⁶ Different classes and series of common stock and preferred stock may be utilized to accommodate the desires of various types of investors.³⁴⁷ Equity can be raised at the base level by common stock and at levels ranking above the common stock by preferred stocks.³⁴⁸ Equity can be leveraged through many types of borrowings and financing devices, including stock options, warrants, and other forms of securities. In addition, convertible debt interests may be utilized. The different levels of a capital structure may include a differentiation in the voting rights assigned to equity holders, which may even be distributed differently among classes of common stock or even denied as to specified classes of common stock.

A Texas corporation may issue shares for such consideration, not less than the par value thereof, approved by its board of directors.³⁴⁹ Shares may be issued for cash, promissory notes, services performed or a contract for services to be performed, securities of the corporation or another entity, any tangible or intangible benefit to the corporation, or any property of any kind or nature.³⁵⁰ When the consideration is a note or future services, the corporation may issue the shares into escrow, or may provide that the shares may not be transferred or entitled to receive distributions, until the note is paid or the services performed.³⁵¹

G. Transferability of Ownership Interests. The ownership interests of shareholders in a corporation are freely transferable, subject to the following restrictions discussed below:

1. **Restrictions on Transfer of Shares.** Shareholders of a closely-held corporation often desire to prohibit the transfer of shares to persons who are not family members or are not employees of the corporation. To be enforceable, these restrictions on transfer must be reasonable under state law. In any event, an absolute restriction on transfer would be unreasonable and therefore void.³⁵² The Tex. Corp. Stats. provide that, among other restrictions,

instrument, to the organization or its owners or members for monetary damages for an act or omission by the person *in the person's capacity as a governing person.*" (emphasis added)). See also TMCLA § 1302-7.06B. A corporate officer is an agent of the corporation. *Joseph Greenspon's Sons Iron & Steel Co. v. Pecos Valley Gas Co.*, 156 A. 350 (Del. Super. 1931); *Holloway v. Skinner*, 898 S.W.2d 793, 795 (Tex. 1995). If an officer commits a tort while acting for the corporation, under the law of agency, the officer is liable personally for his actions. See Dana M. Muir and Cindy A. Schipani, *The Intersection of State Corporation Law and Employee Compensation Programs: Is it Curtains for Veil Piercing?*, 1996 U. Ill. L. Rev. 1059, 1078-1079 (1996); cf. *Centurion Planning Corp., Inc. v. Seabrook Venture II*, 176 S.W.3d 498, 509 (Tex. App.—Houston [1st Dist.] 2004, no pet.). The corporation may also be liable under *respondeat superior*.

³⁴⁶ ROBERT W. HAMILTON, CORPORATIONS 356 (7th ed. 2001).

³⁴⁷ See *id.* at 357–59.

³⁴⁸ See *id.*; TBOC §§ 21.152-21.157.

³⁴⁹ TBOC §§ 21.175 and 21.161.

³⁵⁰ TBOC § 21.159.

³⁵¹ TBOC § 21.157(c), as added in the 2009 Legislative Session by 2009 S.B. 1442 § 30.

³⁵² See TBCA art. 2.22(C); see also TBOC § 21.213.

rights of first refusal and limitations on transfer necessary to maintain S-corporation status or other tax advantages are reasonable restrictions on transfer.³⁵³ They also specify certain procedures that must be followed to assure the enforceability of the share transfer restrictions, such as the placement of a restrictive legend on stock certificates and the maintenance of a copy of the document containing the transfer restrictions at the corporation's principal place of business or registered office.³⁵⁴ Since shares in a closely-held business typically lack an established trading market, those shares may be nontransferable as a practical matter. If the owners of the business enterprise desire to conduct an initial public offering for its shares, the corporate form of entity is the best option except in certain limited circumstances.

2. Securities Law Restrictions. Shares in a corporation are generally considered "securities" within the meaning of federal and state securities laws. Transfers of shares are generally required to be registered under such laws absent an applicable exemption from registration.³⁵⁵

3. Beneficial Owners. The Tex. Corp. Stats. contemplate that a corporation directly communicates and deals with only a record or registered holder of its shares.³⁵⁶ It is typical, however, for publicly held shares to be held by a nominee or through securities depositories (i.e., in "street name"), so that the ultimate owner of the shares is not the record or registered holder. The TBOC was amended in the 2009 Legislative Session to provide that a corporation, if it desires, may recognize the beneficial owner as the "shareholder" and may communicate and deal directly with the beneficial owner instead of the record or registered holder.³⁵⁷ The extent of this recognition is at the corporation's discretion: it may recognize the beneficial owner for all purposes or only for certain purposes, such as giving notice of shareholders' meetings or paying dividends. The procedure for recognition is also subject to the corporation's discretion, except that it must include the nominee's filing with the corporation of a statement identifying, and providing other relevant information regarding, the beneficial owner. A beneficial owner's decision to follow the procedure to become recognized as the "shareholder" is also subject to his or her discretion.

The TBOC was further amended in the 2009 Legislative Session to permit a beneficial owner of an ownership interest that is entitled to dissenters' rights to file a petition for appraisal.³⁵⁸ An ownership interest is entitled to dissenters' rights only if the record or registered owner has taken the steps in Subchapter H of TBOC Chapter 10 to perfect those rights, and a petition for appraisal may be filed only if the dissenting record or registered owner and the entity responsible for satisfying the obligations to dissenters have not agreed on the fair market value of the ownership interest. If the dissenting record or registered owner is the trustee of a voting trust or other nominee holder of the ownership interest for a beneficial owner, then the beneficial

³⁵³ TBCA arts. 2.22(D), (H); TBOC § 21.211.

³⁵⁴ TBCA arts. 2.22(B), (C); TBOC §§ 21.210, 21.213.

³⁵⁵ See *infra* notes 723-726 and related text.

³⁵⁶ TBOC § 21.201.

³⁵⁷ TBOC § 21.201(b)-(d) as added in the 2009 Legislative Session by 2009 S.B. 1442 § 33.

³⁵⁸ TBOC § 10.154(c) and TBOC § 10.361(g) as added in the 2009 Legislative Session by 2009 S.B. 1442 §§ 18 and 19.

owner, as the person with the direct economic interest in the ownership interest entitled to dissenters' rights, may pursue the dissenters' rights by petitioning a court for appraisal. The nominee holder of the ownership interest then need not serve as plaintiff in the appraisal action.

4. **No Bearer Shares.** Certificates for shares in a Texas corporation may not be registered in bearer form.³⁵⁹ Bearer form certificates have no registered owners and have been criticized by federal and other law enforcement agencies as a means to avoid disclosure of actual ownership of entities in order to prevent discovery of the persons responsible for illegal activities by the culpable entity. The prohibition on bearer shares does not affect ownership interest certificates held by nominees.

H. Continuity of Life. Corporations frequently have perpetual existence, either by default under the TBOC or by a provision in a corporation's articles of incorporation under older Texas law.³⁶⁰ Since a corporation is treated as a separate entity with continuity of life, events such as death or bankruptcy of an owner have no effect on the legal structure of a corporation—at least absent a specific shareholder agreement attaching consequences and procedures for certain events. Even in bankruptcy, a shareholder continues to be a shareholder of the bankrupt entity. Shares can be passed down to heirs. In contrast, under some existing non-Texas partnership laws, particularly less modern ones, a partnership is not an entity separate from its partners and a deceased partner's estate may have to be probated in each state where the partnership owns property. Expenses and the hassle of multiple probate proceedings are avoided in a corporation because corporate shares are personal property subject to probate only in the deceased shareholder's state of domicile.

Under the pre-TBOC business entity rules, with respect to other types of entities, the problems associated with a finite lifetime or unanticipated dissolution could be solved in many cases in the drafting of the entity's constituent documents. However, under the TBOC, *all* domestic entities exist perpetually unless otherwise provided in its governing documents.³⁶¹ Thus, the perpetual existence of a corporation is not an advantage to be given much weight in determining the type of business entity to utilize, particularly since the TBOC governs all newly-formed entities.

I. Formation. The formation of a corporation requires certain legal formalities and the preparation of certain documents. Under the TBCA, articles of incorporation had to be prepared and filed with the Secretary of State, along with the payment of a filing fee.³⁶² Under the TBOC, a certificate of formation is the proper filing document.³⁶³ The certificate of formation (hereinafter referred to as the "corporation's governing document") establishes the

³⁵⁹ TBOC § 3.202 (f) as added in the 2009 Legislative Session by 2009 S.B. 1442 § 3. Also TBOC § 21.163(a)(4) was amended in the 2009 Legislative Session by 2009 S.B. 1442 § 31 to eliminate the ability of a corporation to issue scrip in bearer form.

³⁶⁰ TBOC § 3.003; TBCA art. 3.02(A) provides that the articles of incorporation shall set forth: "(2) The period of duration, which may be perpetual."

³⁶¹ TBOC § 3.003.

³⁶² TBCA arts. 3.02 and 3.03.

³⁶³ TBOC §§ 3.001, 4.001. The filing fee for a for-profit corporation remains \$300 under the Code. TBOC § 4.152(1).

initial board of directors and capital structure of the corporation, and designates a registered agent and office for service of process in Texas.³⁶⁴ After the Secretary of State officially acknowledges the filing of the corporation's certificate of formation,³⁶⁵ there should be an organizational meeting of the initial board of directors named in the corporation's governing document (at the call of a majority of the directors) for the purposes of adopting bylaws, electing officers and transacting such other business as may come before the meeting.³⁶⁶ The bylaws may contain any provisions for the regulation and management of the affairs of the corporation not inconsistent with law or the corporation's certificate of formation.³⁶⁷ Although the initial bylaws

³⁶⁴ TBOC § 3.005(a)(5). Under TBOC § 5.201(b), a registered agent in Texas must be a resident individual or business registered or authorized to do business in the state. A registered agent must consent to serve as such before being designated or appointed in a filing with the Secretary of State of Texas after January 1, 2010. TBOC § 5.201(b), as amended in the 2009 Legislative Session by 2009 H.B. 1787 effective January 1, 2010, requires that a registered agent for service of process consent to serve as such in a written or electronic form to be developed by the Secretary of State of Texas. This consent requirement is applicable to any domestic or foreign entity, including any corporation, partnership, LLC or financial institution, that designates a registered agent in a filing with the Secretary of State. It applies to both for-profit and non-profit entities, and to both individual and corporate agents. It does not require an entity formed prior to January 1, 2010 to obtain a consent from an existing agent unless there is a transfer of a majority in interest of the entity, but it does require that a consent be obtained by an existing entity whenever it makes a filing with the Secretary of State that changes the agent.

The consent is not to be filed with the Secretary of State. It should be maintained among the entity's organization documents and be available for review by attorneys and others seeking evidence that the entity has complied with applicable laws. A minute book is a good place to keep the consent.

TBOC § 5.206 specifies that the sole duties of a registered agent are to (i) forward or notify the entity of any process, notice, or demand served on the agent and (ii) provide the notices required or permitted by law to the entity. A person named a registered agent without the person's consent is not required to perform these duties.

TBOC § 5.2011 provides that the appointment of a person as registered agent is an affirmation by the entity that a person has consented to serve as the registered agent. The maintenance of a person as registered agent after a transfer of a majority interest in the ownership or membership interests of the entity is an affirmation by the governing authority of the entity that the person consents to continue as the agent. TBOC § 5.207 extends TBOC §§ 4.007 and 4.008, which prescribe civil remedies and criminal penalties for filing a false statement with the Secretary of State, to a registered agent filing with the Secretary of State that names the registered agent without the person's consent.

TBOC § 5.208 shields a person appointed as the registered agent from liability by reason of the person's appointment for the debts, liabilities, and obligations of the entity. Further, a person who has not consented to appointment as registered agent is shielded from a judgment, decree or order of a court, agency or other tribunal for a debt, obligation or liability of the entity, whether in contract or tort. This liability protection extends to a claim of a person who reasonably relies on the unauthorized designation by reason of the person's failure or refusal to perform the duties of registered agent.

Under TBOC § 5.204, the resignation of a registered agent terminates both the appointment of the agent and the designation of the registered office. TBOC § 5.205 provides that a statement of rejection that may be filed by a person designated or appointed as a registered agent without the person's consent. Filing this statement terminates the appointment and the designation of the registered office, and triggers a notice from the Secretary of State to the entity of the necessity of designating or appointing a new registered agent or registered office.

³⁶⁵ TBOC § 4.002. Under pre-TBOC law, the Secretary of State would issue a Certificate of Incorporation once a corporation properly filed its Articles of Incorporation.

³⁶⁶ TBCA art. 3.06; TBOC § 21.059.

³⁶⁷ TBCA art. 2.33A; TBOC § 21.057.

of a corporation are ordinarily in writing and adopted by the directors at the organization meeting of the board, the shareholders may amend, repeal or adopt the bylaws, unless the corporation's governing document or a bylaw adopted by the shareholders provides otherwise.³⁶⁸ In the absence of a contrary provision in the corporation's governing document, the TBCA or the TBOC, bylaws may be adopted or amended orally or by acts evidenced by a uniform course of proceeding or usage and acquiescence.³⁶⁹

J. Operations in Other Jurisdictions. When a corporation does business outside of its state of incorporation, it may be required to qualify to do business as a foreign corporation in the other states in which it does business under statutory provisions comparable to TBCA Part Eight and TBOC Chapter 9 and subject to taxation by those states. Over the years, there has evolved a substantial body of law for analyzing these questions.³⁷⁰

K. Business Combinations; Conversions. The Tex. Corp. Stats. now allow corporations, LLCs and partnerships to merge with each other (e.g., a limited partnership can merge into a corporation) and to convert from one form of entity to another without going through a merger or transfer of assets.³⁷¹ Both the TBOC and the older entity statutes each have provisions relating to the mechanics of the adoption of a plan of merger or conversion, owner approval, filings with the Secretary of State, and the protection of creditors.

Under the conversion provisions of the Tex. Corp. Stats.,³⁷² a Texas corporation may convert into another corporation or other entity if (a) the conversion is approved by its shareholders in the same manner as a merger where the corporation is not the surviving entity, (b) the conversion is consistent with the laws under which the resulting entity is to be governed, (c) shareholders will have a comparable interest in the resulting entity, unless the shareholder exercises his dissenters' rights under the Tex. Corp. Stats. or he otherwise agrees, (d) no shareholder will become personally liable for the obligations of the resulting entity without his consent, and (e) the resulting entity is a new entity formed as a result of the conversion rather than an existing entity (which would be a merger).

³⁶⁸ TBCA art. 2.23; TBOC § 21.058.

³⁶⁹ *Keating v. K-C-K Corp.*, 383 S.W.2d 69 (Tex. Civ. App.—Houston 1964, no writ).

³⁷⁰ *See* CT Corporation, *What Constitutes Doing Business* (2008). In the 2009 Legislative Session 2009 S.B. 1442 § 14 added a new subdivision (15) to TBOC § 9.251 (Activities Not Constituting Transacting Business in This State) to provide that mere ownership of real or personal property in Texas, without more, will not constitute transaction of business in Texas for the purposes of the requirement to register to do business under TBOC Chapter 9. For example, the ownership by a limited partner of a partnership interest in a limited partnership doing business in Texas, without more, will not require the limited partner to register to transact business in Texas. This amendment would not affect (i) the payment of taxes under the Tax Code, including the Margin Tax, or (ii) the long-arm jurisdiction statute which allows Texas courts to obtain personal jurisdiction over out-of-state entities or having sufficient minimum contacts with Texas.

³⁷¹ *See* TBCA Part Five; TBOC Chapter 10.

³⁷² TBCA arts. 5.17, 5.18, 5.19 and 5.20. Comparable provisions are found for LLCs at LLC Act §§ 10.08-10.11, for limited partnerships at TRLPA § 2.15, and for general partnerships at TRPA §§ 9.01, 9.05 and 9.06. The TBOC contains substantially similar provisions, all consolidated in Chapter 10, Subchapter C.

The Tex. Corp. Stats. require shareholder approval of the sale of all or substantially all of the assets of the corporation in certain circumstances.³⁷³

L. Anti-Takeover. TBCA Part Thirteen and TBOC Chapter 21, Subchapter M deal with business combinations involving public companies where there is a change of control after which there are minority shareholders by imposing a special voting requirement for business combinations and other transactions involving a new controlling shareholder.³⁷⁴ These anti-takeover provisions (i) apply only to an “issuing public corporation”³⁷⁵ and (ii) prohibit a “business combination”³⁷⁶ (which includes a merger, share exchange, sale of assets, reclassification, conversion or other transaction between the issuing public corporation and any “affiliated shareholder”³⁷⁷) for three years after the affiliated shareholder became such unless (iii) the “business combination” is approved by the holders of not less than two-thirds of the voting shares not beneficially owned by the affiliated shareholder at a meeting of shareholders held not less than six months after the affiliated shareholder became such or, prior to the affiliated shareholder becoming such, the board of directors approved either the business combination or the affiliated shareholder’s acquisition of the shares that made him an affiliated shareholder.³⁷⁸ Tex. Corp. Stats. also confirm that a director, in discharging his duties, may consider the long-term, as well as the short-term, interests of the corporation and its shareholders.³⁷⁹

III. GENERAL PARTNERSHIP.

A. General. Texas law will only recognize an association or organization as being a “partnership” if it was created under (1) the TBOC, (2) the TRPA, (3) the older Texas Uniform Partnership Act (“TUPA”),³⁸⁰ (4) the Texas Revised Limited Partnership Act (“TRLPA”)³⁸¹ or

³⁷³ See *supra* notes 244-247 and related text.

³⁷⁴ TBCA arts. 13.01-13.08; TBOC §§ 21.601-21.610. State corporation statutes intended to restrain some of the abuses associated with hostile takeovers were validated by the United States Supreme Court in *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987). See *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 505-09 (7th Cir. 1989), *cert. denied*, 493 U.S. 955 (1989) (upholding Wisconsin’s 3-year moratorium statute); Byron F. Egan & Bradley L. Whitlock, *State Shareholder Protection Statutes*, Address at the University of Texas 11th Annual Conference on Securities Regulation and Business Law Problems (Mar. 10, 1989).

³⁷⁵ “Issuing public corporation” is defined as a Texas corporation that has 100 or more shareholders of record, has a class of voting shares registered under the Securities Exchange Act of 1934, or has a class of voting shares qualified for trading on a national market system. TBCA arts. 13.02(A)(6), 13.03; TBOC §§ 21.601(1), 21.606. These TBCA and TBOC provisions do not apply to corporations that are organized under the laws of another state, but that have a substantial nexus to Texas, because such a “foreign application” provision might jeopardize the constitutionality thereof. See, e.g., *Tyson Foods, Inc. v. McReynolds*, 700 F. Supp. 906, 910-14 (M.D. Tenn. 1988); *TLX Acquisition Corp. v. Telex Corp.*, 679 F. Supp. 1022, 1029-30 (W.D. Okla. 1987).

³⁷⁶ TBCA art. 13.02(A)(4); TBOC § 21.604.

³⁷⁷ “Affiliated shareholder” is defined as a shareholder beneficially owning 20% or more of the corporation’s voting shares and certain of its related persons. TBCA art. 13.02(A)(2); TBOC § 21.602.

³⁷⁸ TBCA art. 13.03 is based on DGCL § 203. See also TBOC § 21.606.

³⁷⁹ TBCA art. 13.06; TBOC § 21.401(b).

³⁸⁰ See statutes cites *supra* note 1.

³⁸¹ Tex. Rev. Civ. Stat. Ann. art. 6132a-1 (Vernon Supp. 2010).

(5) under a statute of another jurisdiction which is comparable to any of the Texas statutes referred to in (1), (2), (3), or (4) above.³⁸² If an association is created under a law other than those listed, then it is not a partnership. A “partnership” is defined as an association of two or more persons to carry on a business for profit, whether they intend to create a partnership and whether they call their association a partnership, a joint venture or other name.³⁸³ The definition of a partnership is crucial in litigation in which a person is arguing that he is not a partner and that the general partner disadvantages (e.g., individual, and joint and several liability, for the obligations of the partnership) should not be imposed upon him.

The TBOC now governs all Texas general partnerships.³⁸⁴ Within the TBOC, Chapter 152 is specifically applicable to general partnerships, though many of the general provisions in Title 1 and Title 4, Chapters 151 and 154, will also apply. The TBOC provides that such provisions may be collectively known as “Texas General Partnership Law.”³⁸⁵ Texas general partnerships formed on or after January 1, 2006 had to be governed by the TBOC, and those formed before January 1, 2006 could voluntarily opt in to TBOC governance between January 1, 2006 and January 1, 2010.³⁸⁶ Until January 1, 2010 (at which time *all* partnerships became subject to the TBOC),³⁸⁷ Texas general partnerships which were formed prior to January 1, 2006 and did not opt into the TBOC were governed by the TRPA.³⁸⁸ Because until 2010 some general partnerships were governed by the TRPA and others by the TBOC and because the substantive principles under both statutes are generally the same, the term “Tex. GP Stats.” is used herein to refer to the TBOC and the TRPA collectively, and the particular differences between the TRPA and the TBOC are referenced as appropriate.

1. Definition of “Person”. Any person may be a partner unless the person lacks capacity apart from the Tex. GP Stats. Under TRPA, a “person” is defined to include “individual[s], corporation[s], business trust[s], estate[s], trust[s], custodian[s], trustee[s], executor[s], administrator[s], nominee[s], partnership[s of any sort], association[s], limited liability compan[ies], government[s], governmental subdivision[s], governmental agenc[ies], etc.] . . . and any other legal or commercial entity.”³⁸⁹ The definition of “person” under the new TBOC comes from the Government Code,³⁹⁰ which provides that “[p]erson’ includes

³⁸² TRPA § 2.02; TBOC § 152.051(c).

³⁸³ TRLPA § 6(a)(1); TRPA § 2.02(a); TBOC § 152.051(b).

³⁸⁴ TBOC §§ 402.001 and 402.005.

³⁸⁵ TBOC § 1.008(f).

³⁸⁶ TBOC §§ 402.001 and 402.003.

³⁸⁷ TBOC § 402.005.

³⁸⁸ TRPA § 11.03(c). Prior to January 1, 1999, some entities were still governed by the Texas Uniform Partnership Act. See TRPA § 11.03(a); Steven M. Cooper, *The Texas Revised Partnership Act and the Texas Uniform Partnership Act: Some Significant Differences*, 57 TEX. BUS. J. 828 (Sept. 1994).

³⁸⁹ TRPA § 1.01(14).

³⁹⁰ See TEX. GOV'T CODE ANN. § 311.002 (Vernon 2010) (regarding application of the Government Code to construction of other Texas laws).

corporation, organization, government or governmental subdivision or agency, business trust, estate, trust, partnership, association, and any other legal entity.”³⁹¹

2. Factors Indicating Partnership. Under the Tex. GP Stats., the following five factors indicate that persons have created a partnership:³⁹²

- Receipt or right to receive a share of profits;
- Expression of an intent to be partners;
- Participation or right to participate in control of the business;
- Sharing or agreeing to share losses or liabilities; or
- Contributing or agreeing to contribute money or property to the business.

In *Ingram v. Deere*,³⁹³ the Supreme Court of Texas held that while “common law required proof of all five factors to establish the existence of a partnership, . . . TRPA does not require direct proof of the parties’ intent to form a partnership” and instead uses a “totality-of-the-circumstances test” in determining the existence of a partnership. The Supreme Court explained:

Whether a partnership exists must be determined by an examination of the totality of the circumstances. Evidence of none of the factors under the Texas Revised Partnership Act will preclude the recognition of a partnership, and even conclusive evidence of only one factor will also normally be insufficient to establish the existence of a partnership under TRPA. However, conclusive evidence of all five factors establishes a partnership as a matter of law. In this case, Deere has not provided legally sufficient evidence of any of the five TRPA factors to prove the existence of a partnership. Accordingly, we reverse the court of appeals’ judgment and reinstate the trial court’s take-nothing judgment.³⁹⁴

3. Factors Not Indicative of Partnership. Conversely, under Tex. GP Stats., the following circumstances do not individually indicate that a person is a partner in a business:³⁹⁵

- The right to receive or share in profits as (a) debt repayment, (b) wages or compensation as an employee or independent contractor, (c) payment of rent, (d) payment to a former partner, surviving spouse or representative of a deceased or

³⁹¹ TEX. GOV’T CODE ANN. § 311.005.

³⁹² TRPA § 2.03(a); TBOC § 152.052(a); John C. Ale & Buck McKinney, *Stumbling into Partnerships: How Bands, Business Owners and Strategic Allies Find Themselves in Inadvertent Partnerships*, 43 TEX. J. BUS. L. 465 (Fall 2009).

³⁹³ 288 S.W.3d 886, 895-96 (Tex. 2009).

³⁹⁴ 288 S.W.3d at 903-904 (Tex. 2009).

³⁹⁵ TRPA § 2.03(b); TBOC § 152.052(b).

disabled partner, (e) a transferee of a partnership interest, (f) payment of interest or (g) payment of the consideration for the sale of a business;

- Co-ownership of property whether in the form of joint tenancy, tenancy in common, tenancy by the entireties, joint property, community property or part ownership, whether combined with sharing of profits from the property;
- Sharing or having the right to share gross revenues regardless of whether the persons sharing gross revenues have a common or joint interest in the property from which they are derived; or
- Ownership of mineral property under a joint operating agreement.³⁹⁶

³⁹⁶

The statement in TRPA § 2.03(b)(4) and TBOC § 152.052(b)(4) that “ownership of mineral property under a joint operating agreement” is not a circumstance evidencing a partnership among the co-owners is included to negate the possibility that a joint operating arrangement constitutes a “mining partnership” and to give effect to the typical operating agreement provision stating that the parties do not intend to create, and are not creating, a mining or other partnership. The law of mining partnerships is ably summarized in Cullen M. Godfrey, *Mining Partnerships: Liability Based on Joint Ownership and Operations in Texas*, XXXVII Landman 35-48 (No. 6 Nov.-Dec. 1993), which states:

The mining partnership exists by operation of law and need not be expressly intended or adopted. Interests in mining partnerships may be freely transferred without the consent of the other mining partners and neither the transfer of an interest nor the death of a partner will serve to terminate the mining partnership. Thus, drilling operations need not be interrupted or postponed due to the death of a mining partner or the transfer of a mining partner’s interest.

Mining partnerships can exist in conjunction with other defined relationships. For example, even though parties may have adopted a joint operating agreement which disclaims any partnership relationship, a mining partnership may exist nonetheless by operation of law.

* * *

The disclaimer of partnership between joint oil and gas interest owners became an accepted and trusted principle of oil and gas law. If there were any doubts about the contract provision, one only had to refer to the Texas Uniform Partnership Act, which stated that “operation of a mineral property under a joint operating agreement does not of itself establish a partnership.” The idea that no mining partnership existed in joint oil and gas operations became so well accepted that there have been very few recent mining partnership cases in Texas, and those that do exist generally support this conventional wisdom.

Notwithstanding the conventional wisdom, however, mining partnerships are being created, and they remain in existence even in the face of the standard “boiler plate” denials of partnership. If the elements of mining partnership exist, then the mining partnership exists as a matter of law without regard to the intent of the parties thereto.

Further, joint oil and gas operations are often commenced and carried out without the adoption of a joint operating agreement. When this occurs, the probability that the parties to an undocumented joint operation have created a mining partnership is significantly increased. * * *

4. Oral Partnerships. A written partnership agreement is not required to form a partnership: “An oral agreement of partnership is valid in Texas and need not set a specific date for termination within one year. What matters for the purpose of statute of frauds is that the partnership can be performed within a year.”³⁹⁷

5. Joint Ventures. The definition of a partnership under Tex. GP Stats. includes a “joint venture” or any other named association that satisfies the definition of “partnership.”³⁹⁸ A joint venture is often thought of as a limited purpose partnership, although a joint venture may be organized as a corporation, limited partnership, LLP or LLC.³⁹⁹ A joint venture may also be no more than a contractual relationship such as a contractual revenue-sharing arrangement, a lease, a creditor/debtor relationship or some other relationship not constituting an entity. A risk to the contractual relationship structure is that a court will impose general partnership duties or liabilities on the venturers if their relationship is found to constitute “an association of two or more persons to operate a business as co-owners for a profit” (the traditional definition of a partnership) regardless of how the venturers characterize and document their relationship.⁴⁰⁰

In order for a mining partnership to exist in Texas, five elements must be proven: (1) joint ownership, (2) joint operations, (3) sharing of profits and losses, (4) community of interests, and (5) mutual agency.

³⁹⁷ *In re Wilson*, 355 B.R. 600 (S.D. Tex. 2006) (citing *Niday v. Niday*, 643 S.W.2d 919 (Tex. 1982)); see Steven A. Waters & Peter Christofferson, *Partnerships*, 61 SMU L. Rev. 995, 999 n.37 (2008):

Under Texas law, the general rule is that where the parties have not fixed a time for performance and the contracted issue does not explicitly state that it cannot be performed within one year, then the contract does not fall within the statutes of frauds. *Niday*, S.W.2d at 920 (citing *Miller v. Riata Cadillac Co.*, 517 S.W.2d 773, 776 (Tex. 1974). Additionally, “where the agreement, either by its terms or by the nature of the required acts, cannot be completed within one year, it falls within the statute and must therefore be in writing.” *Niday*, 643 S.W.2d at 920 (citing *Hall v. Hall*, 308 S.W.2d 12 (Tex. 1957)).

³⁹⁸ TRPA § 2.02; TBOC § 152.051(b).

³⁹⁹ See Byron F. Egan, *Joint Venture Formation*, 44 TEX. J. BUS. LAW 129 (2012); Alan R. Bromberg and Larry E. Ribstein, *Bromberg & Ribstein on Partnership*, § 2.06 (Aspen Publishers 2003).

⁴⁰⁰ In *Dernick Resources, Inc. v. David Wilstein, et al*, 312 S.W.3d 864 (Tex. App.—Houston [1st Dist.] 2009), which involved an oil and gas drilling and production arrangement pursuant to a contract that was called a “joint venture agreement,” the court in an opinion by Justice Evelyn Keyes held that the joint venture agreement created a fiduciary relationship that imposed a fiduciary duty of full and fair disclosure on the managing venturer as it held title to the venture’s properties in its name and had a power of attorney to dispose of the properties. The court explained:

Joint venturers for the development of a particular oil and gas lease have fiduciary duties to each other arising from the relationship of joint ownership of the mineral rights of the lease. [citation omitted] Likewise, if there is a joint venture between the operating owner of an interest in oil and gas well drilling operations and the non-operating interest owners, the operating owner owes a fiduciary duty to the non-operating interest owners. [citation omitted] In addition, “[a]n appointment of an attorney-in-fact creates an agency relationship,” and an agency creates a fiduciary relationship as a matter of law. [citation omitted] The scope of the fiduciary duties raised by a joint venture relationship, however, does not extend beyond the development of the particular lease and activities related to that development.

Because a joint venture may be a type of partnership and loss sharing is not necessary to form a partnership, the Tex. GP Stats. effectively overrule cases in the line represented by *Coastal Plains Development Corp. v. Micrea, Inc.*⁴⁰¹ They also resolve old questions about whether an agreement to share losses was necessary to create a partnership by providing that it is unnecessary.⁴⁰²

B. Taxation.

1. General Rule. A general partnership is basically a conduit for purposes of the liability of its members and the payment of income taxes.

2. Joint Venture/Tax Implications. A joint venture is commonly thought of as a limited duration general partnership formed for a specific business activity.⁴⁰³ Unless the venturers elect otherwise, it is treated for federal income tax purposes like a general partnership in that the entity pays no tax; rather, its income or loss is allocated to the joint venturers.⁴⁰⁴

3. Contributions of Appreciated Property. As a general rule, a transfer of appreciated property in exchange for an interest in a general partnership will not result in any gain or loss being recognized by the transferor, the partnership or any of the other partners of the partnership.⁴⁰⁵ The tax basis of the transferor in his partnership interest and of the partnership in the transferred property is the basis the transferor had in the transferred property at the time of the transfer.⁴⁰⁶ Under certain circumstances, a partner's contribution of property may result in a net reduction in liability to that partner in excess of the partner's tax basis in the contributed property. In such a situation, the partner will recognize a gain to the extent of such excess. In addition, certain contributions can be treated as "disguised sales" of all or a portion of the contributed property by the partner to the partnership if the partner receives cash or other property (in addition to a partnership interest) in connection with the transfer.

The dispute revolved around the manager's sale of parts of its interest after giving oral notice to the other venturer, but not the written notice accompanied by full disclosure specified in the agreement. The opinion is lengthy and very fact specific, but the following lessons can be drawn from it: (i) calling a relationship a joint venture can result in a court categorizing the relationship as fiduciary, which in turn implicates duties of candor and loyalty and could implicate the common law corporate opportunity doctrine; (ii) it is important to document the relationship intended (an LLC could be used as the joint venture entity and the LLC company agreement could define or in Delaware eliminate fiduciary duties); and (iii) written agreements should be understood and followed literally.

⁴⁰¹ See *Coastal Plains Dev. Corp. v. Micrea, Inc.*, 572 S.W.2d 285, 287-88 (Tex. 1978).

⁴⁰² TRPA § 2.03(c); TBOC § 152.052(c).

⁴⁰³ See, e.g., *Tompkins v. Comm'r*, 97 F.2d 396 (4th Cir. 1938); *United States v. U.S. Nat'l Bank of Portland, Or.*, 239 F.2d 475, 475-80 (9th Cir. 1956).

⁴⁰⁴ I.R.C. § 7701(a)(2) (2006).

⁴⁰⁵ I.R.C. § 721(a) (1997). *But see* Treas. Reg. § 1.707-3 (2003) (discussing disguised sales).

⁴⁰⁶ I.R.C. § 722 (1984); I.R.C. § 723 (1984).

4. Texas Entity Taxes. A general partnership was not obligated to pay Texas franchise taxes before January 1, 2007.⁴⁰⁷

The Margin Tax is not applicable to a general partnership (other than an LLP) if all of its partners are individuals.⁴⁰⁸ The Margin Tax is imposed on a general partnership which has a business entity as a partner.⁴⁰⁹

5. Self-Employment Tax. Partners of a general partnership generally will be subject to self-employment tax on their share of the net earnings of trade or business income of the partnership and any guaranteed payments for personal services.⁴¹⁰

C. Owner Liability Issues. Under Tex. GP Stats.,⁴¹¹ and typically under common law, a general partnership as an entity is liable for loss or injury to a person, as well as for a penalty caused by or incurred as a result of a wrongful act or omission of any of its partners acting either in the ordinary course of the business of the partnership or with authority of the partnership. Generally, except as provided for an LLP (which is hereinafter discussed), all partners of a general partnership are jointly and severally liable for all debts and obligations of the partnership unless otherwise agreed by a claimant or otherwise provided by law.⁴¹² Provisions in a partnership agreement that serve to allocate liability among the partners are generally ineffective against third-party creditors.⁴¹³ A partner who is, however, forced to pay more than his allocable share of a particular liability should have a right of contribution under Tex. GP Stats. from the partnership or the other partners who did not pay their allocable share.⁴¹⁴

A person admitted as a new partner into an existing general partnership in Texas does not have personal liability for an obligation of the partnership that arose before his admission if the obligation relates to an action taken or omission occurring prior to his admission or if the obligation arises before or after his admission under a contract or commitment entered into before his admission.⁴¹⁵

A general partner who withdraws from the partnership in violation of the partnership agreement is liable to the partnership and the other partners for damages caused by the wrongful withdrawal.⁴¹⁶ A withdrawn general partner may also be liable for actions committed by the

⁴⁰⁷ TEX. TAX CODE ANN. § 17.001(a)(1) (Vernon 2002 & Supp. 2004). *But see supra* notes 91-105 and related text.

⁴⁰⁸ *See supra* notes 126-227 and related text and *infra* note 850 and related text.

⁴⁰⁹ *Id.*

⁴¹⁰ I.R.C. § 1402(a) (2004).

⁴¹¹ TRPA § 3.03; TBOC § 152.303.

⁴¹² TRPA § 3.04; TBOC § 152.304.

⁴¹³ J. CARY BARTON, TEXAS PRACTICE GUIDE: BUSINESS ENTITIES § 20.205 (2003); *see Fincher v. B & D Air Conditioning & Heating Co.*, 816 S.W.2d 509, 512 (Tex. App.—Houston [1st Dist.] 1991, writ denied).

⁴¹⁴ TRPA §§ 4.01(c), 8.06(c); TBOC §§ 152.203(d), 152.708.

⁴¹⁵ TRPA § 3.07; TBOC § 152.304(b).

⁴¹⁶ TRPA § 6.02(c).

partnership while he was a partner, including malpractice, even though the action was not adjudicated to be wrongful until after the partner withdrew from the firm.⁴¹⁷

In a change from old Texas law, a creditor under current Tex. GP Stats. must exhaust partnership assets before collecting a partnership debt from an individual partner on his or her joint and several liability, except in limited circumstances.⁴¹⁸ Previously, a creditor could obtain a judgment enforceable against an individual partner's assets without suing the partnership.⁴¹⁹ Generally, Tex. GP Stats. require that there be a judgment against the partnership and that the individual partner has been served in that action; however, a judgment against a partnership is not automatically a judgment against its partners.⁴²⁰

Even with the improvements of Tex. GP Stats., it is the unlimited liability exposure of partners in a general partnership that provides the most disadvantageous element of doing business in a the form of a general partnership.

Under the TBOC, a judgment creditor of a partner in a general partnership may on application to a court of competent jurisdiction secure a "charging order" against the partner's partnership interest.⁴²¹ In a "charging order" a court "charges" the partnership interest such that

⁴¹⁷ *In re Keck, Mahin & Cate*, 274 B.R. 740, 745–47 (Bankr. N.D. Ill. 2002). In *Keck*, the court explained:

"A partner cannot escape liability simply by leaving the partnership after the malpractice is committed but before the client wins or settles a malpractice claim Courts have consistently held that, within the context of partnership dissolution, withdrawing partners remain liable for matters pending at the time of dissolution . . . [t]he general rule under Illinois law is that dissolution of the partnership does not of itself discharge the existing liability of any partners . . . partners cannot release one another from liability to [non-consenting] third parties."

See also Molly McDonough, *Judge Orders Former Partners to Pay Creditors of Bankrupt Chicago Firm*, 1 No. 9 ABA J. E-REPORT 1 (Mar. 8, 2002) (describing reactions to the *Keck* decision).

⁴¹⁸ TRPA § 3.05; TBOC § 152.306.

⁴¹⁹ *See* statutes cited *supra* note 1.

⁴²⁰ TRPA § 3.05(c); TBOC § 152.306(a).

⁴²¹ TBOC § 152.308, as added effective September 1, 2011 by 2011 S.B. 748 § 43, reads as follows:

Sec. 152.308. PARTNER'S PARTNERSHIP INTEREST SUBJECT TO CHARGING ORDER. (a) On application by a judgment creditor of a partner or of any other owner of a partnership interest, a court having jurisdiction may charge the partnership interest of the judgment debtor to satisfy the judgment.

(b) To the extent that the partnership interest is charged in the manner provided by Subsection (a), the judgment creditor has only the right to receive any distribution to which the judgment debtor would otherwise be entitled in respect of the partnership interest.

(c) A charging order constitutes a lien on the judgment debtor's partnership interest. The charging order lien may not be foreclosed on under this code or any other law.

(d) The entry of a charging order is the exclusive remedy by which a judgment creditor of a partner or of any other owner of a partnership interest may satisfy a judgment out of the judgment debtor's partnership interest.

(e) This section does not deprive a partner or other owner of a partnership interest of a right under exemption laws with respect to the judgment debtor's partnership interest.

any distributions thereon are made as directed by the court, but does not order foreclosure of the interest or compel any distributions. A charging order should not permit a judgment creditor of a partner to receive distributions on an interest subject to a prior perfected security interest. The TBOC provides that a charging order is a creditor's exclusive remedy against a general partnership interest, but that does not preclude a partner from granting a UCC security interest in a general partnership interest or a creditor from enforcing it, in each case subject to the partnership agreement. The general partnership charging order provisions are comparable to those provided by the TBOC for limited partnerships⁴²² and LLCs.⁴²³

D. Management. Partners have wide latitude to provide in the partnership agreement how the partnership is to be managed. Unless the partnership agreement provides otherwise, each partner has an equal right to participate in the management of the business.⁴²⁴ In such a situation, management of the partnership is decentralized. Often, however, partners will designate a managing partner or partners who will have the authority to manage the business of the partnership, creating a more centralized management structure. Since a partner is an agent of the partnership, he or she may bind the partnership in the ordinary course of its business unless the partner has no authority to so act and the third party with whom the partner is dealing has knowledge that the partner has no authority to so act.⁴²⁵ In the event that a partner exceeds his or her authority to act, the other partners may have a cause of action against such partner for breach of the partnership agreement, although this does not alter the fact that the partnership may be bound by the acts of the partner that exceeded his or her authority.⁴²⁶

E. Fiduciary Duties.

1. **General.** Under Tex. GP Stats., a partner in a general partnership owes duties of loyalty and care to the partnership, the other partners, and the heirs, legatees or personal representatives of a deceased partner to the extent of their respective partnership interests.⁴²⁷ These duties are fiduciary in nature although not so labeled.⁴²⁸

(f) A creditor of a partner or of any other owner of a partnership interest does not have the right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the partnership.

⁴²² TBOC § 153.256; *see* note 499 and related text.

⁴²³ TBOC § 101.112; *see* note 732 and related text.

⁴²⁴ TRPA § 4.01(d); TBOC § 152.203(a).

⁴²⁵ TRPA § 3.02; TBOC §§ 152.301, 152.302.

⁴²⁶ TRPA § 4.05; TBOC §§ 152.210, 152.302.

⁴²⁷ TRPA § 4.04; TBOC § 152.204.

⁴²⁸ *See Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193, 199–200 (Tex. 2002) (asserting that since the Court historically has held that partners owe certain fiduciary duties to other partners, it did not have to consider the impact of the TRPA on such duties); Erin Larkin, *What's in a Word? The Effect on Partners' Duties after Removal of the Term "Fiduciary" in the Texas Revised Partnership Act*, 59 BAYLOR L. REV. 895 (2007).

2. Loyalty. The duty of loyalty requires a general partner to place the interests of the partnership ahead of his own interests.⁴²⁹ It requires a partner to account to the partnership for any partnership asset received or used by the partner and prohibits a partner from competing with the partnership or dealing with the partnership in an adverse manner. The following fact patterns may evidence a breach of the fiduciary duty of loyalty in the general partnership context on the part of general partners, creating liability to the partnership or the other partners:

- Self-dealing or profiting from dealing with the partnership in ways not contemplated by the partnership agreement;
- Appropriation of partnership opportunities;
- Refusal to distribute profits to other members of the partnership;
- Diversion of an asset of the partnership for a non-intended use;
- Failure to disclose plans and conflicts to partners; and
- A general lack of candor with partners.⁴³⁰

3. Care. The duty of care requires a partner to act as an ordinarily prudent person would act under similar circumstances.⁴³¹ A partner is presumed to satisfy the duty of care if the partner acts on an informed basis, in good faith and in a manner the partner reasonably believes to be in the best interest of the partnership.⁴³²

4. Candor. In addition to the duties of loyalty and care, a partner owes his co-partners a fiduciary duty of candor, sometimes referred to as a duty of disclosure.⁴³³

⁴²⁹ *Meinhard v. Salmon*, 249 N.Y. 458, 463-64, 164 N.E. 545, 546 (N.Y. 1928), in which Justice Cardozo wrote:

Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. * * * Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

⁴³⁰ See TRPA § 4.04(b); TBOC § 152.205; *Bromberg & Ribstein*, *supra* note 399, at § 6.07.

⁴³¹ TRPA § 4.04(c); TBOC § 152.206(a).

⁴³² TRPA §§ 4.04(c), (d); TBOC §§ 152.204(b), 152.206(c).

⁴³³ *Bromberg & Ribstein*, *supra* note 399, at §§ 6.05(c) and 6.06.

5. **Liability.** A partner is liable to the partnership and the other partners for violation of a statutory duty that results in harm to the partnership or the other partners and for a breach of the partnership agreement.⁴³⁴ Tex. GP Stats. provide that a partner, in that capacity, is not a trustee and is not held to the same standards as a trustee,⁴³⁵ which represents a change from cases under TUPA.⁴³⁶ A managing partner stands in a higher fiduciary relationship to other partners than partners typically occupy.⁴³⁷

6. **Effect of Partnership Agreement.** A partnership agreement governs the relations of the partners, but may not (i) unreasonably restrict a partner's statutory rights of access to books and records, (ii) eliminate the duty of loyalty, although the agreement may within reason identify specific types or categories of activities that do not violate the duty of loyalty, (iii) eliminate the duty of care, although the agreement may within reason determine the standards by which the performance of the obligation is to be measured, or (iv) eliminate the obligation of good faith, although the agreement may within reason determine the standards by which the performance of the obligation is to be measured.⁴³⁸

F. Ability To Raise Capital. Since partnership interests are not freely transferable (at least with respect to management powers) and due to the unlimited liability and decentralized management features of a partnership, the partnership is a not the most advantageous entity for raising capital. The general partnership, however, does have the advantage in dealing with lenders that all partners are individually liable, jointly and severally, for the partnership's debts, absent a contractual limitation of liability in the case of any particular debt.

G. Transferability of Ownership Interests.

1. **Generally.** A partnership interest is transferable by a partner, but a partner's right to participate in the management of the partnership may not be assigned without the consent of the other partners.⁴³⁹ Texas law differentiates between a transfer of a partner's partnership interest and the admission of a successor as a general partner. A transferee is neither able to participate in management nor liable as a partner solely because of a transfer unless and until he becomes a partner, but such transferee is entitled to receive, to the extent transferred, distributions to which the transferor would otherwise be entitled.⁴⁴⁰ A transfer of a partnership

⁴³⁴ TRPA § 4.05; TBOC § 152.210.

⁴³⁵ TRPA § 4.04(f); TBOC § 152.204(d).

⁴³⁶ See *Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.) (holding that a managing partner owes his co-partners the highest fiduciary duty recognized in the law).

⁴³⁷ See, e.g., *Hughes v. St. David's Support Corp.*, 944 S.W.2d 423 (Tex. App.—Austin 1997, writ denied); *Conrad v. Judson*, 465 S.W.2d 819, 828 (Tex. Civ. App.—Dallas 1971, writ ref'd n.r.e.); *Huffington*, 532 S.W.2d at 579; see also *Brazosport Bank of Tex. v. Oak Park Townhouses*, 837 S.W.2d 652, 659 (Tex. App.—Houston [14th Dist.] 1992, writ granted), *rev'd on other grounds*, 851 S.W.2d 189 (Tex. 1993) (noting that a fiduciary relationship exists between general partners, as well as between general and limited partners); *Crenshaw*, 611 S.W.2d at 890.

⁴³⁸ TRPA § 1.03(b); TBOC § 152.002; see *infra* notes 463-464 and related text.

⁴³⁹ See TRPA § 5.03; TBOC §§ 152.401, 152.402(3).

⁴⁴⁰ See TRPA §§ 5.02, 5.03 and 5.04; TBOC §§ 152.402(3), 152.404(a), (c).

interest is not considered an event of withdrawal; therefore, transfer alone will not cause the winding up of the partnership business.⁴⁴¹ The partnership agreement will often contain a provision prohibiting a partner from assigning his economic rights associated with the partnership interest. Unless otherwise specified by the partnership agreement, all of the partners must consent to the substitution of a new partner.⁴⁴² General partnership interests may be evidenced by transferable certificates, but ordinarily no such certificates are issued.⁴⁴³

2. Partnership Interests as Securities. Under the Securities Act of 1933, the Securities Exchange Act of 1934, and most state blue sky laws, the term “security” is defined to include an “investment contract.”⁴⁴⁴ Neither federal securities act defines a partnership interest, whether general or limited, as a “security.” However, by overwhelming precedent, limited partnership interests are considered investment contracts for purposes of the securities laws.⁴⁴⁵ The question of whether a general partnership interest is a security requires a case-by-case analysis. A general partner interest may be a security when the venture, although a general partnership *de jure*, functions *de facto* as a limited partnership (i.e., certain partners do not actively participate in management and rely primarily on the efforts of others to produce profits). In *Williamson v. Tucker*,⁴⁴⁶ the court stated that a general partnership or joint venture interest may be categorized as a security if the investor can show that:

- (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or
- (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or
- (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.⁴⁴⁷

While quoting from the *Williamson* case, the *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.* court further stated that when a “partnership agreement allocates powers to the general partners that are specific and unambiguous, and when those powers are sufficient to allow the general partners to exercise ultimate control, as a majority, over the partnership and its business, then the presumption that the general partnership is not a security can only be rebutted

⁴⁴¹ TRPA § 5.03(a); TBOC §§ 152.402(1), (2).

⁴⁴² TRPA § 4.01(g); TBOC § 152.201.

⁴⁴³ TRPA § 5.02(b); TBOC § 3.201.

⁴⁴⁴ Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2000); Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (2000).

⁴⁴⁵ See *SEC v. Murphy*, 626 F.2d 633, 640 (9th Cir. 1980) (concluding that shares in LPs fall within the definition of “securities,” as investors had no managerial role); *Stowell v. Ted S. Finkel Inv. Servs., Inc.*, 489 F. Supp. 1209, 1220 (S.D. Fla. 1980) (stating that the issue is whether the limited partnership interest meets the test of an investment contract).

⁴⁴⁶ *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir. 1981), *cert. denied*, 454 U.S. 897 (1981).

⁴⁴⁷ *But cf., Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236 (4th Cir. 1988).

by evidence that it is not possible for the partners to exercise those powers.”⁴⁴⁸ The results should not be affected by the fact that some of the general partners may have remained passive⁴⁴⁹ or that the general partnership had made an LLP election.⁴⁵⁰

H. Continuity of Life. Under Tex. GP Stats., a partnership will continue after the withdrawal of a partner or an event requiring a winding up of the business of the partnership until the winding up of the partnership has been completed.⁴⁵¹ The statutes provide for “events of withdrawal” and “events of winding up.”⁴⁵² Upon the occurrence of an event of withdrawal, the business of the partnership is not required to be wound up.⁴⁵³ An event of withdrawal occurs (i) upon the occurrence of events specified in the partnership agreement, (ii) when the partnership receives notice of a partner’s election to withdraw, (iii) upon the expulsion of a partner by partner vote or judicial decree in statutorily specified circumstances, or (iv) upon the death or bankruptcy of a partner, among other events.⁴⁵⁴ Except for the partner’s right to withdraw, the statutory events of withdrawal may be modified by the partnership agreement,⁴⁵⁵ and in view of the Check-the-Box Regulations, modification has become appropriate and common. Although a partner may withdraw from the partnership at any time, the withdrawal may subject the withdrawing partner to liability and various penalties if he or she violates the partnership agreement or the withdrawal is otherwise wrongful.⁴⁵⁶ Unless the partnership agreement provides otherwise,⁴⁵⁷ the interest of a withdrawing partner (except for a partner who wrongfully withdraws) must be redeemed by the partnership at fair market value.⁴⁵⁸ An event of winding up occurs when, among other things, a majority in interest of the partners elect to wind up the partnership if the partnership does not have a specified duration, the term of the partnership expires, the partnership agreement calls for a winding up in a particular situation or all or substantially all of the assets of the partnership are sold outside the ordinary course of its business.⁴⁵⁹

I. Formation. A general partnership can be one of the simplest, least expensive business entities to form because the existence of a partnership does not depend on the existence or filing of any particular document, but rather depends on the existence of an association of two

⁴⁴⁸ *Id.* at 241.

⁴⁴⁹ *Id.*

⁴⁵⁰ *Cf. SEC v. Merchant Capital, LLC*, 400 F.Supp.2d 1336 (N.D. Ga. 2005), *rev’d in part and vacated in part*, 483 F.3d 747 (11th Cir. 2007).

⁴⁵¹ TRPA §§ 2.06(a), 8.02; TBOC §§ 152.502, 152.701.

⁴⁵² TRPA §§ 1.01(6), (7); 6.01(b), 8.01; TBOC §§ 11.051, 11.057, 152.501(b).

⁴⁵³ TRPA § 2.06(a), TBOC § 152.502.

⁴⁵⁴ TRPA § 6.01; TBOC § 152.501(b).

⁴⁵⁵ TRPA § 1.03; TBOC § 152.002.

⁴⁵⁶ TRPA § 6.02; TBOC § 152.503.

⁴⁵⁷ TRPA § 1.03; TBOC § 152.002.

⁴⁵⁸ TRPA § 7.01; TBOC §§ 152.601-152.602. In the case of a partner who wrongfully withdraws, the redemption price is the lesser of fair market value or liquidation value. TRPA § 7.01; TBOC §§ 152.601-152.602.

⁴⁵⁹ TRPA § 8.01; TBOC §§ 11.051, 11.057.

or more persons carrying on, as co-owners, a business for profit.⁴⁶⁰ The factors discussed in Part III.A. are used to determine whether or not a general partnership exists.⁴⁶¹ Thus, it is not necessary that any written partnership agreement exists or that any significant expenses be incurred in the formation of a partnership.⁴⁶² Most of the time, however, partners will wish to have their relationship governed by a partnership agreement rather than rely on the default statutory provisions, and partnership agreements can be very complex.

Under Tex. GP Stats., a partnership agreement, which does not have to be in writing, governs the relations of the partners and the relations between the partners and the partnership; to the extent the partnership agreement does not otherwise provide, Tex. GP Stats. govern those relationships.⁴⁶³ The partnership agreement, however, may not (i) unreasonably restrict a partner's statutory rights of access to books and records, (ii) eliminate the duty of loyalty, although the agreement may within reason identify specific types of activities that do not violate the duty of loyalty, (iii) eliminate the duty of care, although the agreement may within reason determine the standard by which the performance of the obligation is to be measured, (iv) eliminate the obligation of good faith, although the agreement may within reason determine the standard by which the performance of the obligation is to be measured, (v) vary the power to withdraw as a partner, except to require the notice be in writing, or (vi) vary certain other requirements.⁴⁶⁴ Public policy limitations in some cases may limit the extent to which a partnership agreement may effectively reduce the fiduciary duties of a partner.

Unless the partnership agreement specifically provides otherwise, profits and losses of a general partnership are shared per capita and *not* in accordance with capital contributions or capital accounts.⁴⁶⁵

Because partners are granted wide contractual freedom to specify the terms of their partnership, "standard" partnership agreements are less likely to be useful. Additionally, the time and expense of preparing a partnership agreement can be significant. For these reasons, the cost of organizing a general partnership is usually higher than the cost of organizing a corporation.

J. Operations in Other Jurisdictions. A general partnership generally does not qualify to do business as a foreign general partnership under the laws of other states, although the partnership may have to file tax returns and the partners may be subject to taxation in the other states in which the partnership does business.⁴⁶⁶

⁴⁶⁰ TRPA § 2.02(a); TBOC § 152.051.

⁴⁶¹ TRPA § 2.03(a); TBOC § 152.052(a); *see supra* notes 392-396 and related text.

⁴⁶² *See Pappas v. Gounaris*, 301 S.W.2d 249, 254 (Tex. Civ. App.—Galveston 1957, writ ref'd n.r.e.).

⁴⁶³ TRPA § 1.03(a); TBOC § 152.002(a).

⁴⁶⁴ TRPA § 1.03(b); TBOC § 152.002(b).

⁴⁶⁵ *See* TRPA § 4.01(b); TBOC § 152.202(c).

⁴⁶⁶ *Cf.* TRPA § 9.05(a) (acknowledging that the laws of other states apply to a partnership looking to be bound by that jurisdiction's law as a domestic partnership); *see* TBOC § 10.101(d).

K. Business Combinations. Texas law now authorizes a partnership to merge with a corporation, LLC or another partnership, as well as to convert from one form of entity into another without going through a merger or transfer of assets.⁴⁶⁷ Article IX of the TRPA and chapter 10 of the TBOC include provisions relating to the mechanics of adopting a plan of merger or conversion, obtaining owner approval, filing with the Secretary of State and protecting creditors.⁴⁶⁸

IV. LIMITED PARTNERSHIP.

A. General. A “limited partnership” is a partnership formed by two or more persons, with one or more general partners and one or more limited partners.⁴⁶⁹ Limited partnerships are statutorily authorized entities. Most states have adopted some form of the Uniform Limited Partnership Act or the Revised Uniform Limited Partnership Act to govern the rights, duties and liabilities of limited partnerships organized under such statutes. In Texas, all domestic limited partnerships are now governed by the TBOC.⁴⁷⁰ Like other entities formed under Texas law, limited partnerships formed on or after January 1, 2006 are governed by the TBOC,⁴⁷¹ and those formed prior to January 1, 2006 which did not voluntarily opt into the TBOC continued to be governed by the TRLPA until January 1, 2010.⁴⁷² Because from January 1, 2006 until January 1, 2010 some limited partnerships were governed by the TRLPA and others by the TBOC and because the substantive principles under both statutes are generally the same, the term “Tex. LP Stats.” is used herein to refer to the TBOC and the TRPA collectively, and the particular differences between the TRLPA and the TBOC are referenced as appropriate.

B. Taxation.

1. **Federal Income Taxation.** Unless the partners elect otherwise, a domestic limited partnership should ordinarily be treated as a partnership for federal income tax purposes under the Check-the-Box Regulations so long as it has two or more partners.⁴⁷³

2. **Contributions of Appreciated Property.** With respect to contributions of appreciated property, the same rule applies to limited partnerships as applies to general partnerships: ordinarily, a transfer of appreciated property in exchange for an interest in a limited partnership will not result in any gain or loss being recognized by the transferor, the partnership or any of the other partners of the partnership.⁴⁷⁴ The tax basis of the transferor in his partnership interest, and of the partnership in the transferred property, is the basis the

⁴⁶⁷ TRPA §§ 9.01-9.06; TBOC Chapter 10.

⁴⁶⁸ *Id.*; TBOC §§ 10.001-10.009; 10.101-10.151; 10.154-10.201.

⁴⁶⁹ TRLPA § 1.02(6); TBOC § 1.002(50).

⁴⁷⁰ The TBOC provisions relating to limited partnerships are Title 1 and Chapters 151, 153, and 154, as well as certain provisions of Chapter 152. Such provisions may officially and collectively be referred to as “Texas Limited Partnership Law.” TBOC § 1.008(g).

⁴⁷¹ TBOC § 401.001.

⁴⁷² TBOC § 402.005; TRLPA § 13.10.

⁴⁷³ *See* Treas. Reg. § 301.7701-2(c)(1) (as amended in 2003).

⁴⁷⁴ I.R.C. § 721(a) (1997). *But see* Treas. Reg. § 1.707-3 (1992) (discussing disguised sales).

transferor had in the transferred property at the time of the transfer.⁴⁷⁵ Under certain circumstances, a partner's contribution of property may result in a net reduction in liability⁴⁷⁶ to that partner in excess of the partner's tax basis in the contributed property. In such a situation, the partner will recognize a gain to the extent of such excess.⁴⁷⁷ In addition, certain contributions can be treated as "disguised sales" of all or a portion of the contributed property by the partner to the partnership if the partner receives cash or other property (in addition to a partnership interest) in connection with the transfer.

3. Texas Entity Taxes. A limited partnership was not subject to the Texas franchise tax before January 1, 2007.⁴⁷⁸

Effective for tax years beginning on or after January 1, 2007, the Margin Tax replaces the Texas franchise tax and is imposed on limited partnerships.⁴⁷⁹

4. Self-Employment Tax. A limited partner's share of income of the limited partnership (other than a guaranteed payment for services) is generally not subject to the self-employment tax.⁴⁸⁰ Guaranteed payments made to a limited partner by the partnership for services rendered and the general partner's share of the net earnings of trade or business income of a limited partnership generally will be subject to self-employment tax.⁴⁸¹ On January 13, 1997, the IRS issued proposed regulations under IRC § 1402 that would define "limited partner" for employment tax purposes as follows, irrespective of the partner's status under state law, as follows:

Generally, an individual will be treated as a limited partner under the proposed regulations unless the individual (1) has personal liability (as defined in § 301.7701-3(b)(2)(ii) of the Procedure and Administration Regulations) for the debts of or claims against the partnership by reason of being a partner; (2) has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or, (3) participates in the partnership's trade or business for more than 500 hours during the taxable year. If, however, substantially all of the activities of a partnership involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides services as part of that trade or business will not be considered a limited partner.⁴⁸²

⁴⁷⁵ I.R.C. § 722 (1986); I.R.C. § 723 (1986).

⁴⁷⁶ I.R.C. § 752 (1986).

⁴⁷⁷ I.R.C. § 731 (1997).

⁴⁷⁸ See TEX. TAX CODE ANN. § 171.001 (Vernon 2002 & Supp. 2004).

⁴⁷⁹ See *supra* notes 126-227 and related text.

⁴⁸⁰ I.R.C. § 1402(a)(13) (2007); see Robert G. Fishman, *Self-Employment Tax, Family Limited Partnerships and the Partnership Anti-Abuse Regulations*, 74 TAXES 689 (No. 11, Nov. 1996).

⁴⁸¹ *Lauren A. Howell, et vir. v. Commissioner*, TC Memo 2012-303 (Nov. 1, 2012).

⁴⁸² Definition of Limited Partner for Self-Employment Tax Purposes, Prop. Treas. Reg. 1.1402(a)-2(h), 62 Fed. Reg. 1702-01 (Jan. 13, 1997).

The proposed regulations would also have allowed an individual who fails the test for limited partner status to bifurcate the partnership interest into two classes, one of which could qualify for exclusion from employment taxes if it were demonstrably related to invested capital rather than services.⁴⁸³

The Taxpayer Relief Act of 1997 prohibited the IRS from issuing any temporary or final regulations relating to the definition of a limited partner for employment tax purposes that would be effective before July 1, 1998.⁴⁸⁴ The legislative history indicates that Congress wanted the IRS to withdraw the controversial proposed regulation discussed above, which would impose a tax on limited partners.⁴⁸⁵ A “sense of the Senate” resolution in the Senate amendment expressed dissatisfaction with the proposed regulation, noting that Congress, not the Treasury or the IRS, should determine the law governing self-employment income for limited partners.⁴⁸⁶

The IRS is nevertheless successfully challenging taxpayer claims of limited partner status where the taxpayer provided services to the partnership.⁴⁸⁷

C. Owner Liability Issues. A general partner of a limited partnership has the same unlimited liability as does a partner of a general partnership.⁴⁸⁸ The Tex. LP Stats. authorize a limited partnership to register as an LLP by complying with the LLP provisions of TRPA or TBOC discussed below, whereupon the general partner would be liable for the debts or obligations of the limited partnership only to the extent provided in TRPA section 3.08(a) or TBOC section 152.801 and the limited partnership would be an “LLL.”⁴⁸⁹

By contrast, a limited partner’s liability for debts of or claims against the partnership is limited to the limited partner’s capital contribution to the partnership (plus any additional

⁴⁸³

Id.

⁴⁸⁴

Taxpayer Relief Act of 1997, Pub. L. 105-34, 111 Stat. 788 (1997) (enacted).

⁴⁸⁵

Taxpayer Relief Act of 1997, H.R. 2014, 105th Cong. § 734 (1997) (enacted).

⁴⁸⁶

S. 949, 105th Cong. § 734 (1997).

⁴⁸⁷

See Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 TC 137 (Feb. 9, 2011) (partners’ distributive shares of the law firm’s income found not to arise as a return on the partners’ investment and were not “earnings which are basically of an investment nature;” the attorney partners’ distributive shares arose from legal services they performed on behalf of the law firm and were held to be self-employment income); *Lauren A. Howell v. Commissioner*, TC Memo 2012-303 (Nov. 1, 2012) (spouse providing marketing advice, signing contracts, contributing a business plan and providing credit card held “not merely a passive investor” and not a limited partner for self-employment tax purposes).

⁴⁸⁸

See TRLPA §§ 4.01(d), 4.03(a); TBOC § 153.152. *See KAO Holdings, L.P. v. Young*, 261 S.W.3d 60 (Tex. 2008), in which the Supreme Court of Texas held that under TRPA § 3.05(c), “while partners are generally liable for the partnership’s obligations, a judgment against the partnership is not automatically a judgment against the partner, and that judgment cannot be rendered against a partner who has not been served merely because judgment has been rendered against the partnership. The purpose of the provision is to state that service is necessary, not that it is sufficient. Partners against whom judgment is sought should be both named and served so that they are on notice of their potential liability and will have an opportunity to contest their personal liability for the asserted partnership obligation.”

⁴⁸⁹

TRPA § 3.08(e); TRLPA § 2.14; TBOC §§ 152.805, 153.351, 153.353. *See infra* notes 865-871 and related text.

amounts agreed to be contributed).⁴⁹⁰ Veil piercing is inapplicable to Texas limited partnerships.⁴⁹¹ A limited partner may lose this limited liability, however, if he or she participates in the management of partnership business.⁴⁹² The safe harbor provisions of Tex. LP Stats. specify activities that will not subject a limited partner to unlimited liability, such as consulting with and advising a general partner, acting as a contractor for or an officer, agent or employee of the limited partnership (but not a director) or of a general partner, proposing, approving or disapproving certain specified matters related to the partnership business or the winding up of the partnership business or guaranteeing specific obligations of the limited partnership.⁴⁹³

Even if the limited partner's activities exceed the safe harbors, the limited partner will only have unlimited liability to those third parties dealing with the limited partnership who have actual knowledge of the limited partner's participation and control and who reasonably believe that the limited partner is a general partner based on the limited partner's conduct.⁴⁹⁴ Under the TRLPA, though not under the TBOC, a limited partner who knowingly permits his name to be used in the name of the partnership will be liable to creditors who extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner.⁴⁹⁵ A corporation can serve as the general partner of a limited partnership, although the ordinary grounds for piercing the corporate veil (e.g. if the corporate general partner is not sufficiently

⁴⁹⁰ See TRLPA § 3.03; TBOC § 153.102. The Texas LP Stats. provide that the limitation on a limited partner's liability is not affected by the forfeiture of a limited partnership's right to transact business in Texas because of its failure to file reports with the Secretary of State or by any resulting cancellation of its Certificate of Formation or foreign registration by the Secretary of State. TBOC §§ 153.309(c) and 153.311(d); TRLPA §§ 13.06(d) and 13.08(b). See 2009 S.B. 1442 §§ 54 and 55. See Elizabeth S. Miller, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 TEX. J. BUS. L. 405, 426-435 (Fall 2009).

⁴⁹¹ See *Asshauer v. Wells Fargo Foothill*, 263 S.W.3d 468, 474 (Tex. App.—Dallas 2008, pet. denied). As such, TBCA art. 2.21 and TBOC § 21.223 make no mention of limited partners; neither the TRLPA nor the TBOC makes any effort to incorporate TBCA art. 2.21 or TBOC § 21.223 by reference; and neither the TRLPA nor the TBOC includes any provision limiting the applicability of veil piercing or alter ego theory to cases involving actual fraud. But these omissions are certainly not reflective of a legislative intent to give less protection to limited partners than to shareholders of a Texas corporation. Rather, they reflect the Legislature's understanding that veil piercing is so clearly inapplicable to limited partnerships that to duplicate or incorporate the language of TBCA art. 2.21 would be unnecessary and inappropriate. In *Asshauer v. Wells Fargo Foothill*, veil piercing was not allowed to hold a limited partner personally liable for a partnership liability, even though the limited partnership agreement gave broad approval rights to the defendant limited partner, which was also a mezzanine lender. In so holding, the court wrote that in order to conclude that the partnership entities should be ignored, allowing the limited partner/lender to be sued directly, simply because the limited partnerships were set up to perpetuate a fraud, they "would be required to ignore the rules of limited partnerships as set out in Texas Revised Limited Partnership Act [§ 3.03(a)] . . . [which does not provide] an exception for a limited partner to sue another limited partner or the limited partnership where the entities are allegedly part of a fraudulent scheme." TRLPA § 3.03(a) is the analogue to LLC Act § 4.03A.

⁴⁹² *Id.*

⁴⁹³ TRLPA § 3.03(b); TBOC § 153.103.

⁴⁹⁴ TRLPA § 3.03(a); TBOC § 153.102(b).

⁴⁹⁵ TRLPA § 3.03(d); Revisor's Note to TBOC § 153.102.

capitalized in light of known and contingent liabilities) may be applied to hold the shareholders of such a corporate general partner liable in certain factual contexts.⁴⁹⁶

D. Distributions. A limited partnership may not make a distribution to a partner if, immediately after giving effect to the distribution, the liabilities of the limited partnership, other than liabilities to partners with respect to their partnership interests and liabilities for which the recourse of creditors is limited to specified property of the partnership, exceed the fair value of the partnership assets.⁴⁹⁷ This limitation on distributions does not apply to payments for reasonable compensation for present or past services or reasonable payments made in the ordinary course of business pursuant to a bona fide retirement plan or other benefits program.⁴⁹⁸

Under the TBOC, a judgment creditor of a partner in a limited partnership may on application to a court of competent jurisdiction secure a “charging order” against the partner’s partnership interest.⁴⁹⁹ In a “charging order” a court “charges” the partnership interest such that any distributions thereon are made as directed by the court, but does not order foreclosure of the interest or compel any distributions. A charging order should not permit a judgment creditor of a partner to receive distributions on an interest subject to a prior perfected security interest. The TBOC provides that a charging order is a creditor’s exclusive remedy against a limited partnership interest, but that does not preclude a partner from granting a UCC security interest in a limited partnership interest or a creditor from enforcing it, in each case subject to the

⁴⁹⁶ See *Grierson v. Parker Energy Partners 1984-I*, 737 S.W.2d 375, 377–78 (Tex. App.—Houston [14th Dist.] 1987, no writ) (stating that in tortious activity, the corporate veil of a corporate general partner need not be pierced in order to impose liability, thus implying the veil may be pierced in other circumstances).

⁴⁹⁷ TBOC § 153.210(a).

⁴⁹⁸ TBOC § 153.210(b).

⁴⁹⁹ TBOC § 153.256 reads as follows:

Sec. 153.256. PARTNER’S PARTNERSHIP INTEREST SUBJECT TO CHARGING ORDER. (a) On application by a judgment creditor of a partner or of any other owner of a partnership interest, a court having jurisdiction may charge the partnership interest of the judgment debtor to satisfy the judgment.

(b) To the extent that the partnership interest is charged in the manner provided by Subsection (a), the judgment creditor has only the right to receive any distribution to which the judgment debtor would otherwise be entitled in respect of the partnership interest.

(c) A charging order constitutes a lien on the judgment debtor’s partnership interest. The charging order lien may not be foreclosed on under this code or any other law.

(d) The entry of a charging order is the exclusive remedy by which a judgment creditor of a partner or of any other owner of a partnership interest may satisfy a judgment out of the judgment debtor’s partnership interest.

(e) This section does not deprive a partner or other owner of a partnership interest of a right under exemption laws with respect to the judgment debtor’s partnership interest.

(f) A creditor of a partner or of any other owner of a partnership interest does not have the right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited partnership.

partnership agreement. The limited partnership charging order provisions are comparable to those provided by the TBOC for general partnerships⁵⁰⁰ and LLCs.⁵⁰¹

E. Management. Control of a limited partnership is vested in the general partner or partners, who have all the rights and powers of a partner in a general partnership.⁵⁰² Therefore, management of a limited partnership tends to be centralized in the general partner or partners, although safe harbor provisions in most modern limited partnership statutes give limited partners greater latitude in certain matters of management of the limited partnership than was given previously.⁵⁰³ Under Tex. LP Stats., the partnership agreement may provide for multiple classes or groups of limited partners having various rights or duties, including voting rights.⁵⁰⁴ A limited partnership may have elected or appointed officers (but not directors).⁵⁰⁵

F. Fiduciary Duties. Case law has adopted fiduciary standards for general partners of limited partnerships mirroring the unbending fiduciary standards espoused in general partnership cases.⁵⁰⁶ Because of their control over partnership affairs, general partners may be subjected to an even higher fiduciary standard with respect to limited partners.⁵⁰⁷ Those in control of the general partner have been held to the same high standards.⁵⁰⁸

Since a general partner in a limited partnership has the powers, duties and liabilities of a partner in a general partnership unless applicable law or the partnership agreement provides

⁵⁰⁰ TBOC § 152.308; *see supra* note 421 and related text.

⁵⁰¹ TBOC § 101.112; *see infra* note 732 and related text.

⁵⁰² TRLPA § 4.03(a); TBOC § 153.152.

⁵⁰³ TRLPA § 3.03; TBOC §§ 153.102, 153.103.

⁵⁰⁴ TRLPA § 3.02; TBOC § 154.101.

⁵⁰⁵ TBOC § 151.004.

⁵⁰⁶ *See Hughes v. St. David's Support Corp.*, 944 S.W.2d 423, 425–26 (Tex. App.—Austin 1997, writ denied) (holding that “in a limited partnership, the general partner stands in the same fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of a trust.”); *McLendon v. McLendon*, 862 S.W.2d 662, 676 (Tex. App.—Dallas 1993, writ denied) (holding that “in a limited partnership, the general partner acting in complete control stands in the same fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of a trust.”); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. Civ. App.—Austin 1980, writ ref’d n.r.e.); *Watson v. Limited Partners of WCKT, Ltd.*, 570 S.W.2d 179, 182 (Tex. Civ. App.—Austin 1978, writ ref’d n.r.e.); Robert W. Hamilton, *Corporate General Partners of Limited Partnerships*, 1 J. SMALL & EMERGING BUS. L. 73, 73 (1997) (stating that “[g]eneral partners are personally liable for all partnership obligations, including breaches of fiduciary duties owed to the limited partners.”); *see also Huffington v. Upchurch*, 532 S.W.2d 576 (Tex. 1976); *Johnson v. Peckham*, 120 S.W.2d 786 (Tex. 1938); *Kunz v. Huddleston*, 546 S.W.2d 685 (Tex. Civ. App.—El Paso 1977, writ ref’d n.r.e.).

⁵⁰⁷ In *Palmer v. Fuqua*, 641 F.2d 1146, 1155 (5th Cir. 1981), the Fifth Circuit noted that under Texas law a general partner having exclusive power and authority to control and manage the limited partnership “owe[s] the limited partners an even greater duty than is normally imposed [upon general partners].”

⁵⁰⁸ *See In re Bennett*, 989 F.2d 779, 790 (5th Cir. 1993), *opinion amended on rehearing*, 1993 WL 268299 (5th Cir. July 15, 1993) (explaining that when a partner is in complete control of the partnership, the partner owes the highest level of fiduciary duty); *In re USA Cafes, L.P. Litigation*, 600 A.2d 43 (Del. Ch. 1991) (in holding that directors of corporate general partner of limited partnership owe fiduciary duties to the partnership and its limited partners, the court wrote: “those affiliates of a general partner who exercise control over the partnership’s property may find themselves owing fiduciary duties to both the partnership and its limited partners”).

otherwise, a general partner in a limited partnership has the duties of care and loyalty set forth in TRPA section 4.04 and TBOC section 152.204, which basically codify those duties without giving them the “fiduciary” appellation.⁵⁰⁹ Since Tex. LP Stats. provide that a general partner’s conduct is not to be measured by trustee standards, it may no longer be appropriate to measure general partner conduct in terms of trustee fiduciary standards.⁵¹⁰ Courts, however, continue to refer to the trustee standard.⁵¹¹

A general partner in a limited partnership owes the duties of care and loyalty to the partnership and the other partners.⁵¹² The Tex. LP Stats. define the duty of care as requiring a partner to act in the conduct and winding up of the partnership business with the care of an ordinarily prudent person under similar circumstances.⁵¹³ An error in judgment does not by itself constitute a breach of the duty of care.⁵¹⁴ Further, a general partner is presumed to satisfy the duty of care if the partner acts on an informed basis, in good faith and in a manner the partner reasonably believes to be in the best interest of the partnership.⁵¹⁵ These provisions draw on the corporate business judgment rule in articulating the duty of care. Nevertheless, Texas law does not specify whether the standard of care is one of simple or gross negligence. The sparse case law in this area (pre-dating the TRPA) indicates that a general partner will not be held liable for mere negligent mismanagement.⁵¹⁶

In Texas, the duty of loyalty is defined as including:⁵¹⁷

1. accounting to the partnership and holding for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or from use by the partner of partnership property;
2. refraining from dealing with the partnership on behalf of a party having an interest adverse to the partnership; and
3. refraining from competing with the partnership or dealing with the partnership in a manner adverse to the partnership.

A corporation that controls the general partner may owe a duty of loyalty to the limited partnership.⁵¹⁸ Directors of a corporate general partner who dominate and control the underlying

⁵⁰⁹ TRLPA §§ 4.03(b), 13.03; TBOC §§ 153.003, 153.152. See Erin Larkin, *What’s in a Word? The Effect on Partners’ Duties after Removal of the Term “Fiduciary” in the Texas Revised Partnership Act*, 59 BAYLOR L. REV. 895 (2007).

⁵¹⁰ TRPA § 4.04(f); TBOC § 152.204(d).

⁵¹¹ See *McBeth v. Carpenter*, 565 F.3d 171 (C.A.5 (Tex. 2009)); *Hughes v. St. David’s Support Corp.*, 944 S.W.2d 423, 425-26 (Tex. App.—Austin 1997, writ denied).

⁵¹² TRPA § 4.04(a); TBOC § 152.204(a).

⁵¹³ TRPA § 4.04(c); TBOC § 152.206(a).

⁵¹⁴ TRPA § 4.04(c); TBOC § 152.206(a).

⁵¹⁵ TRPA § 4.04(c)-(d); TBOC §§ 152.204(b), 152.206.

⁵¹⁶ See *Ferguson v. Williams*, 670 S.W.2d 327, 331 (Tex. App.—Austin 1984, writ ref’d n.r.e.).

⁵¹⁷ TRPA § 4.04(b); TBOC § 152.205.

limited partnership can be liable for the corporate general partner's breach of fiduciary duty to the limited partners.⁵¹⁹ Similarly, the parent and grandparent entities of the managing owner of a Delaware statutory business trust may be liable, directly or indirectly, for exercising control over or aiding and abetting the managing owner's actions to serve its own self-interest in violation of its fiduciary duties to the Delaware statutory business trust, which suffered significant losses as a result of a transfer of certain of its assets to a third party shortly before the transferee's collapse.⁵²⁰

These provisions in the Tex. LP Stats. mirror the common areas traditionally encompassed by the duty of loyalty (e.g., self-dealing, conflicts of interest and usurpation of partnership opportunity).⁵²¹ To temper some of the broader expressions of partner duties in older Texas case law and permit a balancing analysis as in the corporate cases, Texas law specifically states that a partner does not breach a duty merely because his conduct furthers his own interest and that the trustee standard should not be used to test general partner conduct.⁵²² It does, however, impose on a general partner in a limited partnership the obligation to discharge any duty, and exercise any rights or powers, in conducting or winding up partnership business in good faith and in a manner that the partner reasonably believes to be in the best interest of the partnership.⁵²³

Under the TBOC *limited* partners, as limited partners, generally do not owe fiduciary duties to the partnership or to other partners.⁵²⁴ Previously, a literal reading of the TRPA and TRLPA suggested that limited partners owed such duties by virtue of the linkage of TRPA to

⁵¹⁸ *James River-Pennington, Inc. v. CRSS Capital, Inc.*, C.A. No. 13870, 1995 WL 106554, at *11 (Del. Ch. Mar. 6, 1995) (also recognizing also that the general partner's fiduciary duties might be modified by the limited partnership agreement); *Bigelow/Diversified Secondary P'ship Fund 1990 v. Damson/Birtcher Partners*, C.A. No. 16630-NC, 2001 WL 1641239, at *1-2, 8-9 (Del. Ch. Dec. 4, 2001) (holding that various "upstream" entities controlling general partners could owe fiduciary duties to either the partnership or the limited partners, the Court explained: "While mere ownership—either direct or indirect—of the general partner does not result in the establishment of a fiduciary relationship, those affiliates of a general partner who exercise control over the partnership's property may find themselves owing fiduciary duties to both the partnership and its limited partners.").

⁵¹⁹ *In re USACafes, L.P. Litig.*, 600 A.2d 43, 48 (Del. Ch. 1991).

⁵²⁰ *Cargill, Inc. v. JWH Special Circumstance LLC*, 959 A.2d 1096 (Del. Ch. 2008).

⁵²¹ Under Texas law, persons engaged in a partnership owe to one another one of the highest duties recognized in law—the duty to deal with one another with the utmost good faith and most scrupulous honesty. *See Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976); *Smith v. Bolin*, 271 S.W.2d 93, 96 (Tex. 1954); *Johnson v. J. Hiram Moore, Ltd.*, 763 S.W.2d 496 (Tex. App.—Austin 1988, writ denied); *see also Brazosport Bank of Tex. v. Oak Park Townhouses*, 837 S.W.2d 652, 659 (Tex. App.—Houston [14th Dist.] 1992, writ granted), *rev'd on other grounds*, 851 S.W.2d 189 (Tex. 1993); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.).

⁵²² TRPA § 4.04(e)-(f); TBOC § 152.204(c)-(d).

⁵²³ TRPA § 4.04(d); TBOC § 152.204(b).

⁵²⁴ TBOC §§ 153.003(b) ("The powers and duties of a limited partner shall not be governed by a provision of Chapter 152 [the TBOC Chapter dealing with general partnerships] that would be inconsistent with the nature and role of a limited partner as contemplated by this chapter [153]") and 153.003(c) ("A limited partner shall not have any obligation or duty of a general partner solely by reason of being a limited partner").

TRLPA under TRLPA section 13.03(a).⁵²⁵ That literal interpretation of the statutes, however, was contrary to the general concept that limited partners are merely passive investors and thus should not be subjected to liability for their actions as limited partners. Further, even before the TBOC was enacted there was some case law to the effect that limited partners do not have fiduciary duties.⁵²⁶ Pre TBOC, an exception was made to this general rule in the case where a limited partner actually had or exercised control in management matters (e.g., because of control of the general partner, contractual veto powers over partnership actions or service as an agent of the partnership).⁵²⁷ In such situations, the limited partner’s conduct could be judged by fiduciary principles.⁵²⁸

The Tex. LP Stats. state in part that except as provided in various statutory provisions or the partnership agreement, a general partner of a limited partnership “has the liabilities of a partner in a partnership without limited partners to the partnership and to the other partners.”⁵²⁹

⁵²⁵ TRLPA § 13.03(a) provides: “In any case not provided by [TRLPA], the applicable statute governing partnerships that are not limited partnerships [TRPA] and the rules of law and equity, including the law merchant, govern.”

⁵²⁶ See, e.g., *Strebel v. Wimberly II*, 311 S.W.3d 267 (Tex. App.—Houston [1st Dist.] 2012) *pet. filed*; *In re Villa West Assocs.*, 146 F.3d 798, 806 (10th Cir. 1998); *In re Kids Creek Partners, L.P.*, 212 B.R. 898, 937 (Bankr. N.D. Ill. 1997).

⁵²⁷ *McBeth v. Carpenter*, 565 F.3d 171 (5th Cir. 2009) (limited partnerships controlled by the same individual who controlled the general partner, and whose individual conduct was held to violate his fiduciary duties to the limited partners, were held to have fiduciary duties to the other limited partners).

⁵²⁸ See *RJ Assocs., Inc. v. Health Payors’ Org. Ltd. P’ship, HPA, Inc.*, No. 16873, 1999 WL 550350, at *10 (Del. Ch. July 16, 1999) (unpublished mem. op.) (suggesting that, unless a partnership agreement provides to the contrary, any limited partner owes fiduciary duties to the partnership); *KE Prop. Mgmt. Inc. v. 275 Madison Mgmt. Inc.*, Civ. A. No. 12683, 1993 WL 285900, at *4 (Del. Ch. July 27, 1993) (unpublished mem. op.). Limited partners who function as officers or managers of a limited partnership are typically considered agents of the limited partnership, and as agents to owe fiduciary duties, including the duty of loyalty, to the limited partnership and its other partners. See American Law Institute, *Restatement of the Law of Agency 2nd* (1958) §§ 13 (“An agent is a fiduciary with respect to matters within the scope of his agency”), 387 (“Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency”), 393 (“Unless otherwise agreed, an agent is subject to a duty not to compete with the principal concerning the subject matter of his agency”), 394 (“Unless otherwise agreed, an agent is subject to a duty not to act or to agree to act during the period of his agency for persons whose interests conflict with those of the principal in matters in which the agent is employed”), and 395 (“Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge”); see also *Daniel v. Falcon Interest Realty Corp.*, 190 S.W.3d 177 (Tex. App.—Houston [1st Dist.] 2005, no *pet. hist.*).

⁵²⁹ TRLPA § 4.03(b); TBOC § 153.152(a). Note, this language should *not* be mistaken as an authorization for partnership agreements to alter partner liabilities to third parties. See *infra* notes 790-893 and related text regarding the LLP provisions in TRPA and the TBOC which permit a general partnership to significantly limit the individual liability of its partners for certain acts of other partners by the partnership making a specified filing with the Secretary of State.

The implied contractual duty of good faith and fair dealing is likely a duty of a general partner, in addition to the general partner’s fiduciary duties. See *Dunnagan v. Watson*, 204 S.W. 3d 30 (Tex. App.—Ft. Worth 2006, *pet. denied*); RESTATEMENT (SECOND) OF CONTRACTS § 205 (“every contract imposes upon each

This language indicates that the partnership agreement may modify the internal liabilities of a general partner, but it is not clear whether it is an authorization without express limits or whether it would link to Texas general partnership statutes that prohibit elimination of duties and set a “manifestly unreasonable” floor for contractual variation.⁵³⁰

Delaware expressly allows the limitation or elimination of partner fiduciary duties in the partnership agreement.⁵³¹ Although limitations on fiduciary duty in a partnership agreement may

party a duty of good faith and fair dealing in its performance and its enforcement”). This contractual duty of good faith and fair dealing is to be contrasted with the fiduciary duty of good faith, which is a component of the common law fiduciary duty of loyalty. *See also infra* note 671.

⁵³⁰ *See* TRPA § 1.03(b); TBOC § 152.002(b). “Partnership agreement” is defined to be either a written *or oral* agreement of the partners concerning the affairs of the partnership and the conduct of its business. *See* TRLPA § 1.02(10); TBOC § 151.001(5) (emphasis added).

Some TRLPA provisions permit modification by either a written or oral partnership agreement, while others require the modification to be in the form of a written partnership agreement. *Compare* TRLPA § 4.03(a) and TBOC § 153.152 concerning restrictions on a general partner *with* TRLPA § 11.02 and TBOC § 8.103(c) concerning indemnification of a general partner.

⁵³¹ Section 17-1101(b)-(f) of the Delaware Revised Limited Partnership Act (“*DRLPA*”), DEL. CODE ANN. tit. 6, § 17-1101(b)-(f) (Supp. 2010), provides as follows:

(b) The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.

(c) It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.

(d) To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner’s or other person’s duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

(e) Unless otherwise provided in a partnership agreement, a partner or other person shall not be liable to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement for breach of fiduciary duty for the partner’s or other person’s good faith reliance on the provisions of the partnership agreement.

(f) A partnership agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement; provided, that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

DEL. CODE ANN. tit. 6, § 17-1101(b)-(f) (Supp. 2010); *see* RESTATEMENT (SECOND) OF CONTRACTS § 205 (“every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement”). This contractual duty of good faith and fair dealing is to be contrasted with the fiduciary duty of good faith, which is a component of the common law fiduciary duty of loyalty. *See Stone v. Ritter*, 911 A.2d 362 (Del. 2006); Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations* at 13-27, University of Texas School of Law 35th Annual Conference on Securities Regulation and Business Law (Feb. 8, 2013), *available at* <http://www.jw.com/publications/article/1830>.

be respected by courts when they are expressly set forth in the four corners of the partnership agreement,⁵³² “a topic as important as this should not be addressed coyly.”⁵³³ Importantly, where

See Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 25 (2007), in which Delaware Supreme Court Chief Justice Steele argues that parties forming limited partnerships and companies should be free to adopt or reject some or all of the fiduciary duties recognized at common law in the context of corporations, that courts should look to the parties’ agreement and apply a contractual analysis, rather than analogizing to traditional notions of corporate governance, in limited partnership and LLC fiduciary duty cases, and that Delaware courts should analyze limited partnership fiduciary duty cases as follows:

The courts’ approach should be, first, to examine the agreement to determine if the act complained of is legally authorized by statute or by the terms of the agreement itself. If so, a court should then proceed to inquire whether the implementation of the lawful act requires equity to intervene and craft a remedy? At this point, the court should look to the agreement to determine the extent to which it establishes the duties and liabilities of the parties, i.e., their bargained for, negotiated, contractual relationship. Is the agreement silent about traditional fiduciary duties, but creates a fiduciary relationship consistent with those duties thus allowing the court to imply them by default? Does the agreement expand, restrict, or eliminate one or more of the traditional fiduciary duties? Is the contract language creating those duties and liabilities so inconsistent with common law fiduciary duty principles that it can be concluded that the parties consciously modified them in a discernible way? If so, which duties and in what respect were they modified? Finally, without regard to traditional overlays of scrutiny under the common law of corporate governance, has a party breached its implied covenant of good faith and fair dealing?

See infra note 671 regarding Chief Justice Steele’s views in respect of fiduciary duties in the LLC context.

⁵³² *Gerber v. EPE Holdings*, C.A. No. 3543-VCN, 2013 WL 209658 (Del. Ch. Jan. 18, 2013), involved allegations by one of EPE’s limited partners that EPE’s purchase of interests in an entity controlled by EPE’s ultimate controlling person (its “*controller*”) was unfair to EPE, in violation of its limited partnership agreement (“*LPA*”), and in breach of the duty of good faith owed by EPE, the controller and some of its affiliates to the EPE unitholders. In finding no breach of fiduciary duties, the Delaware Court of Chancery noted that EPE’s LPA provided that:

Except as expressly set forth in [the LPA], neither the General Partner nor any [of its affiliates] shall have any duties or liabilities, including fiduciary duties, to the Partnership or any Limited Partner and provisions of [the LPA], to the extent that they restrict or otherwise modify the duties and liabilities, including fiduciary duties, of the General Partner or any [of its affiliates] otherwise existing at law or in equity, are agreed by the Partners to replace such other duties and liabilities of the General Partner or such other Indemnitee.

While the LPA did impose a contractual duty of good faith on the General Partner and affiliates whenever their actions were undertaken on behalf of the partnership, the LPA also imposed an “express standard” for the specific situation at issue in *Gerber*—resolving conflicts of interest—which required review and approval by “Special Approval” of the Conflicts Committee established by the General Partner pursuant to the LPA. The *EPE* transaction was, in fact, approved by the Conflicts Committee, which Committee was not under an express contractual duty to act in good faith; rather the Conflicts Committee was charged with approving those transactions that were, within the Committee’s subjective belief, in the best interest of EPE. Accordingly, because fiduciary duties were specifically excluded by contract and EPE followed the proscribed approval process provided for in the LPA, the Court found that the EPE unitholder had no right to place a higher standard on the Special Approval process and did not have a claim against EPE.

⁵³³ *Miller v. Am. Real Estate Partners, L.P.*, C.A. No. 16788, 2001 WL 1045643, at *8 (Del. Ch. Sept. 6, 2001) (unpublished mem. op.). In *Miller*, the general partner contended that the partnership agreement eliminated any default fiduciary duty of loyalty owed by the general partner to the limited partners in section 6.13(d) of the partnership agreement, which read as follows:

Whenever in this Agreement the General Partner is permitted or required to make a decision (i) in its “sole discretion” or “discretion”, with “absolute discretion” or under a grant of similar authority or latitude, the General Partner shall be entitled to consider only such interests and factors as it desires and shall have no duty or obligation to give any consideration to any interest of or factors affecting the Partnership, the Operating Partnership or the Record Holders, or (ii) in its “good faith” or under another express standard, the General Partner shall act under such express standard and shall not be subject to any other or different standards imposed by this Agreement or any other agreement contemplated herein.

In finding that the foregoing provision was not adequate to eliminate the general partner’s fiduciary duty of loyalty, Vice Chancellor Strine wrote:

This is yet another case in which a general partner of a limited partnership contends that the partnership agreement eliminates the applicability of default principles of fiduciary duty, and in which this court finds that the drafters of the agreement did not make their intent to eliminate such duties sufficiently clear to bar a fiduciary duty claim. Here, the drafters of the American Real Estate Partners, L.P. partnership agreement did not clearly restrict the fiduciary duties owed to the partnership by its general partner, a defendant entity wholly owned by defendant Carl Icahn. Indeed, the agreement seems to contemplate that the general partner and its directors could be liable for breach of fiduciary duty to the partnership if they acted in bad faith to advantage themselves at the expense of the partnership.

* * *

Once again, therefore, this court faces a situation where an agreement which does not expressly preclude the application of default principles of fiduciary is argued to do so by implication. Indeed, this case presents the court with an opportunity to address a contractual provision similar to the one it interpreted on two occasions in *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, and contemporaneously with this case in *Gelfman v. Weeden Investors, L.P.* In each of those cases, this court held that the traditional fiduciary entire fairness standard could not be applied because it was inconsistent with a contractual provision providing a general partner with sole and complete discretion to effect certain actions subject solely to a contract-specific liability standard. The court’s decision was based on two factors. First, the court noted the difference between the sole and complete discretion standard articulated in the agreements, which explicitly stated that the general partner had no duty to consider the interests of the partnership or the limited partner in making its decisions, and the traditional notion that a fiduciary acting in a conflict situation has a duty to prove that it acted in a procedurally and substantively fair manner. Second, and even more critically, however, each of the agreements indicated that when the sole and complete discretion standard applied, any other conflicting standards in the agreements, other contracts, or under law (including the DRULPA) were to give way if it would interfere with the general partners’ freedom of action under the sole and complete discretion standard. That is, in each case, the agreement expressly stated that default principles of fiduciary duty would be supplanted if they conflicted with the operation of the sole and complete discretion standard.

This case presents a twist on *Gotham Partners* and *Gelfman*. Like the provisions in *Gotham Partners* and *Gelfman*, § 6.13(d) sets forth a sole discretion standard that appears to be quite different from the duty of a fiduciary to act with procedural and substantive fairness in a conflict situation. What is different about § 6.13(d), however, is that it does not expressly state that default provisions of law must give way if they hinder the General Partner’s ability to act under the sole discretion standard. Rather, § 6.13(d) merely states that other standards in the Agreement or

Delaware courts have found that parties have expressly limited fiduciary duties in partnership agreements, they have been reluctant to impose any sort of implied covenant of good faith or fair dealing, viewing this concept instead as more of a gap-filler where the parties had not contemplated for the particular circumstance.⁵³⁴

Unlike DRLPA, under the Tex. LP Stats., the duties of care and loyalty and the obligation of good faith may not be eliminated by the partnership agreement, but the statute leaves room for some modification by contract.⁵³⁵ For example, the partnership agreement may not eliminate the

agreements contemplated by the agreement give way to the sole discretion standard. By its own terms, § 6.13(d) says nothing about default principles of law being subordinated when the sole discretion standard applies.

* * *

This court has made clear that it will not be tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties. The DRULPA puts investors on notice that fiduciary duties may be altered by partnership agreements, and therefore that investors should be careful to read partnership agreements before buying units. In large measure, the DRULPA reflects the doctrine of *caveat emptor*, as is fitting given that investors in limited partnerships have countless other investment opportunities available to them that involve less risk and/or more legal protection. For example, any investor who wishes to retain the protection of traditional fiduciary duties can always invest in corporate stock.

But just as investors must use due care, so must the drafter of a partnership agreement who wishes to supplant the operation of traditional fiduciary duties. In view of the great freedom afforded to such drafters and the reality that most publicly traded limited partnerships are governed by agreements drafted exclusively by the original general partner, it is fair to expect that restrictions on fiduciary duties be set forth clearly and unambiguously. A topic as important as this should not be addressed coyly.

⁵³⁴ The implied covenant of good faith and fair dealing “provides a limited gap-filling tool that allows a court to impose contractual terms to which the parties would have agreed had they anticipated a situation they failed to address.” *Gerber v. EPE Holdings*, C.A. No. 3543-VCN, 2013 WL 209658 at *28. Generally speaking, if a party to a contract such as a limited partnership agreement is entitled to exercise discretion, such discretion, if challenged, would be examined under the implied covenant’s requirement that it be exercised reasonably. See *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*, 50 A.3d 434, at 440 - 441 (Del. Ch. July 9, 2012). However, what is reasonable:

depends on the parties’ original contractual obligations and reasonable expectations at the time of contracting. Fundamentally, therefore, [t]he implied covenant cannot be invoked to override the express terms of the contract.

Gerber v. EPE Holdings, C.A. No. 3543-VCN, 2013 WL 209658 at *28, citing *In re Encore Energy P’rs*, 2012 WL 3792997, at *12 (Del. Ch. Aug. 31, 2012).

In *Gerber v. EPE Holdings*, although the Plaintiff did not correctly allege claims of breach of implied covenant of good faith and fair dealing, the court choose to consider the argument and examine Delaware common law and the limited partnership agreement at issue to determine whether such a covenant could be implied. Ultimately, the court found that “[h]owever, tempting it may be in a particular case, the implied covenant is not generally a placeholder to facilitate full fiduciary analysis;” and it held that the contractual framework established by the limited partnership agreement could not be reconciled with a judicially-imposed standard based on the implied covenant. *Id.* at *29-30.

⁵³⁵ TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b), 4.04; TBOC §§ 152.002(b); 153.003(a).

duty of care, but may determine the standards by which the performance of the obligation is to be measured, if the standards are not “manifestly unreasonable.”⁵³⁶ In one case decided prior to the passage of the TRPA and the TBOC, the Court stated that, when the parties bargain on equal terms, a fiduciary may contract for the limitation of liability, though public policy would preclude limitation of liability for self-dealing, bad faith, intentional adverse acts, and reckless indifference with respect to the interest of the beneficiary.⁵³⁷

With respect to a partner’s duty of loyalty, Tex. LP Stats. provide that the partnership agreement may not eliminate the duty of loyalty, but may identify specific types or categories of activities that do not violate the duty of loyalty, again if not “manifestly unreasonable.”⁵³⁸ The level of specificity required of provisions in the partnership agreement limiting duties pursuant to Tex. LP Stats. is unknown. In fact, it may depend upon the circumstances, such as the sophistication and relative bargaining power of the parties, the scope of the activities of the partnership, etc.

Tex. LP Stats. provide that the obligation of good faith may not be eliminated by the partnership agreement, but the agreement may determine the standards by which the performance is to be measured if not “manifestly unreasonable.”⁵³⁹ Again the parameters of this provision are not readily apparent and probably will depend, at least in part, on the circumstances of any particular case.

Texas law requires a limited partnership to keep in its registered office, and make available to the partners for copying and inspection, certain minimum books and records of the partnership.⁵⁴⁰ This mandate provides a statutory mechanism by which a partner may obtain the documents specified therein, but should not be viewed as in any way limiting a general partner’s broader fiduciary duty of candor regarding partnership affairs as developed in case law and as provided in Tex. LP Stats.⁵⁴¹

G. Indemnification. A limited partnership is required to indemnify a general partner who is “wholly successful on the merits or otherwise” unless indemnification is limited or prohibited by a written partnership agreement.⁵⁴² A limited partnership is prohibited from indemnifying a general partner who is found liable to the limited partners or the partnership or for an improper personal benefit if the liability arose out of willful or intentional misconduct.⁵⁴³ A limited partnership is permitted, if provided in a written partnership agreement, to indemnify a general partner who is determined to meet certain standards. These standards require that the general partner conducted himself in good faith, reasonably believed the conduct was in the best interest of the partnership (if the conduct was in an official capacity) or that the conduct was not

⁵³⁶ TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b)(3), 4.04; TBOC § 152.002(b)(3).

⁵³⁷ *Grider v. Boston Co., Inc.*, 773 S.W.2d 338, 343 (Tex. App.—Dallas 1989, writ denied).

⁵³⁸ TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b)(2), 4.04; TBOC §§ 152.002(b)(2), 153.003(a).

⁵³⁹ TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b)(4), 4.04; TBOC §§ 152.002(b)(4), 153.003(a).

⁵⁴⁰ TRLPA § 1.07; TBOC §§ 153.551, 153.552.

⁵⁴¹ See TRPA § 4.03; TBOC §§ 153.551, 153.552.

⁵⁴² TRLPA §§ 11.08, 11.21; TBOC §§ 8.003, 8.051.

⁵⁴³ TRLPA §§ 11.03, 11.05; TBOC § 8.102(b).

opposed to the partnership's best interest (in cases of conduct outside the general partner's official capacity), and, in the case of a criminal proceeding, had no reasonable cause to believe the conduct was unlawful.⁵⁴⁴ If a general partner is not liable for willful or intentional misconduct, but is found liable to the limited partners or partnership for improper benefit, permissible indemnification is limited to reasonable expenses.⁵⁴⁵ General partners may only be indemnified to the extent consistent with the statute.⁵⁴⁶ Limited partners, employees and agents who are not also general partners may be indemnified to the same extent as general partners and to such further extent, consistent with law, as may be provided by the partnership agreement, general or specific action of the general partner, by contract, or as permitted or required by common law.⁵⁴⁷ Insurance providing coverage for unindemnifiable areas is expressly permitted.⁵⁴⁸

H. Flexibility In Raising Capital. Limitations on liability and more centralized management make the limited partnership a more suitable entity for raising capital than the general partnership. However, the limited partnership's usefulness with respect to raising capital is limited by restrictions on the ability of owners to deduct passive losses for federal income tax purposes.

Under Tex. LP Stats., contributions to a limited partnership by either a general or a limited partner may consist of any tangible or intangible benefit to the limited partnership or other property of any kind or nature, including cash, a promissory note, services performed, a contract for services to be performed, other interests in or securities of the limited partnership, or interests or securities of any other limited partnership, domestic or foreign, or other entity.⁵⁴⁹ However, a conditional contribution obligation, including a contribution payable upon a discretionary call prior to the time the call occurs, may not be enforced until all conditions have been satisfied or waived.⁵⁵⁰

A general partner in a Texas limited partnership does not need to have an economic ownership interest in the limited partnership. A general partner does not have to make any capital contribution, share in profits or losses or have a capital account in the limited partnership. Although a general partner is personally liable for all of the debts and obligations of the limited partnership⁵⁵¹ and if provided in a written partnership agreement, (i) a person may be admitted as a general partner in a limited partnership, including as the sole general partner, and acquire a partnership interest in the limited partnership without (x) making a contribution to the limited partnership or (y) assuming an obligation to make a contribution to the limited partnership; and

⁵⁴⁴ TRLPA § 11.02; TBOC § 8.101(a).

⁵⁴⁵ TRLPA §§ 11.03, 11.05; TBOC § 8.102(b).

⁵⁴⁶ TRLPA § 11.13; TBOC § 8.004.

⁵⁴⁷ TRLPA §§ 11.15, 11.17; TBOC § 8.105.

⁵⁴⁸ TRLPA § 11.18; TBOC § 8.151.

⁵⁴⁹ TRLPA § 5.01; TBOC § 153.201.

⁵⁵⁰ TRLPA § 5.02(d); TBOC § 153.202.

⁵⁵¹ TRLPA §§ 4.01(d), 4.03(b); TBOC § 153.152.

(ii) a person may be admitted as a general partner in a limited partnership, including as the sole general partner, without acquiring a partnership interest in the limited partnership.⁵⁵²

Absent a contrary provision in the written partnership agreement, profits and losses of a limited partnership are to be allocated in accordance with the partnership interests reflected in the records that the partnership is required to maintain under Tex. LP Stats., or in the absence of such records, in proportion to capital accounts.⁵⁵³ Additionally, absent a different provision in the written partnership agreement, distributions representing a return of capital are to be made in accordance with the relative agreed value of capital contributions made by each partner, and other distributions are made in proportion to the allocation of profits.⁵⁵⁴

I. Transferability of Ownership Interests. Unless otherwise provided by the limited partnership agreement, a partnership interest is assignable in whole or in part and will not require winding up a limited partnership.⁵⁵⁵ The assignment of the partnership interest will not, however, entitle the assignee to become, or to exercise the rights or powers of, a partner unless the partnership agreement provides otherwise.⁵⁵⁶ Instead, the assignment will entitle the assignee to an allocation of income, gain, loss, deductions, credits or similar items and to receive distributions to which the assignor was entitled.⁵⁵⁷ If a general partner assigns all of his or her rights as a general partner, a majority in interest of the limited partners may terminate the assigning general partner's status as a general partner.⁵⁵⁸ Until an assignee of a partnership interest becomes a partner, the assignee has no liability as a partner solely by reason of the assignment.⁵⁵⁹

Limited partnership interests are generally considered "securities" within the meaning of federal and state securities laws. Transfers of limited partnership interests are generally required to be registered under such laws absent an application exemption from such registration.⁵⁶⁰

J. Continuity of Life. Although a limited partnership does not have an unlimited life to the same extent as a corporation, the death or withdrawal of a limited partner or the assignment of the limited partner interest to a third party will not affect the continuity of existence of the limited partnership unless the partners agree otherwise or unless no limited partners remain.⁵⁶¹ A limited partnership was dissolved under TRLPA, or is required to commence winding up under the TBOC, upon the first to occur of the following events: (i) any event specified in the partnership agreement as causing dissolution, or the winding up or termination of, the partnership, (ii) all of the partners of the limited partnership agreeing in

⁵⁵² TRLPA § 4.01(c); TBOC § 153.151(c), (d).

⁵⁵³ See TRLPA § 5.03; TBOC § 153.206.

⁵⁵⁴ See TRLPA § 5.04; TBOC § 153.208.

⁵⁵⁵ TRLPA § 7.02; TBOC § 153.251.

⁵⁵⁶ TRLPA § 7.02(a)(2); TBOC § 153.251(b)(2).

⁵⁵⁷ TRLPA § 7.02(a)(3); TBOC § 153.251(b)(3).

⁵⁵⁸ TRLPA § 7.02(a)(4); TBOC § 153.252(b).

⁵⁵⁹ TRLPA § 7.02(b); TBOC § 153.254(a).

⁵⁶⁰ See *infra* notes 723-726 and related text.

⁵⁶¹ TRLPA §§ 8.01, 8.02; TBOC §§ 11.051, 11.058.

writing to dissolve the limited partnership, (iii) an event of withdrawal of a general partner under the Tex. LP Stats. (i.e., death, removal, voluntary withdrawal and, unless otherwise provided in the partnership agreement, bankruptcy of a general partner)⁵⁶² absent certain circumstances⁵⁶³ or (iv) a court of competent jurisdiction dissolving the partnership because (a) the economic purpose of the partnership is likely to be unreasonably frustrated, (b) a partner has engaged in conduct relating to the partnership that makes it not reasonably practicable to carry on the business in the partnership with that partner, or (c) it is not reasonably practicable to carry on the business of the limited partnership in conformity with the partnership agreement.⁵⁶⁴

If the limited partnership is terminated or dissolved, the limited partnership's affairs must be wound up as soon as reasonably practicable unless it is reconstituted or the partnership agreement provides otherwise.⁵⁶⁵ However, upon the withdrawal of a general partner (unless the limited partnership agreement otherwise provides),⁵⁶⁶ the limited partnership may continue its business without being wound up if (i) at least one general partner remains and the partnership agreement permits the business of the limited partnership to be carried on by the remaining general partner or partners or (ii) all (or a lesser percentage stated in the partnership agreement) remaining partners agree in writing to continue the business of the limited partnership within a specified period after the occurrence of the dissolution event and agree to the appointment, if necessary, of one or more new general partners.⁵⁶⁷

Many existing limited partnership agreements contain provisions defining events of withdrawal in a manner intended to negate continuity of life for purposes of the Former Classification Regulations (e.g., certain events of bankruptcy of the general partner). Since these dissolution provisions are not required under the current Check-the-Box Regulations, consideration should be given to whether the provisions conform to the business purposes of the partners; if they do not, the provisions should be amended. The lenders to these limited partnerships, as well as the lenders' lawyers, may also have an interest in the wording of the limited partnership dissolution provisions.

⁵⁶² TRLPA § 4.02; TBOC § 153.155.

⁵⁶³ Under TRLPA § 6.02 and TBOC § 153.155(b), a general partner has a right to withdraw which cannot be eliminated by the partnership agreement, although the partnership may prohibit withdrawal and violation thereof can result in the general partner being liable for damages. TRLPA § 6.03 and TBOC § 153.110 provide that a limited partner may withdraw in accordance with the partnership agreement; previously a limited partner could withdraw on six months notice if the partnership agreement were silent on limited partner withdrawal. Under TBOC § 11.058(b), as amended in 2007 by 2007 H.B. 1737, a winding up of a limited partnership is not required by the TBOC if the limited partnership agreement provides that withdrawal of the general partner does not require winding up of the limited partnership.

⁵⁶⁴ TRLPA § 8.02; TBOC §§ 11.051, 11.314.

⁵⁶⁵ TRLPA § 8.04; TBOC § 11.052.

⁵⁶⁶ TRLPA § 8.01(3); TBOC §§ 11.051(4), 11.058(b).

⁵⁶⁷ TRLPA § 8.01; TBOC §§ 11.051(4), 11.058(2), 11.152(a), 153.501(b). Under the TRLPA, such agreement must be made within ninety days; under the TBOC, it must be made within a year. TBOC § 153.501 and Revisor's Note thereto. The partnership agreement may also provide for continuation of the partnership after dissolution for reasons in addition to an event of withdrawal in respect of a general partner.

K. Formation. The cost of forming a limited partnership is usually greater than that of forming a general partnership. A certificate of formation containing (1) the name of the entity, (2) a statement that it is a limited partnership, (3) the name and address of each general partner; (4) the address of the registered office and the name and address of the registered agent for service of process; and (5) the address of the principal office where books and records are to be kept, must be filed with the Secretary of State.⁵⁶⁸ Additionally, a filing fee of \$750 must be paid upon filing the certificate of formation.⁵⁶⁹

The Tex. LP Stats. contain a number of default provisions that govern the limited partnership in the absence of any relevant provisions in the partnership agreement. Except as provided in the Tex. LP Stats., the partners generally have the freedom to contract around these default provisions and to provide for the rights and obligations of the partners in the partnership agreement.⁵⁷⁰ Since the default provisions of the Tex. LP Stats. to an extent reflect the requirements of the Former Classification Regulations, attorneys drafting limited partnership agreements should now consider whether the business expectations of the partners require negation of some of the default provisions, particularly in the context of dissolution.

The Tex. LP Stats. assume the existence of a limited partnership agreement, but allow the agreement to be either written or oral.⁵⁷¹ An oral limited partnership agreement is subject to the statute of frauds.⁵⁷²

The name of the limited partnership must contain the word “limited,” the phrase “limited partnership,” or an abbreviation of either.⁵⁷³

Unless the partnership agreement provides otherwise, unanimity is required to amend a limited partnership agreement.⁵⁷⁴ Since it may be difficult to get unanimity, it may be appropriate to provide that amendments may be made with the approval of a simple majority or supermajority of the partners. If this type of provision is included, it is important to specify whether the requisite approval is based on sharing ratios, capital account balances, or some other

⁵⁶⁸ TBOC §§ 3.001, 3.005, 3.011. Limited partnerships formed prior to January 1, 2006 were required to file a certificate of limited partnership instead, though with substantially similar requirements for the contents. See TRLPA § 2.01; see also *Arkoma Basin Exploration Co. v. FMF Assocs.1990-A, Ltd.*, 118 S.W.3d 445, 455 (Tex. App.—Dallas 2003, judgment aff’d in part, rev’d in part, 249 S.W.3d 380 (Tex. 2008)); *Garrett v. Koepke*, 569 S.W.2d 568,569 (Tex. Civ. App.—Dallas 1978, writ ref’d n.r.e.); *Brewer v. Tehuacana Venture, Ltd.*, 737 S.W.2d 349, 352 (Tex. App.—Houston [14th Dist.] 1987, no writ).

⁵⁶⁹ TBOC § 4.155(1). The fee is the same as it was under the TRLPA. See TRLPA §§ 2.01(a), 12.01(1).

⁵⁷⁰ See TRPA § 1.03; TBOC §§ 152.002, 153.003.

⁵⁷¹ TRLPA § 1.02(10); TBOC § 151.001(5).

⁵⁷² An oral agreement which is not to be performed within one year from the date of making of the agreement is barred by the statute of frauds. TEX. BUS. & COM. CODE ANN. § 26.01(b)(6) (Vernon Supp. 2011). See *Chacko v. Mathew*, 2008 WL 2390486 (Tex. App.—Houston [14th Dist.] June 12, 2008, pet. denied).

⁵⁷³ TBOC § 5.055(a). The TBOC has eliminated the TRLPA limitations on using a limited partner’s name in the name of the partnership, as well as the requirement that the necessary words or letters designating a limited partnership be at the end of the entity’s name. See Revisor’s Note to TBOC § 5.055. Under TRLPA § 1.03, an entity’s name had to contain the words “Limited Partnership,” “Limited,” or the abbreviation “L.P.,” “LP” (no periods) or “Ltd.” as the last words or letters of its name.

⁵⁷⁴ TRPA § 4.01(i); TBOC § 152.208.

factor or is merely per capita. Also, even if a majority vote is sufficient for most amendments, certain amendments (e.g., those that disproportionately affect a particular partner or group of partners or increases the capital commitment of partners) require a different approval (e.g., the approval of the affected partner or group of partners (or some percentage of that group of partners)). If the amendment provisions are purposefully drafted to give less than all of the partners the right to make amendments that disproportionately affect a particular partner or group of partners, it may be wise to expressly specify in the partnership agreement, to the extent permitted by the Tex. LP Stats., the ability of the general partners to act inconsistently with the fiduciary duties normally required of them.

L. Operations in Other Jurisdictions. Multistate operations of limited partnerships have been prevalent for a sufficient period for most states to have limited partnership statutes which contain provisions for the qualification of foreign limited partnerships to do business as such so that the limited liability of the limited partners will be recognized under local law.⁵⁷⁵ To qualify to do business as a foreign limited partnership in most states, the limited partnership must file with the state's secretary of state evidence of its existence and an application that generally includes *inter alia* information regarding its jurisdiction and state of organization, its registered office and agent for service of process in the state (and providing that in the event that there is at any relevant time no duly designated agent for service of process in the state, then appointing the state's secretary of state as agent for service of process), the names and addresses of its general partners, the business it proposes to pursue in the state and the address of its principal office.

In New York there is now an additional requirement that within 120 days after the filing of its application for authority, the foreign limited partnership must publish once each week for six successive weeks in one daily and one weekly newspaper (each being designated by the county clerk in the county where the partnership is located) generally the same information required to be filed with the New York Department of State and must file a proof of publication with the New York Department of State. Failure to file such proof of publication will result in automatic suspension of the entity's right to transact business in New York.⁵⁷⁶

M. Business Combinations. Under Texas law, a limited partnership may merge with a corporation, LLC or another partnership and convert from a limited partnership into another form of entity without effecting a merger or transfer of assets.⁵⁷⁷ The Tex. LP Stats.

⁵⁷⁵ See TRLPA article 9; see generally TBOC title 1, chapter 9.

⁵⁷⁶ N.Y. REV. LTD. P'SHP ACT § 121-902 (McKinney Supp. 2006). N.Y. REV. LTD. P'SHP ACT § 121-201 (McKinney Supp. 2006) contains similar publication requirements for newly formed domestic limited partnerships.

⁵⁷⁷ TRLPA §§ 2.11, 2.15; TBOC §10.001. In order for a limited partnership to participate in a conversion, consolidation, or merger, the partnership agreement *must* authorize such action and the process for its approval. See TRLPA §§ 2.11(a)(1), 2.11(a)(2), 2.11(d)(1)(F), 2.15(a)(1); TBOC § 10.009(f). Therefore, it is important to include such a provision. Failure to include the provision will mean that, if such a transaction is desired, the partnership agreement will first need to be amended to permit it. To the extent the merger also results in amendments to the partnership agreement, the provisions relating to amendments will also need to be followed, so it would be prudent to coordinate the vote needed for conversions, consolidations, and mergers with the vote needed for amendments.

have provisions relating to the mechanics of adopting a plan of merger or conversion, obtaining owner approval, filing with the Secretary of State, and protecting creditors.

The Tex. LP Stats. do not contain any analogue to TBCA articles 5.09 and 5.10 and the parallel TBOC provisions which require shareholder approval of sales of all or substantially all of a corporation's assets in certain circumstances.⁵⁷⁸ Requirements for limited partner approval of an asset transaction are left to the limited partnership agreement if the partners wish to provide such requirements.

V. LIMITED LIABILITY COMPANY.

A. **General.** LLCs formed under Texas law are now governed by Title 3 and pertinent provisions of Title 1 of the TBOC.⁵⁷⁹ Because until January 1, 2010 some LLCs were governed by the LLC Act⁵⁸⁰ and others by the TBOC and because the substantive principles under both statutes are generally the same, the term "Tex. LLC Stats." is used herein to refer to the TBOC and the LLC Act collectively, and the particular differences between the LLC Act and the TBOC are referenced as appropriate. Texas was the fourth state to adopt an LLC statute and now every state has adopted an LLC statute.⁵⁸¹

"The allure of the [LLC] is its unique ability to bring together in a single business organization the best features of all other business forms - properly structured, its owners obtain both a corporate-styled liability shield and the pass-through tax benefits of a partnership."⁵⁸² All equity holders of an LLC have the limited liability of corporate shareholders even if they participate in the business of the LLC. Thus the Tex. LLC Stats. contemplate that LLCs will be organized with features that resemble corresponding features of corporations.

Under the Check-the-Box Regulations, a domestic LLC with two or more Members typically would be treated for federal income tax purposes as a partnership.⁵⁸³ An LLC is subject to Texas Margin Tax.⁵⁸⁴

⁵⁷⁸ See *supra* notes 246-247 and related text regarding the requirements of TBCA arts. 5.09 and 5.10 and the parallel TBOC provisions.

⁵⁷⁹ TBOC §§ 401.001, 402.003. The TBOC provisions applicable to LLCs may be officially and collectively referred to as "Texas Limited Liability Company Law." TBOC § 1.008(e).

⁵⁸⁰ The Texas Limited Liability Company Act, as amended, is found at TEX. REV. CIV. STAT. ANN. art. 1528n (Vernon Supp. 2011) (hereinafter "LLC Act"). The operational provisions of the LLC Act are modeled after the TBCA, the TMCLA, and TRLPA. *Summary of Business Organizations Bill (HB 278)*, 28 BULL. OF BUS. L. SEC. OF THE ST. B. OF TEX. 2, 31-41 (June 1991) [hereinafter "*1991 Bill Analysis Summary*"]; TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon Supp. 2011); TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon 2003 & Supp. 2004); TEX. REV. CIV. STAT. ANN. art. 6132a-1, arts. 1-13 (Vernon Supp. 2011).

⁵⁸¹ See Charles W. Murdock, *Limited Liability Companies in the Decade of the 1990s: Legislative and Case Law Developments and Their Implications for the Future*, 56 BUS. LAW 499, 502 (2001).

⁵⁸² *PB Real Estate, Inc. v. DEM Properties II*, 719 A.2d 73, 74 (Conn. App., 1998); see Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006*, XV FORDHAM J. CORP. & FIN. L. 459 (2010)

⁵⁸³ See *supra* notes 91-105 and related text.

An underlying premise of the Tex. LLC Stats. is that the LLC is based in large part upon a contract between its Members, similar to a partnership agreement. As a result, fundamental principles of freedom of contract imply that the owners of an LLC have maximum freedom to determine the internal structure and operation of the LLC. Thus the Tex. LLC Stats. would be classified as “flexible” LLC statutes.⁵⁸⁵ This freedom of contract, however, could have resulted in the inadvertent loss of partnership classification for federal income tax purposes under the Former Classification Regulations.⁵⁸⁶

The Tex. LLC Stats. in many cases provide “default” provisions⁵⁸⁷ designed to reflect the common expectations of persons engaged in business under the Former Classification Regulations, and to permit those expectations to be met in the event that the LLC’s organizational documents do not include a provision specifically dealing with an issue. These default provisions, however, may result in restrictions on the LLC that are not necessary under the Check-the-Box Regulations and may unnecessarily change the intended business deal.⁵⁸⁸ Examples of provisions that were often included in an LLC structure because of the Former Classification Regulations, and which are not required by either the Tex. LLC Stats. or the Check-the-Box Regulations, include:

- (i) limited duration (Texas law now permits an LLC to have a perpetual duration like a corporation);
- (ii) management by Members rather than Managers;
- (iii) restrictions on assignments of interests beyond what is required by applicable securities laws and the desires of the parties; and
- (iv) dissolution of the LLC upon the death, expulsion, withdrawal, bankruptcy or dissolution of a Member.

B. Taxation.

1. Check the Box Regulations. Domestic LLCs that have two or more Members ordinarily will be classified as partnerships for federal income tax purposes unless the LLC makes an election to be classified as an association taxable as a corporation.⁵⁸⁹ A single

⁵⁸⁴ See *supra* notes 126-227 and related text. The LLC is not subject to a franchise tax in Delaware or most other states. See Bruce P. Ely & Christopher R. Grissom, *State Taxation of LLCs and LLPs: An Update*, 1 BUS. ENTITIES 24 (Mar./Apr. 1999).

⁵⁸⁵ See Robert B. Keatinge, *New Gang in Town - Limited Liability Companies: An Introduction*, 4 BUS. L. TODAY 5 (Mar./Apr. 1995).

⁵⁸⁶ See Robert F. Gray *et al.*, *Corporations*, 45 Sw.L.J. 1525, 1537 (1992).

⁵⁸⁷ See HOUSE COMM. ON BUS. & INDUS., BILL ANALYSIS, Tex. H.B. 1239, 73d Leg., R.S. (1993) at 1 [hereinafter 1993 LLC Bill Analysis].

⁵⁸⁸ See William D. Bagley, *The IRS Steps Back - Entity Classification Rules are Relaxed*, 6 BUS. L. TODAY 41 (1997).

⁵⁸⁹ Treas. Reg. § 301.7701-3(b)(i) (as amended in 2003).

Member LLC will be disregarded as an entity separate from its owner under the Check-the-Box Regulations unless the LLC elects to be taxed as a corporation.⁵⁹⁰

2. Other Tax Issues Relating to LLCs.

(a) Texas Entity Taxes. An LLC with gross receipts of \$150,000 or more was subject to the Texas franchise tax until January 1, 2007.⁵⁹¹ As a result, an LLC was subject to a franchise tax equal to the greater of (1) 0.25% of its “net taxable capital,” which equals its Members’ contributions and surplus, and (2) 4.5% of its “net taxable earned surplus.”⁵⁹² Unless the LLC had more than one Member but did not have more than 35 Members, the “net taxable earned surplus” of an LLC was based on the entity’s reportable federal taxable income with the compensation of officers and Managers being added back plus certain other adjustments and with the amount being apportionable to Texas based on the percentage of the LLC’s gross receipts from Texas sources.⁵⁹³ An LLC with fewer than 35 Members could eliminate its Texas franchise tax based on “net taxable earned surplus” with Member compensation, subject to limits on unreasonable compensation.⁵⁹⁴ Texas administrative regulations provided that a single Member LLC could not deduct compensation paid to the Member in computing “net taxable earned surplus.”⁵⁹⁵ Such an LLC could, however, deduct compensation paid to officers or managers other than a Member-Manager.

Effective for tax years beginning on or after January 1, 2007, the Margin Tax replaces the Texas franchise tax and is imposed on LLCs.⁵⁹⁶

In each other state in which an LLC does business it will be necessary to ascertain the franchise and income tax treatment of foreign LLCs doing business therein. Since most state income tax regimes are based on the federal adjusted gross income, an LLC treated as a partnership for federal income tax purposes should be treated as such for state income tax purposes in the absence of a specific state statute.⁵⁹⁷

(b) Flexible Statute. In Revenue Ruling 88-76,⁵⁹⁸ a Wyoming LLC was held to lack continuity of life and free transferability of interest, because the Wyoming LLC *statute* requires the unanimous vote of *all* remaining Members to continue the LLC upon a Dissolution Event, and the consent of *all* LLC Members for any transferee of an interest to participate in the management of the LLC or to become a Member.⁵⁹⁹ The Wyoming LLC

⁵⁹⁰ Treas. Reg. § 301.7701-3(b)(ii).

⁵⁹¹ TEX. TAX CODE ANN. §§ 171.001, 171.002(d) (Vernon 2002 & Supp. 2004).

⁵⁹² *Id.* § 171.002(a).

⁵⁹³ See Brandon Janes and Steven D. Moore, *The New Texas Franchise Tax*, TEX. B.J., Nov. 1991, at 1108.

⁵⁹⁴ TEX. TAX CODE ANN. § 171.110(a)(1).

⁵⁹⁵ 34 TEX. ADMIN. CODE § 3.562(f)(2) (2003) (Public Finance, Franchise Tax, Limited Liability Companies).

⁵⁹⁶ See *supra* notes 126-227 and related text.

⁵⁹⁷ David G. Dietze, *The Limited Liability Company: Latest Strategy and Developments*, 6 No. 1 INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR, Jan. 1992, at 7.

⁵⁹⁸ 1988-2 C.B. 360, *obsoleted by* Rev. Rul. 98-37, 1998-2 C.B. 133.

⁵⁹⁹ Rev. Rul. 88-76, 1988-2 C.B. 360, *obsoleted by* Rev. Rul. 98-37, 1998-2 C.B. 133.

statute was considered a “bullet proof statute” because an LLC formed thereunder would always lack these two corporate characteristics important under the Former Classification Regulations.⁶⁰⁰ By contrast, the Tex. LLC Stats. are considered “flexible” statutes because they allow the Members to vary the Regulations or Company Agreement to allow greater organizational flexibility (thus, creating the possibility that an LLC organized thereunder would be taxable as an “association” rather than a partnership under the Former Classification Regulations).⁶⁰¹

(c) One Member LLC. The Tex. LLC Stats. permit formation of a one-Member LLC, the status of which is now certain under the Check-the-Box Regulations.⁶⁰² As previously stated, for federal income tax purposes, a single Member domestic LLC will be disregarded as an entity separate from its owner unless it elects to be taxed as a corporation.⁶⁰³ Some state LLC statutes do not authorize single Member LLCs.⁶⁰⁴

(d) Contributions of Appreciated Property. As a general rule, a transfer of appreciated property in exchange for an interest in an LLC classified as a partnership will not result in any recognizable gain or loss for the transferor, the LLC or any other Member of the LLC.⁶⁰⁵ The tax basis of the transferor in the LLC interest thereof and of the LLC in the transferred property is the basis the transferor had in the transferred property at the time of the transfer.⁶⁰⁶ Under certain circumstances, a Member’s contribution of property may result in a net reduction in liability⁶⁰⁷ to that Member in excess of the Member’s tax basis in the contributed property. In such a situation, the Member will recognize a gain to the extent of such excess.⁶⁰⁸ In addition, certain contributions can be treated as “disguised sales” of all or a portion of the

⁶⁰⁰ Rev. Rul. 88-76, WYO. STAT. ANN. §§ 17-15-101–17-15-147 (Michie 2003).

⁶⁰¹ LLC Act §§ 3.02(A), 6.01(B); TBOC § 101.052.

⁶⁰² Treas. Reg. § 301.7701-2(a), (c)(2) (as amended in 2003).

⁶⁰³ In I.R.S. Priv. Ltr. Rul. 2001-18023 (Jan. 31, 2001), the issue was the application of § 1031 of the IRC (dealing with tax-free like-kind property exchanges) to a transaction in which an individual conveyed qualifying real property to the sole member of an LLC for the membership interest of a single member LLC (which is a disregarded business entity for federal tax purposes). The conveyance of the real property to the taxpayer would be subject to a real estate transfer fee under state law, but the transfer of an ownership interest in an LLC to the taxpayer would not be subject to the transfer fee. To avoid incurring a liability for the local real estate transfer fees incident to the transfer of the real property by the LLC, the taxpayer was proposing to simply acquire the LLC from its single member. The IRS ruled that, because the LLC is a single member LLC and will, therefore, be disregarded as an entity separate from its owner, the receipt of the ownership of the LLC by the taxpayer is treated as the receipt by the taxpayer of the real property owned by the LLC. Accordingly, the taxpayer’s receipt of the sole membership interest in the LLC which owns the real property would be treated as the receipt of real property directly by the taxpayer for purposes of qualifying the receipt of the real property for non-recognition of gain under § 1031. The ruling applies only to the extent the property held by the LLC at the time it is transferred to the taxpayer is property of a like kind to the real property held for use by the taxpayer in his trade or business or for investment (not like kind property held by the LLC would be taxable to the taxpayer as boot).

⁶⁰⁴ See Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 7 (1995).

⁶⁰⁵ I.R.C. § 721(a). *But see* 26 C.F.R. § 1.707-3 (2003) (discussing disguised sales).

⁶⁰⁶ I.R.C. §§ 722, 723.

⁶⁰⁷ I.R.C. § 752.

⁶⁰⁸ I.R.C. § 731.

contributed property by the member to the LLC if the member receives cash or other property (in addition to an LLC interest) in connection with the transfer.

(e) Self-Employment Tax. Individuals are subject to a self-employment tax on self-employment income.⁶⁰⁹ The tax rate on self-employment income aggregates up to 15.3% and consists of (i) a 12.40% social security equivalent tax on self-employment income up to a 2013 contribution base of \$113,700 (adjusted annually for inflation), plus (ii) a 2.9% (3.8% on individual self-employment income in excess of \$200,000 [\$250,000 in the case of a joint return; \$125,000 in the case of a married taxpayer filing separately]) component for hospital insurance (“Medicare”) (there is no ceiling).⁶¹⁰ An individual’s wage income is applied against the contribution base.⁶¹¹ Self-employment income generally means an individual’s net earnings from the individual’s trade or business.⁶¹² An individual’s self-employment income includes his distributive share of the trade or business income from a partnership of which he is a partner (including an LLC classified as a partnership for federal income tax purposes), *subject to* the exception that a limited partner’s distributive share of income or loss from a limited partnership generally will not be included in his net income from self employment.⁶¹³

In 1994, the IRS issued proposed regulations providing that an individual Member’s share of income from a trade or business of the LLC is subject to self-employment tax (assuming the LLC is treated as a partnership for federal income tax purposes) unless (i) the Member is not a managing Member and (ii) the entity could have been formed as a limited partnership rather than an LLC in the same jurisdiction with the Member qualifying as a limited partner.⁶¹⁴ Under such regulations, if the LLC did not have designated Managers with continuing and exclusive authority to manage the LLC, then all Members would be treated as Managers for this purpose.

On January 13, 1997 the IRS withdrew its 1994 proposed regulation dealing with employment taxes in the LLC context and proposed new regulations that would apply to all entities (including LLCs) classified as partnerships under the Check-the-Box Regulations.⁶¹⁵ The IRS said that it was proposing a “functional” approach that would define “limited partner” for federal tax purposes, irrespective of the state law classification, because of

⁶⁰⁹ See I.R.C. § 1401; SSA Pub. No. 05-10003 (2011), available at <http://www.ssa.gov/pubs/10003.html>.

⁶¹⁰ The combined rate of tax on self-employment income of 15.3% consists of a 12.4% component for old-age, survivors, and disability insurance (“OASDI” or “social security”) and a 2.9% (3.8% on individual self-employment income in excess of \$200,000 [\$250,000 in the case of a joint return; \$125,000 in the case of a married taxpayer filing separately]) component for hospital insurance (“Medicare”). A similar addition to Medicare tax applies for FICA purposes. This self-employment tax is treated as part of the income tax and must also be taken into account for purposes of the estimated tax. If the taxpayer has wages subject to FICA, then the taxpayer’s social security equivalent wage base would be reduced by amount of wages on which these taxes were paid. There is no cap on self-employment income subject to the Medicare tax.

⁶¹¹ *Id.*

⁶¹² I.R.C. § 1402(a).

⁶¹³ I.R.C. § 1402. See *Howell v. Comm’r*, TC Memo 2012-303 (Nov. 1, 2012).

⁶¹⁴ See 26 C.F.R. § 1.1402(a)-18, 59 Fed. Reg. 67,253-01 (proposed Dec. 29, 1994).

⁶¹⁵ 26 C.F.R. § 1.1402(a)-2, 62 Fed. Reg. 1702 (proposed Jan. 13, 1997).

the proliferation of new business entities such as the LLC as well as the evolution of state limited partnership statutes.⁶¹⁶ Under the proposed regulations:

Generally, an individual will be treated as a limited partner under the proposed regulations unless the individual (1) has personal liability (as defined in section 301.7701-3(b)(2)(ii) of the Procedure and Administration Regulations) for the debts of or claims against the partnership by reason of being a partner; (2) has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or, (3) participates in the partnership's trade or business for more than 500 hours during the taxable year. If, however, substantially all of the activities of a partnership involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides services as part of that trade or business will not be considered a limited partner.⁶¹⁷

Until the proposed regulations are effective for an LLC Member, there is a risk that the IRS will treat any individual Member's distributive share of the trade or business income of the LLC as being subject to self-employment tax, even if the Member is not a Manager and would be treated as a limited partner under the 1997 proposed regulations, based on the IRS position set forth in Private Letter Ruling 94-32-018, which was issued prior to the proposed regulation. Under both current law and the 1997 proposed regulations, an LLC Member will be subject to self-employment tax on guaranteed payments for services, and Members will not be subject to self-employment tax on distributions if the LLC is treated as an association taxable as a corporation for Federal tax purposes.

The Taxpayer Relief Act of 1997 prohibited the IRS from issuing any temporary or final regulations relating to the definition of a limited partner for employment tax purposes that would be effective before July 1, 1998.⁶¹⁸ The legislative history indicates that Congress wanted the IRS to withdraw the controversial proposed regulation discussed above, which would impose a tax on limited partners.⁶¹⁹ A "sense of the Senate" resolution in the Senate amendment expressed dissatisfaction with the proposed regulation, noting that Congress, not the Treasury or the IRS, should determine the law governing self-employment income for limited partners.⁶²⁰

⁶¹⁶ *See id.*

⁶¹⁷ *Id.*

⁶¹⁸ H.R. CONF. REP. NO. 105-220, at 765 (1997).

⁶¹⁹ *Id.*

⁶²⁰ *Id.* In a letter to the Chairman of the House Ways and Means Committee dated July 6, 1999, the American Bar Association Tax Section commented on the uncertainty of the law in this area, recommending that the IRC be amended to provide that the income of an entity taxable as a partnership (including an LLC) that is attributable to capital is not subject to self-employment tax, but suggested that, if legislation is not forthcoming, the best immediately available approach is that contained in the 1997 proposed regulations. Paul A. Sax, *ABA Tax Section Suggests Legislative Fix for LLC Self-Help Employment Tax*, TAX NOTES TODAY, July 13, 1999, 1999 TNT 133-23, available at <http://www.taxanalysts.com>.

Congress may again consider ways to rationalize the self-employment tax treatment of LLCs, partnerships and S-corporations.⁶²¹

The IRS is nevertheless successfully challenging taxpayer claims of limited partner status where the taxpayer provided services to the partnership.⁶²²

C. Members; Managers. The owners of an LLC are called “Members,”⁶²³ and are analogous to shareholders in a corporation or limited partners of a limited partnership.⁶²⁴ 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.⁶²⁵ Under the Tex. LLC Stats., 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,⁶²⁶ 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.⁶²⁷ For an LLC to be taxed as a partnership, it must have at least two Members, although the TBOC expressly permits an LLC to have only one Member;⁶²⁸ a single Member LLC is not treated as a separate entity for federal tax purposes under the Check-the-Box Regulations unless it elects to be taxed as a corporation (i.e., a single Member LLC may be taxed as a sole proprietorship or corporation, but not as a partnership).⁶²⁹

Under the Tex. LLC Stats., any “person” may become a Member or Manager.⁶³⁰ Because of the broad definition given to “person” by the Tex. LLC Stats., any individual, corporation, partnership, LLC or other person may become a Member or Manager.⁶³¹ Thus, it is possible to

⁶²¹ See “Options to Improve Tax Compliance and Reform Tax Expenditures” prepared by the Staff of the Joint Committee on Taxation (January 27, 2005).

⁶²² See *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 TC 137 (Feb. 9, 2011) (partners’ distributive shares of the law firm’s income found not to arise as a return on the partners’ investment and were not “earnings which are basically of an investment nature;” the attorney partners’ distributive shares arose from legal services they performed on behalf of the law firm and were held to be self-employment income); *Lauren A. Howell v. Commissioner*, TC Memo 2012-303 (Nov. 1, 2012) (spouse providing marketing advice, signing contracts, contributing a business plan and providing credit card held “not merely a passive investor” and not a limited partner for self-employment tax purposes).

⁶²³ LLC Act § 4.01; TBOC §§ 1.002(53), 101.101, 101.102.

⁶²⁴ 1991 Bill Analysis Summary at 41.

⁶²⁵ See LLC Act § 2.13; TBOC § 101.302; 1991 Bill Analysis Summary at 41.

⁶²⁶ LLC Act § 2.12; TBOC §§ 1.002(35), 101.251.

⁶²⁷ 1991 Bill Analysis Summary at 41.

⁶²⁸ TBOC § 101.101.

⁶²⁹ See *supra* notes 91-105 and related text and notes 602-604 and related text. In 1993, Article 4.01(A) of the LLC Act was amended to expressly provide that an LLC “may have one or more members.” Tex. H.B. 1239, 73d Leg., R.S. (1993). See also TBOC § 101.101.

⁶³⁰ LLC Act § 4.01C; TBOC § 101.102(a).

⁶³¹ “Person” is defined in TBOC § 1.002(69-b) as follows:

(69-b) “Person” means an individual or a corporation, partnership, limited liability company, business trust, trust, association, or other organization, estate, government or governmental subdivision or agency, or other legal entity.

“Person” was similarly defined in LLC Act § 1.02(4).

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.

D. Purposes and Powers. Under Texas law, an LLC may generally be formed to conduct any lawful business, subject to limitations of other statutes which regulate particular businesses.⁶³² It has all of the powers of a Texas corporation or limited partnership, subject to any restrictions imposed by statute or its governing documents.⁶³³

E. Formation. An LLC is formed when one or more persons file a certificate of formation with the Texas Secretary of State along with a \$300 filing fee.⁶³⁴ 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.⁶³⁵ 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.⁶³⁶ 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. In such case the LLC's formation takes effect on the effectiveness of the plan.⁶³⁷

⁶³² LLC Act § 2.01 provides as follows:

Art. 2.01. PURPOSES. A. A limited liability company formed under this Act may engage in any lawful business unless a more limited purpose is stated in its articles of organization or regulations.

B. A limited liability company engaging in a business that is subject to regulation by another Texas statute may be formed under this Act only if it is not prohibited by the other statute. The limited liability company is subject to all limitations of the other statute.

LLC Act § 2.01 provides that a limited liability company “may engage in any lawful business.” The term “business,” as defined in LLC Act § 1.02.A(6), means every “trade and occupation or profession.” Based on the foregoing, a limited liability company governed by the LLC Act possibly could not be used for a nonprofit purpose. However, under the TBOC, an LLC's purpose “may be stated to be or include any lawful purpose for [an LLC].” TBOC § 3.005(3). Such broad language would seem to negate the prior profit versus nonprofit ambiguity. *See also* TBOC § 2.001 (providing “A domestic entity has any lawful purpose or purposes, unless otherwise provided by this code.”).

⁶³³ Governing documents, as used here, includes an LLC's Articles of Organization, Certificate of Formation, Regulations, or Company Agreement. LLC Act § 2.02; *see* TBOC § 101.402.

⁶³⁴ TBOC §§ 3.001, 4.152(1), 4.154. Prior to January 1, 2006, an LLC was formed by filing articles of organization with the Secretary of State, which were similar to a certificate of limited partnership under TRLPA and articles of incorporation under the TBCA. *See* LLC Act §§ 3.01, 9.01.

⁶³⁵ TBOC §§ 3.005, 3.010, 3.014.

⁶³⁶ TBOC §§ 4.051, 4.052.

⁶³⁷ TBOC § 3.006(b).

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.⁶³⁸ 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.⁶³⁹ Prior to accepting a certificate of formation for filing, the Secretary of State reviews its LLC, limited partnership and corporation records to determine whether the LLC’s proposed name is impermissibly close to that of an existing filing entity.⁶⁴⁰

The Tex. LLC Stats. provide 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.⁶⁴¹ Any such amendment must include a statement that it was approved in accordance with the proper provisions of governing laws,⁶⁴² or for entities governed by the LLC Act, alternately as provided in the articles of organization or Regulations, along with the date of approval.⁶⁴³

LLC Act section 2.23G provided that if the LLC has not received any capital and has not otherwise commenced business, the articles of organization may be amended by and the LLC may be dissolved by (a) a majority of the Managers, if there are no Members, or (b) a majority of the Members, if there are no Managers. The TBOC does not contain such an express provision, but simply grants broad leeway for an LLC’s Company Agreement (equivalent to the “Regulations” under the LLC Act) to govern such matters.⁶⁴⁴

F. Company Agreement. Most of the provisions relating to the organization and management of an 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.⁶⁴⁵ A Company Agreement is the same as the document referred to as the “Regulations” for LLCs governed by the LLC Act. A Company Agreement may be oral or in writing,⁶⁴⁶ but an oral Company Agreement is subject to

⁶³⁸ TBOC § 5.056. However, LLCs formed prior to September 1, 1993 in compliance with the laws then in existence need not change their names to comply with the current provisions. TBOC § 5.056(b).

⁶³⁹ TBOC § 5.053.

⁶⁴⁰ *Id.*

⁶⁴¹ LLC Act § 2.23H; TBOC §§ 101.356(d), 101.051, 101.052. For LLCs that continue to be governed by the LLC Act, the pertinent documents are referred to as the articles of organization and the Regulations.

⁶⁴² LLC Act § 3.06(3); TBOC § 3.053(4).

⁶⁴³ LLC Act § 3.06(3).

⁶⁴⁴ *See* TBOC §§ 101.051, 101.052.

⁶⁴⁵ LLC Act § 2.09A; TBOC § 101.052; Joint Task Force of the Committee on LLCs, Partnerships and Unincorporated Entities and the Committee on Taxation, ABA Section of Business Law, *Model Real Estate Development Operating Agreement with Commentary*, 63 BUS. LAW. 385 (February 2008).

⁶⁴⁶ TBOC § 101.001(1); DLLCA § 18-101(7).

the statute of frauds.⁶⁴⁷ The complexity of the matters typically addressed in a Company Agreement make it rare and inadvisable to have an oral Company Agreement.

Under the TBOC, the Company Agreement controls the majority of LLC governance matters and generally trumps the default TBOC provisions relating to LLCs, but certain provisions of the Tex. LLC Stats. may not be waived or modified by Regulations or Company Agreement.⁶⁴⁸ For example, the TBOC provides that the Company Agreement or certificate of

⁶⁴⁷ An oral agreement which is not to be performed within one year from the date of making of the agreement is barred by the statute of frauds. TEX. BUS. & COM. CODE ANN. § 26.01(b)(6) (Vernon Supp. 2011). To be enforceable, an agreement to make contributions of cash or property to an LLC must be in writing and signed by the person making the promise. TBOC § 101.151. Likewise, profits and losses are to be allocated, and distributions made, according to the written agreed value of contributions found in the LLC's company records. TBOC §§ 101.501, 101.201, 101.203. See *Olson v. Halvorsen*, 982 A.2d 286 (Del. Ch. 2008), judgment aff'd by 986 A.2d 1150 (Del. 2009) (Delaware statute of frauds, which provides "an agreement 'that is not to be performed within the space of one year from the making thereof' must be reduced to writing and signed by the party against which the agreement is to be enforced," applies to a Delaware LLC agreement; noting that "the statute of frauds does not apply to any contract which may, by any possibility, be performed within a year," the court observed that few oral LLC agreements would contain terms that could not possibly be performed within one year and thus ordinarily the statute of frauds would not limit the enforcement of oral LLC agreements; nevertheless, in the case before it, the court held that the earnout provision at issue violated the statute of frauds because it could not be performed within a year and none of the exceptions to the statute of frauds was applicable).

⁶⁴⁸ TBOC §§ 101.052 and 101.054 provide as follows:

Sec. 101.052. COMPANY AGREEMENT. (a) Except as provided by Section 101.054, the company agreement of a limited liability company governs:

(1) the relations among members, managers, and officers of the company, assignees of membership interests in the company, and the company itself; and

(2) other internal affairs of the company.

(b) To the extent that the company agreement of a limited liability company does not otherwise provide, this title and the provisions of Title 1 applicable to a limited liability company govern the internal affairs of the company.

(c) Except as provided by Section 101.054, a provision of this title or Title 1 that is applicable to a limited liability company may be waived or modified in the company agreement of a limited liability company.

(d) The company agreement may contain any provisions for the regulation and management of the affairs of the limited liability company not inconsistent with law or the certificate of formation.

Sec. 101.054. WAIVER OR MODIFICATION OF CERTAIN STATUTORY PROVISIONS PROHIBITED; EXCEPTIONS. (a) Except as provided by this section, the following provisions may not be waived or modified in the company agreement of a limited liability company:

(1) this section;

(2) Section 101.101(b)[Members Required], 101.151 [Requirements for Enforceable Promise [to make contribution]], 101.206 [Prohibited Distribution; Duty to Return], 101.501 [Supplemental Records Required for Limited Liability Companies], or 101.502 [Right to Examine Records and Certain Other Information];

formation may only be amended by unanimous member consent,⁶⁴⁹ but if either document provides otherwise (such as for amendment by manager consent), then it may be amended pursuant to its own terms.⁶⁵⁰ The only statutory provisions not subject to contrary agreement are enumerated in TBOC section 101.054.⁶⁵¹ While the structure and wording of the TBOC relating

(3) Chapter 1 [Definitions and Other General Provisions], if the provision is used to interpret a provision or define a word or phrase contained in a section listed in this subsection;

(4) Chapter 2 [Purposes and Power of Domestic Entity], except that Section 2.104(c)(2) [Power to Make Guaranties], 2.104(c)(3) [Power to Make Guaranties], or 2.113 [Limitation on Powers] may be waived or modified in the company agreement;

(5) Chapter 3 [Formation and Governance], except that Subchapters C [Governing Persons and Officers] and E [Certificates Representing Ownership Interest] may be waived or modified in the company agreement; or

(6) Chapter 4 [Filings], 5 [Names of Entities; Registered Agents and Registered Offices], 7 [Liability], 10 [Mergers, Interest Exchanges, Conversions, and Sales of Assets], 11 [Winding Up and Termination of Domestic Entity], or 12 [Administrative Powers], other than Section 11.056 [Supplemental Provisions for Limited Liability Company].

(b) A provision listed in Subsection (a) may be waived or modified in the company agreement if the provision that is waived or modified authorizes the limited liability company to waive or modify the provision in the company's governing documents.

(c) A provision listed in Subsection (a) may be modified in the company agreement if the provision that is modified specifies:

(1) the person or group of persons entitled to approve a modification;

or

(2) the vote or other method by which a modification is required to be approved.

(d) A provision in this title or in that part of Title 1 [General Provisions] applicable to a limited liability company that grants a right to a person, other than a member, manager, officer, or assignee of a membership interest in a limited liability company, may be waived or modified in the company agreement of the company only if the person consents to the waiver or modification.

Although TBOC § 101.054 expressly states which provisions *cannot* be modified, its predecessor, the LLC Act, only expressly states which provisions *can* be modified. As the Revisor's Note to TBOC § 101.052 explains:

Because of the reversal of the prior assumption that each provision of the [LLC Act] was mandatory (unless expressly qualified) to the new assumption in Sections 101.052 and 101.054 [of the TBOC] that most provisions of the code governing limited liability companies may be waived or modified, a number of the provisions of Title 3 are now stated in such a way that the new provision appears to be the converse of the corresponding provision under the Texas Limited Liability Company Act.

⁶⁴⁹ TBOC §§ 101.053, 101.356(d).

⁶⁵⁰ See TBOC §§ 101.052, 101.054.

⁶⁵¹ See *supra* note 648.

to these matters differs from the source LLC Act, the requirements for amending a Company Agreement have not substantively changed.⁶⁵²

Although the Company Agreement will ordinarily contain the capital account and other financial and tax provisions found in a typical limited partnership agreement,⁶⁵³ the Tex. LLC Stats. do 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 agree to be contractually bound thereby.⁶⁵⁴ The Members' express agreement to be contractually bound by the Company Agreement should facilitate enforcement thereof and their treatment as a "partnership agreement" for federal income tax purposes.⁶⁵⁵

In some other states, the agreement which is referred to in Texas as the Company Agreement is referred to as "operating agreement" or the "LLC agreement."⁶⁵⁶

G. Management. 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

⁶⁵² See Revisor's Note to TBOC § 101.052; LLC Act §§ 2.09B, 2.23H. With respect to LLCs that continue to be governed by the LLC Act, the default provision in LLC Act § 2.23D provides that the affirmative vote, approval, or consent of a majority of all the Members is required to approve any merger or interest exchange, dissolution or any act which would make it impossible to carry on the ordinary business of the LLC. The LLC Act default provisions would require unanimous approval of the Members to amend the Articles (LLC Act § 2.23H), issue additional membership interests (LLC Act § 4.01B-1, as amended by 2003 H.B. 1637 effective September 1, 2003) or take action beyond the stated purposes of the LLC (LLC Act § 2.02B). The general default voting provision is in LLC Act § 2.23C-1, which provides that Members or Managers may take action at a meeting or without a meeting in any manner permitted by the Articles, the Regulations or the LLC Act and that, unless otherwise provided by the Articles or the Regulations, an action is effective if it is taken by (1) an affirmative vote of those persons having not fewer than the minimum number of votes that would be necessary to take the action at a meeting at which all Members or Managers, as the case may be, entitled to vote on the action were present and voted; or (2) consent of each Member of the LLC, which may be established by (a) the Member's failure to object to the action in a timely manner, if the Member has full knowledge of the action, (b) consent to the action in writing signed by the Member, or (c) any other means reasonably evidencing consent. Thus, when drafting the Regulations, it is important to override these provisions if they do not properly reflect the desires of the parties. Also, Paragraph F of LLC Act § 2.23 provides, as the default rule, that a majority is defined to be determined on a per-capita basis and not, for instance, by capital contributions or sharing ratios; since this may or may not be appropriate, it is critical that the Regulations properly set forth the appropriate standard for determining what constitutes a majority.

⁶⁵³ It is critical that the Company Agreement accurately reflect the business deal of the parties. Absent a different provision therein, profits and losses of an LLC are to be allocated, and all distributions, whether a return of capital or otherwise, are to be made in accordance with the relative agreed value of capital contributions made by each member reflected in the records that the LLC is required to maintain under the Tex. LLC Stats. LLC Act §§ 2.22, 5.01-1, 5.03; TBOC §§ 3.151, 101.203, 101.501.

⁶⁵⁴ The agreement to be contractually bound could be through signing the Company Agreement directly or indirectly through a subscription agreement or power of attorney.

⁶⁵⁵ Philip M. Kinkaid, *Drafting Limited Liability Company Regulations and Articles: Sample Documents*, Address at The University of Texas School of Law Sponsored Conference on Current Issues in Partnerships, Limited Liability Companies, and Registered Limited Liability Partnerships (Jan. 23-24, 1992).

⁶⁵⁶ See, e.g., OHIO REV. CODE ANN. § 1705.01(J) (West 2003) ("operating agreement"); DEL. CODE ANN. tit. 6, § 18-101(7) (2013) ("limited liability company agreement").

officers and other agents to act on behalf of the LLC.⁶⁵⁷ 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.⁶⁵⁸ 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.⁶⁵⁹ 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.

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.⁶⁶⁰ The Tex. LLC Stats. provide 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).⁶⁶¹ 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 LLC Act section 2.21C or 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.⁶⁶² 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.

Members and Managers acting on behalf of an LLC should disclose that they are acting on behalf of the entity and that it is an LLC. Under common law agency principles, an agent can be personally liable on a contract made for an undisclosed or unnamed principal.⁶⁶³

The Tex. LLC Stats. contain no requirements as to the terms of Managers, but allow the Company Agreement to provide for specified terms of Managers and annual or other regularly scheduled meetings of Members.⁶⁶⁴ If the Company Agreement is silent as to the terms of Managers, the default provision is retention of the Managers. Tex. LLC Stats. allow any number

⁶⁵⁷ LLC Act §§ 2.12, 2.21; TBOC §§ 101.251-101.253.

⁶⁵⁸ LLC Act §§ 2.12, 1.02(4); TBOC § 101.302; TEX. GOV'T CODE § 311.005(2).

⁶⁵⁹ LLC Act § 2.12; *see* TBOC § 101.251.

⁶⁶⁰ TBOC § 101.252. Along the same lines, LLC Act § 2.21B provides that all officers, agents, Managers and Members of an LLC, as among themselves and the LLC, have such authority in the management of the LLC as may be provided in its Regulations or as may be determined by resolution of the Managers or, to the extent to which management is reserved to them, the Members.

⁶⁶¹ LLC Act § 2.21C; TBOC §§ 1.002(35), (37), 101.254(a).

⁶⁶² LLC Act § 2.21D; TBOC § 101.254(b).

⁶⁶³ *See Water, Waste & Land, Inc. v. Lanham*, 955 P.2d 997, 1001 (Colo. 1998).

⁶⁶⁴ *See* TBOC § 101.303.

of classes of Managers, and contains no requirement that such classes either be equal or nearly equal in number or be elected in strict rotation at successive annual meetings of Members.⁶⁶⁵

H. Fiduciary Duties. The Tex. LLC Stats. do not address specifically whether Manager or Member fiduciary duties exist or attempt to define them,⁶⁶⁶ but they implicitly recognize that these duties may exist in statutory provisions which permit them to be expanded or restricted in the Company Agreement.⁶⁶⁷ 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. 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.⁶⁶⁸ 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.⁶⁶⁹

The Tex. LLC Stats. allow 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.⁶⁷⁰ This provision of Texas law was designed,

⁶⁶⁵ See LLC Act § 2.14; TBOC § 101.307.

⁶⁶⁶ See Elizabeth M. McGeever, *Hazardous Duty? The Role of the Fiduciary in Noncorporate Structures*, 4 BUS. L. TODAY 51, 53 (Mar.–Apr.1995); Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 401 (1992) (noting that LLC statutes usually do not specify fiduciary duties of Members or Managers).

⁶⁶⁷ LLC Act § 2.20B provides that the Regulations may expand or reduce fiduciary duties as follows:

To the extent that at law or in equity, a member, manager, officer, or other person has duties (including fiduciary duties) and liabilities relating thereto to a limited liability company or to another member or manager, such duties and liabilities may be expanded or restricted by provisions in the regulations.

Similarly, TBOC § 101.401 provides:

The company agreement of a limited liability company may expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person has to the company or to a member or manager of the company.

⁶⁶⁸ See *supra* notes 317-327 and related text.

⁶⁶⁹ *Suntech Processing Sys., L.L.C. v. Sun Communications, Inc.*, 2000 WL 1780236, at *6 (Tex. App.—Dallas Dec. 5, 2000, pet. denied) (not designated for publication). In *Suntech*, a minority Member of a Texas LLC claimed that the controlling Member owed a fiduciary duty as a matter of law in connection with the winding up of operations and distribution of assets. *Id.* at *5. The Court pointed out that the Regulations expressly provided for a duty of loyalty to the LLC rather than between the Members, and, noting the absence of Texas case law on fiduciary duties of LLC Members and looking to case law regarding fiduciary duties of shareholders of a closely held corporation, held that there was no fiduciary relationship between the Members as a matter of law. *Id.* at *1.

⁶⁷⁰ See LLC Act § 2.20B; TBOC § 101.401. Prior to the effectiveness of 1997 S.B. 555 on September 1, 1997, LLC Act § 8.12 had incorporated by reference the limitation of liability afforded to corporate directors under TMCLA 1302-7.06 and thereby allowed the limitation of Manager liability by a provision in the

in the same vein as the Delaware Limited Liability Company Act (the “DLLCA”) from which it drew inspiration, to allow LLCs the flexibility to address fiduciary duties through contract principles.⁶⁷¹ Unlike the DLLCA which allows an LLC agreement to eliminate fiduciary duties,⁶⁷² the Tex. LLC Stats. only permit an LLC Company agreement to “restrict” duties.⁶⁷³

Articles (now, the Certificate of Formation) to the extent permitted for a director under TMCLA 1302-7.06. 1997 S.B. 555 deleted such incorporation by reference of TMCLA 1302-7.06 in favor of the broader authorization now in LLC Act § 2.20B.

⁶⁷¹ DEL. CODE ANN. tit. 6, § 18-1101(a)-(f) (2013).

⁶⁷² DLLCA § 18-1101(e) provides:

(e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

In re Atlas Energy Resources LLC, Consolidated 2010 WL 4273122 (Del Ch. Oct. 28, 2010), involved breach of fiduciary duty claims arising from a merger between a publicly traded LLC and its controlling unitholder. In *In re Atlas*, the Chancery Court held that an LLC agreement eliminated the traditional fiduciary duties of the LLC’s directors and officers, replacing them with a contractually-defined duty of good faith, which was not breached, but did not address the duties of the controlling unitholder, which were held to be equivalent to those of a controlling shareholder of a Delaware corporation. The Court commented that LLCs are creatures of contract designed to afford the maximum amount of freedom of contract, private ordering, and flexibility to the parties involved. One aspect of this flexibility, the Court wrote, is that parties to an LLC agreement can contractually expand, restrict, modify or fully eliminate the fiduciary duties owed by its members, subject to certain limitations, but in the absence of explicit provisions in the LLC agreement to the contrary, the traditional fiduciary duties owed by corporate directors and controlling shareholders apply in the LLC context. Because this LLC agreement did not eliminate the fiduciary duties of the controlling unitholder, it owed directly to the LLC’s minority unitholders the traditional fiduciary duties that controlling shareholders owe minority shareholders. Since the merger created a conflict between the controlling unitholder’s interest in acquiring the balance of the LLC for the lowest possible price and the minority unitholders’ interest in obtaining a high price for their units and the LLC agreement did not address this conflict of interest, the Court evaluated the merger under the entire fairness standard of review in order to assure that the controlling unitholder “has been assiduous in fulfilling those duties,” held that “plaintiffs’ allegations as to price and process, adequately suggest that the merger was not entirely fair to the public unitholders,” and denied defendants’ motion to dismiss the claim for breach of fiduciary duty by the controlling unitholder.

DLLCA § 18-1101(e) was followed in *In re Heritage Org., LLC*, 2008 WL 5215688 (Bankr. N.D. Tex. Dec. 12, 2008), which involved a bankruptcy trustee’s breach of fiduciary duty claims against former officers of a bankrupt Delaware LLC which had an LLC agreement that eliminated fiduciary duties in the following sweeping language:

The Manager shall not be required to exercise any particular standard of care, nor shall he owe any fiduciary duties to the Company or the other Members. Such excluded duties include, by way of example, not limitation, any duty of care, duty of loyalty, duty of reasonableness, duty to exercise proper business judgment, duty to make business opportunities available to the company, and any other duty which is typically imposed upon corporate officers and directors, general partners or trustees. The Manager shall not be held personally liable for any harm to the Company or the other Members resulting from any acts or omissions attributed to him. Such acts or omissions may include, by

Although Delaware law would permit the elimination of fiduciary duties in an LLC, not all Delaware LLC agreements effectively do so. In *Auriga Capital Corp. v. Gatz Properties, LLC*,⁶⁷⁴ Delaware Chancellor 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. 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.

The Delaware Supreme Court affirmed *Auriga* in *Gatz Properties, LLC v. Auriga Capital Corp.*,⁶⁷⁵ 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:

The pivotal legal issue presented on this appeal is whether Gatz owed contractually-agreed-to fiduciary duties to Peconic Bay [the LLC] and its minority investors. Resolving that issue requires us to interpret Section 15 of the LLC Agreement, which both sides agree is controlling. Section 15 pertinently provides that:

Neither the Manager nor any other Member shall be entitled to cause the Company to enter into any amendment of any of the

way of example but not limitation, any act of negligence, gross negligence, recklessness, or intentional misconduct.

Faced with this broad clause, the bankruptcy court in *Heritage* held that the defendants had no fiduciary duties to breach, and thus rejected the trustee's breach of fiduciary duty claim. *Cf. Kahn v. Portnoy*, 2008 WL 5197164 (Del. Ch. December 11, 2008) (under freedom of contract principles, fiduciary duties held to be defined, but not eliminated, by LLC agreement).

⁶⁷³ See *supra* note 667 and related text

⁶⁷⁴ 40 A.3d 839 (Del. Ch. 2012).

⁶⁷⁵ No. 148, 2012, 2012 WL 5425227 (Del. Nov. 7, 2012), *aff'g* 40 A.3d 839. See Jessica Liou, *Fiduciary Duty Bound (Part 1): "Default" Fiduciary Duties Apply in Delaware LLC's...Or Maybe They Don't*, Weil Bankruptcy Blog, Mar. 8, 2013, <http://business-finance-restructuring.weil.com/fiduciary-duties/fiduciary-duty-bound-part-1-default-fiduciary-duties-apply-in-delaware-llcs-or-maybe-they-dont/>.

Initial Affiliate Agreements which would increase the amounts paid by the Company pursuant thereto, or enter into any additional agreements with affiliates on terms and conditions which are less favorable to the Company than the terms and conditions of similar agreements which could then be entered into with arms-length third parties, without the consent of a majority of the non-affiliated Members (such majority to be deemed to be the holders of 66-2/3% of all Interests which are not held by affiliates of the person or entity that would be a party to the proposed agreement).

The Court of Chancery determined that Section 15 imposed fiduciary duties in transactions between the LLC and affiliated persons. We agree. To impose fiduciary standards of conduct as a contractual matter, there is no requirement in Delaware that an LLC agreement use magic words, such as “entire fairness” or “fiduciary duties.” Indeed, Section 15 nowhere expressly uses either of those terms. Even so, we construe its operative language as an explicit contractual assumption by the contracting parties of an obligation subjecting the manager and other members to obtain a fair price for the LLC in transactions between the LLC and affiliated persons. Viewed functionally, the quoted language is the contractual equivalent of the entire fairness equitable standard of conduct and judicial review.

We conclude that Section 15 of the LLC Agreement, by its plain language, contractually adopts the fiduciary duty standard of entire fairness, and the “fair price” obligation which inheres in that standard. Section 15 imposes that standard in cases where an LLC manager causes the LLC to engage in a conflicted transaction with an affiliate without the approval of a majority of the minority members. There having been no majority-of-the-minority approving vote in this case, the burden of establishing the fairness of the transaction fell upon Gatz. That burden Gatz could easily have avoided. If (counterfactually) Gatz had conditioned the transaction upon the approval of an informed majority of the nonaffiliated members, the sale of Peconic Bay would not have been subject to, or reviewed under, the contracted-for entire fairness standard.

* * *

Entire fairness review normally encompasses two prongs, fair dealing and fair price. “However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.” In this case, given the language of Section 15 which speaks only in terms of fair price, the Court of Chancery formally applied only the fair price prong. But, in doing so that court also properly considered the “fairness” of how Gatz dealt with the minority “because the extent to which the process leading to the self-dealing either replicated or deviated from the behavior one would expect in an arms-length deal bears importantly on the price determination.” The court further held that “in order to take cover under the

contractual safe harbor of Section 15, Gatz bears the burden to show that he paid a fair price to acquire [the LLC].

* * *

Although the trial court's adjudication subjects Gatz to liability under Section 15 of the LLC Agreement, another provision, Section 16, permits both exculpation and indemnification of Peconic Bay's manager in specified circumstances. Gatz, however, did not cause those circumstances to come about. Having failed to satisfy the criteria of Section 16, Gatz was not eligible for exculpation or indemnification, and the Court of Chancery properly so held.

Section 16 of the LLC Agreement pertinently provides:

No Covered Person [defined to include, among others, the members, manager, and officers and the employees] shall be liable to the Company, [or] any other Covered Person or any other person or entity who has an interest in the Company for any loss, damage or claim incurred by reason of any act or omission performed or omitted by such Covered Person in good faith in connection with the formation of the Company or on behalf of the Company and in a manner reasonably believed to be within the scope of the authority conferred on such Covered Person by this Agreement, except that a Covered Person shall be liable for any such loss, damage or claim incurred by reason of such Covered Person's gross negligence, willful misconduct or willful misrepresentation.

Gatz was not entitled to exculpation because the Court of Chancery properly found that he had acted in bad faith and had made willful misrepresentations in the course of breaching his contracted-for fiduciary duty. Consequently, Section 16 of the LLC Agreement provides no safe harbor.

* * *

At this point, we pause to comment on one issue that the trial court should not have reached or decided. We refer to the court's pronouncement that the Delaware Limited Liability Company Act imposes "default" fiduciary duties upon LLC managers and controllers unless the parties to the LLC Agreement contract that such duties shall not apply. Where, as here, the dispute over whether fiduciary standards apply could be decided solely by reference to the LLC Agreement, it was improvident and unnecessary for the trial court to reach out and decide, *sua sponte*, the default fiduciary duty issue as a matter of statutory construction. The trial court did so despite expressly acknowledging that the existence of fiduciary duties under the LLC Agreement was "no longer contested by the parties." For the reasons next discussed, that court's statutory pronouncements must be regarded as dictum without any precedential value.

First, the Peconic Bay LLC Agreement explicitly and specifically addressed the “fiduciary duty issue” in Section 15, which controls this dispute. Second, no litigant asked the Court of Chancery or this Court to decide the default fiduciary duty issue as a matter of statutory law. In these circumstances we decline to express any view regarding whether default fiduciary duties apply as a matter of statutory construction. The Court of Chancery likewise should have so refrained.

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,⁶⁷⁶ the Delaware Court of Chancery “recently 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.”⁶⁷⁷

⁶⁷⁶ See *infra* note 678 and related text.

⁶⁷⁷ *Zimmerman v. Adhezion Biomedical LLC*, C.A. No. 6001-VCP, at *44 (Del. Ch. Jan. 31, 2013) (*emphasis added*), referencing *Feeley v. NHAOCG, LLC*, 2012 WL 5949209, at *8-10 (Del. Ch. Nov. 28, 2012). In *Zimmerman*, Robert Zimmerman, co-founder and former CEO of Adhezion, sued the current majority owners, alleging breach of the LLC Agreement (failure to obtain consent of the common members) and fiduciary duties (self-dealing transactions) when such majority owners caused Adhezion to enter into certain financing transactions. The majority owners denied any fundamental breach of fiduciary duty, and argued, in any event, that the LLC Agreement proscribed an applicable standard of review (the business judgment rule), which they contend they did not breach.

The Court of Chancery found that the majority owners did breach the LLC Agreement in issuing units without written consent, involving a detailed analysis of the LLC Agreement, which the Court found to be an unusually ambiguous contract. It also noted that the LLC Agreement imposed duties of good faith (to act with an objective standard of reasonableness) and enumerated specific safe harbors for intercompany dealings; and accordingly, because the Court found that (i) Zimmerman failed to show that the financing transactions were unfair to Adhezion and (ii) the financing transactions were approved in compliance with the requisite safe harbor, the Court held that the majority owners had not breached their contracted-for fiduciary duties to the company. With respect to this latter finding, the Court of Chancery specifically distinguished *Auriga*, which placed the burden of proving the fairness of the self-dealing transaction on the LLC manager (because of language in the LLC Agreement prohibited such a manager from entering into self-dealing transaction without the consent of the other managers), as opposed to the LLC Agreement in *Zimmerman*, which gave members, directors, or officers the affirmative right to engage in transactions with the company, so long as such a transaction was comparable to a third-party one. Ultimately, the Court awarded Zimmerman \$1 for his successful breach of contract claim with respect to the majority owners’ failure to obtain written consent and otherwise found that the majority owners were protected by the indemnification provisions of the LLC Agreement with respect to Zimmerman’s requests for attorneys’ fees advanced by Adhezion on behalf of the majority owners.

See also *Kelly v. Blum*, 2010 WL 629850 (Del.Ch. February 24, 2010), the Chancery Court denied motions for summary judgment, dealing with (among other things) fiduciary duties in a merger challenged by a minority Member/Manager of an LLC who was squeezed out in a merger into a sister company of the majority Member. The Court held that: (i) the claims of the minority were direct rather than derivative, (ii) the Managers and majority Members owed traditional fiduciary duties to the minority Member in the absence of any express provisions in the operating agreement to limit fiduciary duties, and (iii) the corporate parent of the majority Member and the surviving Member could be liable for aiding and abetting breaches of fiduciary duty. In so holding, the Court explained:

Though few Delaware cases deal specifically with the distinction between derivative and direct claims in the LLC context, Sections 18-1001 to 18-1004 of the Delaware Limited Liability Company Act (“LLC Act”) were modeled, in significant part, on the corporate

derivative suit. Consequently, “case law governing corporate derivative suits is equally applicable to suits on behalf of an LLC,” and I look to corporate case law to determine the proper method for distinguishing between derivative actions brought on behalf of Marconi and Kelly’s direct claims.

The distinction between the rights of an LLC and the individual rights of its members is often quite narrow. Though several early Delaware cases addressing this distinction relied largely on the “amorphous and confusing concept of ‘special injury,’” the Delaware Supreme Court expressly disavowed use of that concept in *Tooley*. In *Tooley*, the Court stated that determining whether a claim is derivative or direct depends solely upon two questions: First, “who suffered the alleged harm,” the LLC or its members, and second, “who would receive the benefit of any recovery or other remedy,” the LLC or its members, individually. In answering these questions, the Court looks to the nature of the wrong alleged, not merely at the form of words used in the complaint.

In the second count of the Complaint, Kelly claims that, by virtue of their status as Members or Managers of Marconi, Defendants Blum, Breen, Kestenbaum, MBC Investment, and MBC Lender each “owed various fiduciary duties to Kelly as the minority equity owner.” Kelly further avers that these Defendants violated their duties of loyalty and care to him by entering into a self-interested Merger on terms that were unfair to Kelly.

The basic approach of the LLC Act is to “provide members with broad discretion in drafting the [LLC] Agreement and to furnish default provisions when the members’ agreement is silent.” In the case of fiduciary duties, the LLC Act permits LLC contracting parties to expand, restrict, or eliminate duties, including fiduciary duties, owed by members and managers to each other and to the LLC. Section 18-1101(c) does not specify a statutory default provision as do other sections of the LLC Act; rather, it implies that some default fiduciary duties may exist “at law or in equity,” inviting Delaware courts to make an important policy decision and determine the default level of those duties.

Accepting that invitation, Delaware cases interpreting Section 18-1101(c) have concluded that, despite the wide latitude of freedom of contract afforded to contracting parties in the LLC context, “in the absence of a contrary provision in the LLC agreement,” LLC managers and members owe “traditional fiduciary duties of loyalty and care” to each other and to the company. Thus, unless the LLC agreement in a manager-managed LLC explicitly expands, restricts, or eliminates traditional fiduciary duties, managers owe those duties to the LLC and its members and controlling members owe those duties to minority members. Therefore, I must determine whether the 2008 LLC Agreement expanded, restricted, or eliminated the default fiduciary duties the Managers (Blum, Breen, and Kestenbaum) and controlling Members (MBC Investment and MBC Lender) owed to Kelly, and whether a breach of any existing duty would support a direct, as opposed to a derivative, claim.

In large measure, the 2008 LLC Agreement is silent on the issue of duties owed by Managers to the LLC and its Members, with the exception of Sections 7.5 and 7.9. In its entirety, Section 7.5, entitled “Duties,” states that

[t]he Board of Managers shall manage the affairs of the Company in a prudent and business-like manner and shall devote such time to the Company affairs as they shall, in their discretion exercised in good faith, determine is reasonably necessary for the conduct of such affairs.

In relevant part, Section 7.9, which limits the monetary liability of Managers, states that

[i]n carrying out their duties hereunder, the Managers shall not be liable for money damages **for breach of fiduciary duty to the Company nor to any Member** for their good faith actions or failure to act ... but

only for their own willful or fraudulent misconduct or willful breach of their contractual or **fiduciary duties** under this Agreement.

(Emphasis added).

I do not read these clauses, individually or collectively, as “explicitly disclaim[ing or limiting] the applicability of default principles of fiduciary duty.” Indeed, far from limiting such duties, Section 7.9 suggests that the parties intended traditional fiduciary duties to apply. Additionally, Section 7.5 does not limit the Managers’ duties so much as place control of Marconi’s affairs in the board of Managers, rather than the Members, allowing each Manager the discretion to determine the amount of time she must devote to running Marconi.

Because no clause in the 2008 LLC Agreement explicitly restricts or eliminates the default applicability of fiduciary duties, I find that Blum, Breen, and Kestenbaum, as Managers of Marconi, were required to treat Kelly in accordance with such traditional fiduciary duties. Furthermore, if the allegations in Kelly’s Complaint are true, then Blum, Breen, and Kestenbaum entered the Merger largely intending to profit from a “premeditated scheme to squeeze Kelly out of Marconi and seize control of the FCC license” held by Marconi—actions that support a claim for breach of the duty of loyalty. Thus, drawing reasonable inferences in Kelly’s favor, I find that his Complaint alleges sufficient facts to support his claim that the Managers breached these duties by entering into a Merger designed solely to eliminate Kelly’s interest in Marconi.

Even though Kelly alleged facts that, if true, are sufficient to show that Blum, Breen, and Kestenbaum may have breached their fiduciary duties, those Defendants still might avoid liability because the 2008 LLC Agreement contains an exculpatory provision limiting the monetary liability of Managers. Section 18-1101(e) of the LLC Act permits members, in their LLC agreement, to limit or eliminate a manager’s or member’s liability for “breach of contract and breach of duties (including fiduciary duties),” except for liability arising from a “bad faith violation of the implied contractual covenant of good faith and fair dealing.” While somewhat analogous to 8 *Del. C.* § 102(b)(7), which authorizes a corporation to adopt provisions limiting liability for a director’s breach of the duty of care, Section 18-1101(e) goes further by allowing broad exculpation of *all* liabilities for breach of fiduciary duties—including the duty of loyalty.

Here, Section 7.9 of the 2008 LLC Agreement eliminates the Managers’ monetary liability for all conduct except “willful or fraudulent misconduct or willful breach of ... contractual or fiduciary duties under this Agreement.” Although the default duties of loyalty and care remain, this provision requires more than application of a standard like entire fairness and requires that Kelly allege facts showing scienter. That is, under Section 7.9, liability attaches only where a Manager willfully breaches his fiduciary duties.

* * *

As with LLC managers, “in the absence of provisions in the LLC agreement explicitly disclaiming the applicability of default principles of fiduciary duty,” controlling members in a manager-managed LLC owe minority members “the traditional fiduciary duties” that controlling shareholders owe minority shareholders. Controlling shareholders—typically defined as shareholders who have voting power to elect directors, cause a break-up of the company, merge the company with another, or otherwise materially alter the nature of the corporation and the public shareholder’s interests—owe certain fiduciary duties to minority shareholders. Specifically, and very pertinently to this case, such fiduciary duties include the duty “not to cause the corporation to effect a transaction that would benefit the fiduciary at the expense of the minority stockholders.”

* * *

Further, the DLLCA is proposed to be amended to provide that unless modified in an LLC's governing documents, common law fiduciary duties apply to LLCs.⁶⁷⁸

The DLCCA 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).⁶⁷⁹ The DLCCA does not have any provision which itself creates or negates

Because the 2008 LLC Agreement is silent as to what duties controlling members owe minority members, I find that MBC Investment and MBC Lender owed Kelly traditional fiduciary duties, including, among others, the duty not to cause Marconi to enter a transaction that would benefit the controlling Members at the expense of Kelly, Marconi's minority Member. I also find that Kelly has stated facts that, if true, are sufficient to show that MBC Investment and MBC Lender did, with the aid of their appointed Managers, effect the Merger in order to benefit themselves at the expense of Kelly. Thus, Kelly has stated a direct claim that is not subject to any exculpation provision in the Agreement, and I deny Defendants' motion to dismiss Count II of Kelly's Complaint as to MBC Investment and MBC Lender.

⁶⁷⁸ DLLCA § 18-1104 is proposed to be amended as follows: “In any case not provided for in this chapter, the rules of law and equity, including the rules of law and equity relating to fiduciary duties and the law merchant, shall govern.” [proposed new language underlined]. The synopsis accompanying the proposed amendment explains it as follows:

The amendment to Section 18-1104 confirms that in some circumstances fiduciary duties not explicitly provided for in the limited liability company agreement apply. For example, a manager of a manager-managed limited liability company would ordinarily have fiduciary duties even in the absence of a provision in the limited liability company agreement establishing such duties. Section 18-1101(c) continues to provide that such duties may be expanded, restricted or eliminated by the limited liability company agreement.

If adopted, this section would become effective August 1, 2013. For the text of this and proposed amendments to the DLLCA, see *Proposed LLC Act Amendments* at www.practicallaw.com/4-525-3603.

⁶⁷⁹ In *Fisk Ventures, LLC v. Segal*, 2008 WL 1961156 (Del. Ch. 2008), judgment aff'd 984 A.2d 124 (Del. 2009), Delaware Chancellor William Chandler wrote that LLCs are creatures of contract and that a prerequisite to any breach of contract analysis is to determine if there is a *duty* in the document that has been breached. The Chancellor quoted in footnote 34 Chief Justice Steele's article entitled *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 Del. J. Corp. L. 1, 4 (2007) (“Courts should recognize the parties' freedom of choice exercised by contract and should not superimpose an overlay of common law fiduciary duties...”), and found no provision in the LLC Agreement at issue that: “create[d] a code of conduct for all members; on the contrary, most of those sections expressly claim to limit or waive liability.” The Chancellor wrote:

There is no basis in the language of the LLC Agreement for Segal's contention that all members were bound by a code of conduct, but, even if there were, this Court could not enforce such a code because there is no limit whatsoever to its applicability”.

In addressing the breach of fiduciary duty claims asserted by plaintiff, the Chancellor focused on DLLCA § 18-1101(c) which allows for the complete elimination of all fiduciary duties in an LLC agreement. The Court then read the subject LLC Agreement to eliminate fiduciary duties because it flatly stated that:

No Member shall have any duty to any Member of the Company except as expressly set forth herein or in other written agreements. No Member, Representative, or Officer of the Company shall be liable to the Company or to any Member for any loss or damage sustained by the Company or to any Member, unless the loss or damage shall have been the result of gross negligence, fraud or intentional misconduct by the Member, Representative, or Officer in question....

Because the foregoing LLC Agreement exception for gross negligence, fraud or intentional misconduct did not create a fiduciary duty and the LLC Agreement did not otherwise expressly articulate fiduciary obligations, the foregoing LLC Agreement provision was held to be sufficient to eliminate defendant's fiduciary duties.

The Chancellor considered and disposed of plaintiff's "implied covenant of good faith and fair dealing" claim as follows:

Every contract contains an implied covenant of good faith and fair dealing that "requires a 'party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits' of the bargain." Although occasionally described in broad terms, the implied covenant is not a panacea for the disgruntled litigant. In fact, it is clear that "a court cannot and should not use the implied covenant of good faith and fair dealing to fill a gap in a contract with an implied term unless it is clear from the contract that the parties would have agreed to that term had they thought to negotiate the matter." Only rarely invoked successfully, the implied covenant of good faith and fair dealing protects the spirit of what was *actually bargained and negotiated for* in the contract. Moreover, because the implied covenant is, by definition, *implied*, and because it protects the *spirit* of the agreement rather than the form, it cannot be invoked where the contract itself expressly covers the subject at issue.

Here, Segal argues that Fisk, Rose and Freund breached the implied covenant of good faith and fair dealing by frustrating or blocking the financing opportunities proposed by Segal. However, neither the LLC Agreement nor any other contract endowed him with the right to unilaterally decide what fundraising or financing opportunities the Company should pursue, and his argument is "another in a long line of cases in which a plaintiff has tried, unsuccessfully, to argue that the implied covenant grants [him] a substantive right that [he] did not extract during negotiation." Moreover, the LLC Agreement *does* address the subject of financing, and it specifically requires the approval of 75% of the Board. Implicit in such a requirement is the right of the Class B Board representatives to disapprove of and therefore block Segal's proposals. As this Court has previously noted, "[t]he mere exercise of one's contractual rights, without more, cannot constitute ... a breach [of the implied covenant of good faith and fair dealing]." Negotiating forcefully and within the bounds of rights granted by the LLC agreement does not translate to a breach of the implied covenant on the part of the Class B members.

In *Related Westpac LLC v. JER Snowmass LLC*, 2010 WL 2929708 (Del. Ch. July 23, 2010), the Delaware Chancery Court held that one Member of an LLC could not force another to advance funds in a joint redevelopment project and consent to related projects, finding that the partner's refusal was permitted by the project's operating agreements. In so deciding, the Court refused to find that a condition of reasonableness to the right to refuse consent:

In this decision, I dismiss the complaint. Under the operating agreements that govern the LLCs, the defendant member could not unreasonably withhold its consent to certain decisions. But as to the type of decisions at issue in this case — so-called "material actions" — the defendant member was not subject to such a constraint and had contractually bargained to remain free to give or deny its consent if that was in its own commercial self-interest. Here, the plaintiff operating member seeks to have the court impose a contractual reasonableness overlay on a contract that is clearly inconsistent with the parties' bargain. Delaware law respects contractual freedom and requires parties like the operating member to adhere to the contracts they freely enter. The operating agreements here preclude the relief the operating member seeks, including its attempt to end-run the operating agreements by arguing that the defendant member had a fiduciary duty to act reasonably in granting consent. Under the plain terms of the operating agreements, the defendant member had bargained for the right to give consents to decisions involving material actions or not, as its own commercial interests dictated.

Member or Manager fiduciary duties, but instead allows modification or elimination of fiduciary duties⁶⁸⁰ by an LLC agreement,⁶⁸¹ but does not allow the elimination of “the implied contractual covenant of good faith and fair dealing.”⁶⁸²

Having bargained for that freedom and gained that concession from the operating member, the defendant member is entitled to the benefit of its bargain and the operating member cannot attempt to have the court write in a reasonableness condition that the operating member gave up. The words “not unreasonably withheld” are well known and appear in other sections of the operating agreements. They do not qualify the defendant member’s right to deny consent to major decisions involving a material action.

Likewise, the operating agreements clearly state the sole remedy the operating member has if the defendant member fails to meet a capital call. The operating member again seeks to have this court impose a remedy inconsistent with the plain terms of the operating agreements. This court cannot play such a role, and the operating member’s claims relating to the capital call are dismissed because they are inconsistent with the operating agreements.

⁶⁸⁰ Section 18-1101 of the Delaware Limited Liability Company Act provides as follows:

18-1101 CONSTRUCTION AND APPLICATION OF CHAPTER AND LIMITED LIABILITY COMPANY AGREEMENT.

(a) The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.

(b) It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.

(c) To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member’s or manager’s or other person’s duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

(d) Unless otherwise provided in a limited liability company agreement, a member or manager or other person shall not be liable to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement for breach of fiduciary duty for the member’s or manager’s or other person’s good faith reliance on the provisions of the limited liability company agreement.

(e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

(f) Unless the context otherwise requires, as used herein, the singular shall include the plural and the plural may refer to only the singular. The use of any gender shall be applicable to all genders. The captions contained herein are for purposes of convenience only and shall not control or affect the construction of this chapter.

⁶⁸¹ See Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 25 (2007), in which Delaware Supreme Court Chief Justice Steele argues that parties forming limited liability companies should be free to adopt or reject some or all of the fiduciary duties recognized at common law, that courts should look to the parties’ agreement and apply

a contractual analysis, rather than analogizing to traditional notions of corporate governance, in LLC fiduciary duty cases, and that:

Delaware's Limited Liability Company Act does not specify the duties owed by a member or manager. It does, however, like the Limited Partnership Act, provide for a default position "to the extent, at law or in equity" limited liability companies have "duties (including fiduciary duties)." These duties, in turn, "may be expanded or restricted or eliminated" in the agreement, provided that the "agreement may not eliminate the implied contractual covenant of good faith and fair dealing."

The same issues and considerations that arise in limited partnerships arise in governance disputes in limited liability companies. There is an assumed default to traditional corporate governance fiduciary duties where the agreement is silent, or at least not inconsistent with the common law fiduciary duties. Lack of clarity in the agreements on this point may confuse the court and cause it to focus improperly when addressing the conduct complained of in a derivative action or in an action to interpret, apply, or enforce the terms of the limited liability company agreement. Predictably, but not necessarily correctly, Delaware courts will gravitate toward a focus on the parties' status relationship and not their contractual relationship in the search for a legal and equitable resolution of a dispute unless the agreement explicitly compels the court to look to its terms and not to the common law fiduciary gloss.

See supra note 531 and related text regarding Chief Justice Steele's views in respect of fiduciary duties in the limited partnership context.

682

Id. See RESTATEMENT (SECOND) OF CONTRACTS and related Comment which provide:

§ 205. Duty of Good Faith and Fair Dealing

Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.

Comment:

a. Meanings of "good faith." Good faith is defined in Uniform Commercial Code § 1-201(19) as "honesty in fact in the conduct or transaction concerned." "In the case of a merchant" Uniform Commercial Code § 2-103(1)(b) provides that good faith means "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." The phrase "good faith" is used in a variety of contexts, and its meaning varies somewhat with the context. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving "bad faith" because they violate community standards of decency, fairness or reasonableness. The appropriate remedy for a breach of the duty of good faith also varies with the circumstances.

b. Good faith purchase. In many situations a good faith purchaser of property for value can acquire better rights in the property than his transferor had. See, e.g., § 342. In this context "good faith" focuses on the honesty of the purchaser, as distinguished from his care or negligence. Particularly in the law of negotiable instruments inquiry may be limited to "good faith" under what has been called "the rule of the pure heart and the empty head." When diligence or inquiry is a condition of the purchaser's right, it is said that good faith is not enough. This focus on honesty is appropriate to cases of good faith purchase; it is less so in cases of good faith performance.

c. Good faith in negotiation. This Section, like Uniform Commercial Code § 1-203, does not deal with good faith in the formation of a contract. Bad faith in negotiation, although not within the scope of this Section, may be subject to sanctions. Particular forms of bad faith in bargaining are the subjects of rules as to capacity to contract, mutual assent and consideration and of rules as to invalidating causes such as fraud and duress. See, for example, §§ 90 and 208. Moreover, remedies for bad faith in

the absence of agreement are found in the law of torts or restitution. For examples of a statutory duty to bargain in good faith, see, e.g., National Labor Relations Act § 8(d) and the federal Truth in Lending Act. In cases of negotiation for modification of an existing contractual relationship, the rule stated in this Section may overlap with more specific rules requiring negotiation in good faith. See §§ 73, 89; Uniform Commercial Code § 2-209 and Comment.

d. Good faith performance. Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance.

e. Good faith in enforcement. The obligation of good faith and fair dealing extends to the assertion, settlement and litigation of contract claims and defenses. See, e.g., §§ 73, 89. The obligation is violated by dishonest conduct such as conjuring up a pretended dispute, asserting an interpretation contrary to one's own understanding, or falsification of facts. It also extends to dealing which is candid but unfair, such as taking advantage of the necessitous circumstances of the other party to extort a modification of a contract for the sale of goods without legitimate commercial reason. See Uniform Commercial Code § 2-209, Comment 2. Other types of violation have been recognized in judicial decisions: harassing demands for assurances of performance, rejection of performance for unstated reasons, willful failure to mitigate damages, and abuse of a power to determine compliance or to terminate the contract. For a statutory duty of good faith in termination, see the federal Automobile Dealer's Day in Court Act, 15 U.S.C. §§ 1221-25 (1976).

In *Kuroda v. SPJS Holdings, L.L.C.*, 971 A.2d 872 (Del. Ch. April 15, 2009), a dispute among members of an LLC, the Chancellor dismissed plaintiff's allegations that the defendant members had breached the implied covenant of good faith and fair dealing by failing to pay him monies due, disparagements and threats because plaintiff had "failed to articulate a contractual benefit he was denied as a result of defendants' breach of an implied provision in the contract," and explained:

The implied covenant of good faith and fair dealing inheres in every contract and "requires 'a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits' of the bargain." The implied covenant cannot be invoked to override the express terms of the contract. Moreover, rather than constituting a free floating duty imposed on a contracting party, the implied covenant can only be used conservatively "to ensure the parties' 'reasonable expectations' are fulfilled." Thus, to state a claim for breach of the implied covenant, Kuroda "must allege a specific implied contractual obligation, a breach of that obligation by the defendant, and resulting damage to the plaintiff." General allegations of bad faith conduct are not sufficient. Rather, the plaintiff must allege a specific implied contractual obligation and allege how the violation of that obligation denied the plaintiff the fruits of the contract. Consistent with its narrow purpose, the implied covenant is only rarely invoked successfully.

This contractual duty of good faith and fair dealing is to be contrasted with the fiduciary duty of good faith, which is a component of the common law fiduciary duty of loyalty. See *Stone v. Ritter*, 911 A.2d 362 (Del. 2006); see *supra* notes 95-100. DLLCA §§ 18-1101(a)-(f) are counterparts of, and virtually identical to, §§

The contractual elimination or restriction of fiduciary duties is an important developing issue in the context of fiduciary duties in LLC's for both Delaware and Texas entities. Since the Tex. LLC Stats. only permit an LLC Company Agreement to "restrict" duties, fiduciaries in Texas could be exposed to stricter default duties if Texas courts follow the emerging Delaware trend of finding default LLC fiduciary duties. As discussed above, the Legislatures in both Texas⁶⁸³ and Delaware⁶⁸⁴ are considering legislation that would deal with contractual modification of fiduciary duties or liabilities of Members and Managers.

Although the Tex. LLC Stats., unlike their Delaware counterpart, do not include provisions that expressly emphasize the principles of freedom of contract and enforceability of LLC Company Agreements that expand, restrict or eliminate liability for breach of fiduciary duties, the legislative history and scope of LLC Act section 2.20B, the precursor to TBOC section 101.401, indicate that there may be more latitude to exculpate Managers and Members for conduct that would otherwise breach a fiduciary duty under the Tex. LLC Stats. than under provisions of the TBOC and the TBCA relating specifically to corporations.⁶⁸⁵ Provisions in

17-1101(a)-(f) of the Delaware Revised Limited Partnership Act. See DEL. CODE ANN. tit. 6, § 17-1101 (2009). Thus, Delaware cases regarding contractual limitation of partner fiduciary duties should be helpful in the LLC context.

⁶⁸³ C.S.H.B. No. 1929 by Oliveira would amend TBOC § 7.001(d) to read as follows:

(d) The liability of a governing person may be limited or eliminated ~~restricted~~:

(1) in a general partnership by its partnership agreement to the same extent Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent permitted under Chapter 152;

(2) in a limited partnership by its partnership agreement to the same extent Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent permitted under Chapter 153 and, to the extent applicable to limited partnerships, Chapter 152; and

(3) in a limited liability company by its certificate of formation or company agreement to the same extent Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent permitted under Section 101.401.

See supra note 22.

⁶⁸⁴ *See supra* note 678.

⁶⁸⁵ In Texas a common-law duty of good faith and fair dealing does not exist in all contractual relationships. *Blackmon-Dunda v. Mary Kay, Inc.*, 2009 WL 866214 (Tex.App.-Dallas April 1, 2009, pet. denied). Rather, the duty arises only when a contract creates or governs a special relationship between the parties. *Subaru of Am. v. David McDavid Nissan*, 84 S.W.3d 212, 225 (Tex. 2002). 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 (*see Arnold v. Nat'l County Mut. Fire Ins. Co.*, 725 S.W.2d 165, 167 (Tex.1987)). The elements which make a relationship special are absent in the relationship between an employer and an employee. *See City of Midland v. O'Bryant*, 18 S.W.3d 209, 215 (Tex. 2000). 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

Company Agreements purporting to limit fiduciary duties need to be explicit and conspicuous as LLC coyness can lead to unenforceability.⁶⁸⁶ A provision which purports to limit fiduciary duties in the LLC context “to the maximum extent permitted by the laws in effect at the effective date of this Company Agreement, as such Agreement may be amended from time to time” probably is not adequate.

Persons who control Members can be held responsible for fiduciary duty breaches of the Members.⁶⁸⁷ A legal claim exists in some jurisdictions for aiding and abetting a breach of fiduciary duty, whether arising under statute, contract, common law or otherwise.⁶⁸⁸

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 Tex. LLC Stats. *See supra* notes 438 and 530.

⁶⁸⁶ *Solar Cells, Inc. v. True N. Partners, LLC*, No. CIV.A.19477, 2002 WL 749163, at *4 (Del. Ch. Apr. 25, 2002). In *Solar Cells*, Chancellor Chandler enjoined the merger of an LLC with an affiliate of the controlling owner on the basis of the Delaware “entire fairness” doctrine notwithstanding an operating agreement section providing in relevant part as follows:

Solar Cells and [First Solar] acknowledge that the True North Managers have fiduciary obligations to both [First Solar] and to True North, which fiduciary obligations may, because of the ability of the True North Managers to control [First Solar] and its business, create a conflict of interest or a potential conflict of interest for the True North Managers. Both [First Solar] and Solar Cells hereby waive any such conflict of interest or potential conflict of interest and agree that neither True North nor any True North Manager shall have any liability to [First Solar] or to Solar Cells with respect to any such conflict of interest or potential conflict of interest, provided that the True North managers have acted in a manner which they believe in good faith to be in the best interest of [First Solar].

Chancellor Chandler noted that the above clause purports to limit liability stemming from any conflict of interest, but that Solar Cells had not requested that the Court impose liability on the individual defendants; rather it was only seeking to enjoin the proposed merger. Therefore, exculpation for personal liability would have no bearing on whether the proposed merger was inequitable and should be enjoined. Further, Chancellor Chandler wrote that “even if waiver of liability for engaging in conflicting interest transactions is contracted for, that does not mean that there is a waiver of all fiduciary duties [for the above quoted provision] expressly states that the True North Managers must act in ‘good faith.’”

Noting that the LLC was in financial distress and that the owners had been negotiating unsuccessfully to develop a mutually acceptable recapitalization, the Chancellor found that the managers appointed by the controlling owners appeared not to have acted in good faith when they had adopted the challenged plan of merger by written consent without notice to the minority managers. Chancellor Chandler commented:

The fact that the Operating Agreement permits action by written consent of a majority of the Managers and permits interested transactions free from personal liability does not give a fiduciary free reign to approve any transaction he sees fit regardless of the impact on those to whom he owes a fiduciary duty.

⁶⁸⁷ In *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, 2009 WL 1124451 (Del.Ch. April 20, 2009), Delaware Vice Chancellor Strine wrote that “in the absence of a contrary provision in the LLC agreement, the manager of an LLC owes the traditional fiduciary duties of loyalty and care to the members of the LLC,” and held that LLC agreement provisions that “Members shall have the same duties and obligations to each other that members of a limited liability company formed under the Delaware Act have to each other” and “except for any duties imposed by this Agreement . . . each Member shall owe no duty of any kind towards the Company or the other Members in performing its duties and exercising its rights hereunder or otherwise” had the effect of leaving in place the traditional Delaware common law fiduciary duties. The Vice Chancellor then summarized those duties as follows in footnote 33:

The Tex. LLC Stats., which are based on TBCA article 2.35-1, provide that, unless the articles of organization, certificate of formation, Regulations or Company Agreement provide 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

(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.⁶⁸⁹

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

The Delaware LLC Act is silent on what fiduciary duties members of an LLC owe each other, leaving the matter to be developed by the common law. The LLC cases have generally, in the absence of provisions in the LLC agreement explicitly disclaiming the applicability of default principles of fiduciary duty, treated LLC members as owing each other the traditional fiduciary duties that directors owe a corporation. Moreover, when addressing an LLC case and lacking authority interpreting the LLC Act, this court often looks for help by analogy to the law of limited partnerships. In the limited partnership context, it has been established that “[a]bsent a contrary provision in the partnership agreement, the general partner of a Delaware limited partnership owes the traditional fiduciary duties of loyalty and care to the Partnership and its partners.” (Citations omitted)

The court then held the owner and manager of the LLC personally liable for the fiduciary duty breaches of the LLC's managing member.

See also In re USACafes, L.P. Litigation, 600 A.2d 43, 48 (Del. Ch. 1991); *Carson v. Lynch Multimedia Corp.*, 123 F. Supp. 2d 1254, 1264 (D. Kan. 2000).

⁶⁸⁸ *Fitzgerald v. Cantor*, No. CIV.A.16297-NC, 1999 WL 182573, at *1 (Del. Ch. Mar. 25, 1999) (holding that the elements of a claim for aiding and abetting a breach of fiduciary duty are: (1) the existence of a fiduciary relationship; (2) the fiduciary breached its duty; (3) a defendant, who is not a fiduciary, knowingly participated in a breach; and (4) damaged to the plaintiff resulted from the concerted action of the fiduciary and the non-fiduciary).

⁶⁸⁹ LLC Act § 2.17; TBOC § 101.255 as amended in the 2009 Legislative Session by 2009 S.B. 1442 § 44.

in the name of the Members. In such a situation, the Members would likely have fiduciary duties analogous to partners in a general partnership.⁶⁹⁰

In reviewing and analyzing the Delaware holdings in *Auriga* and *Gatz*, a recent article from Business Law Today published by the American Bar Association (the “*ABA Article*”) offers specific advice for drafters of LLC Agreements with respect to modifying the fiduciary duties which may now be implied by law.⁶⁹¹ To dispense with the unpredictability of such implications, the ABA Article suggests specific provisions and strategies for three types of common LLC situations: (1) LLCs as private equity/hedge funds, (2) LLCs as joint ventures/multimember LLCs, and (3) LLCs in structured finance transactions, as discussed below.

(1) Private Equity/Hedge Funds. In LLC hedge or private equity funds, a Manager may owe fiduciary duties to the LLC fund and the investor Members; however, the Manager typically also manages other similarly situated funds, creating an inherent conflict of interest. Accordingly, the ABA Article recommends including unambiguous provisions modifying or eliminating fiduciary duties in the LLC agreement of such a fund to permit Managers to more effectively make decisions without the fear of a breach of fiduciary duty claim affecting each action. To do so, drafters could include a provision in the LLC agreement that explicitly eliminates all fiduciary duties for Managers and its affiliates, although a downside to such an “all or nothing” approach is that it may cause potential investors to question the loyalty of such conflicted Managers and balk. A next option would be to provide that default principles of fiduciary duties would not be applicable to certain actions of the Managers which would be subject to a “sole discretion” standard.⁶⁹² Another option to curtail the application of default fiduciary duties would be to provide for advisory committee approval of Managers’ actions, invoking a review mechanic similar to that of a “special committee” in the corporate context.⁶⁹³ Finally, drafters could specifically authorize certain relationships or transactions they know to be potentially problematic but acceptable for the LLC in advance, notwithstanding any fiduciary duties that may exist. Calling out specific situations where fiduciary duty conflicts tend to arise may be particularly helpful where broader modifications or the outright elimination of fiduciary duties are not feasible in a particular fund.⁶⁹⁴

⁶⁹⁰ *Id.*; see TRPA § 4.04; see also TBOC § 152.204.

⁶⁹¹ Altman, Paul, Elisa Erlenbach Maas and Michael P. Maxwell, *Eliminating Fiduciary Duty Uncertainty: The Benefits of Effectively Modifying Fiduciary Duties in Delaware LLC Agreements*, Business Law Today, February 22, 2013, available at <http://apps.americanbar.org/buslaw/blt/content/2013/02/article-05-altman.shtml>.

⁶⁹² Such a “sole discretion” standard should be well defined in a manner that precludes application of traditional fiduciary duties. *Id.*

⁶⁹³ If appropriately drafted, such a structure would permit Managers to contractually “cleanse” interested transactions and avoid becoming subject to the more strict entire fairness review. *Id.* Cf. *Gerber v. EPE Holdings, infra* note 532, regarding the use of such a committee in the context of a limited partnership.

⁶⁹⁴ *Id.*

(2) Joint Ventures; Multimember LLCs. Because of the many advantages of the LLC structure, more joint ventures, start-up companies, large and small businesses, and even large publicly held companies are being formed as LLCs. In these multimember LLC structures, there are a number of factors to consider in the fiduciary duty context, including the duration of any duties, Manager and non-Manager duties, duties amongst the LLC's Members, and potential conflicts of interest. In order to memorialize their desired level of fiduciary duty commitments, parties to a multimember LLC could seek to avoid the uncertainty of default duties and clearly delineate each person's obligations to the LLC and each other. For example, in the context of potential conflicts of interest, parties to a multimember LLC agreement could seek to avoid the application of the corporate opportunity doctrine by including specific provisions on what the business of the LLC will likely be, what it will seek to accomplish, and what (if any) opportunities the Members and Managers will be able to pursue without having to present them to the LLC first (or at all).⁶⁹⁵ Multimember LLCs could also seek to modify or eliminate fiduciary duties by contract in order to provide flexibility and certainty for Managers and Members making decisions in a management capacity for the LLC. In publicly traded LLCs with many Members, the number of potential plaintiffs in a fiduciary duty-gone-wrong claim can be magnified, and accordingly, a well-reasoned LLC agreement with appropriate advance fiduciary duty modifications is of paramount importance. The ABA Article points out that the means of effecting such modifications in the publicly traded LLC arena can vary – for example, an LLC Agreement could establish a “special approval” process for potential conflicted transactions such that a Manager of an LLC and its affiliates could rebut any claim for breach of fiduciary duty simply by following a proscribed approval process.⁶⁹⁶

(3) Structured Finance. Fiduciary duties can also be modified in structured finance transactions involving the use of an LLC established to own specific assets (“*SPEs*”). SPEs must follow specific guidelines, including having an individual with no relationship to the parent Member designated as an “independent Manager,” who must approve any material actions of the LLC. This relationship carries special fiduciary duty considerations. For example, in a bankruptcy situation, lenders and credit agencies will often require that the fiduciary duties in the SPE's LLC agreement be modified such that independent Manager must take into account the interest not only of the SPE and the SPE's parent Member, but also the SPE's creditors with respect to its interest in the SPE when deciding to approve a material action.⁶⁹⁷ Because the creditors of an SPE may be prejudiced by a voluntary bankruptcy filing of the SPE, an independent Manager who also owes fiduciary duties to the SPE's creditors can make the SPE more attractive to future debt investors.

The alternatives discussed above are but a few in the evolving world of provisions that are emerging in LLC agreements in the light of the increasing likelihood that courts will imply certain fiduciary duties to Managers and Members of an LLC in the absence of contrary

⁶⁹⁵ *Id.*

⁶⁹⁶ *Id.*

⁶⁹⁷ *Id.*

language in the LLC agreement. Drafters have the opportunity to consider and contract around thorny issues such as conflicts of interest, approval processes for material actions, and other highly-litigated matters in the LLC agreement rather than waiting for the courts to impose a potentially undesirable standard.

I. Indemnification. Under the Tex. LLC Stats., an LLC may 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.⁶⁹⁸ The restrictions on indemnification applicable to regular corporations are not applicable to LLCs.⁶⁹⁹ This approach is similar to the approach taken under Delaware law, but could be subject to public policy limitations.⁷⁰⁰ In any event, this change increases the importance of having long form indemnification 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.

J. Capital Contributions. 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.⁷⁰¹ The Company Agreement ordinarily would contain provisions relative to capital accounts and the allocation of profits and losses comparable to those in a limited partnership agreement.

K. Allocation of Profits and Losses; Distributions. 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 Agreement.⁷⁰² If the Company Agreement does not otherwise provide, allocations and distributions are made on the basis of the agreed value of the

⁶⁹⁸ LLC Act § 2.20A; TBOC § 101.402.

⁶⁹⁹ See generally Chapter 8 of the TBOC, specifically § 8.002(a).

⁷⁰⁰ Cf. DEL. CODE ANN. tit. 6, § 18-108 (1999 & Supp. 2002) (providing that an LLC may, and shall have the power to, indemnify and hold harmless Members, Managers, and other persons from and against any and all claims).

⁷⁰¹ LLC Act § 5.01; TBOC § 1.002(9). LLC Act § 5.02 and TBOC §§ 101.052 and 101.151 provide that written obligations to make contributions are enforceable, except to the extent otherwise provided in the Articles or Regulations (or Certificate of Formation or Company Agreement, as appropriate), and LLC Act § 4.07 and TBOC § 101.111(b) provide that an obligation to make a contribution will survive the assignment of the membership interest. LLC Act § 5.02 and TBOC § 101.156 provide that a conditional obligation to make a contribution to an LLC, which includes contributions payable upon a discretionary call prior to the time the call occurs, must be in writing and signed by the Member, and may not be enforced unless the conditions of the obligation have been satisfied or waived.

⁷⁰² LLC Act §§ 5.02-1, 5.03; TBOC §§ 101.052, 101.201. A new Subchapter M was added to TBOC Chapter 101 in the 2009 Legislative Session by 2009 S.B. 1442 § 45 to permit LLCs to establish series of members, managers, membership interests or assets to which different assets and liabilities may be allocated. Through appropriate provisions in the Company Agreement and Certificate of Formation, the assets of one series could be isolated from the liabilities attributable to a different series.

contributions made by each Member.⁷⁰³ A Member is not entitled to receive distributions from an LLC prior to its winding up unless specified in the Company Agreement if the LLC is governed by the TBOC.⁷⁰⁴ 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.⁷⁰⁵ A Member who receives a distribution that is not permitted under the preceding sentence has no liability to return the distribution under the LLC Act unless the Member knew that the distribution was prohibited.⁷⁰⁶ 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.⁷⁰⁷

L. Owner Limited Liability Issues. The Tex. LLC Stats. provide 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.⁷⁰⁸ Members may participate in the management of

⁷⁰³ LLC Act §§ 5.02-1, 5.03; TBOC §§ 101.052, 101.201.

⁷⁰⁴ TBOC § 101.204 provides this as a new default rule, subject to contrary agreement under § 101.052. The older LLC Act, however, simply provides that Members are entitled to pre-winding up distributions in accordance with the Articles of Incorporation. LLC Act § 5.04.

⁷⁰⁵ LLC Act § 5.09A; TBOC § 101.206.

⁷⁰⁶ LLC Act § 5.09B; TBOC § 101.206(d).

⁷⁰⁷ TBOC § 101.206(f) as amended in 2009 Legislative Session by 2009 S.B. 1442 § 41. *See infra* Appendix D.

⁷⁰⁸ LLC Act §§ 4.03, 5.02A; TBOC §§ 101.114; 101.151. LLC Act § 4.03 provides as follows:

Art. 4.03. LIABILITY TO THIRD PARTIES. A. Except as and to the extent the regulations specifically provide otherwise, a member or manager is not liable for the debts, obligations or liabilities of a limited liability company including under a judgment, decree, or order of a court.

B. Transaction of business outside state. It is the intention of the legislature by the enactment of this Act that the legal existence of limited liability companies formed under this Act be recognized beyond the limits of this state and that, subject to any reasonable registration requirements, any such limited liability company transacting business outside this state be granted the protection of full faith and credit under Section 1 of Article IV of the Constitution of the United States.

C. Parties to actions. A member of a limited liability company is not a proper party to proceedings by or against a limited liability company, except where the object is to enforce a member's right against or liability to the limited liability company.

(emphasis added)

TBOC § 101.114 provides for substantially the same protection of Members and Managers as LLC Act § 4.03A. *See infra* notes 894-920 and related text regarding uncertainties as to the extent to which this statutory limitation of liability will be recognized in other states.

The legislative history of the LLC Act mirrors the clear statutory statement that members and managers of an LLC are not to be personally liable for the obligations of the LLC (whether arising in tort or contract) by virtue of being a member or manager:

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

the LLC without forfeiting this liability shield,⁷⁰⁹ but may be liable for their own torts.⁷¹⁰ 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 this issue is not settled.⁷¹¹

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.

(emphasis added)

The clear and unequivocal limitation of personal liability wording of LLC Act § 4.03A is to be contrasted with the more complicated and narrow wording of TBCA art. 2.21, which evolved as the Legislature attempted to drive a stake through the heart of *Castleberry v. Branscum*, 721 S.W.2d 270 (Tex. 1986) and its progeny. If the Bar Committee or the Legislature had conceived that the case law which had evolved in the corporate context would be applicable to LLCs, the wording of the LLC Act would have been different and might have mirrored that of the TBCA (which was already in place when the LLC Act was drafted). Intending that corporate veil piercing principles not be applicable to LLCs, and to prevent LLCs from being infected with the principles of *Castleberry v. Branscum*, which were considered inappropriate for LLCs, the Bar Committee and the Legislature opted for a simple, expansive and unequivocal statement that members and managers of LLCs do not have liability for any LLC obligations.

⁷⁰⁹ The LLC Act does not contain any provision comparable to TRLPA § 3.03 or TBOC § 153.102, which make a limited partner liable for partnership obligations under certain circumstances if “the limited partner participates in the control of the business.”

⁷¹⁰ Even though corporate veil piercing theories should not be applicable to Texas LLCs, parties dealing with an LLC are not without remedies against those responsible for the actions of the entity in appropriate situations. In contract situations, persons dealing with an LLC can condition their doing business with the LLC on (i) an LLC including in its Regulations or Operating Agreement provisions for the personal liability of Members or Managers in specified circumstances or (ii) Members or Managers personally guaranteeing obligations of the LLC. In the tort context, a Member or Manager individually may be a direct tortfeasor and liable under traditional tort law theories for his own conduct. See *Walker v. Anderson*, 232 S.W.3d 899 (Tex. App.—Dallas 2007, no pet.); *Shapolsky v. Brewton*, 56 S.W.3d 120, 133 (Tex. App.—Houston [14th Dist.] 2001, pet. denied); *Weber v. U.S. Sterling Sec., Inc.*, 924 A.2d 816 (Conn. 2007) (holding that liability protection of managers and members under the Delaware LLC statute does not protect members or managers from direct liability for their own torts). In addition, Texas and federal fraudulent transfer laws provide protection to entity creditors where insiders have improperly transacted business with an entity which is insolvent or would be rendered insolvent thereby. See 11 U.S.C. §548 (2008); TEX. BUS. & COM. CODE ANN. §§24.001-013 (Vernon 2011); Byron F. Egan, *Acquisition Structure Decision Tree*, 150–153, prepared for the TexasBarCLE & Business Law Section of State Bar of Texas Choice and Acquisition of Entities in Texas Course on May 25, 2012, and available at: <http://images.jw.com/com/publications/1736.pdf>.

⁷¹¹ Despite the clear legislative intent to the contrary, some lower court opinions in Texas have suggested that veil-piercing concepts from corporation law are applicable to LLCs. But they have done so only in narrow circumstances, have acknowledged that a mere absence of corporate formalities is not sufficient to support veil piercing, and have consistently recognized the applicability of TBCA art. 2.21 to LLC veil-piercing cases. See Elizabeth S. Miller, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 TEX. J. OF BUS. L. 405, 416-426 (Fall 2009).

In *Pinebrook Props., Ltd. v. Brookhaven Lake Prop. Owners Ass’n*, 77 S.W.3d 487, 500 (Tex. App.—Texarkana 2002, pet. denied), a complicated real estate use and maintenance case, the Texarkana Court of Appeals assumed that corporate veil piercing rules must be applicable to an LLC because the LLC is a limited liability entity. The court cited *Castleberry*, even though *Castleberry* was decided five years before the enactment of the LLC Act, made no reference to the LLC (or any entity other than a business corporation) and had been repudiated by the Legislature in amendments to TBCA art. 2.21A. The Texarkana court did

conclude that failure to comply with corporate formalities is no longer a relevant factor in the veil-piercing context and cited TBCA art. 2.21 as the relevant governing authority.

McCarthy v. Wani Venture, A.S., 251 S.W.3d 573 (Tex. App.—Houston [1st Dist] 2007, no pet.) held that corporate veil piercing principles apply to Texas LLCs notwithstanding the wording of LLC Act § 4.03(a) that “[e]xcept and to the extent the regulations specifically provide otherwise, a member or manager is not liable for the debts, obligations or liabilities of a limited liability company, including under a judgment, decree, or order of a court.” The court in *McCarthy* acknowledged that the LLC Act does not address whether the “corporate veil” of a LLC may be pierced, but cited *Pinebrook* and several cases from other jurisdictions to support its conclusion that veil piercing principles are applicable to LLCs under the LLC Act. *Id.* at 590. The court failed to incorporate into its analysis the clear legislative intent embodied in LLC Act § 4.03—namely, that the corporate veil piercing principles should not be applicable to LLCs and that LLCs were intended to be free from the uncertainties created by *Castleberry*. Nonetheless, *McCarthy* still recognizes that actual fraud is necessary to pierce the veil of an LLC, and that TBCA art. 2.21 is still the applicable standard. The jury instructions in *McCarthy* required that, in order to hold the defendant shareholders directly liable, the jury would have to find that defendants caused the LLC “to be used to perpetrate a fraud and did perpetrate an actual fraud . . . primarily for [their] own personal benefit.” In fact, no Texas court has ever applied corporate veil piercing principles to an LLC without also applying the restrictions of TBCA art. 2.21.

In a non-Texas case, *Taurus IP, LLC v. DaimlerChrysler Corp.*, 534 F.Supp. 2d 849 (W.D. Wis. 2008), the court, relying on *Castleberry*, held the non-owner Manager of a Texas LLC individually liable by employing a novel interpretation of TBCA art. 2.21. According to the *Taurus* court, TBCA art. 2.21 “limits alter ego liability only for shareholders, owners, subscribers and affiliates, not directors, officers, managers or members.” *Id.* at 871. The court eventually sidesteps the limits of TBCA art. 2.21 by asserting that the non-owner manager was never a shareholder or owner of the LLC, simply a Manager. In declaring this statutory exemption to veil-piercing liability inapplicable to Managers, the court ignores the fact that veil-piercing liability itself is inapplicable to Managers (much as it is inapplicable to officers and directors), and engages in an alter ego analysis that is entirely defective. But more problematic than the *Taurus* court’s apparent application of veil piercing to non-owner Managers is the court’s belief that because “Members” were not specifically included in the protections of TBCA art. 2.21, it was the Texas Legislature’s intent to give Members of an LLC even *less* protection from individual liability than shareholders of a Texas corporation. This is simply not the case. As discussed above, Members were not mentioned in TBCA art. 2.21 because it was never envisioned by the Legislature or the Bar Committee that veil piercing would be applied to Members of an LLC; had this been anticipated, LLC Act § 4.03 would have been drafted to mirror TBCA art. 2.21. (This also explains the absence of a reference to TBCA art. 2.21 in LLC Act § 8.12, which incorporates a few technical sections of the TBCA into the LLC Act: No reference was included because it was believed that veil-piercing would not be applied to LLCs.)

The Tex. LLC Stats. do not generally incorporate general corporate law or principles for situations not addressed in the Tex. LLC Stats. See LLC Act § 8.12 (Applicability of Other Statutes) for reference to the few provisions of the TBCA and the TMCLA which apply to LLCs. None of those provisions relates to piercing the corporate veil. The provisions referenced in LLC Act § 8.12 were expressly incorporated into the TBOC, but still without reference to piercing the corporate veil.

Although not the intent of the Legislature and inconsistent with the clear wording of LLC Act § 4.03A, it is at least understandable that some courts would apply veil piercing to Texas LLCs. But to apply this corporate law theory to LLCs without also applying the limitations of TBCA art. 2.21 is inconsistent—not only with the express intent of the Bar Committee and the Legislature—but with the holdings of every single Texas court that has addressed the issue. The Texas Supreme Court’s decision in *SSP* (*see supra* note 306 and related text) makes this even clearer: by extending TBCA art. 2.21 to cases grounded purely in tort law, the Texas Supreme Court has acknowledged the Legislature’s intent that TBCA art. 2.21 be the law of the land.

Texas has its own body of precedent in the corporate context with respect to piercing the corporate veil, and if the Texas Supreme Court were to determine to look to corporate precedent in determining whether to respect the limitation of liability provided by the LLC Act, the Texas court would not necessarily consider the same factors as the courts in the reported cases from other jurisdictions. In *Gearhart Industries, Inc. v. Smith*

While TBOC § 101.114 (Liability for Obligations), like its source LLC Act § 4.03, provides that a member or manager is not liable for the debts, obligations or liabilities of an LLC, except as and to the extent the company agreement or regulations specifically provide otherwise and thus prohibits a court from holding the members or managers liable for the debts, obligations and liabilities of an LLC, some judicial opinions have failed to follow this express statutory mandate and have applied corporate veil piercing principles to LLCs, causing uncertainty as to the proper standards to be applied if LLC veil piercing is to be recognized.

International, 741 F.2d 707, 719 n.4 (5th Cir. 1984), the Fifth Circuit sharply criticized the parties' failure to cite Texas jurisprudence:

We are both surprised and inconvenienced by the circumstances that, despite their multitudinous and voluminous briefs and exhibits, neither plaintiffs nor defendants seriously attempt to analyze officers' and directors' fiduciary duties or the business judgment rule under Texas law. This is a particularity so in view of the authorities cited in their discussions of the business judgment rule: Smith and Gearhart argue back and forth over the applicability of the plethora of out-of-state cases they cite, yet they ignore the fact that we are obligated to decide these aspects of this case under Texas law.

If the Texas Supreme Court were to sanction veil piercing concepts to hold Members or Managers of an LLC liable for LLC obligations, the Supreme Court should also apply the public policy inherent in TBCA art. 2.21 and make actual fraud a requirement for veil piercing.

There have been a number of cases in other jurisdictions in which courts have applied corporate veil piercing theories to LLCs. See, e.g., *N. Tankers (Cyprus) Ltd. v. Backstrom*, 967 F. Supp. 1391, 1402 (D. Conn. 1997); *Hollowell v. Orleans Reg'l. Hosp.*, No. CIV.A.95-4029, 1998 WL 283298, at *9 (E.D. La. May 29, 1998); *In re Multimedia Communications Group Wireless Assoc.*, 212 B.R. 1006 (Bankr. M.D. Fla. 1997); *Marina, LLC v. Burton*, No. CA 97-1013, 1998 WL 240364, at *7 (Ark. App. May 6, 1998); *Ditty v. CheckRite, Ltd.*, 973 F. Supp. 1320, 1336 (D. Utah 1997). In *Ditty*, a case examining a Utah limitation of Member liability statute similar to LLC Act § 4.03, the court wrote: "While there is little case law discussing veil piercing theories outside the corporate context, most commentators assume that the doctrine applies to limited liability companies." *Ditty*, 973 F. Supp. at 1336. The court then proceeded to uphold the limited liability of the sole Member, officer and director for the LLC, noting that the fact that defendant "played an active role in the firm's business is, at best, only marginally probative of the factors considered when determining whether to pierce the corporate veil." *Id.* In the court's view, the significant factors in determining whether to pierce the entity are "undercapitalization of a close corporation; failure to observe corporate formalities; siphoning of corporate funds by the dominant shareholder; nonfunctioning of other officers and directors; and the use of the corporation as a facade for operations of the dominant shareholder." *Id.*

Texas has its own body of precedent in the corporate context with respect to piercing the corporate veil and, if a Texas court were to determine to look to corporate precedent in determining whether to respect the limitation of liability provided by the LLC Act, would not necessarily consider the same factors as the courts in the reported cases from other jurisdictions. In *Shook v. Walden*, 368 S.W.3d 604 (Tex. App.—Austin 2012, pet. denied), a Texas Court of Appeals discussed the history of TBCA Art. 2.21 and the application of veil piercing principles to LLCs prior to the recent addition of TBOC § 101.002 in 2011, and concluded that the actual fraud standard should apply as a matter of common law to LLC veil piercing cases pre-dating the 2011 amendment to TBOC § 101.002. The majority opinion in *Shook* acknowledges the *Taurus* case discussed above (where federal court in Wisconsin applying Texas law concluded that *Castleberry* standard applied to LLC since LLC not corporation governed by TBCA Art. 2.21), but reaches a different conclusion and cites the Bill Analysis of 2011 S.B. 323 discussed *infra*, which the dissenting justice argued should have made the *Castleberry* standards apply to LLCs prior to the September 1, 2011 effectiveness of TBOC § 101.002. See generally Elizabeth S. Miller, *Cases Involving Limited Liability Companies and Registered Limited Liability Partnerships*, PUBOGRAM, A.B.A. SEC. OF BUS. L. COMMITTEE ON PARTNERSHIPS AND UNINCORPORATED BUS. ORG., Vol. XXIV, No. 3, at 19; Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 8-9 (Nov. 1995).

Some Texas opinions have applied corporate veil piercing standards in disregarding the statutory liability shield.⁷¹² When applying corporate veil piercing standards to LLCs, these courts recognized that the provisions of TBCA Article 2.21 (Liability of Subscribers and Shareholders), which are carried over in TBOC §§ 21.223 (Liability for Obligations) through 21.226 (Liability for Obligations), were controlling with respect to such standards.

2011 S.B. 323 clarified 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). TBOC § 101.002 as added by 2011 S.B. 323 provides as follows:

Sec. 101.002. APPLICABILITY OF OTHER LAWS. (a) Subject to Section 101.114, Sections 21.223, 21.224, 21.225, and 21.226 apply to a limited liability company and the company's members, owners, assignees, affiliates, and subscribers.

(b) For purposes of the application of Subsection (a):

(1) a reference to "shares" includes "membership interests";

(2) a reference to "holder," "owner," or "shareholder" includes a "member" and an "assignee";

(3) a reference to "corporation" or "corporate" includes a "limited liability company";

(4) a reference to "directors" includes "managers" of a manager-managed limited liability company and "members" of a member-managed limited liability company;

(5) a reference to "bylaws" includes "company agreement"; and

(6) the reference to "Sections 21.157-21.162" in Section 21.223(a)(1) refers to the provisions of Subchapter D of this chapter.

⁷¹² See, e.g., *Shook v. Walden*, 368 S.W.3d 604 (Tex. App.—Austin, pet. denied); *McCarthy v. Wani Venture, A.S.*, 251 S.W.3d 573, (Tex. App.—Houston [1st Dist.] 2007, pet. denied); *In re JNS Aviation, LLC (Nick Corp. v. JNS Aviation, Inc.)*, 376 B.R. 500 (Bankr. N.D. Tex. 2007, amended in part by 2008 WL 686159 (Bankr. N.D. Tex. 2008)).

If there was any uncertainty prior to 2011 S.B. 323, it should now be clear that the LLC liability shield is to be respected even if the LLC has only one member or is a disregarded entity for federal income tax purposes.⁷¹³

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.⁷¹⁴ Some state LLC statutes expressly deal with the veil piercing issue by providing that the LLC veil will be pierced to the same extent as the corporate veil⁷¹⁵ or that the Members will have the same liabilities as corporate shareholders.⁷¹⁶

M. Nature and Classes of Membership Interests. A membership interest in an LLC is personal property.⁷¹⁷ It does not confer upon the Member any interest in specific LLC property.⁷¹⁸ A membership interest may be evidenced by a certificate if the Company Agreement so provides.⁷¹⁹

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.⁷²⁰ The Company Agreement could provide for different classes of Members, each authorized to elect a specified number or percentage of the Managers.⁷²¹ The Tex. LLC Stats. generally allow even more flexibility in structuring classes of Members than is available under Texas law in structuring classes of corporate stock.⁷²²

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

⁷¹³ See *supra* note 590 and related text; *cf. Singh v. Duane Morris, L.L.P.*, 338 S.W.3d 176, 182 (Tex. App.—Houston [14th Dist.] 2011) (the fact that a corporation is an IRC Subchapter S-corporation with a single shareholder who is taxed on its earnings does not alter the bedrock principle of Texas law that an individual can incorporate a business and thereby normally shield himself from personal liability for the corporation’s obligations).

⁷¹⁴ *NetJets Aviation, Inc. v. LHC Communications, LLC*, 537 F.3d 168, 176 (2d Cir. 2008); *Heritage Organization, LLC*, 2008 WL 5215688 (Bankr. N.D. Tex. Dec. 12, 2008).

⁷¹⁵ See COLO. REV. STAT. 7-80-107 (1998); MINN. STAT. ANN. 322B.303.2 (1995 & Supp. 1998); N.D. CENT. CODE §§ 10-32-29.3, 44-22-09 (2001); WASH. REV. CODE. ANN. § 25.15.060 (West Supp. 2003).

⁷¹⁶ See W. VA. CODE § 31-B-3-303(b) (2003).

⁷¹⁷ LLC Act § 4.04; TBOC § 101.106.

⁷¹⁸ LLC Act § 4.04; TBOC § 101.106.

⁷¹⁹ LLC Act § 4.05B; TBOC § 3.201(e).

⁷²⁰ LLC Act § 4.02; TBOC § 101.104.

⁷²¹ See LLC Act § 2.13; TBOC § 101.104.

⁷²² See 1993 LLC Bill Analysis at 2; *see also* TBOC §§ 21.152, 101.104.

ability of the investor to exercise meaningful control over his investment.⁷²³ The offer and sale of an interest must either be registered under applicable federal and state securities laws⁷²⁴ or effected in a private⁷²⁵ or other transaction structured to be exempt from those requirements.⁷²⁶

⁷²³ The Securities Act of 1933, 15 U.S.C.A. 77a, et seq. (1997) (the “1933 Act”), in § 77b(a)(1) defines the term “security” to include:

any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

As a result of judicial construction of the term “investment contract” this definition now encompasses most long-term means for raising funds. See Carl W. Schneider, *The Elusive Definitions of a “Security”*, 14 REV. SEC. REG. 981, 981 (1981); Carl W. Schneider, *Developments in Defining a “Security”*, 16 REV. SEC. REG. 985 (1983). The United States Supreme Court has held that the test for determining whether an “investment contract” exists is “whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.” *SEC v. W. J. Howey Co.*, 328 U.S. 293, 301 (1946); ; see *Robinson v. Glynn*, 349 F.3d 166 (4th Cir. 2003). In *Robinson*, the Fourth Circuit wrote:

Since *Howey*, however, the Supreme Court has endorsed relaxation of the requirement that an investor rely only on others’ efforts, by omitting the word “solely” from its restatements of the *Howey* test. And neither our court nor our sister circuits have required that an investor like *Robinson* expect profits “solely” from the efforts of others. Requiring investors to rely wholly on the efforts of others would exclude from the protection of the securities laws any agreement that involved even slight efforts from investors themselves. It would also exclude any agreement that offered investors control in theory, but denied it to them in fact. Agreements do not annul the securities laws by retaining nominal powers for investors unable to exercise them.

What matters more than the form of an investment scheme is the “economic reality” that it represents. The question is whether an investor, as a result of the investment agreement itself or the factual circumstances that surround it, is left unable to exercise meaningful control over his investment. Elevating substance over form in this way ensures that the term “investment contract” embodies “a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”

Id. at 170. By analogy to corporate stock and investment contracts, a membership interest in an LLC which is governed by Managers is most likely to be considered to be a security. By analogy to interests in a general partnership, however, where the LLC is managed by its Members, the membership interest may not be deemed a security:

A general partnership interest normally is not a security, even if the investor elects to remain passive. But a general partnership interest may be a security if the rights of a partner are very limited in substance, or if the partner is an unsophisticated investor who must rely in fact on the business acumen of some other person.

A limited partnership interest normally is a security. On unusual facts, however, a limited partnership might not be a security -- e.g., where there is a single limited partner who negotiates directly with the general partner and retains significant influence over the venture, or where the limited partner otherwise has an active role in the venture.

Carl W. Schneider, *The Elusive Definition of a 'Security' – 1990 Update*, 24 REV. SEC. & COM. REG. 13, 22 (Jan. 23, 1991); see also Marc I. Steinberg & Karen L. Conway, *The Limited Liability Company As A Security*, 19 PEPP. L. REV. 1105 (1992). Steinberg and Conway concluded that:

While each LLC interest must be analyzed by looking at the applicable statutes as well as the specific provisions contained in the member agreement and other operating documents, this article takes the position that LLC interests normally are securities. Three different methods of analysis lead to this result. First, one may look at the traditional “investment contract” test and find that LLC interests satisfy the *Howey* test, especially in light of the *Williamson* rationale. Second, LLC interests meet the attributes of stock test as set forth by the Supreme Court. Finally, one can classify an interest in a LLC as “any interest commonly known as a security.

Id. at 1122. See also *SEC v. Parkersburg Wireless, LLC*, 991 F.Supp. 6, 8 (D.D.C. 1997) (holding that interests in an LLC with 700 Members were investment contracts); *SEC v. Vision Communications, Inc.*, CIV. No. 94-0615, 1994 WL 855061, at *1 (D.D.C. May 11, 1994) remanded by 74 F.3d 287 (D.C. Cir. 1996) (holding LLC interests are securities); Mark A. Sargent, *Will Limited Liability Companies Punch a Hole in the Blue Sky?*, 21 SEC. REG. L.J. 429 (1994).

The federal definition of “security” has served as a model for most modern state statutes. JOSEPH C. LONG, 1985 BLUE SKY LAW HANDBOOK § 2.01 (1988 revision).

724

Section 5 of the 1933 Act provides that a registration statement must be in effect as to a non-exempt security before any means of transportation or communication in interstate commerce or of the mails may be used for the purpose of sale or delivery of such non-exempt security. The primary purpose of the 1933 Act is to provide a full disclosure of material information concerning public offerings of securities to investors. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976). The registration statement is the primary means for satisfying the full disclosure requirement. The 1933 Act (particularly §§ 5-7 and Schedule A) and Regulations C and S-K thereunder contain the general registration requirements. The Securities and Exchange Commission (“SEC”) has set forth a number of registration forms to be used under varying circumstances. Form S-1 is the basic form to be used by an issuer unless another form is specifically prescribed. There are basically three stages in the registration process: the pre-filing stage, the waiting period, and the post-effective stage. During the pre-filing stage, § 5(c) of the 1933 Act prohibits the use of interstate facilities (including telephones) or the mails to “offer to sell.” Further, § 5(a) prohibits sales or deliveries at any time before the “effective” date of the registration statement, which includes the pre-filing stage. The term sale is defined to include “every contract of sale or disposition of a security or interest in a security, for value.” During the waiting period, written offers are still prohibited, but oral offers are permitted. Since the registration statement is still not “effective,” sales or deliveries are still forbidden. During the post-effective stage, sales may be made freely. A prospectus satisfying the requirements under the 1933 Act must accompany any interstate or mailed “delivery” of the security if the prospectus has not preceded the delivery. See generally, LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION ch. 2B (1988). Unlike the federal statute that seeks full disclosure, many of the state “blue sky” acts are based on a concept known as “merit regulation.” *Id.* at chs. 1B, 1C. Under these systems, the state securities administrator can prohibit a particular security from being offered in that state if the administrator determines that the terms of the offering are not “fair, just and equitable.” Most state acts do not define “fair, just and equitable.” In the Blue Sky Cases, the United States Supreme Court validated a number of state acts regulating securities on the basis that the acts neither violated the Fourteenth Amendment nor unduly burdened interstate commerce. See *Hall v. Geiger - Jones Co.*, 242 U.S. 539 (1917); *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559 (1917); *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917).

Section 4(2) of the 1933 Act exempts from the registration requirements of the 1933 Act “transactions by an issuer not involving any public offering” – generally referred to as “private placements.” The U.S. Supreme Court has held that the § 4(2) exemption must be interpreted in light of the statutory purpose of the 1933 Act to “protect investors by promoting full disclosure of information thought necessary to informed investment decisions” and that its applicability “should turn on whether the particular class affected needs the protection of the Act.” *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119, 124-25 (1953). Subsequent court opinions have enumerated a number of more specific factors to be considered in determining whether a transaction involves a “public offering,” including the following:

- (a) the number of offerees (there is no number of offerees that always makes an offering either private or public; 25 to 35 is generally considered consistent with a private offering, but the sophistication of the offerees is more important; an offer to a single unqualified investor can defeat the exemption and an offering to a few hundred institutional investors can be exempt; note that the judicial focus is upon the number of persons to whom the securities are offered, not the number of actual purchasers);
- (b) offeree qualification (each offeree should be sophisticated and able to bear the economic risk of the investment; a close personal, family or employment relationship should also qualify an offeree);
- (c) manner of offering (the offer should be communicated directly to the prospective investors without the use of public advertising or solicitation);
- (d) availability of information (each investor should be provided or otherwise have access to information comparable to that contained in a registration statement filed under the 1933 Act; commonly investors are furnished a “private offering memorandum” describing the issuer and the proposed transaction in at least as much detail as would be found in a registration statement filed with the SEC for a public offering registered under the 1933 Act); and
- (e) absence of redistribution (the securities must come to rest in the hands of qualified purchasers and not be redistributed to the public; securities sold in a private placement generally may be replaced privately, freely sold by a person who is not an affiliate of the issuer in limited quantities to the public pursuant to SEC Rule 144, 17 C.F.R. 230.144 (2008), after a one-year holding period (if the issuer files reports with the SEC, the securities may be sold in limited quantities to the public pursuant to Rule 144 after a six-month holding period), or sold to the public pursuant to a registration statement filed and effective under the 1933 Act; the documentation of a private placement normally includes contractual restrictions on subsequent transfers of the securities purchased).

See 1933 Act Release No. 33-8869 (December 6, 2007); *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 900 (5th Cir. 1977); Carl W. Schneider, *The Statutory Law of Private Placements*, 14 REV. SEC. REG. 869, 870 (1981); ABA Comm. on Fed. Regulation of Sec., *Integration of Securities Offerings: Report of the Task Force on Integration*, 41 BUS. LAW. 595, 595 (1986); C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L. J. 1081, 1120-24 (1988).

SEC Regulation D (“Reg D”), 17 C.F.R. 230.501-506 (2007), became effective April 15, 1982 and is now the controlling SEC regulation for determining whether an offering of securities is exempt from registration under § 4(2) of the 1933 Act. Under Rule 506 of Reg D, there is no limitation on the dollar amount of securities that may be offered and sold, and the offering can be sold to an unlimited number of “accredited investors” (generally institutions, individuals with a net worth of over \$1 million and officers and directors and general partners of the issuer) and to a maximum of thirty-five nonaccredited investors (there is no limit on the number of offerees so long as there is no general advertising or solicitation). Each of the purchasers, if not an accredited investor, must (either alone or through a representative) have such knowledge and experience in financial matters as to be capable of evaluating the risks and merits of the proposed investment. Unless the offering is made solely to accredited investors, purchasers must generally be furnished with the same level of information that would be contained in a registration statement under the 1933 Act. Resales of the securities must be restricted and a Form D notice of sale must be filed with the SEC. An offering which strictly

Prior to September 1, 1995, an LLC membership interest represented by a certificate would ordinarily have been considered a “security” for the purposes of Chapter 8 of the Texas Business and Commerce Code as in effect prior to that date (“Pre 9/1/95 B&CC”).⁷²⁷ Such an interest would ordinarily have been considered a “certificated security” under Pre 9/1/95 B&CC section 8.102 because it would have been (a) represented by an instrument issued in bearer or registered form; (b) of a type dealt in as a medium for investment; and (c) a class or series of shares, participations, interests or obligations. Under Pre 9/1/95 B&CC, security interests in certificated LLC interests would have been perfected by possession, as in the case of corporate shares.⁷²⁸ Security interests in membership interests which were not evidenced by an instrument would have been perfected by a financing statement filing under Pre 9/1/95 B&CC section 9.⁷²⁹

conforms to the Reg D requirements will be exempt even if it does not satisfy all of the judicial criteria discussed above; however, since Reg D does not purport to be the exclusive means of compliance with § 4(2), a placement which conforms to the foregoing judicial standards also will be exempt from registration under § 4(2) of the 1933 Act, even if it does not strictly conform to Reg D.

After being approved by Congress with wide bipartisan support, on April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (the “JOBS Act”). The JOBS Act is an amalgamation of various bills the combined impact of which is intended to provide entrepreneurs, start-ups and small businesses increased access to the capital markets while at the same time provide average investors increased investment opportunities. The JOBS Act considerably alters the regulations surrounding public and private security offerings and, for certain issuers with revenues of less than \$1 billion, reduces the burden of certain periodic reporting obligations.

Title II of the JOBS Act will allow general solicitation and advertising (by all issuers, not just emerging growth companies) in connection with private offerings pursuant to Rule 506 of Regulation D and Rule 144A, provided that all purchasers in Rule 506 offerings are accredited investors and all purchasers in Rule 144A offerings are qualified institutional buyers. The JOBS Act does not alter state preemption of offerings under Rule 506. Additionally, the JOBS Act clarifies that certain persons acting to bring issuers and potential purchasers together for a Rule 506 offering will not be required to register with the SEC as a broker or dealer if that person complies with certain requirements, including that it may not receive compensation or have possession of customer funds in connection with the purchase or sale of the securities. The Title II provisions of the JOBS Act become effective upon SEC rulemaking.

⁷²⁶ Section 3(a)(11) of the 1933 Act exempts from the registration requirements of the 1933 Act “any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or if a corporation, incorporated by and doing business within, such State or Territory.” Consequently there are two principal conditions to the intrastate offering exemption: (a) that the entire issue of securities be offered and sold exclusively to, and come to rest in the hands of, residents of the state in question (an offer or sale to a single non-resident will render the exemption unavailable to the entire issue); and (b) the issuer be organized under the laws of and doing substantial business in the state. Rule 147 promulgated under the 1933 Act articulates specific standards for determining whether an offering is intrastate within the meaning of Section 3(a)(11).

⁷²⁷ Act of June 17, 1983, 68th Leg., R.S., ch. 442, § 1, 1983 Tex. Gen. Laws 2511, *amended by* Act of June 16, 1995, 74th Leg., R.S., ch. 962, § 1, sec. 8.102, 1995 Tex. Gen. Laws 4760, 4761.

⁷²⁸ Pre 9/1/95 B&CC § 8.321.

⁷²⁹ A membership interest not represented by an instrument would be a “general intangible” under Pre 9/1/95 B&CC § 9.106. A security interest therein would attach as provided in Pre 9/1/95 B&CC § 9.203 when the debtor has signed a proper security agreement, value has been given and the debtor has rights therein, and would be perfected by a financing statement filing under Pre 9/1/95 B&CC § 9.302.

As of September 1, 1995, LLC membership interests are not “securities” governed by Chapter 8 of the Texas Business & Commerce Code, as amended by House Bill 3200 (“Post 9/1/95 B&CC”), unless the interests are dealt in or traded on securities exchanges or markets or unless the parties expressly agree to treat them as such.⁷³⁰ Under Post 9/1/95 B&CC Chapter 9, LLC membership interests should be classified as “general intangibles,” whether or not represented by a certificate, and security interests would be perfected by a financing statement filing.⁷³¹

Under the Tex. LLC Stats., a judgment creditor of a Member may on application to a court of competent jurisdiction secure a “charging order” against the Member’s membership interest.⁷³² In a “charging order” a court “charges” the membership interest such that any distributions thereon are made as directed by the court, but does not order foreclosure of the interest or compel any distributions. A charging order should not permit a judgment creditor of a Member to receive distributions on an interest subject to a prior perfected security interest. The TBOC provides that a charging order is a creditor’s exclusive remedy against an LLC membership interest, but that does not preclude a member from granting a UCC security interest in a membership or enforcing it, in each case subject to the LLC’s governing documents.

⁷³⁰ Post 9/1/95 B&CC §§ 8.102, 8.103(c).

⁷³¹ Post 9/1/95 B&CC §§ 9.102(a)(42), 9.310. An LLC membership interest held in a securities account at a broker or dealer would be a “financial asset” and a “security entitlement” under Post 9/1/95 B&CC §§ 8.102(a)(17), 8.103(c) and 8.501(b)(1), and a security interest therein could be perfected by “control” or by filing under Post 9/1/95 B&CC §§ 9.106 and 9.115.

⁷³² LLC Act § 4.06A, as amended in 2007 by 2007 H.B. 1737; TBOC § 101.112, which provides:

Sec. 101.112. MEMBER’S MEMBERSHIP INTEREST SUBJECT TO CHARGING ORDER. (a) On application by a judgment creditor of a member of a limited liability company or of any other owner of a membership interest in a limited liability company, a court having jurisdiction may charge the membership interest of the judgment debtor to satisfy the judgment.

(b) If a court charges a membership interest with payment of a judgment as provided by Subsection (a), the judgment creditor has only the right to receive any distribution to which the judgment debtor would otherwise be entitled in respect of the membership interest.

(c) A charging order constitutes a lien on the judgment debtor’s membership interest. The charging order lien may not be foreclosed on under this code or any other law.

(d) The entry of a charging order is the exclusive remedy by which a judgment creditor of a member or of any other owner of a membership interest may satisfy a judgment out of the judgment debtor’s membership interest.

(e) This section may not be construed to deprive a member of a limited liability company or any other owner of a membership interest in a limited liability company of the benefit of any exemption laws applicable to the membership interest of the member or owner.

(f) A creditor of a member or of any other owner of a membership interest does not have the right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company.

See LLC Act § 7.03. TBOC § 101.112 provides substantially the same.

N. Assignment of Membership Interests. Unless otherwise provided in an LLC's Company Agreement, a Member's interest in an LLC is assignable in whole or in part.⁷³³ 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.⁷³⁴ 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.⁷³⁵ 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.⁷³⁶ 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.⁷³⁷ Until an assignee is admitted as a Member, the assignee does not have liability as a Member solely as a result of the assignment.⁷³⁸

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.⁷³⁹

O. Dissolution. The LLC Act provides that an LLC is dissolved, and the TBOC requires that an LLC commence winding up its affairs, 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;⁷⁴⁰
- (2) 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;⁷⁴¹

⁷³³ LLC Act § 4.05A; TBOC § 101.108.

⁷³⁴ *Id.*

⁷³⁵ LLC Act § 4.05A; TBOC § 101.109.

⁷³⁶ LLC Act § 4.05A; TBOC § 101.111.

⁷³⁷ LLC Act § 4.07A; TBOC §§ 101.109(b); 101.052. Under Tex. LLC Stats., an assignee who becomes a Member (i) has (to the extent assigned) the rights and powers, and is subject to the restrictions of, a Member under the Company Agreement and the Tex. LLC Stats., and (ii) becomes liable for the obligations of the assignor to make contributions known to him at the time he becomes a member or as provided in the Company Agreement, although the assignment does not release the assignor from his liabilities to the LLC. LLC Act § 4.07B; TBOC §§ 101.110; 101.111(b).

⁷³⁸ LLC Act § 4.05C; TBOC § 101.109(c).

⁷³⁹ Tex. LLC Stats. provide that a membership interest is assignable unless otherwise provided by the Company Agreement. LLC Act § 4.05A; TBOC § 101.108(a). There is no statutory requirement of "reasonableness" with respect to LLC transfer restrictions as is found in TBCA art. 2.22 and TBOC §§ 21.211 and 21.213.

⁷⁴⁰ LLC Act §§ 3.02A(2), 6.01A(1); TBOC § 11.051(1); *see* 1993 LLC Bill Analysis at 4.

⁷⁴¹ LLC Act § 6.01A(2); TBOC § 11.051(3).

- (3) 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);⁷⁴²
- (4) the occurrence of any event that terminates the continued membership of the last remaining Member of the LLC, absent certain circumstances;⁷⁴³ or
- (5) entry of decree of judicial dissolution under the Tex. LLC Stats.⁷⁴⁴

Under the Tex. LLC Stats., the bankruptcy of a Member does not dissolve an LLC 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.⁷⁴⁵

⁷⁴² LLC Act §§ 2.23D(2), 6.01A(3); TBOC §§ 11.051(2), 101.552. See 1993 LLC Bill Analysis at 5. Additionally, the TBOC provides that if there are no members, dissolution may occur upon the majority vote of the LLC’s managers. See TBOC § 101.552. This provision was intended to parallel the LLC Act provision which provided for dissolution upon the act of a majority of the Managers or Members named in the Articles, if no capital has been paid into the LLC and the LLC has not otherwise commenced business. LLC Act § 6.01A(4); see Revisor’s Note to TBOC § 101.552.

⁷⁴³ LLC Act § 6.01A(5), as amended by 2003 H.B. 1637 effective September 1, 2003; TBOC § 11.056. An LLC is not dissolved upon the termination of membership of the last remaining Member if the legal representative or successor of the last remaining Member agrees to continue the LLC and to become a Member as of the date of the termination of the last remaining Member’s membership in the LLC or designates another person who agrees to become a Member of the LLC as of the date of the termination. LLC Act § 6.01C as amended by 2003 H.B. 1637 effective September 1, 2003; TBOC § 11.056.

⁷⁴⁴ LLC Act §§ 6.01A(6), 6.02A; TBOC § 11.051(5). The availability of judicial dissolution may not be modified by Regulations or Company Agreement under either the LLC Act or the TBOC. TBOC § 101.054(a)(6) expressly states that judicial dissolution may not be modified or waived by Company Agreement, and LLC Act § 6.02 does not provide for modification or waiver in Regulations. Although TBOC § 101.054 expressly states which provisions *cannot* be modified, its predecessor, the LLC Act, only expressly states which provisions *can* be modified. As the Revisor’s Note to TBOC § 101.052 explains:

Because of the reversal of the prior assumption that each provision of the [LLC Act] was mandatory (unless expressly qualified) to the new assumption in Sections 101.052 and 101.054 [of the TBOC] that most provisions of the code governing limited liability companies may be waived or modified, a number of the provisions of Title 3 are now stated in such a way that the new provision appears to be the converse of the corresponding provision under the Texas Limited Liability Company Act.

The Revisor’s Notes make no mention of any substantive change from the LLC Act to TBOC with respect to judicial dissolution, or the waivability thereof, because there was no substantive change. TBOC § 11.314—which is substantially similar to LLC Act § 6.02—is explicitly listed as being unwaivable under TBOC § 101.054. But under the LLC Act, all provisions are assumed mandatory unless it is explicitly stated that they are subject to variation by an LLC’s governing documents, and LLC Act § 6.02 contains no such qualification allowing modification or waiver of the right of judicial dissolution.

In contrast to the Texas LLC Stats. which do not permit the availability of judicial dissolution to be modified by Regulations or Company Agreement, the DLLCA permits an LLC agreement to waive judicial dissolution under DLLCA § 18-802. *R&R Capital, LLC v. Duck & Doe Run Valley Farms, LLC*, CA No. 3803-CC (Del. Ch. August 19, 2008) (LLC agreement could waive judicial dissolution under the DLLCA principle that LLCs “are creatures of contract, ‘designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved’”). Just as DLLCA § 18-1101(e) expressly states fiduciary duties may be eliminated by contract and the Tex. LLC Stats. do not so provide and do not allow that degree of contractual freedom to Texas LLCs, Texas differs from Delaware in that Texas LLCs do not have the power by Regulations or Company Agreement to eliminate the statutory right of judicial dissolution of a Texas LLC.

An LLC may in many cases cancel the event that would otherwise require dissolution or termination and carry on its business. The procedures for doing so differ both by whether the LLC is governed by the TBOC or the LLC Act and by the type of event requiring dissolution. Unless otherwise provided in its Company Agreement, the TBOC requires a majority vote of all the LLC's Members (or, if there are no Members, a majority vote of all its Managers) to revoke a voluntary winding up, or a unanimous vote of all of its Members to approve cancellation of an event that would otherwise require termination and winding up, other than a judicial decree.⁷⁴⁶ Under the LLC Act and the TBOC, revocation of a voluntary dissolution simply requires the written consent of all its members,⁷⁴⁷ while an election to continue following the expiration of a fixed period of duration for the LLC or the occurrence of events in the LLC's governing documents requiring dissolution can only happen if there is at least one remaining member and all members vote to continue (unless a lesser percentage is specified in its certificate of formation or Company Agreement).⁷⁴⁸

The time frames for permissible elections to continue in business also differ by governing law and type of event of dissolution, and are all subject to restrictions in an LLC's governing documents. Where the event of dissolution is the termination of the LLC's period of duration, the TBOC allows three years for cancellation, whereas the LLC Act requires an election to cancel within 90 days of the expiration, and subject to the amendment within three years of the LLC's formation document allowing for a longer duration.⁷⁴⁹ For voluntary dissolutions, the LLC Act allows the LLC to cancel such dissolution within 120 days of the issuance of a certificate of dissolution, whereas the TBOC mandates that such election be made before the effective date of termination of the LLC's existence.⁷⁵⁰ For the occurrence of an event determined in the LLC's governing documents to require automatic dissolution, the LLC Act requires any cancellation election to be made within 90 days of the event, subject to amendment of the LLC's governing documents within three years to eliminate dissolution upon such event, while the TBOC allows one year to revoke such dissolution.⁷⁵¹ For other circumstances requiring termination under the TBOC, LLCs are permitted one year to cancel the event of termination.⁷⁵²

Since (i) under the Check-the-Box Regulations continuity of life is not an issue in determining whether an LLC will be treated as a partnership for federal income tax purposes and (ii) there is considerable flexibility under the Tex. LLC Stats. in defining the circumstances in which an LLC is dissolved, the Certificate and Company Agreement should henceforth focus on dissolution from a business rather than a tax standpoint. The result in many cases will be that the LLC will not dissolve until the parties take affirmative action to cause dissolution.

⁷⁴⁵ DLLCA § 18-304.

⁷⁴⁶ TBOC §§ 101.552.

⁷⁴⁷ LLC Act § 6.06A; TBOC § 101.552.

⁷⁴⁸ LLC Act § 6.01B; TBOC § 101.552.

⁷⁴⁹ LLC Act § 6.01B; TBOC § 11.152(b).

⁷⁵⁰ LLC Act § 6.06A; TBOC § 11.151.

⁷⁵¹ LLC Act § 6.01B; TBOC § 11.152(a).

⁷⁵² TBOC § 11.152(a).

Upon the dissolution of an LLC, its affairs must be wound up as soon as practicable by its Managers, or Members or other persons as provided in its Certificate or Company Agreement or by resolution of the Managers or Members.⁷⁵³ Before filing a certificate of termination with the Secretary of State,⁷⁵⁴ the LLC shall (i) cease to carry on its business, except as may be necessary for the winding up thereof, (ii) send written notice of its intention to dissolve to each of its known creditors and claimants,⁷⁵⁵ and (iii) collect its assets, discharge its obligations or make provision therefor and distribute the remaining assets to its Members.⁷⁵⁶ In the event a dissolving LLC's assets are not sufficient to discharge its obligations, the LLC is required to apply the assets as far as they will go to the just and equitable payment of its obligations.⁷⁵⁷ Upon the filing of a certificate of termination with the Secretary of State, the existence of the LLC terminates except for the purpose of suits and other proceedings by Members, Managers and other LLC representatives.⁷⁵⁸

P. Merger; Conversion. Part Ten of LLC Act and Chapter 10 of the TBOC contain 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.⁷⁵⁹ The merger must be pursuant to a written plan of merger containing certain provisions,⁷⁶⁰ and the entities involved must approve the merger by the vote required by their respective governing laws and organizational documents. Under Tex. LLC Stats., 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.⁷⁶¹

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.⁷⁶² The Tex. LLC Stats. grant broad authority for who can execute merger documents on a company's

⁷⁵³ LLC Act § 6.03A; TBOC § 101.551.

⁷⁵⁴ For entities still governed by the LLC Act, the proper filing document is articles of dissolution. *See* LLC Act § 6.07. For the required elements that must appear in a certificate of termination under the TBOC, see TBOC § 11.101.

⁷⁵⁵ Under § 6.05 of the LLC Act, notice must be sent by registered or certified mail. Under the new TBOC, notice must still be written, but can alternately be sent through a variety of technological means. *See* Revisor's Note to TBOC § 11.052.

⁷⁵⁶ LLC Act § 6.05; TBOC § 11.052.

⁷⁵⁷ LLC Act § 6.05(A)(3); TBOC § 11.053(b). The TBOC provides that such distribution may be delayed if continuing the business for a limited period will prevent unreasonable loss of the LLC property. *See* TBOC § 11.053(d).

⁷⁵⁸ LLC Act § 6.08(B); TBOC §§ 11.055, 11.102. Under the LLC Act, such existence terminates upon the issuance of a certificate of dissolution by the Secretary of State. LLC Act § 6.08B.

⁷⁵⁹ However, the TBOC does impose restrictions on mergers involving nonprofit corporations. *See* TBOC § 10.010.

⁷⁶⁰ The LLC Act's requirements appear in its § 10.02. The TBOC's requirements are in its §§ 10.002 and 10.003.

⁷⁶¹ LLC Act §§ 9.03, 10.03; TBOC § 10.007 and Revisor's Note thereto.

⁷⁶² LLC Act § 10.01A; TBOC §§ 10.001, 101.356, 101.052.

behalf.⁷⁶³ Their provisions on short form mergers are broadly drafted to allow their application to all types of entities that own, are owned by, or are under common ownership with a domestic limited liability company in the required percentage.⁷⁶⁴

The Tex. LLC Stats. also authorize 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.⁷⁶⁵

The Texas LLC Stats. allow 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.⁷⁶⁶ 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.⁷⁶⁷

Q. TLLCA Relationship to TBCA and TMCLA. While LLCs governed by the TBOC need only look to the TBOC to ascertain applicable law, those LLCs still governed by the LLC Act are subject not only to that Act but also other pre-TBOC business entity statutes incorporated by reference thereto. The 1991 LLC Act section 8.12 provided that, to the extent that the LLC Act contains no provision with respect to one of the matters provided for in the TBCA and the TMCLA, such acts (as amended from time to time) will supplement the LLC Act to the extent not inconsistent with the LLC Act.⁷⁶⁸ In particular, TBCA article 2.02-1 and Part 5 with respect to indemnification and mergers, respectively, and TMCLA article 7.06 with respect to the limitation of director liability (made applicable to Managers) were incorporated.⁷⁶⁹

The 1991 LLC Act was left relatively short to provide maximum flexibility to parties to tailor their organizational structures to transactional needs. The references to the TBCA and TMCLA were inserted to allow established bodies of law under those statutes to serve as gap fillers in areas where the LLC Act, the Articles and the Company Agreement are silent. The concept of “piercing the corporate veil,” which developed under the TBCA, is inconsistent with the concept of limited liability for Members in the LLC Act and was not intended to be carried over.⁷⁷⁰ The concepts of cumulative voting and preemptive rights, from TBCA articles 2.29D and 2.22-1 respectively, may have been incorporated into the 1991 LLC Act by LLC Act section 8.12, although this conclusion is not free from doubt.

⁷⁶³ LLC Act § 10.03A; TBOC §§ 10.001(b), 10.151(b).

⁷⁶⁴ See LLC Act § 10.05; TBOC § 10.006.

⁷⁶⁵ LLC Act §§ 10.08-10.09; TBOC §§ 10.101-10.105. Note, the TBOC permits LLCs still governed by the LLC Act to convert into another entity form to be governed by the TBOC. TBOC § 10.102.

⁷⁶⁶ See *supra* notes 246-247 and related text regarding the requirements of TBCA arts. 5.09 and 5.10 and the parallel TBOC provisions.

⁷⁶⁷ TBOC § 1.002(32) defines “fundamental business transaction” to include a “sale of all or substantially all of the entity’s assets” and TBOC § 101.356 requires a member vote to approve any fundamental business transaction, although TBOC § 101.052 would allow the parties to include in the Company Agreement provisions that trump this TBOC requirement.

⁷⁶⁸ 1991 LLC Act § 8.12.

⁷⁶⁹ *Id.*

⁷⁷⁰ See LLC Act § 4.03; see also *supra* notes 708-716 and related text.

The Bar Committee preparing the 1993 amendments to the LLC Act concluded that the 1991 LLC Act section 8.12 was overbroad and presented interpretive difficulties and revised LLC Act section 8.12 to designate the sections of the TBCA and the TMCLA incorporated by reference. As amended in 1993, 1997 and 2003, LLC Act section 8.12A provides that only the following TBCA articles apply to an LLC and its Members, Managers and officers:

- 2.07 (registered name)
- 2.08 (renewal of registered name)
- 4.14 (amendments of Articles, merger and dissolution pursuant to Federal bankruptcy laws)
- 5.14 (derivative suits)
- Part Seven (involuntary dissolution and receivership)

LLC Act section 8.12B provides that the following TMCLA articles apply to an LLC, its Members, Managers and officers:

- 2.03 (obligations to ostensible LLC)
- 2.04 (exclusive right of trustee to sue under indentures and security documents)
- 2.05 (facsimile signatures on debt instruments)
- 2.06 (consideration for indebtedness and guarantees)
- 2.09 (interest rate on borrowings)
- 2.09A (alternative interest rate on borrowings)
- 3.01 (veteran entities)
- 7.01-7.05 (correction of defective filings with Secretary of State)

TMCLA articles 2.03, 2.04, 2.09 and 2.09A were repealed by 2003 H.B. 1165 effective September 1, 2003, but LLC Act section 8.12B was not correspondingly amended.

TBCA concepts of cumulative voting and preemptive rights are not incorporated by reference into the LLC Act. Organizers desiring to provide those rights must expressly provide them in the Articles or Company Agreement, although an express denial thereof in the Articles or Company Agreement still seems useful so that all parties will be aware of the result.

R. Foreign LLCs. The Tex. LLC Stats. provide a mechanism by which a limited liability company formed under the laws of another jurisdiction can qualify to do business in Texas as a foreign limited liability company (a “Foreign LLC”) and thereby achieve in Texas the limited liability afforded by the Tex. LLC Stats. to a domestic LLC.⁷⁷¹ The LLC Act defines Foreign LLC broadly so that business trusts and other entities afforded limited liability under the laws under which they were organized, but which would not qualify for LLC status if formed in Texas, can still qualify to do business and achieve limited liability in Texas.⁷⁷² However, under

⁷⁷¹ LLC Act Part Seven; TBOC chapter 101.

⁷⁷² “Foreign limited liability company” is broadly defined in LLC Act § 1.02(9) as follows:

(9) “Foreign Limited Liability Company” means an entity formed under the laws of a jurisdiction other than this state (a) that is characterized as a limited liability company by such laws or (b) although not so characterized by such laws, that elects to procure a certificate of authority pursuant to Article 7.01 of this act, that is formed under laws which

the TBOC, such specific provision was unnecessary, as such entities may register directly to transact business in Texas under TBOC Chapter 9 and be afforded the limited liability shield.⁷⁷³ A foreign entity comparable to a Texas LLC and doing business in Texas registers and thereby qualifies to do business in Texas by filing an application to do so with the Secretary of State.⁷⁷⁴ The analysis of whether a Foreign LLC is doing business in Texas so as to require qualification is the same as for a foreign corporation.⁷⁷⁵

The internal affairs of a Foreign LLC, including the personal liability of its Members for its obligations, are governed by the laws of its jurisdiction of organization.⁷⁷⁶ However, for matters affecting intrastate business in Texas, a Foreign LLC is subject to the same duties, restrictions, and liabilities as a domestic LLC.⁷⁷⁷ The failure of a Foreign LLC to qualify to do business in Texas will not impair the limitation on liability of its Members or Managers, which gives specific effect to the applicability of the internal affairs doctrine relating to foreign entities in the case of a non-qualified Foreign LLC.⁷⁷⁸

S. Professional LLCs. Tex. LLC Stats. expressly provide for the formation of a professional limited liability company (a “PLLC”) and specify the statutory requirements for such entities.⁷⁷⁹ The pertinent provisions of the LLC Act (a predecessor to the TBOC), including

provide that some or all of the persons entitled to receive a distribution of the assets thereof upon the entity’s dissolution or otherwise or to exercise voting rights with respect to an interest in the entity shall not be liable for the debts, obligations or liabilities of the entity and which is not eligible to become authorized to do business in this state under any other statute.

⁷⁷³ See TBOC §§ 9.001 and 101.001 and the Revisor’s Notes thereto.

⁷⁷⁴ LLC Act §§ 7.01A, 7.05; TBOC §§ 9.001, 9.004.

⁷⁷⁵ LLC Act § 7.01B; TBCA art. 8.01B; TBOC § 9.251.

⁷⁷⁶ LLC Act § 7.02 provides in relevant part as follows with respect to a Foreign LLC that has procured a certificate of authority from the Secretary of State to transact business in Texas pursuant to LLC Act Part Seven:

. . . only the laws of the jurisdiction of organization of a foreign limited liability company shall govern (1) the internal affairs of the foreign limited liability company, including but not limited to the rights, powers, and duties of its manager and members and matters relating to its ownership, and (2) the liability, if any, of members of the foreign limited liability company for the debts, liabilities and obligations of the foreign limited liability company for which they are not otherwise liable by statute or agreement.

The TBOC also provides for governance of a Foreign LLC’s internal affairs by the laws of its jurisdiction of organization. In fact, such governance is in the TBOC’s very definition of “foreign entity,” which states that the term “means an organization formed under, and the internal affairs of which are governed by, the laws of a jurisdiction other than this state.” TBOC § 1.002(28).

⁷⁷⁷ LLC Act § 7.02A; TBOC § 9.203.

⁷⁷⁸ LLC Act § 7.13B; TBOC § 9.051(c).

⁷⁷⁹ See Part Eleven of the LLC Act; see also TBOC chapters 301 and 304. The Texas Disciplinary Rules of Professional Conduct permit Texas lawyers to form a Texas LLC for the practice of law. Op. Tex. Ethics Comm’n No. 486 (1994). Most (but not all) states will also allow attorneys to practice in an LLC, at least so long as the client is on notice of dealing with a limited liability entity and each lawyer rendering services to a client remains fully accountable to the client. Lance Rogers, *Questions of Law and Ethics Face Firms*

the definition of “professional service,” were based upon the Texas Professional Corporation Act (“TPCA”).⁷⁸⁰ Unlike the TPCA, however, physicians, surgeons and other doctors of medicine are not excluded from forming PLLCs under the Tex. LLC Stats.⁷⁸¹

A PLLC is required to contain in its name the words “Professional Limited Liability Company” or an abbreviation thereof.⁷⁸² Only a “professional individual”⁷⁸³ or a “professional organization”⁷⁸⁴ may be a governing person⁷⁸⁵ of a PLLC.⁷⁸⁶ The PLLC, but not the other individual Members, Managers or officers, is jointly and severally liable with a Member, Manager, officer, employee or agent rendering professional service for an error, omission, negligence, incompetence, or malfeasance on the part of the Member, Manager, officer, employee or agent when the Member, Manager, officer, employee or agent is rendering professional service in the course of employment for the PLLC.⁷⁸⁷

T. Diversity Jurisdiction. The cases are divided as to whether the citizenship of an LLC for federal diversity jurisdiction purposes should be determined by analogy to a partnership or a corporation. Where citizenship is determined in accordance with partnership precedent, an LLC is deemed a citizen of each state in which it has a Member.⁷⁸⁸ Where corporate precedent is applied, an LLC is a citizen of its state of incorporation and the state where its principal place of business is located.⁷⁸⁹

Becoming LLPs, LLCs, 12 ABA/BNA Law. Manual on Prof. Conduct 411 (No. 23, Dec. 11, 1996); see ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 96-401 (1996).

⁷⁸⁰ TEX. REV. CIV. STAT. ANN. art. 1528e, §3(a) (Vernon 2011).

⁷⁸¹ 1993 LLC Bill Analysis at 6; LLC Act § 11.01; TBOC §§ 301.003, 301.012.

⁷⁸² LLC Act § 11.02; TBOC § 5.059.

⁷⁸³ The LLC Act defines “professional individual” to mean an individual who is licensed or otherwise authorized to render the same professional service as the PLLC, either within Texas or in any other jurisdiction. LLC Act § 11.01B(3); TBOC § 301.003(5).

⁷⁸⁴ TBOC § 301.003(7). The LLC Act uses the alternate term “professional entity,” LLC Act § 11.01B(4), but either term indicates a person other than an individual that renders the same professional service as the PLLC, only through owners, members, employees, agents, and the like, each of whom is either a professional individual or professional organization or entity.

⁷⁸⁵ “Governing person” is a new term of art in the TBOC, and refers to a person entitled to manage and direct an entity’s affairs under the TBOC and the entity’s governing documents. TBOC §§ 1.001(37), (35). In terms of the LLC Act, the governing person would be the same as the members, if member-managed, and the managers if manager-managed.

⁷⁸⁶ LLC Act § 11.03A; TBOC §§ 301.007(a), 301.004(2).

⁷⁸⁷ LLC Act § 11.05; TBOC § 301.010.

⁷⁸⁸ *International Flavors & Textures, LLC v. Gardner*, 966 F.Supp. 552 (W.D. Mich. 1997).

⁷⁸⁹ *SMS Fin. II, L.L.C. v. Stewart*, 1996 WL 722080 (N.D. Tex. 1996); *Carlos v. Adamany*, 1996 WL 210019 (N.D. Ill. 1996).

VI. LIMITED LIABILITY PARTNERSHIP.⁷⁹⁰

A. General. An LLP is a general partnership in which the individual liability of partners for partnership obligations is substantially limited. This species of general partnership represents a dramatic innovation and was first authorized in 1991 by provisions (the “LLP Provisions”) added to the TUPA by Sections 83-85 of House Bill 278 (“1991 H.B. 278”).⁷⁹¹ The LLP Provisions were refined and carried forward as section 3.08 of the TRPA⁷⁹² passed in 1993, and then were substantially expanded by 1997 S.B. 555 effective September 1, 1997.⁷⁹³ The LLP Provisions were substantially revised and made more protective in the 2011 Legislative Session, effective September 1, 2011, by 2011 S.B. 748.

The LLP provisions initially appearing in the TBOC⁷⁹⁴ took effect on January 1, 2006 and governed all LLPs formed on or after that date.⁷⁹⁵ The source LLP Provisions in TRPA governed LLPs formed before that date which did not voluntarily opt in to TBOC governance until their registrations expired, unless they are revoked or withdrawn prior to expiration, and, after January 1, 2010, all LLPs (like all other Texas entities) became subject to the TBOC.⁷⁹⁶ The LLP Provisions or TBOC LLP provisions, as each may be applicable to a particular LLP, will be hereinafter collectively referred to as “Tex. LLP Stats.,” with differences between the two noted as appropriate.

B. Evolution of the LLP in Texas.

1. First LLP in 1991 in Texas. The LLP Provisions of TUPA originated in 1991 in Senate Bill 302 (“1991 S.B. 302”)⁷⁹⁷ as an alternate means for allowing professionals the limitation of liability already available to them under the Texas Professional Corporation Act.⁷⁹⁸

⁷⁹⁰ The discussion of LLPs herein, insofar as it relates to LLP’s under 1991 H.B. 278, is drawn in part from R. Dennis Anderson, Alan R. Bromberg, Byron F. Egan, Campbell A. Griffin, Larry L. Schoenbrun and Charles Szalkowski, *Registered Limited Liability Partnerships*, Vol. 28, No. 3 BULL. OF SEC. OF BUS. L. 1 (Jan. 1992); reprinted 55 TEX. B. J. 728 (July 1992).

⁷⁹¹ Tex. H.B. 278, 72d Leg., R.S. (1991).

⁷⁹² TRPA § 1.01 et seq.

⁷⁹³ Tex. S.B. 555, 75th Leg., R.S. (1997). Under TRPA § 11.03(b), TRPA § 3.08 governs all LLPs between January 1, 1994 and December 31, 2005 (regardless of when formed). Its coverage continues until December 31, 2009 for those LLPs formed prior to January 1, 2006 but not opting into the TBOC. However, an LLP formed before January 1, 1994 and governed by the TRPA is subject to TUPA for the purposes of determining liability for acts occurring prior to January 1, 1994. The TRPA phase-in provisions relating to LLPs deal only with the LLP Provisions in TRPA § 3.08. The other aspects of a partnership entity which is an LLP are governed by the remaining provisions of TRPA which have a different statutory phase-in. TRPA § 11.03 provides that, except for § 3.08, TRPA applies on and after January 1, 1994 to (i) new partnerships formed on and after that date and (ii) existing partnerships which elect to be governed by TRPA; and all partnerships will be governed by TRPA after January 1, 1999 (though again, subject to the phase in of the TBOC).

⁷⁹⁴ See TBOC Title 1 and §§ 152.801-152.805.

⁷⁹⁵ TBOC §§ 401.001, 402.003, 402.005.

⁷⁹⁶ TBOC § 402.001(b). Even prior to January 1, 2010, LLP registration renewal was governed by the TBOC after January 1, 2006 under TBOC § 402.001(c). See *supra* notes 43-45 and related text.

⁷⁹⁷ Senate Bill 302 by Sen. John Montford (“1991 S.B. 302”).

⁷⁹⁸ TEX. REV. CIV. STAT. ANN. art. 1528e (Vernon Supp. 2010).

Although that statute allows professionals to limit their liability, the federal income tax consequences of joining and separating from professional corporations often made this avenue unavailable as a practical matter. The solution embodied in 1991 S.B. 302 was to amend TUPA to allow professionals to achieve through a new kind of partnership the same liability limitation already available in corporate form.⁷⁹⁹ Thus, the proposed amendments to TUPA that were contained in 1991 S.B. 302 applied only to certain kinds of professional partners: physicians, surgeons, other doctors of medicine, architects, attorneys at law, certified public accountants, dentists, public accountants and veterinarians. 1991 S.B. 302 passed the Senate but encountered criticism in hearings before the House Business and Commerce Committee on grounds, among others, that 1991 S.B. 302 was discriminatory against non-professional partnerships, that 1991 S.B. 302 did not tell persons dealing with a partnership whether the partnership had the liability shield, and that 1991 S.B. 302 did not require any substitute source of recovery for a person injured by partnership misconduct.⁸⁰⁰ These criticisms led to the enlargement of the LLP Provisions to be applicable to all partnerships, and to the addition of the requirements of LLP registration with the Secretary of State, use of LLP status words or initials in the partnership name and maintenance by LLP's of liability insurance. In this form, the LLP Provisions were added to 1991 H.B. 278 in the Senate, and the House concurred in 1991 H.B. 278 as so amended. With the adoption of TRPA in House Bill 273 ("1994 H.B. 273") in 1994, the LLP Provisions of TUPA were refined and carried over into TRPA.

The LLP Provisions originated as part of a liability limiting trend that has included (i) the LLC Act; (ii) amendments to the Texas Professional Corporation Act in 1989 and in 1991 H.B. 278; (iii) the passage of TRPA in 1994 H.B. 273, maintaining the LLP entity created by 1991 H.B. 278; (iv) the 1989 and 1993 amendments to TBCA article 2.21 to clarify non-liability of shareholders for corporate contractual obligations; (v) the passage of TRLPA in 1987, which allowed limited partners to engage in widely expanded activities without sacrificing their limited liability; and (vi) the 1987 enactment and subsequent amendment of TMCLA art. 1302-7.06 authorizing the limitation of liability of directors. These legislative changes were made during a period of increasing litigation against individuals for actions that they allegedly took, or failed to take, while serving as directors, officers or partners of a firm that failed or provided services to a firm that failed. This litigation often involved amounts that dwarfed the net worth of the individuals involved.

2. LLP Now Nationwide. The LLP has spread beyond its Texas roots, and now every state has adopted an LLP statute. As the adoption of LLP statutes became more widespread, the LLP statutes of an increasing number of states protected partners from liabilities arising other than from the negligence, malpractice, wrongful acts or misconduct of other partners and employees.⁸⁰¹ The "full shield" LLP statutes of a number of states (including Colorado, Georgia, Idaho, Indiana, Maryland, Minnesota and New York) insulate a partner from personal liability for any debts, obligations or liabilities of, or chargeable to, the partnership, if

⁷⁹⁹ See Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065 (1995).

⁸⁰⁰ See TEX. LAW. 7 (May 13, 1991); TEX. LAW. 1 (Oct. 21, 1991).

⁸⁰¹ See, e.g., N.Y. Partnership Law § 26(b) (McKinney 1988 & Supp.); Hamilton, *Registered Limited Liability Partnerships: Present at Birth (Nearly)*, 66 U. COLO. L. REV. 1065, 1097 (1995).

such liability would exist solely by reason of their being partners, rendering professional services, or participating in the conduct of the business of the LLP, but do not protect a partner from liability arising from the partner's own negligence, wrongful acts or misconduct, or from that of any person acting under his direct supervision and control.⁸⁰²

3. 1997 Amendment to Limit Contract Liabilities. Although Texas was the first jurisdiction in the nation to permit the creation of LLPs, TRPA lagged behind other jurisdictions in providing partners of LLPs with protection from liabilities of the partnership. To address this deficiency, 1997 S.B. 555 amended TRPA section 3.08 in 1997 to bring the Texas statute more in line with the laws of other jurisdictions relating to LLPs, in particular the liability of partners of an LLP for contractual obligations. TRPA section 3.08(a), as so amended, provided that, except for liability for errors, omissions, negligence, incompetence or malfeasance committed by, or attributed to, a partner in an LLP, a partner will not be individually liable, directly or indirectly, by contribution, indemnity or otherwise, for the debts and obligations of the partnership incurred while the partnership is an LLP.⁸⁰³

A new subsection (5) was added to TRPA section 3.08(a) by 1997 S.B. 555⁸⁰⁴ to provide that in the case of an LLP, the limitations of liability provided in section 3.08(a) will prevail over other parts of TRPA regarding the liability of partners, their chargeability for the debts and obligations of the partnership and their obligations regarding contributions and indemnity. The amendment to TRPA section 3.08 relating to limitation of liability of partners of an LLP did not impair the obligations under a contract existing before the effective date of 1997 S.B. 555.⁸⁰⁵ Thus, the partners of an LLP which was subject to a long-term lease entered into prior to September 1, 1997 remained personally liable for those lease obligations notwithstanding the amendment of TRPA section 3.08, although they would be shielded against contractual obligations created thereafter. Similarly, for organizations subject to the TBOC, the TBOC's provisions govern contracts the LLP enters on and after the first date the TBOC applies to the LLP, but prior law governs any contracts entered into under such old law.⁸⁰⁶

TRPA section 8.06 was amended by 1997 S.B. 555 to clarify that the obligations of a partner to make contributions to a partnership for the partner's negative balance in the partner's capital account and to satisfy obligations are subject to the limitations contained in TRPA sections 3.07 and 3.08 relating to LLPs and the liability of incoming partners.

The amendment to TRPA section 3.08 making Texas a full shield state did not apply to contractual obligations incurred prior to the September 1, 1997 effective date of 1997 S.B. 555 by virtue of 1997 S.B. 555 section 125(d), which provided as follows:

⁸⁰² N.Y. Partnership Law § 26(c), (d) (McKinney 1988 & Supp.).

⁸⁰³ TRPA § 3.08.

⁸⁰⁴ The TBOC's parallel provision is in § 152.801(f).

⁸⁰⁵ 1997 S.B. 555 § 125(d) provides as follows:

(d) The change to Article 3.08, Texas Revised Partnership Act (Article 6132b-3.08, Vernon's Texas Civil Statutes), made by this Act shall not impair the obligations of a contract existing before the effective date of this Act.

⁸⁰⁶ TBOC § 402.006.

“(d) The change to Article 3.08, Texas Revised Partnership Act (Article 6132b-3.08, Vernon’s Texas Civil Statutes), made by this Act shall not impair the obligations of a contract existing before the effective date of this Act.”

Such obligations were similarly unshielded for partnerships governed by the TBOC.⁸⁰⁷ Thus, the partners of an LLP which was subject to a long term lease entered into prior to September 1, 1997 remained personally liable for those lease obligations notwithstanding the amendment of TRPA section 3.08, although the same obligation incurred thereafter would be shielded unless the partners had agreed to be liable therefor.

4. Insurance Requirement. A requirement for LLP status under the Tex. LLP Stats. prior to 2011 S.B. 748 was that the partnership must:

(1) carry at least \$100,000 of liability insurance of a kind that is designed to cover the kind of error, omission, negligence, incompetence, or malfeasance for which liability is limited by Section 152.801(b); or

(2) provide \$100,000 specifically designated and segregated for the satisfaction of judgments against the partnership for the kind of error, omission, negligence, incompetence, or malfeasance for which liability is limited by Section 152.801(b) by:

(A) deposit of cash, bank certificates of deposit, or United States Treasury obligations in trust or bank escrow;

(B) a bank letter of credit; or

(C) insurance company bond.⁸⁰⁸

The requirement that the partnership “carry at least \$100,000 of liability insurance of a kind that is designed to cover the kind of error, omission, negligence, incompetence, or malfeasance for which liability is limited by” the Tex. LLP Stats. (and the option to provide \$100,000 of funds instead) was intended to provide some source of recovery as a substitute for the assets of partners who were shielded from liability by the Tex. LLP Stats. The \$100,000 figure was arbitrary and might or might not be greater than the partners’ individual assets otherwise available to partnership creditors. Nevertheless, the maintenance by the LLP of the required \$100,000 of insurance or segregated funds at the time a liability was incurred was a requirement for the liability to be shielded, and it was not sufficient that a partner individually maintains insurance in such amount.⁸⁰⁹

⁸⁰⁷ TBOC § 402.006.

⁸⁰⁸ TBOC § 152.804(a). TRPA § 3.08(d)(1) provides substantially the same. The partnership should, of course, be a named insured. While a policy naming only the partners may suffice, caution suggests not relying on this approach.

⁸⁰⁹ In *Elmer v. Santa Fe Properties, Inc.*, 2006 WL 3612359 (Tex. App.—San Antonio 2006, no pet.), a partner of an LLP was held personally liable for the LLP’s obligations under a lease executed at a time when the LLP was not in compliance with the requirement of the applicable LLP Stats. that an LLP maintain liability insurance of at least \$100,000 “of a kind that is designed to cover the kinds of errors, omissions, negligence, incompetence, or malfeasance for which liability is limited by” the LLP Stats. It did not matter that (i) a judgment was first obtained against the partnership on pleadings alleging that the

The \$100,000 requirement referred to the liability limit of the insurance, above any deductibles, retentions or similar arrangements; thus, deductibles, retentions and the like were permitted so long as the coverage would allow aggregate proceeds of at least \$100,000. The statute was not explicit about the effect on one claim of exhaustion of the policy limits by a prior claim. The intent was clear that exhaustion by one claim does not remove the liability shield for the same claim. If an LLP had the requisite insurance in place at the time the error or omission occurred, the insurance requirement should be satisfied even though subsequent events made the coverage unavailable to the aggrieved party. For example, if there were a number of lawsuits pending against an LLP at the time an error or omission occurred and judgments subsequently entered depleted the insurance available for the aggrieved party, the subsequent events should not retroactively deny the LLP shield to the partnership. Renewal or replacement of policies on their periodic expirations is probably enough to satisfy the insurance requirement of TRPA section 3.08(d) and TBOC section 152.804.

The insurance must be “designed to cover the kinds of” acts for which partner liability was shielded by Tex. LLP Stats.⁸¹⁰ The quoted phrase contained some flexibility; actual coverage of the misconduct that occurs was not an absolute necessity. The partner claiming the shield from liability, however, had the burden of proof that the insurance satisfied this statutory requirement.

Insurance coverage for particular conduct is not always available. TRPA section 3.08(d) and TBOC section 152.804(a) allowed an LLP the option of providing \$100,000 in funds in lieu of obtaining insurance, but require one or the other. Proof of compliance with the insurance or financial responsibility requirements was on the partner claiming the liability shield of TBOC section 152.801 or TRPA section 3.08(a).⁸¹¹

The Tex. LLP Stats. provided that the LLP insurance requirements “shall not be admissible nor in any way made known to the jury in determining the issue(s) of liability for or extent of the debt or obligation or damages in question.”⁸¹² These provisions were intended to keep the existence of insurance from influencing a jury decision on liability or damages. The Tex. LLP Stats. specifically stated that if compliance with their insurance or fund provisions was disputed, “compliance must be determined separately from the trial or proceeding” to determine liability or damages.⁸¹³

partnership was an LLP, (ii) the individual partner sued in the case had actually maintained errors and omissions coverage for himself individually (the Tex. LLP Stats. require that the insurance cover the partnership and covering an individual partner is not good enough—substantial compliance is not enough under the Tex. LLP Stats: strict compliance is required), and (iii) the liability at issue was a contract obligation rather than the kind of tort liability for which the statutorily required insurance would provide coverage. *See* Elizabeth S. Miller, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 TEX. J. BUS. L. 405, 440 (Fall 2009).

⁸¹⁰ TRPA § 3.08(d)(1)(A); TBOC § 152.804(a)(1).

⁸¹¹ *See* TRPA § 3.08(d)(3); TBOC § 152.804(c).

⁸¹² TRPA § 3.08(d)(2); *see also* TBOC § 152.804(b).

⁸¹³ TRPA § 3.08(d)(3); *see also* TBOC § 152.804(c).

5. TBOC Prior to 2011 S.B. 748. The TBOC as originally adopted afforded LLP partners the same protection as TRPA section 3.08(a), although the TBOC in referring to the LLP dropped the “registered” in limited liability partnership and referred to an LLP as a limited liability partnership.⁸¹⁴ This provision, however, did not apply to the liability of a partnership to pay its debts and obligations out of partnership property, the liability of a partner, if any, imposed by law or contract independently of the partner’s status as a partner, or the manner in which service of citation or other civil process may be served in an action against the partnership. Prior to 2011 S.B. 748, the LLP shield in TBOC § 152.801 protected a partner in an LLP from both tort and contract liabilities of the LLP.

Partners in a general partnership that is not an LLP are individually liable, jointly and severally, for all partnership obligations, including partnership liabilities arising from the misconduct of other partners, although under Texas law a creditor generally must first seek to satisfy the obligations out of partnership property.⁸¹⁵ Although an LLP is a general partnership, the general partnership joint and several liability scheme is dramatically altered by the Tex. LLP Stats. when LLP status is attained.

The essence of the Tex. LLP Stats. prior to 2011 S.B. 748 was to relieve a partner from individual liability for partnership obligations, except to the extent that they are attributable to the fault of the partner. The shield was set forth in TBOC § 152.801 (prior to 2011 S.B. 748) as follows:

Sec. 152.801. Liability of Partner.

(a) Except as provided by Subsection (b) or the partnership agreement, a partner in a limited liability partnership is not personally liable to any person, including a partner, directly or indirectly, by contribution, indemnity, or otherwise, for a debt or obligation of the partnership incurred while the partnership is a limited liability partnership.⁸¹⁶

⁸¹⁴ TBOC §§ 1.002(48) and 152.801-152.805.

⁸¹⁵ TRPA § 3.05(a), (d), (e); TBOC § 152.306(b). *See Bromberg & Ribstein, supra* note 399, § 1.01 and ch. 5 for a general discussion of the liabilities of general partners.

⁸¹⁶ In *Evanston Ins. Co. v. Dillard Dep’t Stores, Inc.*, 602 F.3d 610 (5th Cir. 2010), the Fifth Circuit held that the partners in an LLP were personally liable for trademark infringement and business torts that occurred when the partnership was an LLP because the judgment creating the partnership “debt” was entered after the partnership dissolved and its LLP registration had expired. The facts of the case elucidate why the Fifth Circuit reached a result that appears inconsistent with both the intent and the wording of the Tex. LLP Stats. The two defendants formed a law partnership in 2002, registered it as an LLP and prosecuted lawsuits against plaintiff (“Dillard’s”), alleging that Dillard’s racially discriminated against its customers. In an attempt to solicit business, the firm developed a website which included a link using the “Dillard’s” name and logo. Clicking this link took visitors to dillardsalert.com, a separate website documenting acts of alleged racial profiling by the department stores. Dillard’s sued the firm for trademark infringement and various business torts. It sought damages and an injunction against CELLP’s use of its trademark. In 2004, while the litigation continued, the partners executed a separation agreement that provided for “dissolution” of the partnership, and the partnership’s registration as an LLP was not renewed and expired. Notwithstanding these facts, the defunct LLP remained a party to the Dillard’s litigation, no party was substituted on its behalf, and a final judgment was entered ordering the LLP to pay Dillard’s \$143,500. Dillard’s attempt to collect on the judgment did not succeed and ultimately it sued the two lawyers individually for the obligations of the partnership.

(b) A partner in a limited liability partnership is not personally liable for a debt or obligation of the partnership arising from an error, omission, negligence, incompetence, or malfeasance committed by another partner or representative of the partnership while the partnership is a limited liability partnership and in the course of the partnership business unless the first partner:

In affirming on other grounds the district court holding which had stated that the partners became personally liable because they did not wind up the business upon dissolution of the partnership and expiration of the LLP registration, the Fifth Circuit explained:

Appellants [the LLP partner defendants] argue that [TRPA] § 3.08(a)(1) insulates them from liability because CELLP's debt was incurred when the infringing website was created in June 2003, at which time CELLP was still a registered limited liability partnership. Dillard's, meanwhile, contends that the debt was incurred when the judgment was entered on November 2, 2004, at which time the erstwhile LLP had lost its liability-limiting attributes.

* * *

Although the terms "debt" and "incurred" are not defined by the TRPA, a plain reading of the statute's text supports Dillard's proffered interpretation. Neither partner was necessarily aware in June 2003 that displaying the Dillard's mark on the law firm website would ultimately lead to a partnership debt. The underlying conduct gave rise to the possibility of a future debt, but to say that a debt was "incurred" at that time unrealistically distorts the meaning of the word. After all, CELLP's conduct may have gone undetected, it may have been adjudged perfectly innocent, or Dillard's may have opted not to sue. Under any of those scenarios, no debt would ever have been incurred, let alone incurred in June 2003. It was only when the district court entered judgment against CELLP in November 2004 that a payable debt came into existence. It was then that CELLP incurred the debt within the meaning of the provision.

Moreover, the neighboring language of § 3.08(a)(2) demonstrates that the Texas legislature, when it so chooses, is capable of drafting a provision that focuses on the commission of events that lead to liability, rather than the fixing of consequent liability from those events. In that provision, the legislature insulated an LLP partner from personal liability "arising from errors, omissions, negligence, incompetence, or malfeasance committed " by another partner "while the partnership is a registered limited liability partnership." TRPA § 3.08(a)(2) (emphasis added). Thus, to decide whether the first partner's liability is limited for the second partner's malfeasance under § 3.08(a)(2), a court must look to when the second partner committed the malfeasance. Had the legislature intended to enact the same "when committed" approach for § 3.08(a)(1), it could have used the language from § 3.08(a)(2). [Citation omitted] It chose, however, to use different language, and created a regime in which partners could be held individually liable for debts and obligations incurred when the partnership was not a registered LLP [§ 3.08(a)(1)], but in which partners would not bear liability for one another's independent malfeasance committed while the LLP existed [§ 3.08(a)(2)].

Because CELLP's registration had expired, it was not a valid registered LLP at the time its debt was incurred. Therefore, § 3.08 does not foreclose individual liability and § 3.04's default rule operates to hold appellants personally liable for CELLP's debt.

See Elizabeth S. Miller, Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities, 43 TEX. J. OF BUS. L. 405, 435-445 (Fall 2009).

- (1) was supervising or directing the other partner or representative when the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative;
 - (2) was directly involved in the specific activity in which the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative; or
 - (3) had notice or knowledge of the error, omission, negligence, incompetence, or malfeasance by the other partner or representative at the time of the occurrence and then failed to take reasonable action to prevent or cure the error, omission, negligence, incompetence, or malfeasance.
- (c) Sections 2.101(1), 152.305, and 152.306 do not limit the effect of Subsection (a) in a limited liability partnership.
- (d) In this section, “representative” includes an agent, servant, or employee of a limited liability partnership.
- (e) Subsections (a) and (b) do not affect:
- (1) the liability of a partnership to pay its debts and obligations from partnership property;
 - (2) the liability of a partner, if any, imposed by law or contract independently of the partner’s status as a partner; or
 - (3) the manner in which service of citation or other civil process may be served in an action against a partnership.
- (f) This section controls over the other parts of this chapter and the other partnership provisions regarding the liability of partners of a limited liability partnership, the chargeability of the partners for the debts and obligations of the partnership, and the obligations of the partners regarding contributions and indemnity.⁸¹⁷

The Tex. LLP Stats. prior to 2011 S.B. 748 expressly did not relieve a partner for any liability imposed by law or contract independently of his status as a partner.⁸¹⁸ In addition, there were three situations in which the LLP Provisions did not shield a partner from liability for a partnership obligation arising from the specified misconduct of a copartner or representative of the partnership:

⁸¹⁷ The provisions of TBOC § 152.801 prior to 2011 S.B. 748 were substantially the same as those found in TRPA § 3.08(a), except that TBOC § 152.801(a) was amended as follows in the 2009 Legislative Session by 2009 S.B. 1442 § 47 without a corresponding change being made to TRPA § 3.08(a):

SECTION 47. Subsection (a), Section 152.801, Business Organizations Code, is amended to read as follows:

(a) Except as provided by Subsection (b) or the partnership agreement, a partner in a limited liability partnership is not personally liable to any person, including a partner, directly or indirectly, by contribution, indemnity, or otherwise, for a debt or obligation of the partnership incurred while the partnership is a limited liability partnership.

⁸¹⁸ TRPA § 3.08(a)(3)(B); TBOC § 152.801(e).

- (1) The miscreant copartner or representative was working under the supervision or direction of the partner.⁸¹⁹
- (2) The partner was directly involved in the specific activity in which the copartner or representative commits the misconduct.⁸²⁰
- (3) The partner had “notice” or “knowledge” of the misconduct at the time of occurrence and fails to take reasonable steps to prevent the misconduct.⁸²¹

All three situations involve fact questions as well as legal interpretations of the statutory language.

In situation (1), the supervision should be direct, or the direction should be specific, for the exception to apply. The language in situation (1) was not intended to deny the liability shield to someone (such as a managing or senior partner) who exercises indirect supervision over all partnership activity or over a particular segment of the partnership’s business or who generally directs other partners by establishing policies and procedures or by assigning responsibilities.

In situation (2), the direct involvement should relate to the particular aspect of the endeavor in which the misconduct occurred. The language in situation (2) was not intended to deny the liability shield to someone who was directly involved in one facet of a multifaceted matter (e.g., one involving several different areas of expertise) but did not participate in that facet of the matter that gave rise to the liability.

Neither exception (1) nor (2) should denude someone who had direct supervisory responsibility for, and therefore was directly involved in, a particular project but was not directly supervising the person who engaged in misconduct or directly involved in the aspect of the project in which the misconduct occurred.⁸²² For example, an environmental lawyer who negligently rendered legal advice with respect to the environmental law aspects of a real property acquisition would not ordinarily be viewed as “working under the supervision or direction” of a real estate lawyer having overall responsibility for the acquisition (which means that exception (1) would not be applicable), and the real estate lawyer would not ordinarily be viewed as

⁸¹⁹ TRPA § 3.08(a)(2); TBOC § 152.801(b)(1).

⁸²⁰ TRPA § 3.08(a)(2)(A); TBOC § 152.801(b)(2).

⁸²¹ TRPA § 3.08(a)(2)(B); TBOC § 152.801(b)(3). Tex. LLP Stats. provided prior to 2011 S.B. 748 that a person has “notice” of a fact if such person (i) has actual knowledge of such fact, (ii) has received a communication of the fact, or (iii) reasonably should have concluded, from all facts known to such person at the time in question, that the fact exists. A person is treated as having received a communication of a fact if the fact is communicated to the person, the person’s place of business, or another place held out by the person as the place for receipt of communications. TRPA § 1.02; TBOC § 151.003.

⁸²² *But see* Fortney, *Am I My Partner’s Keeper? Peer Review in Law Firms*, 66 U. COL. L. REV. 329, 331-32 (1995) (notes that in six “actions brought in connection with failed savings and loan associations, the government has alleged that *each law firm partner is personally liable for failing to monitor the conduct of other firm partners.* * * * In making such allegations the government has asserted that the failure to monitor claims are distinct from the vicarious liability claims,” for which the LLP shield was designed).

“involved in the specific activity” (i.e., advising with respect to environmental law) in which the misconduct occurred (which means that exception (2) would not apply).

C. Liability Shielded After 2011 S.B. 748. The individual liability of partners of a general partnership that is an LLP is even more drastically altered after 2011 S.B. 748. The essence of the LLP liability shield continues to be that a partner in an LLP is not liable for the tort or contract liabilities of the partnership incurred while it is an LLP, but 2011 S.B. 748 removed wording in the LLP Provisions that a partner could have responsibility for the actions of another partner where the partner was supervising or involved in the actions of the miscreant partner or aware of the miscreant partner’s actionable conduct.⁸²³ A partner, however, is always liable for the partner’s own tortious conduct.

⁸²³ 2011 S.B. 748 § 46 provided as follows:

SECTION 46. Section 152.801, Business Organizations Code, is amended to read as follows:

Sec. 152.801. LIABILITY OF PARTNER. (a) Except as provided by [~~Subsection (b) of~~] the partnership agreement, a partner [~~in a limited liability partnership~~] is not personally liable to any person, including a partner, directly or indirectly, by contribution, indemnity, or otherwise, for any [~~a debt of~~] obligation of the partnership incurred while the partnership is a limited liability partnership.

(b) [~~A partner in a limited liability partnership is not personally liable for a debt or obligation of the partnership arising from an error, omission, negligence, incompetence, or malfeasance committed by another partner or representative of the partnership while the partnership is a limited liability partnership and in the course of the partnership business unless the first partner:~~

[~~(1) — was supervising or directing the other partner or representative when the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative;~~

[~~(2) — was directly involved in the specific activity in which the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative; or~~

[~~(3) — had notice or knowledge of the error, omission, negligence, incompetence, or malfeasance by the other partner or representative at the time of the occurrence and then failed to take reasonable action to prevent or cure the error, omission, negligence, incompetence, or malfeasance.~~

[~~(e)~~] Sections 2.101(1), 152.305, and 152.306 do not limit the effect of Subsection (a) in a limited liability partnership.

(c) For purposes of this section, [(d) In this section, “representative” includes] an obligation is incurred while a partnership is [agent, servant, or employee of] a limited liability partnership if:

(1) the obligation relates to an action or omission occurring while the partnership is a limited liability partnership; or

(2) the obligation arises under a contract or commitment entered into while the partnership is a limited liability partnership.

(d) Subsection [(e) Subsections] (a) does [and (b) do] not affect:

1. LLP Shield. After 2011 S.B. 748, the liability of a partner in an LLP is shielded by TBOC § 152.801 as follows, effective September 1, 2011:

Sec. 152.801. LIABILITY OF PARTNER. (a) Except as provided by the partnership agreement, a partner is not personally liable to any person, including a partner, directly or indirectly, by contribution, indemnity, or otherwise, for any obligation of the partnership incurred while the partnership is a limited liability partnership.

(b) Sections 2.101(1), 152.305, and 152.306 do not limit the effect of Subsection (a) in a limited liability partnership.

(c) For purposes of this section, an obligation is incurred while a partnership is a limited liability partnership if:

(1) the obligation relates to an action or omission occurring while the partnership is a limited liability partnership; or

(2) the obligation arises under a contract or commitment entered into while the partnership is a limited liability partnership.

(d) Subsection (a) does not affect:

(1) the liability of a partnership to pay its obligations from partnership property;

(2) the liability of a partner, if any, imposed by law or contract independently of the partner's status as a partner; or

(3) the manner in which service of citation or other civil process may be served in an action against a partnership.

(e) This section controls over the other parts of this chapter and the other partnership provisions regarding the liability of partners of a limited liability

(1) the liability of a partnership to pay its ~~debts and~~ obligations from partnership property;

(2) the liability of a partner, if any, imposed by law or contract independently of the partner's status as a partner; or

(3) the manner in which service of citation or other civil process may be served in an action against a partnership.

~~(e)~~ ~~(f)~~ This section controls over the other parts of this chapter and the other partnership provisions regarding the liability of partners of a limited liability partnership, the chargeability of the partners for the ~~debts and~~ obligations of the partnership, and the obligations of the partners regarding contributions and indemnity.

partnership, the chargeability of the partners for the obligations of the partnership, and the obligations of the partners regarding contributions and indemnity.⁸²⁴

2. Limits to LLP Shield. The LLP shield of TBOC § 152.801 after 2011 S.B. 748 does not protect partnership assets from claims of contract and tort creditors of the LLP.⁸²⁵ Further, the LLP Provisions do not protect a partner in an LLP from liabilities of the partner imposed by law or contract independently of the partner's status as a partner in an LLP.⁸²⁶ A partner is always liable for the partner's own tortious conduct.

3. Burden of Proof. The liability shield of the Tex. LLP Stats. is an affirmative defense, with the burden of proof on the partner claiming its benefit to show that the partnership is an LLP (i.e. that it complied at the relevant time(s) with the registration and name requirements). The burden would then shift to the plaintiff to prove that one or more of the three exceptions apply to remove the liability shield from particular partners.

4. LLP Status Does Not Affect Liability of Partnership. LLP status does not relieve a partnership itself from liability for misconduct of its partners or representatives or prevent its assets from being reached to satisfy partnership obligations.⁸²⁷ A partnership may still be sued as an entity in its common name under Rule 28 of the Texas Rules of Civil Procedure, with or without the partners.⁸²⁸ Citation or other process against a partnership may still be served on a partner under Section 17.022 of the Texas Civil Practice and Remedies Code, regardless of whether the partner is shielded from liability by the partnership's LLP status.⁸²⁹

5. Shielded vs. Unshielded Obligations; Time Obligations Incurred. The LLP shield only applies to the liability of partners for the partnership obligations incurred while the partnership is an LLP.⁸³⁰ For purposes of TBOC § 152.801 after 2011 S.B. 748, an obligation is incurred while a partnership is an LLP if: (i) the obligation relates to an action or omission occurring while the partnership is an LLP; or (ii) the obligation arises under a contract or commitment entered into while the partnership is an LLP.

The partners remain jointly and severally liable for all other partnership obligations. A partnership at any time may have both shielded and unshielded obligations.

⁸²⁴ 2011 S.B. 748 § 66 (3) repealed old TBOC § 804 which required that an LLP maintain insurance or a segregated fund of at least \$100,000 to provide for claims against the LLP.

⁸²⁵ TBOC § 152.801(d)(1) after 2011 S.B. 748.

⁸²⁶ TBOC § 152.801(d)(2) after 2011 S.B. 748.

⁸²⁷ TBOC § 152.801(d)(1) after 2011 S.B. 748 provides that the other LLP provisions do not affect "the liability of a partnership to pay its obligations from partnership property."

⁸²⁸ TEX. R. CIV. P. 28.

⁸²⁹ TRPA § 3.08(a)(3)(C) (Vernon Supp. 2010).

⁸³⁰ See *Elmer v. Santa Fe Properties, Inc.*, 2006 WL 3612359 (Tex. – San Antonio 2006, no pet.) (under Tex. LLP Stats. in effect prior to 2011 S.B. 748, partner held liable for LLP lease obligations because it "was not a properly registered limited liability partnership when it incurred its lease obligations" because it did not have the required insurance at that time).

The Tex. LLP Stats. do not deal with the right of a partnership to pay unshielded obligations before paying shielded obligations or whether partner contributions may be earmarked to cover particular unshielded obligations. These matters are left to fiduciary principles and laws pertaining to creditors rights.

6. Other State LLP Statutes. In the other states that have LLP statutes, the scope of liability from which an innocent partner in an LLP is protected varies from state to state. Some LLP statutes only protect partners from vicarious liability for tort-type liabilities (“*partial shield*”), while others provide a “*full shield*” of protection from both tort and contract liabilities of the partnership,⁸³¹ perhaps in recognition that some malpractice claims could be pled in contract as well as in tort.⁸³² Under most LLP statutes, including that of Delaware,⁸³³ a partner is liable not only for his own negligence, malpractice, wrongful act or misconduct, but also for that of someone under his direct supervision and control. The Maryland LLP statute preserves liability for a partner who is negligent in appointing, supervising or cooperating with the partner, employee or agent who was negligent or committed the wrongful act or omission.⁸³⁴ At least two states, Kentucky and Utah, have adopted LLP statutes providing that a partner is personally liable only for his own negligence, malpractice, wrongful acts and misconduct.⁸³⁵

D. Post 2011 S.B. 748 Requirements for LLP Status. Each of the two requirements described below must be satisfied in order for the LLP shield to be in place in Texas. Creditors seeking to break the shield can be expected to require proof of satisfaction of each of the conditions and to challenge any noncompliance.

1. Name. The Tex. LLP Stats. require that an LLP must include in its name the words “limited liability partnership” or an abbreviation thereof.⁸³⁶

⁸³¹ See Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 BUS. LAW. 101 (Nov. 1997), which contains a table of LLP Liability Shield Features (through October 31, 1997) showing those LLP statutes which are full shield or partial shield).

⁸³² Miller, *Procedural and Conflict Laws Issues Arising In Connection With Multi-State Partnerships* (ABA BUS. L. SEC. 1996 Spring Meeting).

⁸³³ DEL. CODE ANN. tit. 6, § 1515 (1999 & Supp. 2005).

⁸³⁴ MD. CORP. & ASS’N. CODE ANN. § 9A-306(d)(1) (1999).

⁸³⁵ See KY. REV. STAT. ANN. § 362.220 (Michie 2002); UTAH CODE ANN. § 48-1-12(2) (2002).

⁸³⁶ TRPA § 3.08(c); TBOC § 5.063; TEX. ADMIN. CODE tit. 1, § 80.1(b) (2003). Under the TRPA, LLPs were officially called registered limited liability partnerships. The TRPA also imposed additional restrictions regarding an LLP’s name which have been omitted from the TBOC. See Revisor’s Notes to TBOC §§ 1.002(48) and 5.063. A firm with a written partnership agreement should amend the agreement to include the required words or letters as part of its name.

Compliance with the Texas name requirements by a law firm should not conflict with the misleading name prohibition in Rule 7.01 of Texas Disciplinary Rules of Professional Conduct, which provides in relevant part as follows:

- (a) A lawyer in private practice shall not practice under a trade name, a name that is misleading as to the identity of the lawyer or lawyers practicing under such name, or a firm name containing names other than those of one or more of the lawyers in the firm, except that the names of a professional corporation or professional association may contain “P.C.” or “P.A.” or similar symbols indicating the nature of the organization . . .

2. Filing with the Secretary of State of Texas. LLPs are considered to be non-filing entities under the TBOC.⁸³⁷ Nonetheless, to achieve domestic LLP status, a partnership must file with the Secretary of State of Texas⁸³⁸ an application accompanied by a fee for each partner of \$200.⁸³⁹ The application must (a) state the name of the partnership, the address of its principal office, the number of partners and the business in which the partnership engages, plus the federal tax identification number of the partnership,⁸⁴⁰ and (b) be executed by a majority in interest⁸⁴¹ of the partners or by one or more partners authorized by a majority in interest of the partners. The Tex. LLP Stats. do not require that an LLP filing with the Secretary of State have any express authorization in the partnership agreement, but changing the name to include the required words or abbreviation required by Tex. LLP Stats. would ordinarily require that the partnership agreement contemplate LLP status.⁸⁴²

If the required information is supplied in the application and the fee is paid, the LLP registration becomes effective upon filing.⁸⁴³ There is no requirement for the Secretary of State to issue a certificate. As evidence of the filing, the Secretary of State will return a file-stamped duplicate of the application. The Tex. LLP Stats. now permit electronic filings of LLP documents as soon as the Secretary of State's procedures will permit.⁸⁴⁴

[emphasis added]. The underscored language was in Rule 7.04 before LLPs were authorized and was intended to clarify that it is permissible to include in a firm name words, initials or symbols indicating the nature of the limited liability form of organization. The references to "professional corporation," "professional association," "P.C." and "P.A." are by way of example and not limitation, and they do not limit the use of the words or letters "registered limited liability partnership" or "L.L.P." in a firm name. The legislative history of the LLP Provisions clearly shows that the legislature intended the LLP form of business organization to be available to firms of lawyers and other professionals.

⁸³⁷ See TBOC §§ 1.002(57), (34).

⁸³⁸ The rules of the Secretary of State dealing with LLP filings may be found at TEX. ADMIN. CODE tit. 1, §§ 80.1-80.7 (2003) as well as TRPA § 3.08(b) and TBOC § 152.802.

⁸³⁹ The \$200 per partner fee for LLPs organizing under Texas law is based on the total partners in the firm, and not the number of partners in Texas, under TRPA § 3.08(b)(3) and TBOC § 4.158(1). For a foreign LLP, the fee is \$200 per partner in Texas, not to exceed \$750, under TRPA § 10.02(c) and TBOC § 4.158(1).

⁸⁴⁰ The Secretary of State's form of application and the Tex. LLP Stats. require the tax identification number of the partnership as part of the application to provide more positive identification than the partnership name, which may change or may be similar to other names.

⁸⁴¹ "Majority in interest" is defined in TRPA § 1.01(10), TRLPA § 1.02(7), and TBOC § 151.001(3) as more than 50% of the current interest in profits of the partnership. Although not required by the Secretary of State's form or the Tex. LLP Stats., it is prudent for an application to recite that it is signed by a majority in interest of the partners or by one or more partners authorized by a majority in interest of the partners.

⁸⁴² In some states, electing LLP status requires unanimous partner approval or an amendment to the partnership agreement in accordance with the applicable partnership agreement provisions. See Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 BUS. LAW. 101, 114-115 (Nov. 1997).

⁸⁴³ TBOC § 4.051. The Secretary of State must register or renew as an LLP any partnership that submits a completed application with the required fee. See Tex. Admin. Code tit. 1, § 80.3 (2008); TBOC § 4.002.

⁸⁴⁴ TRPA § 3.08(b)(16); TBOC § 4.001(a)(2).

Registration remains effective for a year,⁸⁴⁵ regardless of changes in the partnership, unless the registration is earlier withdrawn or revoked or unless renewed.⁸⁴⁶ Because the registration is a notice filing and no listing of partners is required in the application, partnership changes due to withdrawals or to admissions of new partners do not require any refiling with the Secretary of State until the next renewal filing.⁸⁴⁷ Caution suggests an amendment to the application if the partnership changes its name. LLPs should arrange their own reminders, since the Secretary of State is not obliged to send renewal notices.

E. Taxation.

1. Federal Tax Classification. Since a domestic LLP must have two or more partners, it can be classified as a partnership for federal income tax purposes under the Check-the-Box Regulations.

2. Texas Entity Taxes. As a species of general partnership, an LLP was not subject to the Texas franchise tax prior to the enactment of the Margin Tax in 2006.⁸⁴⁸

The Margin Tax is expressly imposed on LLPs.⁸⁴⁹ Although the LLP is a species of general partnership to which the Margin Tax is not generally applicable, the Margin Tax applies to all LLPs even if all of its partners are individuals.⁸⁵⁰

3. Self-Employment Tax. Partners in an LLP generally will be subject to self-employment tax on their share of the trade or business income of the LLP since an LLP is a species of general partnership and under state law different from a limited partnership.⁸⁵¹

F. Other Issues.

1. Advertisement of LLP Status. Although not required by the Tex. LLP Stats., an LLP should include the LLP words or initials wherever the partnership's name is used, e.g., on directory listings, signs, letterheads, business cards and other documents that typically contain the name of the partnership. Although the LLP designation is part of the partnership's name and should be used as such, it is common and should be permissible for some partnership communications to be shorthanded and omit the designation. A rule of reason should apply in

⁸⁴⁵ TRPA § 3.08(b)(5); TBOC § 152.802(e).

⁸⁴⁶ TRPA §§ 3.08(b)(6), (7); TBOC § 152.802(e).

⁸⁴⁷ See TRLPA § 3.08(b)(4); TEX. ADMIN. CODE tit. 1, §§ 80.1, 80.4 (2008); see also TBOC § 152.802(d).

⁸⁴⁸ TEX. TAX CODE ANN. § 171.001 (Vernon 2002 and Supp. 2004).

⁸⁴⁹ TEX. TAX CODE ANN. § 171.0002(a); 2007 H.B. 3928 § 2 (amended TEX. TAX CODE ANN. § 171.0002(a) to add "limited liability partnership" to the statutory definition of "taxable entity").

⁸⁵⁰ TEX. TAX CODE ANN. § 171.0002(a); 2007 H.B. 3928 § 2; see *supra* notes 126-230 and related text.

⁸⁵¹ *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 TC 137 (Feb. 9, 2011) (partners' distributive shares of the law firm's income found not to arise as a return on the partners' investment and were not "earnings which are basically of an investment nature;" the attorney partners' distributive shares arose from legal services they performed on behalf of the law firm and were held to be self-employment income); see Burgess J. W. Raby & William L. Raby, *Partners, LLC Members, and SE Tax*, 87 Tax Notes 665, 668 (April 26, 2000).

deciding how far a partnership should go in using the LLP designation. Thus, a partnership should, in answering the telephone, be able to use a shortened version of its name that does not refer to its LLP status and, when an existing partnership elects to become an LLP, it should have a reasonable period of time in which to implement the use of the LLP status words or symbols in printed matter and should be able to use up existing supplies of letterhead, etc.

There is no requirement, beyond the name change, that a partnership that becomes an LLP notify its customers, clients or patients of the partnership's new status. Further, there is no requirement that a partnership publish notice of its becoming an LLP comparable to the notice required of certain incorporations in other states.⁸⁵²

2. Assumed Name Certificate. Since an LLP is a species of general partnership, prior to House Bill 1239 ("1993 H.B. 1239") which became effective September 1, 1993, an LLP was required to make filings under the Texas Assumed Business or Professional Name Act (the "Assumed Name Statute")⁸⁵³ like any other general partnership. 1993 H.B. 1239 sections 1.29-1.31 amended the Assumed Name Statute so that LLPs, LLCs and limited partnerships are not deemed to be conducting business under an "assumed name," and do not have to make filings under the Assumed Name Statute if they conduct business in the same name as shown in their documents on file in the office of the Secretary of State.⁸⁵⁴ However, a general partnership which is not an LLP would have to file under the Assumed Name Statute if it conducted business under a name that does not include the surname or legal name of each general partner.⁸⁵⁵ If an LLP, LLC or limited partnership regularly conducts business under any other name (an "assumed name"), it would be required to file in the office of the county clerk of each county in which it maintains a business or professional premises a certificate setting forth the assumed name of the firm and the name and residence address of each general partner.⁸⁵⁶ Failure to comply with the filing requirements of the Assumed Name Statute should not affect the partnership's LLP status but would subject the partnership to the penalties specified in the Assumed Name Statute.⁸⁵⁷ Although under the Assumed Name Statute it would be possible for an LLP to adopt an assumed name that did not include the LLP designation, failure to include the designation is inadvisable since it would frustrate the LLP Act requirement that the designation be in the firm name.

3. Time of Compliance. A partnership must be in compliance with the Tex. LLP Stats. requirements for an LLP at the time of misconduct giving rise to an obligation in

⁸⁵² The New York LLP statute requires publication of a notice once per week for six weeks upon creation of an LLP. N.Y. Partnership Law § 121-1500(a)(9) (McKinney Supp. 2004).

⁸⁵³ TEX. BUS. & COM. CODE § 71.001 *et seq.* (Vernon 2011).

⁸⁵⁴ *See also* TEX. BUS. & COM. CODE §§ 71.001-71.203 as amended in the 2009 Legislative Session by 2009 S.B. 1442.

⁸⁵⁵ TEX. BUS. & COM. CODE § 36.02(7) as amended in the 1993 Legislative Session by 1993 H.B. 1239.

⁸⁵⁶ TEX. BUS. & COM. CODE § 36.10 as amended in the 1993 Legislative Session by 1993 H.B. 1239.

⁸⁵⁷ TEX. BUS. & COM. CODE §§ 36.25 and 36.26.

order to raise the liability shield. Texas law explicitly states that the shielded partners are not liable for misconduct incurred while the partnership is an LLP.⁸⁵⁸

The liabilities of a general partnership that incorporates or becomes a limited partnership remain the individual liabilities of the former general partners notwithstanding the assumption of those liabilities by the new entity.⁸⁵⁹ Likewise, dissolution of a corporation or limited partnership does not result in the liability of its shareholders or limited partners for the entity's obligations,⁸⁶⁰ and the result should be no different in the case of the dissolution of an LLP. Thus, for example, if an LLP were to dissolve, its partners should not lose the liability shield in an action brought during winding up for misconduct that occurred, or upon a contract made, before dissolution.

4. Effect on Pre-LLP Liabilities. An LLP is the same partnership that existed before it became an LLP.⁸⁶¹ Since the Tex. LLP Stats. shield protects partners only against liabilities incurred while the partnership is an LLP, attainment of LLP status has no effect on pre-existing partnership liabilities. In *Medical Designs, Inc. v. Shannon, Gracey, Ratliff & Miller, L.L.P.*,⁸⁶² a law firm was sued for malpractice and obtained a summary judgment that was upheld on appeal on the basis that a "successor partnership" is *not liable* for the torts of a predecessor partnership, although the liabilities of the prior partners would remain their liabilities. The law firm defendant had, subsequent to the time the alleged malpractice occurred, merged and unmerged with another law firm, and the miscreant partner of the prior partnership was not associated with the defendant law firm. Under these facts the court of appeals wrote, "Texas does not recognize that successor partnerships are liable for the tortious conduct of predecessor partnerships."⁸⁶³ However, there is nothing in the court's opinion suggesting that registration as an LLP is enough to make the partnership a different partnership.⁸⁶⁴

5. Limited Partnership as LLP. A limited partnership can become an LLP simply by complying with the applicable LLP provisions, in which case it would be a "LLLLP."⁸⁶⁵

⁸⁵⁸ TBOC § 152.801(a); *see also* TRPA § 3.08(a)(1). This result is buttressed by the Bar Committee Bill Analysis of 1994 H.B. 273 which at 14 states that TRPA § 3.08(a)(1) "clarifies that the partnership must be a registered limited liability partnership at the time of the errors and omissions for which partner liability is limited."

⁸⁵⁹ TRPA § 3.08(a)(1); *see also* *Baca v. Weldon*, 230 S.W.2d 552 (Tex. Civ. App.—San Antonio, 1950, writ ref'd n.r.e.).

⁸⁶⁰ *See* *Hunter v. Fort Worth Capital Corp.*, 620 S.W.2d 547 (Tex. 1981); *Anderson v. Hodge Boats & Motors, Inc.*, 814 S.W.2d 894 (Tex. App.—Beaumont 1991).

⁸⁶¹ *See* *Middlemist v. BDO Seidman, LLP*, 958 P.2d 486 (Colo. Ct. App. 1997); *Sasaki v. McKinnon*, 707 N.E. 2d 9 (Ohio Ct. App. 1997); and *Howard v. Klynveld Peat Marwick Goerdeler*, 977 F. Supp. 654 (S.D. N.Y. 1997).

⁸⁶² 922 S.W.2d 626 (Tex. App.—Fort Worth 1996, writ denied).

⁸⁶³ *Id.* at 629.

⁸⁶⁴ For an analysis of the *Shannon Gracey* case, *see* Elizabeth S. Miller, *The Advent of LLCs and LLPs in the Case Law: A Survey of Cases Dealing With Registered Limited Liability Partnerships and Limited Liability Companies* presented at symposium on Partnerships and LLCs - Important Case Law Developments 1998 at ABA Annual Meeting in Toronto, Ontario, Canada on August 4, 1998.

⁸⁶⁵ *See* TRPA § 3.08(e); TBOC §§ 152.805, 1.002(47).

In addition, Tex. LLP Stats. provide that a limited partnership is an LLP as well as a limited partnership if it (i) registers as an LLP under the proper provisions,⁸⁶⁶ as permitted by its partnership agreement or with the consent of partners required to amend its partnership agreement to so permit, (ii) complies with the insurance or financial responsibility provisions of Tex. LLP Stats.,⁸⁶⁷ and (iii) contains in its name⁸⁶⁸ “limited liability partnership,” “limited liability limited partnership” or an abbreviation thereof.⁸⁶⁹

In an LLLP the general partners should have the same liability shield as partners in any other LLP. In a limited partnership, a limited partner is not liable to creditors unless (i) the limited partner participates in the control of the business and (ii) the creditor reasonably believed that the limited partner was a general partner.⁸⁷⁰ Under Tex. LLP Stats., a limited partner in an LLLP whose conduct would otherwise render it liable as a general partner has the benefit of the LLP shield.⁸⁷¹

6. Indemnification and Contribution. The Tex. LLP Stats. eliminate the usual right of a partner who is held personally liable for a partnership obligation to obtain indemnification from the partnership or contribution from co-partners.⁸⁷² It seems inconsistent with the Tex. LLP Stats. to allow a partner to recover, directly or indirectly, from co-partners who are shielded from liability by the same statutes, absent a specific agreement of indemnification.⁸⁷³ Indeed, TRPA section 3.08(a) and TBOC section 152.801 expressly provide that a partner is not individually liable “by contribution, indemnity, or otherwise” for partnership obligations except as otherwise provided. Quite apart from the Tex. LLP Stats., there is authority that a partner who commits malpractice cannot recover from his or her non-negligent copartners.⁸⁷⁴ It would certainly be inconsistent with the Tex. LLP Stats. to let a plaintiff reach those co-partners through some theory of subrogation based on an alleged indemnification or contribution right of the misfeasant partner.

7. Inconsistent Partnership Agreement Provisions. A written or oral partnership agreement can modify or defeat the LLP liability shield. In cases where a partnership agreement sets forth partner indemnification or contribution obligations inconsistent

⁸⁶⁶ TRPA § 3.08(b); TBOC § 152.802.

⁸⁶⁷ TRPA § 3.08(d); TBOC § 152.804.

⁸⁶⁸ TBOC § 5.055(b). The name requirements differ slightly for entities still governed by the TRLPA. *See* TRLPA § 2.14(a)(3).

⁸⁶⁹ TRLPA § 2.14; TBOC § 153.351.

⁸⁷⁰ TRLPA § 3.03; TBOC § 153.102.

⁸⁷¹ TRLPA § 2.14(c); TBOC § 153.353.

⁸⁷² TRPA § 3.08; TBOC § 152.801.

⁸⁷³ *See Henry v. Masson*, 333 S.W.3d 825 (Tex. App.—Houston [1st Dist.] 2010, no pet.), in which the Court held that the partnership agreement, which provided that if no partner agreed to lend funds needed to discharge the partnership’s debts, obligations and liabilities as they came due, each partner was required to timely contribute the partner’s proportionate share of funds needed applied in the winding up process and was not inconsistent with the LLP Provisions in TRPA.

⁸⁷⁴ *See, e.g., Flynn v. Reaves*, 218 S.E.2d 661 (Ga. App. 1975).

with those described above,⁸⁷⁵ a creditor could argue that the partnership agreement supersedes the shield afforded by the Tex. LLP Stats.⁸⁷⁶ Thus, if a miscreant partner is entitled to indemnification from the innocent partners in excess of the firm's assets, then a creditor could claim the indemnification right has become an asset of the miscreant partner's bankruptcy estate and the indemnification agreement could lead to a series of payments from the innocent partners, with each payment ultimately being for the benefit of creditors entitled to recover for the actions of the miscreant partner.⁸⁷⁷ The LLP could counter that compliance with the Tex. LLP Stats. amends or otherwise trumps any inconsistent partnership agreement provisions. Attorneys should exercise care to assure that the partnership agreement of an LLP does not contain indemnification or contribution provisions that would inadvertently frustrate the LLP purpose.

Since a partnership agreement may be written or oral,⁸⁷⁸ an LLP should have a written partnership agreement that provides that it may be amended only by a written amendment. Otherwise a creditor might argue that partner contributions to pay unshielded obligations (e.g., rent on a lease executed before September 1, 1997) constituted an amendment by conduct to the partnership agreement that dropped the LLP liability shield.⁸⁷⁹

⁸⁷⁵ Any LLP that intends by contract to require partners whose liabilities are shielded by the Tex. LLP Stats. to indemnify or contribute to partners whose liability is not shielded (due to their own misconduct) should be particularly sensitive to the "express negligence doctrine." Under the "express negligence doctrine" as articulated by the Supreme Court of Texas, an indemnification agreement is not enforceable to indemnify a party from the consequences of its own negligence unless such intent is specifically stated in the agreement. *See Ethyl Corp. v. Daniel Constr. Co.*, 725 S.W.2d 705, 708 (Tex. 1987), wherein the Supreme Court held:

The express negligence doctrine provides that parties seeking to indemnify the indemnitee from the consequences of its own negligence must express that intent in specific terms. Under the doctrine of express negligence, the intent of the parties must be specifically stated within the four corners of the contract. We now reject the clear and unequivocal test in favor of the express negligence doctrine. In so doing, we overrule [prior decisions] stating it is unnecessary for the parties to say, 'in so many words,' they intend to indemnify the indemnitee from liability for its own negligence.

* * *

The contract between Daniel and Ethyl speaks to 'any loss . . . as a result of operations growing out of the performance of this contract and caused by the negligence or carelessness of [Daniel]. . . .' Ethyl emphasizes the 'any loss' and 'as a result of operations' language to argue an intent to cover its own negligence. We do not find such meaning in those words. The indemnity provision in question fails to meet the express negligence test.

See also Dresser Industries, Inc. v. Page Petroleum, Inc., 853 S.W.2d 505 (Tex 1993); *Atlantic Richfield Co. v. Petroleum Personnel, Inc.*, 768 S.W.2d 724 (Tex. 1989).

⁸⁷⁶ Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 BUS. LAW. 101, 118-120 (Nov. 1997).

⁸⁷⁷ *See Banoff, Alphabet Soup: A Navigator's Guide*, 4 BUS. L. TODAY 10, 12 (March/April 1995).

⁸⁷⁸ TRPA § 1.01(12); TBOC § 151.001(4).

⁸⁷⁹ Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 BUS. LAW. 101, 120 (Nov. 1997).

8. Fiduciary Duties. Partners in an LLP are in a fiduciary relationship and owe each other fiduciary duties just as in any other partnership. In *Sterquell v. Archer*,⁸⁸⁰ the court wrote:

No one disputed that Archer, Sterquell, and Harris were partners. As such, they were involved in a fiduciary relationship which obligated each to act loyally towards one another and to fully disclose information affecting the partnership and their interests in same. [Citations omitted] So too were each prohibited from personally taking advantage of information unknown to the others but concerning partnership interests. *Id.* (each is a confidential agent of the other, each has a right to know all that the others know). Furthermore, in violating any of these fiduciary duties, the actor committed fraud. [Citations omitted]

9. Foreign LLP Qualification. A foreign LLP doing business in Texas⁸⁸¹ may qualify to do business in Texas like a foreign LLC⁸⁸² (the filing fee would be the lesser of

⁸⁸⁰ 1997 WL 20881, 6 (Tex. App.—Amarillo 1997, writ denied) (not designated for publication).

⁸⁸¹ Texas law does not define what constitutes “transacting business in Texas” for the purposes of the requirement of TBOC § 152.905 (and the substantially similar TRPA § 10.02(a)) that “[b]efore transacting business in this state, a foreign limited liability partnership must file an application for registration in accordance with this section and Chapters 4 and 9.” TBOC § 9.251, however, does contain the following non-exclusive list of activities not constituting transacting business in Texas:

Sec. 9.251. Activities Not Constituting Transacting Business In This State.

For purposes of this chapter, activities that do not constitute transaction of business in this state include:

- (1) maintaining or defending an action or suit or an administrative or arbitration proceeding, or effecting the settlement of:
 - (A) such an action, suit, or proceeding; or
 - (B) a claim or dispute to which the entity is a party;
- (2) holding a meeting of the entity’s managerial officials, owners, or members or carrying on another activity concerning the entity’s internal affairs;
- (3) maintaining a bank account;
- (4) maintaining an office or agency for:
 - (A) transferring, exchanging, or registering securities the entity issues; or
 - (B) appointing or maintaining a trustee or depository related to the entity’s securities;
- (5) voting the interest of an entity the foreign entity has acquired;
- (6) effecting a sale through an independent contractor;
- (7) creating, as borrower or lender, or acquiring indebtedness or a mortgage or other security interest in real or personal property;
- (8) securing or collecting a debt due the entity or enforcing a right in property that secures a debt due the entity;

\$200 per resident partner⁸⁸³ or \$750); however, the failure of the foreign LLP to qualify would not affect its LLP shield in Texas.⁸⁸⁴ Under the Tex. LLP Stats., the laws of the state under

- (9) transacting business in interstate commerce;
- (10) conducting an isolated transaction that:
 - (A) is completed within a period of 30 days; and
 - (B) is not in the course of a number of repeated, similar transactions;
- (11) in a case that does not involve an activity that would constitute the transaction of business in this state if the activity were one of a foreign entity acting in its own right:
 - (A) exercising a power of executor or administrator of the estate of a nonresident decedent under ancillary letters issued by a court of this state; or
 - (B) exercising a power of a trustee under the will of a nonresident decedent, or under a trust created by one or more nonresidents of this state, or by one or more foreign entities;
- (12) regarding a debt secured by a mortgage or lien on real or personal property in this state:
 - (A) acquiring the debt in a transaction outside this state or in interstate commerce;
 - (B) collecting or adjusting a principal or interest payment on the debt;
 - (C) enforcing or adjusting a right or property securing the debt;
 - (D) taking an action necessary to preserve and protect the interest of the mortgagee in the security; or
 - (E) engaging in any combination of transactions described by this subdivision;
- (13) investing in or acquiring, in a transaction outside of this state, a royalty or other non-operating mineral interest; or
- (14) the execution of a division order, contract of sale, or other instrument incidental to ownership of a non-operating mineral interest.

See also TBOC § 153.903. The TRPA provides substantially the same. TRPA § 10.04.

⁸⁸² *See* TRPA article X; TBOC Chapter 9 and §§ 152.901-152.914 and 402.001(e).

⁸⁸³ The Secretary of State has adopted a regulation for determining whether a partner is in Texas for purposes of annual fee calculations. Texas Administrative Code title 1, § 80.2(f) provides as follows:

- (f) *Partners in Texas.* For purposes of this section, a partner is considered to be in Texas if:
 - (1) the partner is a resident of the state;
 - (2) the partner is domiciled or located in the state;
 - (3) the partner is licensed or otherwise legally authorized to perform the services of the partnership in this state; or

which a foreign LLP is formed will govern its organization and internal affairs and the liability of partners for obligations of the partnership.⁸⁸⁵

Thus, under the Tex. LLP Stats., partners may choose the state law, and hence the liability shield, that they wish to apply to their relationship.⁸⁸⁶ That choice should not be subject to the general limitation in the Tex. GP Stats. that the law chosen by the partners to govern binds only “if that state bears a reasonable relation to the partners or to the partnership business and affairs under principles that apply to a contract among the partners other than the partnership agreement.”⁸⁸⁷

A determination of whether a foreign LLP must qualify to do business in any particular state must be made on a state by state basis. A number of states, such as Delaware,⁸⁸⁸ do not require such qualification, but recognize that the law governing the internal affairs of a partnership also governs its liability to third parties. By contrast, New York and Maryland require foreign LLPs to qualify to do business in the state.⁸⁸⁹

10. Bankruptcy. Section 723 of the Bankruptcy Code⁸⁹⁰ addresses the personal liability of general partners for the debts of the partnership, granting the trustee a claim against “any general partner” for the full partnership deficiency owing to creditors to the extent that the partner would be personally liable for claims against the partnership. In recognition of uncertainty as to how this provision would be construed to apply with regard to LLPs which had been authorized by a number of states since the advent of the 1978 Bankruptcy Code, the 1994 amendments to the Bankruptcy Code clarified that a partner of an LLP would only be liable in bankruptcy to the extent that the partner would be personally liable for a deficiency according to the LLP statute under which the partnership was formed.⁸⁹¹

(4) the partner, or a representative of the partnership working under the direct supervision or control of the partner, will be providing services or otherwise transacting the business of the partnership within the state for a period of more than 30 days.

⁸⁸⁴ TRPA § 10.03(c); TBOC §§ 9.051, 152.910.

⁸⁸⁵ The TBOC places governance by foreign law into the very definition of “foreign”: “‘Foreign’ means, with respect to an entity, that the entity is formed under, and the entity’s internal affairs are governed by, the laws of a jurisdiction other than this state.” TBOC § 1.002(27). *See also* TBOC § 1.103. TRPA § 10.01 similarly recognizes foreign governance of a foreign LLP’s internal affairs.

⁸⁸⁶ TRPA § 10.01; TBOC §§ 1.101-1.105.

⁸⁸⁷ TRPA § 1.05(a)(1). *See* TBOC § 1.002(43)(C)(i), providing substantively the same. *See also* TEX. BUS. & COM. CODE § 35.51.

⁸⁸⁸ DEL. CODE ANN., tit. 6, §§ 15-1001–15-1004.

⁸⁸⁹ N.Y. P’SHP LAW § 121-1502 (McKinney Supp. 2006); MD. CODE ANN. CORPS. & ASS’NS § 9A-1101 (1999).

⁸⁹⁰ 11 U.S.C. § 723, as amended by Pub.L. 103-394, Title II, § 212, Oct. 22, 1994, 108 Stat. 4125 (the “Bankruptcy Code”).

⁸⁹¹ Congressional Record—House H 10767 (Oct. 4, 1994). This amendment to the Bankruptcy Code is attributable in large part to efforts of representatives of the Texas Business Law Foundation.

11. Federal Diversity Jurisdiction. An LLP is a citizen of every state in which one of its partners resides for the purposes of Federal court diversity jurisdiction.⁸⁹² As a result, large accounting firms with offices in most states are likely beyond the reach of the diversity jurisdiction of the Federal courts.⁸⁹³

VII. EXTRATERRITORIAL RECOGNITION OF LLC AND LLP LIMITED LIABILITY.

A. General. Courts of other states should recognize the Texas statutory liability shield of LLCs and LLPs under the “internal affairs” doctrine, which treats the laws of the state of organization as governing the liability of members of business organizations, such as corporations and limited partnerships.⁸⁹⁴ The principal case that did not follow this doctrine was a 1938 Texas case, which has been effectively overturned by 1991 H.B. 278.⁸⁹⁵ The extent to which LLC or LLP status will be recognized in other jurisdictions absent a specific statute, however, remains a question for which there is little case-law precedent.⁸⁹⁶

B. Texas Statutes. The LLC Act states that it is the “intention of the legislature by the enactment of this Act that the legal existence of limited liability companies formed under this Act be recognized beyond the limits of this state and that, subject to any reasonable registration requirements, any such limited liability company transacting business outside this state shall be granted the protection of full faith and credit under Section 1 of Article IV of the Constitution of the United States.”⁸⁹⁷

There is no comparable statement of legislative intention in the Tex. LLP Stats. However, they do provide that (1) a partnership’s internal affairs are governed by the law of the state chosen by the partners if the law chosen bears a reasonable relationship to the partnership’s business and affairs under applicable choice of law principles and (2) the law governing a partnership’s internal affairs also governs the liability of its partners to third parties.⁸⁹⁸ Texas has

⁸⁹² *Reisman v. KPMG Peat Marwick LLP*, 965 F. Supp. 165 (D. Mass. 1997), relying on *Carden v. Arkoma Assoc.*, 494 U.S. 185 (1990).

⁸⁹³ The court in *Reisman* wrote that it was “particularly troubled that a Big Six accounting firm which operates offices within every state in the United States has effectively immunized itself from the reach of the diversity jurisdiction of the federal courts simply by organizing itself as a limited liability partnership rather than a corporation. Nevertheless, until Congress addresses the jurisdictional implications of this new class of business entities, this Court can reach no other result.”

⁸⁹⁴ TBOC § 1.101-1.105; *cf.* Revised Uniform Limited Partnership Act § 9.01 adopted in many states and in this state as TRLPA § 9.01(a); TBCA art. 8.02; 59A Am. Jur. 2d Partnership § 30 (1987); 29 A.L.R. 2d 295 (1953). For a discussion of the history of TBCA art. 8.02, see R. Dennis Anderson and Harva R. Dockery, *Formalities of Corporate Operations*, Texas Corporations—Law and Practice § 31.05 (1986).

⁸⁹⁵ *Means v. Limpia Royalties*, 115 S.W.2d 468 (Tex. Civ. App.—Ft. Worth 1938, writ dismissed).

⁸⁹⁶ See Herbert B. Chermiside, Jr., Annotation, *Modern Status of the Massachusetts or Business Trust*, 88 A.L.R. 3d 704 (1978) (“In some jurisdictions a Massachusetts or business trust has been treated as a partnership for some purposes.”).

⁸⁹⁷ LLC Act § 4.03B.

⁸⁹⁸ TRPA § 1.05; TBOC §§ 1.101-1.105.

thus codified the internal affairs doctrine recognized by the courts of other states, as discussed below.

C. **Texas Cases.** Texas appears to be the only state with a reported decision denying limited liability to owners of an unincorporated entity formed under another state's law because the forum state did not have such a statute.⁸⁹⁹ In *Means v. Limpia Royalties*,⁹⁰⁰ suit was brought in Texas by a purchaser of trust interests for rescission of the purchase because of misrepresentations by the defendant that holders of trust interests could not be liable for trust obligations. Limpia Royalties was an unincorporated association operating under a declaration of trust, was organized under the laws of Oklahoma and had its principal office in Oklahoma. In holding that the representations were materially misleading, the court wrote:

It is well settled in this state by a long line of decisions that a shareholder in an unincorporated or joint-stock association is liable to its creditor for debts of the association; his liability being that of a partner. 25 Tex. Jur. section 20, p. 202, and authorities there cited.

The fact that, under the laws of the state of Oklahoma and under the provisions of the declaration of trust, a shareholder in the Limpia Royalties could not be held liable for the debts or obligations of the association would not operate to extend the same immunity from liability growing out of transactions by the association in the state of Texas, since, as is well said in the opinion in *Ayub v. Automobile Mortgage Company*, 252 S.W. 287, 290 [(Tex. Civ. App.—El Paso 1923, writ granted) *rev'd. Auto. Mortgage Co. v. Ayub*, 266 S.W. 134 (Tex. Comm'n. App. 1924)]. “The established public policy of the forum is supreme, and will not be relaxed upon the ground of comity to enforce contracts which contravene such policy, even though such contracts are valid where made.”⁹⁰¹

⁸⁹⁹ Commentators generally suggest that uncertainty as to whether the statutory limited liability of Members will be recognized in a jurisdiction other than the jurisdiction of the LLC's organization is a drawback to using an LLC for a business with operations in more than one state, but the only authorities cited for that concern are the Texas cases discussed herein. See, e.g., Lederman, *Miami Device: The Florida Limited Liability Company*, 67 TAXES 339, 342 (June 1989); and Roche, Keatinge and Spudis, *Limited Liability Companies Offer Pass-Through Benefits Without S Corp. Restrictions*, 74 J. TAX'N 248, 253 (April 1991).

⁹⁰⁰ 115 S.W.2d 468, 475 (Tex. Civ. App.—Ft. Worth 1938, writ *dism'd*).

⁹⁰¹ 115 S.W.2d at 475. The *Limpia Royalties* case was cited and its rationale followed in *Cherokee Village v. Henderson*, 538 S.W.2d 169, 173 (Tex. Civ. App.—Houston 1976, writ *dism'd*), a personal injury case in which the property on which the injury occurred was held pursuant to a trust agreement. The trust agreement, which apparently was governed by Texas law, recited that no partnership was intended and that no party had any right to incur any liability on account of any other party. The defendants in the case were holders of beneficial interests in the trust, which was a successor to a general partnership in which the holders had been partners. Two years after the creation of the trust, but two years prior to the injury, three individuals withdrew from the arrangement by a document which purported to be an amendment to the venture's “agreement of general partnership” and an assumed name certificate was filed in which the defendants were listed as general partners. The court was not persuaded by the defendants' testimony that these actions were erroneous. In holding that the defendants were liable and that the trust was a partnership under Texas law, the court wrote:

Article 6132b, the Texas Uniform Partnership Act, Section 6, defines a partnership as “an association of two or more persons to carry on as co-owners a business for profit.” Section

The sections of the Tex. LLC Stats. providing for qualification of Foreign LLCs were intended to repudiate, and resolve the concern raised by, the *Limpia Royalties* case with respect to limited liability of non-corporate entities created under the laws of other states but not authorized to be created under Texas law.⁹⁰² The Bill Analysis⁹⁰³ used by the Legislature in connection with the consideration of 1991 H.B. 278 states:

The provisions of Part 7 providing for the qualification of foreign Limited Liability Companies is intended to eliminate the concern raised by *Means v. Olympia [sic] Royalties*, 115 S.W.2d 468 (Tex. Civ. App.—Ft. Worth 1938 [writ dism'd]), as to whether a Texas court would honor the limitation of liability of a foreign business entity. Moreover, the definition of “Foreign Limited Liability Company” is sufficiently broad to provide for the qualification of any business entity affording limited liability, not entitled to qualify under another statute, whether or not characterized as a limited liability company.⁹⁰⁴

7 of this Act sets forth certain criteria for determining the existence of a partnership under the Act. Under this section it is provided that with the exception of certain circumstances not here existent, the receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner of the business. TEX. REV. CIV. STAT. ANN. art. 6132a, the Texas Uniform Limited Partnership Act, sets forth the method by which limited partners, who do not wish to be bound by the obligations of the partnership, may carry on a business as a limited partnership. TEX. REV. CIV. STAT. ANN. art. 6138a sets forth the requirements for creation of a Real Estate Investment Trust. Section 8 of that Act provides for limited liability of the shareholders of such a trust. Appellants here do not contend that there was compliance with the requisites of either of these statutes.

Where two or more persons associate themselves as co-owners of a business for profit they become jointly and severally responsible for obligations incurred in the conduct of such business unless they have established, under some applicable statute, an association which the law recognizes as providing limited personal liability.

⁹⁰² 1991 H.B. 278 § 46 Part Seven. Prior to the enactment of 1991 H.B. 278, Texas was already firmly committed by statute to the internal affairs doctrine for both corporate and non-corporate business organizations. The 1977 amendment to Texas Uniform Limited Partnership Act, art. 6132a § 32(c) specified that, in the case of a foreign limited partnership qualified in Texas, “its internal affairs and the liability of its limited partners shall be governed by the laws of the jurisdiction of its formation.” That principle is carried forward in Texas Revised Limited Partnership Act, article 6132a-1 § 9.01(a): “The laws of the state under which a foreign limited partnership is formed govern its organization and internal affairs and the liability of its partners” (whether or not the foreign limited partnership is registered to do business in Texas). The 1989 amendment to Texas Business Corporation Act art. 8.02 prescribes that “only the laws of the jurisdiction of incorporation of a foreign corporation shall govern (1) the internal affairs of the foreign corporation . . . and (2) the liability, if any, of shareholders . . .” The TBOC provides substantively the same. TBOC §§ 1.002(27), (28), 1.102-1.105.

⁹⁰³ Bill Analysis of H.B. 278 by Wolens at 10 (1991). See 1991 Bill Analysis Summary at 41.

⁹⁰⁴ “Foreign Limited Liability Company” is broadly defined in LLC Act § 1.02(9) as follows:

(9) “Foreign Limited Liability Company” means an entity formed under the laws of a jurisdiction other than this state (a) that is characterized as a limited liability company by such laws or (b) although not so characterized by such laws, that elects to procure a certificate of authority pursuant to Article 7.01 of this act, that is formed under laws which provides [sic] that some or all of the persons entitled to receive a distribution of

D. Decisions in Other States. There is precedent in other jurisdictions suggesting that their courts would apply the internal affairs doctrine to unincorporated entities not organized or qualified to do business as foreign entities under local law, thus preserving the liability shield of Texas law for LLCs and LLPs. Further, there apparently are no reported cases in other jurisdictions that follow the reasoning of, or reach the same result as, the *Limpia Royalties* case.

This issue of which jurisdiction's law governs liabilities of partners to third parties arose in *King v. Sarria*, an 1877 New York case of first impression.⁹⁰⁵ The defendants entered into a contract of partnership in Cuba, which was then ruled by Spanish law. Under the contract, defendant Sarria became a special partner whose liability was expressly limited to a fixed amount. As a special partner under Spanish law, Sarria was entitled to participate in the profits of the partnership, but could not be made liable for its debts. The plaintiffs sought to recover from Sarria a sum of money due under a contract with the partnership.

The court held that the partnership agreement was governed by the laws of Spain⁹⁰⁶ and that the liability of Sarria and the extent of the authority of his partners to bind him⁹⁰⁷ were to be determined by those laws. The court stated:

the assets thereof upon the entity's dissolution or otherwise or to exercise voting rights with respect to an interest in the entity shall not be liable for the debts, obligations or liabilities of the entity and which is not authorized to qualify to do business in this state under any other statute.

See also supra notes 771-778 and related text and TBOC §§ 9.001-9.003.

1991 H.B. 278 § 46 art. 7.02 provides in relevant part as follows with respect to a foreign limited liability company that has procured a certificate of authority from the Secretary of State to transact business in Texas pursuant to 1991 H.B. 278 § 46 Part Seven:

. . . only the laws of the jurisdiction of organization of a foreign limited liability company shall govern (1) the internal affairs of the foreign limited liability company, including but not limited to the rights, powers, and duties of its manager and members and matters relating to its ownership, and (2) the liability, if any, of members of the foreign limited liability company for the debts, liabilities and obligations of the foreign limited liability company for which they are not otherwise liable by statute or agreement.

See also TBOC §§ 1.104 and 1.105.

⁹⁰⁵ *King v. Sarria*, 69 N.Y. 24 (N.Y. Ct. of App. 1877).

⁹⁰⁶ Where a partnership is formed under the laws of a particular state and there is no conflicting choice of law provision in the agreement, it is as if the partners have implicitly agreed to be bound by the laws of that state. *See Rogers v. Guaranty Trust*, 288 U.S. 123 (1933); *Seidman & Seidman v. Wolfson*, 123 Cal. Rptr. 873 (Cal. Ct. App. 1975) (California court held that New York law should determine the rights and obligations among partners in an accounting firm where the partnership agreement so provided); *Hill-Davis Co. v. Atwell*, 10 P.2d 463 (Cal. 1932) (a court will generally refer to the law of the state of the entity's organization to determine the precise nature of the powers or qualities enjoyed by such entity); *Gilman Paint & Varnish v. Legum*, 80 A.2d 906, 29 A.L.R. 2d 236 (Md. 1951) (the liability to third persons of a partner with limited liability is an issue to be determined under Maryland law where the partners were all from Maryland, the partnership agreement was made in Maryland, it was a Maryland partnership in its inception and no representations were made otherwise); *Froelich & Kuttner v. Sutherland*, 22 F.2d 870 (D.C. 1927) (where entity was organized under Philippine statutes, that country's laws determined whether the organization was a general partnership, limited partnership or a corporation).

[W]here the essentials of a contract made under foreign laws are not hostile to the law and policy of the State, the contract may be relied upon and availed of in the courts of this State. If the substance of the contract is against that law and policy, our judicatories will refuse to entertain it and give it effect.⁹⁰⁸

In *King v. Sarria*, the court held that the Spanish statute limiting liability of particular partners was not contrary to New York public policy and therefore applied the Spanish statute to limit Sarria's liability.⁹⁰⁹ However, in reaching this conclusion, the court noted that the Spanish statute resembled New York's own statute for the formation of limited partnerships.⁹¹⁰

The 1982 New York case of *Downey v. Swan*⁹¹¹ helps answer the question of what happens when the forum state has no corresponding statute. In *Downey*, the defendant Swan was a member of a limited partnership association formed under New Jersey law. Under New Jersey law, the members and managers of a limited partnership association were not personally liable for a wrongful death that occurred on property owned by the partnership. In remanding the case to the trial court for a determination whether the association was operating after its term had expired, the court held that if the association were still in existence, the liabilities of its members would be governed by New Jersey law and the limited liability afforded by that law would be given full effect.⁹¹² Because New York had no limited partnership association law, the New York court could not have applied analogous New York law to reach the same result.⁹¹³

In a case involving a Texas LLP law firm, the internal affairs doctrine was recognized by a federal district court in Massachusetts. In *Liberty Mutual Insurance Co. v. Gardere & Wynne*,

⁹⁰⁷ The court in *King v. Sarria* noted that, since the contract in question was made by persons other than Sarria, the plaintiff had to show that the other partners had authority to bind Sarria and that the plaintiff was relying upon the mutual general agency which results from the relation of partnership to show that authority. The court noted that, if the Spanish statute were not applicable, the plaintiff would prevail "for by virtue of the relationship of partnership, one partner becomes the general agent for the other, as to all matters within the scope of the partnership dealings, and has thereby given to him all authority needful for carrying on the partnership, and which is usually exercised by partners in that business" and "that any restriction which by agreement amongst the partners is attempted to be imposed upon the authority, which one partner possesses as the general agent of the other, is operative only between the partners themselves, and does not limit the authority as to third persons . . . unless they know that such restriction has been made." *Sarria*, 69 N.Y. at 28-29. The court noted that the foregoing common law principles, which are comparable to TUPA §§ 9, 13, 14 and 15(1) (without the LLP exception), were qualified by the provisions of any applicable statute providing for the formation of partnerships with limited liability.

⁹⁰⁸ *Sarria*, 69 N.Y. at 34.

⁹⁰⁹ For a contract to be void as against New York public policy, it must be quite clearly repugnant to the public conscience. See *Kloberg v. Teller*, 171 N.Y.S. 947, 948 (N.Y. Sup. 1918).

⁹¹⁰ The court indicated that the same reasoning would apply to contract and tort claims.

⁹¹¹ *Downey v. Swan*, 454 N.Y.S. 2d 895 (N.Y. App. Div. 1982).

⁹¹² Cf. *Schneider v. Schimmels*, 64 Cal. Rptr. 273 (Cal. Ct. App. 1967) (California court permitted recovery for loss of consortium pursuant to a Colorado statute although California did not have a similar statute granting such damages).

⁹¹³ Cf. *Abu-Nassar v. Elders Futures, Inc.*, 1991 U.S. Dist. LEXIS 3794 (S.D.N.Y. Mar. 28, 1991) (treating an LLC organized under Lebanese law as though it were a foreign corporation for purposes of analyzing choice of law and veil piercing liability).

L.L.P.,⁹¹⁴ although the court granted a motion to transfer a case to a federal court in Texas largely to avoid having to decide numerous questions about the effect of the Texas LLP status⁹¹⁵

⁹¹⁴ *Liberty Mutual Insurance Co. v. Gardere & Wynne, L.L.P.*, 1994 WL 707133 (D. Mass. 1994).

⁹¹⁵ *Liberty Mutual Insurance Co. v. Gardere & Wynne, L.L.P.* involved claims of breach of fiduciary duty and conflict of interest asserted by Liberty Mutual Insurance Company (“Liberty”) against the Dallas based law firm of Gardere & Wynne, L.L.P. (“Gardere”), which had represented Liberty for many years. Gardere was a Texas partnership that had taken the steps to become a registered LLP under the TRPA. Two Gardere lawyers, Nabors and Woods, also were defendants in the suit; Nabors clearly was a partner in Gardere, but the facts were uncertain about whether Woods’s election to “income partner” status had been given effect before he left Gardere to join another firm. Liberty filed its suit in the federal district court in Massachusetts, where its principal office was located. Gardere, Nabors, and Woods moved for dismissal or, alternatively, to have the case transferred to Texas.

Gardere’s motion to dismiss was based upon Massachusetts law providing that a general partnership could not be sued in its common name but that, instead, suit must be brought against each of the partners individually. The individual defendants’ motions to dismiss were based upon a claimed lack of personal jurisdiction over Nabors and Woods by a court located in Massachusetts. Both of these asserted grounds for dismissal would be moot if the case were transferred to Texas, because Texas law permits a partnership to be sued in its common name, and Nabors and Woods clearly were subject to the personal jurisdiction of a court sitting in Texas.

Massachusetts had no counterpart to the Texas LLP statute. The court observed that, if it undertook to consider the motions to dismiss, its analysis would be complicated the fact that Gardere was not a general partnership “in the traditional sense familiar to Massachusetts judges and lawyers.” The court identified numerous procedural and substantive questions emanating from the uncertainty of Gardere’s organizational status under Massachusetts law, including the following issues:

- (1) Whether, for Massachusetts law purpose, Gardere was a limited partnership;
- (2) If Gardere was a limited partnership, whether suit could be brought against it by naming only its general partners as defendants;
- (3) If Gardere was a limited partnership and could be sued by naming only its general partners, whether the “general partners” were only those partners who, under TRPA, could be liable for the alleged breaches of duty claimed by Liberty;
- (4) Whether the breaches of duty alleged by Liberty were the type of “errors, omissions, negligence, incompetence, or malfeasance” enumerated in TRPA for which a registered LLP member’s liability was limited to cases of direct involvement or failure to prevent errors and omissions;
- (5) With respect to the individual defendants’ claims of lack of personal jurisdiction, whether certain Gardere partners who had actually visited Massachusetts from time to time had been agents of other Gardere partners, by operation of general partnership law;
- (6) Whether such presence by other Gardere partners constituted agency on behalf of the individual defendants when it occurred prior to the individual defendants’ joining the Gardere firm; and
- (7) If such agency occurred, whether it was effective with respect to an “income partner” such as Woods, who did not have an equity interest or many of the rights held by equity partners (assuming Woods actually became an income partner).

The court concluded that, despite the deference normally accorded to a plaintiff’s choice of forum, the complicated issues stemming from Gardere’s uncertain legal status under Massachusetts law, combined with the fact these issues would be moot if the case were transferred to Texas, compelled the court to transfer the

on a case pending in Massachusetts which did not have an LLP statute, the limited liability of partners under the Tex. LLP Stats. was recognized under the internal affairs doctrine as follows:

The court assumes that, if this case were tried in a state or federal court in Massachusetts, the court would look to Texas substantive law to determine the liability of partners in a Texas RLLP for debts arising out of claims for breach of fiduciary duty by other partners. *See* Mass.Gen.L. ch. 109, § 48 (liability of limited partners of a foreign limited partnership “shall be governed by the laws of the state under which it is organized”); *Klaxon v. Stentor Elec. Mfgs. Co.*, 313 U.S. 487, 496, 61 S.Ct. 1020, 1021-22 (1941) (federal court in diversity case applies choice of law principles of state in which federal court is located). Thus, Texas law will apply to this question whether or not the case is transferred . . .⁹¹⁶

The *Gardere* case illustrates the difficult procedural issues which can be encountered when liability is asserted against an LLC or an LLP outside of the jurisdiction of its creation. Under general conflict of law principles, (i) for contract claims, in the absence of a valid contractual choice of law provision, the law of the jurisdiction with the most significant contacts will govern; and (ii) for tort claims, the law of the state with the most significant relationship to the occurrence and the parties will generally govern.⁹¹⁷ Whether a court adjudicating a claim against a foreign LLC or LLP, after applying one state’s laws in determining that an LLC or LLP is liable for a contract or tort claim, will then apply the internal affairs doctrine or the full faith and credit clause of the Constitution to uphold the liability shield of the entity’s jurisdiction of organization remains an issue in those few jurisdictions still lacking statutory guidance, although the better authority to date would apply the internal affairs principle and uphold the statutory liability shield.

E. Qualification as Foreign Entity and Other Ways to Reduce Extraterritorial Risk. Since all 50 states (including Texas) plus the District of Columbia now have LLC statutes, the LLC extraterritorial risk analysis requires analysis of the applicable LLC statute in each of the states in which the LLC contemplates doing business. Generally qualification as a foreign LLC in a jurisdiction will protect Members’ limited liability, but failure to qualify may not result in the loss of limited liability, although it may result in the imposition of statutory penalties. The LLC statutes in Texas, New York and Delaware, which each contain provisions for the registration/qualification of foreign LLCs, expressly provide that the failure of a foreign LLC to so qualify shall not affect the limited liability of its members or managers, which shall be determined by the laws of the LLC’s jurisdiction of organization.⁹¹⁸ Likewise, since all states

litigation to a federal district court sitting in Texas. The court thus saved itself from resolving the many issues it had identified that were produced by the incompatibility of Texas and Massachusetts partnership law by transferring the case to Texas.

⁹¹⁶ *Gardere & Wynne*, 1994 WL 707133 at *6 n. 7.

⁹¹⁷ Elizabeth S. Miller, *Procedural and Conflict of Laws Issues Arising In Connection With Multi-State Partnerships*, ABA Bus. L. Sec. (1996 Spring Meeting).

⁹¹⁸ LLC Act §§ 7.01, 7.02; N.Y. LLC Law §§ 801, 802 (2006); 6 DEL. CODE §§ 18-901, 18-902 (2013). N.Y. LLC Law § 802 further provides that within 120 days after the filing of its application for authority, the foreign LLC must publish once each week for six successive weeks in one daily and one weekly newspaper (each designated by the county clerk in the county where the LLC is located) generally the same

plus the District of Columbia have LLP statutes, foreign qualification needs to be considered as a means of reducing extraterritorial risk for LLPs. Delaware, New York, and Maryland all provide for foreign qualification.⁹¹⁹

Although the LLP is the entity of choice for many professionals, not all states permit all types of professionals to avail themselves of limited liability for professional malpractice (whether through a professional corporation, a PLLC or an LLP), thus necessitating additionally a review of the applicable professional rules in each jurisdiction in which the entity proposes to transact business.⁹²⁰

VIII. DECISION MATRIX.

Key elements in deciding among business entities are:

- (1) How the entity will be taxed under federal and state law; and
- (2) Who will be liable for its contract, tort and statutory obligations (the entity itself will always be liable to the extent of its assets; the question is whether owners will be liable if entity's assets insufficient to satisfy all claims).

These two considerations tend to receive the principal focus in the entity choice decision, although management, capital raising, interest transferability, continuity of life and formation issues such as cost and timing can be critical in many cases.

If the owners are content to pay federal income taxes at the entity level at corporate rates of 15% to 35%, plus Margin Taxes, and then pay federal income taxes on earnings distributed to them, the choice is typically a "C corporation" (i.e., a regular business corporation without an S-corporation election)⁹²¹ or an LLC that elects to be taxed as a "C" corporation under the

information required to be filed with the New York Department of State and must file a proof of publication with the New York Department of State, and failure to file such proof of publication will result in automatic suspension of the LLC's right to transact business in New York.

⁹¹⁹ DEL. CODE ANN. tit. 6 § 15-1101 et seq (2013); N.Y. P'SHIP LAW § 121-1502 (McKinney 1998 & Supp. 2006); MD. CODE ANN., CORPS. & ASS'NS § 9A-1101 (1999). N.Y. P'SHIP LAW § 121-1502 (McKinney 1998 & Supp. 2006) further provides that within 120 days after the filing of its application for authority, the foreign LLP must publish once each week for six successive weeks in one daily and one weekly newspaper (each designated by the county clerk in the county where the LLP is located) generally the same information required to be filed with the New York Department of State and must file a proof of publication with the New York Department of State, and failure to file such proof of publication will result in automatic suspension of the LLP's right to transact business in New York.

⁹²⁰ See Rogers, *Questions of Law and Ethics Face Firms Becoming LLPs, LLCs*, 12 ABA/BNA Lawyers' Manual of Professional Conduct 411 (No. 23 Dec. 11, 1996); *Meyer v. Oklahoma Alcoholic Beverage Laws Enforcement Comm'n.*, 890 P.2d 1361 (Okla. Civ. App. 1995) (finding that an LLC is not permitted to hold liquor license).

⁹²¹ See *supra* notes 91-101, 276-282 and related text.

Check-the-Box Regulations.⁹²² Such an LLC may be preferable to a corporation in closely held situations because of greater governance structuring flexibility.⁹²³

If the owners do not want the entity's earnings to be taxed twice under the IRC, the entity selection process becomes more complicated,⁹²⁴ and the choices are:

- General partnership⁹²⁵
- LLP⁹²⁶
- Limited partnership⁹²⁷
- LLC that elects to be taxed as a partnership under the Check-the-Box Regulations⁹²⁸
- S-corporation⁹²⁹

A. If limited liability of the owners is not important and all of them are individuals, the choice is a general partnership in which partners are jointly and severally liable for all partnership liabilities, as such a general partnership is not subject to the Margin Tax.⁹³⁰

B. If the owners are willing to accept liability for their own torts but want to avoid liability for contracts and torts of other partners for which they have no culpability and are willing to risk being subject to the Margin Tax, the LLP becomes the entity of choice.⁹³¹

C. The limited partnership will provide tax flow through without the S-corporation restrictions discussed below, with no self-employment tax on income of limited partners, and with limited liability for limited partners,⁹³² but has its own limitations:

1. Must have a general partner which is liable for all partnership obligations — contract and tort — but under Check-the-Box Regulations, capitalization of general partner is not important and a limited partnership can elect to also be an LLLP which has the effect of limiting the liability of the general partner;⁹³³
2. Limited partners who participate in the management of the business may become liable as general partners, but the limited partnership statutes

⁹²² See *supra* notes 91-101, 579-789 and related text.

⁹²³ See *supra* notes 657-732 and related text.

⁹²⁴ See *supra* notes 91-101 and related text.

⁹²⁵ See *supra* notes 380-468 and related text.

⁹²⁶ See *supra* notes 790-893 and related text.

⁹²⁷ See *supra* notes 469-578 and related text.

⁹²⁸ See *supra* notes 91-101, 579-789 and related text.

⁹²⁹ See *supra* notes 283-296 and related text.

⁹³⁰ See *supra* notes 380-468 and related text.

⁹³¹ See *supra* notes 790-893 and related text.

⁹³² See *supra* notes 469-578 and related text.

⁹³³ See *supra* notes 91-101 and 488-496 and related text.

generally allow a degree of participation without general partner personal liability unless the creditor relied upon the limited partner as a general partner;⁹³⁴ and

3. Effective for tax years beginning on or after January 1, 2007, the Margin Tax is imposed on LLPs, although the LLP is a species of general partnership to which the Margin Tax generally is not applicable.⁹³⁵

D. The LLC can be structured under the Check-the-Box Regulations to have tax flow through and the limited liability of S-corporation or limited partnership without any of their drawbacks, but:

- (i) Effective for tax years beginning on or after January 1, 2007, the Margin Tax has replaced the Texas franchise tax and is imposed on LLCs;⁹³⁶
- (ii) Questions remain as to whether, or to what extent, individuals who are Members of an LLC will be subject to federal self-employment taxes;⁹³⁷ and
- (iii) Questions regarding:
 - State income taxation issues in other states; and
 - The extent to which other states will recognize statutory limitation of Members' liability and the related questions of whether/how to qualify as a foreign LLC.⁹³⁸

E. The S-corporation will give limitation of owner liability and federal income tax flow through (even when there is only one owner), but an S-corporation is subject to the Texas Margin Tax, and there are limitations on its availability under the IRC.⁹³⁹ S-corporation status is not available where the entity:

1. has more than 100 equity holders;
2. has more than one class of stock;
3. has among its shareholders any:
 - General or limited partnership;
 - Trust (certain exceptions);

⁹³⁴ See *supra* notes 91-101 and 488-496 and related text.

⁹³⁵ See *supra* notes 126-230 and related text.

⁹³⁶ See *supra* notes 126-227 and related text.

⁹³⁷ See *supra* notes 609-621 and related text.

⁹³⁸ See *supra* notes 894-920 and related text.

⁹³⁹ See *supra* notes 283-299 and related text.

- Non resident alien; or
- Corporation (exception for “qualified subchapter S subsidiary”).

IX. TAX COSTS IN CHOICE OF ENTITY DECISION.

A. Assumptions in Following Chart. The following chart compares the taxes that would be paid by different types of entities and their individual owners based on assumed gross receipts, gross margin and net income in 2013. In each case, the entity is assumed to have (i) \$1,000 of gross revenue, (ii) \$700 of gross margin for Margin Tax purposes, which would be the maximum taxable margin under Tex. Tax Code § 171.101(a)(1) and all of which is apportioned to Texas under Tex. Tax Code § 171.101(a)(2), and (iii) \$100 of net income that is of a type subject to self-employment taxes (i.e., is income from a trade or business and is not investment income) and is distributed (after taxes) to its owners. It is also assumed that the individual owners will have earned income or wages in excess of the base amount for the tax year and will therefore be subject to only a 2.9% (3.8% on individual self employment income in excess of \$200,000 [\$250,000 in the case of a joint return; \$125,000 in the case of a married taxpayer filing separately]) Medicare tax on all self employment income (there is no ceiling), and not the 12.40% social security equivalent tax to a base of \$113,700 in 2013, which increases for subsequent years as disclosed in note (a) below.

B. 3.8% Unearned Income Medicare Contribution Tax. The following chart does not consider the Unearned Income Medicare Contribution Tax to which individuals, estates and trusts are subject to for tax years beginning after December 31, 2012 on the lesser of net investment income for the tax year or the excess of modified adjusted gross income (“MAGI”) for the tax year over a threshold amount. Although the tax is an addition to regular federal income tax liability, it is taken into account for purposes of calculating estimated tax penalties of the individual, estate or trust. The Unearned Income Medicare Contribution Tax in the case of an individual is 3.8% of the lesser of (1) the taxpayer’s net investment income for the tax year or (2) the excess of MAGI 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). MAGI is the taxpayer’s adjusted gross income increased by any foreign earned income excluded from gross income for the year, less any properly allocable deductions, exclusions or credits. Net investment income for purposes of the Unearned Income Medicare Contribution Tax is the sum of the following items (less any otherwise allowable deductions properly allocable thereto): (i) gross income from interest, dividends, annuities, royalties and rents other than such income derived in the ordinary course of a trade or business other than a passive trade or business; (ii) other gross income from a passive trade or business; and (iii) net gain which is included in computing taxable income of the taxpayer that is attributable to the disposition of property unless such property is held in a trade or business other than a passive trade or business. A passive trade or business for this purpose includes any trade or business of the taxpayer that is either a passive activity or consists of trading financial instruments or commodities. In the case of the disposition of an interest in a partnership or S-corporation, net gain or loss is considered net investment income only to the extent it would be taken into account by the partner or shareholder if all of the property of the partnership or S-corporation were sold

at fair market value immediately before the disposition of the interest. Net investment income does not include any distribution from qualified employee benefit plans or arrangements. The Unearned Income Medicare Contribution Tax is not deductible in computing other federal income taxes.

Item	C-Corporation	S-Corp or Limited Liability Company ^(b)	General Partner in General or Limited Partnership ^(b)	Limited Partner in Limited Partnership ^(b)
Entity Level				
Total Revenue	1,000.00	1,000.00	1,000.00	1,000.00
Taxable Margin	700.00	700.00	700.00	700.00
Net Income	100.00	100.00	100.00	100.00
Margin Tax ^(c)	7.00	7.00	7.00	7.00
Taxable Income of Entity	93.00	93.00	93.00	93.00
Fed. Income Tax (at 35%)	32.55	0	0	0
Income After Taxes ^(d)	60.45	93.00	93.00	93.00
Owner Level				
Distribution & Share of Income	60.45	93.00	93.00	93.00
Self-Employment Tax	0	2.90 ^(e)	2.90	0
Taxable Income of Owner	60.45	91.55 ^(f)	91.55 ^(f)	93.00
Fed. Tax on Dividends or Income Allocation (at 20%)	12.09	36.25	36.25	36.83
Amount Received After Taxes	48.36	55.30	55.30	56.17

- (a) Individuals are subject to a self-employment tax on self-employment income. For 2013 the tax rate aggregates up to 15.3% and consists of (i) a 12.40% social security equivalent tax on self-employment income up to a 2013 contribution base of \$113,700 (adjusted annually for inflation), plus (ii) a 2.9% (3.8% on individual self-employment income in excess of \$200,000 [\$250,000 in the case of a joint return; \$125,000 in the case of a married taxpayer filing separately]) tax for hospital insurance (“Medicare”) on all self-employment income (there is no ceiling). This self-employment tax is treated as part of the income tax and must also be taken into account for purposes of the estimated tax. A similar addition to Medicare tax applies for FICA purposes. If the taxpayer has wages subject to FICA, then the taxpayer’s social security equivalent wage base would be reduced by amount of wages on which these taxes were paid. There is no cap on self-employment income subject to the Medicare tax.
- (b) Assumes that the entity is treated as a partnership for federal income tax purposes.
- (c) Assumes that (i) Margin Tax is applicable since gross receipts are all in 2013, (ii) the gross margin for Margin Tax purposes is \$700, which would be the maximum taxable margin under Tex. Tax Code § 171.101(a)(1), and all of it is apportioned to Texas under Tex. Tax Code § 171.101(a)(2), and (iii) the applicable Margin Tax rate is 1% (the rate is 0.5% for a narrowly defined group of retail and wholesale businesses). Under Tex. Tax Code § 171.101(a)(1) a taxable entity’s taxable margin is the lesser of (x) 70% of its total revenue or (y) an amount determined by subtracting from its total revenue either its cost of goods sold or its compensation paid as elected or deemed elected pursuant to the Tex. Tax Code. See *supra* notes 126-227 and related text. Assumes the business cannot take advantage of exclusions for businesses with \$1,030,000 or less in total revenue. Tex. Tax Code § 171.002.
- (d) The income after taxes of most entities is the net income of the entity less the Margin Tax and, in the case of the C-corporation, the applicable federal income taxes.
- (e) A non-managing member of an LLC may not be subject to the self-employment tax; a shareholder of an S-corporation is not subject to self-employment tax on his share of its income but would be subject to employment tax on compensation received.
- (f) Only one-half of the self-employment tax is deductible against the individual’s income for federal income tax purposes.
- (g) Does not take into account the 3.8% Unearned Income Medicare Contribution Tax on net investment income discussed above under B. 3.8% Unearned Income Medicare Contribution Tax.

X. CONCLUSION.

There are several entity forms to consider when organizing a business in Texas. The characteristics of each, which are discussed above and are tabulated on the Entity Comparison Chart attached as Appendix A, will influence the choice among the entities for a particular situation.

APPENDIX A: ENTITY COMPARISON CHART

Note: Chart reflects requirements and allowances from the TBOC, not from source law, which may apply to some entities until January 1, 2010.

Item	Sole Proprietorship	General Partnership	Limited Liability Partnership	Limited Partnership	Limited Liability Company	"C" Corp.	"S" Corp.
Limited liability of owners for entity obligations	No	No	Yes	Yes	Yes	Yes	Yes
Name	No requirements	No requirements	L.L.P. must contain "limited liability partnership" or an abbreviation thereof.	Must contain "limited partnership," "limited," or an abbreviation of either.	Must contain "limited liability company," "limited company," or an abbreviation of either (unless formed prior to September 1, 1993 in compliance with the laws then in effect).	Must contain "corporation," "company," "incorporated," "limited," or an abbreviation of any of these.	Must contain "corporation," "company," "incorporated," "limited," or an abbreviation of any of these.
Filing Requirements	Assumed name certificate filing and payment of applicable filing fees	Assumed name certificate filing and payment of applicable filing fees	Annual registration and filing fee of \$200 per partner; must maintain liability insurance or meet alternative financial responsibility test	Certificate of formation and filing fee of \$750	Certificate of formation and filing fee of \$300	Certificate of formation and filing fee of \$300	Certificate of formation and filing fee of \$300
Ownership Types	Individuals	Any	Any	Any	Any	Any	Limited
No. of Owners	One	Minimum of 2	Minimum of 2	Minimum of 2	Single member LLCs permitted in texas	No restrictions	No more than 100

Item	Sole Proprietorship	General Partnership	Limited Liability Partnership	Limited Partnership	Limited Liability Company	“C” Corp.	“S” Corp.
Professionals	Yes	Yes	Yes	Yes	Yes	Yes, but generally governed by TBOC Title 7 Professional Entities if there is conflict with TBOC Title 2 Corporations. For entities existing prior to January 1, 2006, generally governed by Texas Professional Corporation Act or Texas Professional Association Act	Yes, but generally governed by TBOC Title 7 Professional Entities if there is conflict with TBOC Title 2 Corporations. For entities existing prior to January 1, 2006, generally governed by Texas Professional Corporation Act or Texas Professional Association Act
Ownership Classes	One	Multiple classes allowed	Multiple classes allowed	Multiple classes allowed but must have at least 1 general partner and 1 limited partner.	Multiple classes allowed	Multiple classes allowed	Limitation as to 1 class of stock
Transferability of Interests	Freely transferable	Economic interest is transferable unless restricted by partnership agreement; however, the status of partner is not transferable without consent of all partners	Economic interest is transferable unless restricted by partnership agreement; however, the status of partner is not transferable without consent of all partners	Economic interest is transferable unless restricted by partnership agreement; however, the status of partner is not transferable without consent of all partners	Economic membership interest freely transferable unless restricted by articles of organization or regulations; however, unless otherwise provided in articles of organization or regulations, the status of member is not transferable without consent of all members	Freely transferable unless restricted by articles of incorporation, bylaws or shareholder agreement	Freely transferable unless restricted by articles of incorporation, bylaws or shareholder agreement

**APPENDIX B: BASIC TEXAS BUSINESS ENTITIES AND
FEDERAL/STATE TAXATION ALTERNATIVES CHART**

<i>Texas Law Entity</i>	<i>Check-the-Box</i>	<i>Federal Taxation</i>	<i>TX Franchise Tax until 1/1/07¹</i>	<i>TX Margin Tax 1/1/07</i>
Proprietorship	Not Applicable	Form 1040, Schedule C or E	None	None
LLC / single individual member	Disregarded²	Form 1040, Schedule C or E (Proprietorship)	Yes	Yes
LLC / single entity member	Disregarded²	Division of Member Entity	Yes	Yes
General Partnership or LLP	Partnership³	Partnership	None	Depends
General Partnership or LLP	Corporation	C or S-Corp⁴	None	Depends
Limited Partnership	Partnership³	Partnership	None	Yes
Limited Partnership	Corporation	C or S-Corp⁴	None	Yes⁵
LLC / multi-members	Partnership³	Partnership	Yes	Yes
LLC / multi-members	Corporation	C or S-Corp⁴	Yes	Yes
Corporation	Not Applicable	C or S-Corp⁴	Yes	Yes

¹ Effective January 1, 2007, the Margin Tax replaced the Texas franchise tax and is applicable to all partnerships (other than general partnerships composed entirely of individuals). *See supra* notes 126-231 and related text.

² Unless a single member LLC affirmatively makes an election on IRS Form 8832 to be taxed as a corporation, it defaults to being disregarded for federal tax purposes. Treas. Reg. § 301.7701-3(b)(ii). Thus, where the single member of the LLC is an individual, the result is that the LLC is treated as a proprietorship for federal income tax purposes; where the single member of the LLC is an entity, the result is that the LLC is treated as if it were a division of the owning entity for federal income tax purposes.

³ Unless a partnership or multi-member LLC affirmatively makes an election on IRS Form 8832 to be taxed as a corporation, it defaults to being taxed as a partnership for federal tax purposes. Treas. Reg. § 301.7701-3(b)(i). *See supra* notes 91-105 and related text.

⁴ To be taxed as an S Corp, the entity and all of its equity owners must make a timely election on Form 2553 and meet several other requirements, generally having only citizen/resident individuals or estates as equity owners (with the exception of certain qualifying trusts and other holders), no more than 100 owners, and only one “class of stock.” IRC § 1361(b).

⁵ Unless LP qualifies as a “passive” entity. Tex. Tax Code § 171.0003. *See supra* notes 142-148 and related text.

BUSINESS ORGANIZATIONS CODE
(As Amended through the 82nd Texas Legislature, 2011 Regular Session, and
Effective September 1, 2011)

TABLE OF CONTENTS

Title 1. General Provisions

Chapter 1. Definitions and Other General Provisions

Subchapter A. Definitions and Purpose

- Sec. 1.001. Purpose
- Sec. 1.002. Definitions
- Sec. 1.003. Disinterested Person
- Sec. 1.004. Independent Person
- Sec. 1.005. Conspicuous Information
- Sec. 1.006. Synonymous Terms
- Sec. 1.007. Signing of Document or Other Writing
- Sec. 1.008. Short Titles
- Sec. 1.009. Dollars as Monetary Units

Subchapter B. Code Construction

- Sec. 1.051. Construction of Code
- Sec. 1.052. Reference in Law to Statute Revised by Code
- Sec. 1.053. Applicability to Foreign and Interstate Affairs
- Sec. 1.054. Reservation of Power

Subchapter C. Determination of Applicable Law

- Sec. 1.101. Domestic Filing Entities
- Sec. 1.102. Foreign Filing Entities
- Sec. 1.103. Entities Not Formed by Filing Instrument
- Sec. 1.104. Law Applicable to Liability
- Sec. 1.105. Internal Affairs
- Sec. 1.106. Order of Precedence

Chapter 2. Purposes and Powers of Domestic Entity

Subchapter A. Purposes of Domestic Entity

- Sec. 2.001. General Scope of Permissible Purposes
- Sec. 2.002. Purposes of Nonprofit Entity
- Sec. 2.003. General Prohibited Purposes
- Sec. 2.004. Limitation on Purposes of Professional Entity
- Sec. 2.005. Limitation in Governing Documents
- Sec. 2.006. Permissible Purpose of For-Profit Corporation Related to Railroads
- Sec. 2.007. Additional Prohibited Activities of For-Profit Corporation
- Sec. 2.008. Nonprofit Corporations
- Sec. 2.009. Permissible Purpose of Nonprofit Corporation Related to Organized Labor

- Sec. 2.010. Prohibited Activities of Nonprofit Corporation
- Sec. 2.011. Purposes of Cooperative Association
- Sec. 2.012. Limitation on Purposes of Real Estate Investment Trust

Subchapter B. Powers of Domestic Entity

- Sec. 2.101. General Powers
- Sec. 2.102. Additional Powers of Nonprofit Entity or Institution
- Sec. 2.103. Power to Incur Indebtedness
- Sec. 2.104. Power to Make Guaranties
- Sec. 2.105. Additional Powers of Certain Pipeline Businesses
- Sec. 2.106. Power of Nonprofit Corporation to Serve as Trustee
- Sec. 2.107. Standard Tax Provisions for Certain Charitable Nonprofit Corporations; Power to Exclude
- Sec. 2.108. Powers of Professional Association
- Sec. 2.109. Powers of Professional Corporation
- Sec. 2.110. Powers of Cooperative Association
- Sec. 2.111. Limitation on Powers of Cooperative Association
- Sec. 2.112. Stated Powers in Subchapter Sufficient
- Sec. 2.113. Limitation on Powers
- Sec. 2.114. Certificated Indebtedness; Manner of Issuance; Signature and Seal

Chapter 3. Formation and Governance

Subchapter A. Formation, Existence, and Certificate of Formation

- Sec. 3.001. Formation and Existence of Filing Entities
- Sec. 3.002. Formation and Existence of Nonfiling Entities
- Sec. 3.003. Duration
- Sec. 3.004. Organizers
- Sec. 3.005. Certificate of Formation
- Sec. 3.006. Filings in Case of Merger or Conversion
- Sec. 3.007. Supplemental Provisions Required in Certificate of Formation of For-Profit or Professional Corporation
- Sec. 3.008. Supplemental Provisions Required in Certificate of Formation of Close Corporation
- Sec. 3.009. Supplemental Provisions Required in Certificate of Formation of Nonprofit Corporation
- Sec. 3.010. Supplemental Provisions Required in Certificate of Formation of Limited Liability Company
- Sec. 3.011. Supplemental Provisions Regarding Certificate of Formation of Limited Partnership
- Sec. 3.012. Supplemental Provisions Required in Certificate of Formation of Real Estate Investment Trust
- Sec. 3.013. Supplemental Provisions Required in Certificate of Formation of Cooperative Association
- Sec. 3.014. Supplemental Provisions Required in Certificate of Formation of Professional Entity
- Sec. 3.015. Supplemental Provisions Required in Certificate of Formation of Professional Association

Subchapter B. Amendments and Restatements of Certificate of Formation

- Sec. 3.051. Right to Amend Certificate of Formation
- Sec. 3.052. Procedures to Amend Certificate of Formation
- Sec. 3.053. Certificate of Amendment
- Sec. 3.054. Execution of Certificate of Amendment of For-Profit Corporation
- Sec. 3.055. Supplemental Provisions for Certificate of Amendment of Real Estate Investment Trust
- Sec. 3.056. Effect of Filing of Certificate of Amendment
- Sec. 3.057. Right to Restate Certificate of Formation
- Sec. 3.058. Procedures to Restate Certificate of Formation
- Sec. 3.059. Restated Certificate of Formation
- Sec. 3.060. Supplemental Provisions for Restated Certificate of Formation for For-Profit Corporation or Professional Corporation

- Sec. 3.061. Supplemental Provisions for Restated Certificate of Formation for Nonprofit Corporation
- Sec. 3.0611. Supplemental Provisions for Restated Certificate of Formation for Limited Liability Company
- Sec. 3.062. Supplemental Provisions for Restated Certificate of Formation for Real Estate Investment Trust
- Sec. 3.063. Effect of Filing of Restated Certificate of Formation

Subchapter C. Governing Persons and Officers

- Sec. 3.101. Governing Authority
- Sec. 3.102. Rights of Governing Persons in Certain Cases
- Sec. 3.103. Officers
- Sec. 3.104. Removal of Officers
- Sec. 3.105. Rights of Officers in Certain Cases

Subchapter D. Recordkeeping of Filing Entities

- Sec. 3.151. Books and Records for All Filing Entities
- Sec. 3.152. Governing Person's Right of Inspection
- Sec. 3.153. Right of Examination by Owner or Member

Subchapter E. Certificates Representing Ownership Interest

- Sec. 3.201. Certificated or Uncertificated Ownership Interest; Applicability
- Sec. 3.202. Form and Validity of Certificates; Enforcement of Entity's Rights
- Sec. 3.203. Signature Requirement
- Sec. 3.204. Delivery Requirement
- Sec. 3.205. Notice for Uncertificated Ownership Interest

Subchapter F. Emergency Governance

- Sec. 3.251. Emergency Defined
- Sec. 3.252. Provisions in Governing Documents
- Sec. 3.253. Effect of Emergency Provisions
- Sec. 3.254. Effect of Other Provisions in Governing Documents During Emergency
- Sec. 3.255. Effect of Action Taken

Chapter 4. Filings

Subchapter A. General Provisions

- Sec. 4.001. Signature and Delivery
- Sec. 4.002. Action by Secretary of State
- Sec. 4.003. Filing or Issuance of Reproduction or Facsimile
- Sec. 4.004. Time for Filing
- Sec. 4.005. Certificates and Certified Copies
- Sec. 4.006. Forms Adopted by Secretary of State
- Sec. 4.007. Liability for False Filing Instruments
- Sec. 4.008. Offense; Penalty
- Sec. 4.009. Filings by Real Estate Investment Trust

Subchapter B. When Filings Take Effect

- Sec. 4.051. General Rule
- Sec. 4.052. Delayed Effectiveness of Certain Filings
- Sec. 4.053. Conditions for Delayed Effectiveness
- Sec. 4.054. Delayed Effectiveness on Future Event or Fact
- Sec. 4.055. Statement of Event or Fact

- Sec. 4.056. Failure to File Statement
- Sec. 4.057. Abandonment Before Effectiveness
- Sec. 4.058. Delayed Effectiveness Not Permitted
- Sec. 4.059. Acknowledgment of Filing With Delayed Effectiveness

Subchapter C. Correction and Amendment

- Sec. 4.101. Correction of Filings
- Sec. 4.102. Limitation on Correction of Filings
- Sec. 4.103. Certificate of Correction
- Sec. 4.104. Filing Certificate of Correction
- Sec. 4.105. Effect of Certificate of Correction
- Sec. 4.106. Amendment of Filings

Subchapter D. Filing Fees

- Sec. 4.151. Filing Fees: All Entities
- Sec. 4.152. Filing Fees: For-Profit Corporations
- Sec. 4.153. Filing Fees: Nonprofit Corporations
- Sec. 4.154. Filing Fees: Limited Liability Companies
- Sec. 4.155. Filing Fees: Limited Partnerships
- Sec. 4.156. Filing Fees: Professional Associations
- Sec. 4.157. Filing Fees: Professional Corporations
- Sec. 4.158. Filing Fees: General Partnerships
- Sec. 4.159. Filing Fees: Nonprofit Associations
- Sec. 4.160. Filing Fees: Foreign Filing Entities
- Sec. 4.161. Filing Fees: Cooperative Associations

Chapter 5. Names of Entities; Registered Agents and Registered Offices

Subchapter A. General Provisions

- Sec. 5.001. Effect on Rights Under Other Law

Subchapter B. General Provisions Relating to Names of Entities

- Sec. 5.051. Assumed Name
- Sec. 5.052. Unauthorized Purpose in Name Prohibited
- Sec. 5.053. Identical and Deceptively Similar Names Prohibited
- Sec. 5.054. Name of Corporation, Foreign Corporation, Professional Corporation,
or Foreign Professional Corporation
- Sec. 5.055. Name of Limited Partnership or Foreign Limited Partnership
- Sec. 5.056. Name of Limited Liability Company or Foreign Limited Liability Company
- Sec. 5.057. Name of Cooperative Association or Foreign Cooperative Association
- Sec. 5.058. Name of Professional Association or Foreign Professional Association
- Sec. 5.059. Name of Professional Limited Liability Company or Foreign Professional
Limited Liability Company
- Sec. 5.060. Name of Professional Entity or Foreign Professional Entity; Conflicts With Other
Law or Ethical Rule
- Sec. 5.061. Name Containing “Lotto” or “Lottery” Prohibited
- Sec. 5.062. Veterans Organizations; Unauthorized Use of Name
- Sec. 5.063. Name of Limited Liability Partnership

Subchapter C. Reservation of Names

- Sec. 5.101. Application for Reservation of Name
- Sec. 5.102. Reservation of Certain Names Prohibited; Exceptions

- Sec. 5.103. Action on Application
- Sec. 5.104. Duration of Reservation of Name
- Sec. 5.1041. Prohibition on Fee for Withdrawal of Reservation of Name
- Sec. 5.105. Renewal of Reservation
- Sec. 5.106. Transfer of Reservation of Name

Subchapter D. Registration of Names

- Sec. 5.151. Application by Certain Entities for Registration of Name
- Sec. 5.152. Application for Registration of Name
- Sec. 5.153. Certain Registrations Prohibited; Exceptions
- Sec. 5.154. Duration of Registration of Name
- Sec. 5.155. Renewal of Registration

Subchapter E. Registered Agents and Registered Offices

- Sec. 5.201. Designation and Maintenance of Registered Agent and Registered Office
- Sec. 5.202. Change by Entity to Registered Office or Registered Agent
- Sec. 5.203. Change by Registered Agent to Name or Address of Registered Office
- Sec. 5.204. Resignation of Registered Agent

Subchapter F. Service of Process

- Sec. 5.251. Failure to Designate Registered Agent
- Sec. 5.252. Service on Secretary of State
- Sec. 5.253. Action by Secretary of State
- Sec. 5.254. Required Records of Secretary of State
- Sec. 5.255. Agent for Service of Process, Notice, or Demand as Matter of Law
- Sec. 5.256. Other Means of Service Not Precluded
- Sec. 5.257. Service of Process by Political Subdivision

Chapter 6. Meetings and Voting for Domestic Entities

Subchapter A. Meetings

- Sec. 6.001. Location of Meetings
- Sec. 6.002. Alternative Forms of Meetings
- Sec. 6.003. Participation Constitutes Presence

Subchapter B. Notice of Meetings

- Sec. 6.051. General Notice Requirements
- Sec. 6.052. Waiver of Notice
- Sec. 6.053. Exception

Subchapter C. Record Dates

- Sec. 6.101. Record Date for Purpose Other than Written Consent to Action
- Sec. 6.102. Record Date for Written Consent to Action
- Sec. 6.103. Record Date for Suspended Distributions

Subchapter D. Voting of Ownership Interests

- Sec. 6.151. Manner of Voting of Interests
- Sec. 6.152. Voting of Interests Owned by Entity
- Sec. 6.153. Voting of Interests Owned by Another Entity
- Sec. 6.154. Voting of Interests in an Estate or Trust
- Sec. 6.155. Voting of Interests by Receiver
- Sec. 6.156. Voting of Pledged Interests

Subchapter E. Action by Written Consent

- Sec. 6.201. Unanimous Written Consent to Action
- Sec. 6.202. Action by Less than Unanimous Written Consent
- Sec. 6.203. Delivery of Less than Unanimous Written Consent
- Sec. 6.204. Advance Notice Not Required
- Sec. 6.205. Reproduction or Electronic Transmission of Consent

Subchapter F. Voting Trusts and Voting Agreements

- Sec. 6.251. Voting Trusts
- Sec. 6.252. Voting Agreements

Subchapter G. Applicability of Chapter

- Sec. 6.301. Applicability of Chapter to Partnerships
- Sec. 6.302. Applicability of Subchapters C and D to Limited Liability Companies

Chapter 7. Liability

- Sec. 7.001. Limitation of Liability of Governing Person

Chapter 8. Indemnification and Insurance

Subchapter A. General Provisions

- Sec. 8.001. Definitions
- Sec. 8.002. Application of Chapter
- Sec. 8.003. Limitations in Governing Documents
- Sec. 8.004. Limitations in Chapter

Subchapter B. Mandatory and Court-Ordered Indemnification

- Sec. 8.051. Mandatory Indemnification
- Sec. 8.052. Court-Ordered Indemnification

Subchapter C. Permissive Indemnification and Advancement of Expenses

- Sec. 8.101. Permissive Indemnification
- Sec. 8.102. General Scope of Permissive Indemnification
- Sec. 8.103. Manner for Determining Permissive Indemnification
- Sec. 8.104. Advancement of Expenses to Present Governing Persons or Delegates
- Sec. 8.105. Indemnification of and Advancement of Expenses to Persons Other than Governing Persons
- Sec. 8.106. Permissive Indemnification of and Reimbursement of Expenses to Witnesses

Subchapter D. Liability Insurance; Reporting Requirements

- Sec. 8.151. Insurance and Other Arrangements
- Sec. 8.152. Reports of Indemnification and Advances

Chapter 9. Foreign Entities

Subchapter A. Registration

- Sec. 9.001. Foreign Entities Required to Register
- Sec. 9.002. Foreign Entities Not Required to Register
- Sec. 9.003. Permissive Registration
- Sec. 9.004. Registration Procedure

- Sec. 9.005. Supplemental Information Required in Application for Registration of Foreign Limited Liability Company
- Sec. 9.006. Supplemental Information Required in Application for Registration of Foreign Nonprofit Corporation
- Sec. 9.007. Application for Registration of Foreign Limited Liability Partnership
- Sec. 9.008. Effect of Registration
- Sec. 9.009. Amendments to Registration
- Sec. 9.010. Name Change of Foreign Filing Entity
- Sec. 9.011. Voluntary Withdrawal of Registration
- Sec. 9.012. Automatic Withdrawal on Conversion to Domestic Filing Entity

Subchapter B. Failure to Register

- Sec. 9.051. Transacting Business or Maintaining Court Proceeding without Registration
- Sec. 9.052. Civil Penalty
- Sec. 9.053. Venue
- Sec. 9.054. Late Filing Fee
- Sec. 9.055. Requirements of Other Law

Subchapter C. Revocation of Registration by Secretary of State

- Sec. 9.101. Revocation of Registration by Secretary of State
- Sec. 9.102. Certificate of Revocation
- Sec. 9.103. Reinstatement by Secretary of State After Revocation
- Sec. 9.104. Procedures for Reinstatement
- Sec. 9.105. Use of Name Similar to Previously Registered Name
- Sec. 9.106. Reinstatement of Registration Following Tax Forfeiture

Subchapter D. Judicial Revocation of Registration

- Sec. 9.151. Revocation of Registration by Court Action
- Sec. 9.152. Notification of Cause by Secretary of State
- Sec. 9.153. Filing of Action by Attorney General
- Sec. 9.154. Cure Before Final Judgment
- Sec. 9.155. Judgment Requiring Revocation
- Sec. 9.156. Stay of Judgment
- Sec. 9.157. Opportunity for Cure After Affirmation of Findings by Appeals Court
- Sec. 9.158. Jurisdiction and Venue
- Sec. 9.159. Process in State Action
- Sec. 9.160. Publication of Notice
- Sec. 9.161. Filing of Decree of Revocation Against Foreign Filing Entity
- Sec. 9.162. Applicability of Subchapter to Foreign Limited Liability Partnerships

Subchapter E. Business, Rights, and Obligations

- Sec. 9.201. Business of Foreign Entity
- Sec. 9.202. Rights and Privileges
- Sec. 9.203. Obligations and Liabilities
- Sec. 9.204. Right of Foreign Entity to Participate in Business of Certain Domestic Entities

Subchapter F. Determination of Transacting Business in this State

- Sec. 9.251. Activities Not Constituting Transacting Business in this State
- Sec. 9.252. Other Activities

Subchapter G. Miscellaneous Provisions

Sec. 9.301. Applicability of Code to Certain Foreign Entities

Chapter 10. Mergers, Interest Exchanges, Conversions, and Sales of Assets

Subchapter A. Mergers

- Sec. 10.001. Adoption of Plan of Merger
- Sec. 10.002. Plan of Merger: Required Provisions
- Sec. 10.003. Contents of Plan of Merger: More than One Successor
- Sec. 10.004. Plan of Merger: Permissive Provisions
- Sec. 10.005. Creation of Holding Company by Merger
- Sec. 10.006. Short Form Merger
- Sec. 10.007. Effectiveness of Merger
- Sec. 10.008. Effect of Merger
- Sec. 10.009. Special Provisions Applying to Partnership Mergers
- Sec. 10.010. Special Provisions Applying to Nonprofit Corporation Mergers

Subchapter B. Exchanges of Interests

- Sec. 10.051. Interest Exchanges
- Sec. 10.052. Plan of Exchange: Required Provisions
- Sec. 10.053. Plan of Exchange: Permissive Provisions
- Sec. 10.054. Effectiveness of Exchange
- Sec. 10.055. General Effect of Interest Exchange
- Sec. 10.056. Special Provisions Applying to Partnerships

Subchapter C. Conversions

- Sec. 10.101. Conversion of Domestic Entities
- Sec. 10.102. Conversion of Non-Code Organizations
- Sec. 10.1025. Conversion and Continuance
- Sec. 10.103. Plan of Conversion: Required Provisions
- Sec. 10.104. Plan of Conversion: Permissive Provisions
- Sec. 10.105. Effectiveness of Conversion
- Sec. 10.106. General Effect of Conversion
- Sec. 10.107. Special Provisions Applying to Partnership Conversions
- Sec. 10.108. Special Provisions Applying to Nonprofit Corporation Conversions
- Sec. 10.109. Special Provisions Applying to Conversion and Continuance

Subchapter D. Certificate of Merger, Exchange, or Conversion

- Sec. 10.151. Certificate of Merger and Exchange
- Sec. 10.152. Certificate of Merger: Short Form Merger
- Sec. 10.153. Filing of Certificate of Merger or Exchange
- Sec. 10.154. Certificate of Conversion
- Sec. 10.155. Filing of Certificate of Conversion
- Sec. 10.156. Acceptance of Certificate for Filing

Subchapter E. Abandonment of Merger, Exchange, or Conversion

- Sec. 10.201. Abandonment of Plan of Merger, Exchange, or Conversion
- Sec. 10.202. Abandonment After Filing
- Sec. 10.203. Abandonment if No Filing Required

Subchapter F. Property Transfers and Dispositions

- Sec. 10.251. General Power of Domestic Entity to Sell, Lease, or Convey Property
- Sec. 10.252. No Approval Required for Certain Dispositions of Property

- Sec. 10.253. Recording Instrument Conveying Real Property of Domestic Entity
- Sec. 10.254. Disposition of Property Not a Merger or Conversion; Liability

Subchapter G. Bankruptcy Reorganization

- Sec. 10.301. Reorganization Under Bankruptcy and Similar Laws
- Sec. 10.302. Signing of Documents
- Sec. 10.303. Reorganization With Other Entities
- Sec. 10.304. Right of Dissent and Appraisal Excluded
- Sec. 10.305. After Final Decree
- Sec. 10.306. Chapter Cumulative of Other Changes

Subchapter H. Rights of Dissenting Owners

- Sec. 10.351. Applicability of Subchapter
- Sec. 10.352. Definitions
- Sec. 10.353. Form and Validity of Notice
- Sec. 10.354. Rights of Dissent and Appraisal
- Sec. 10.355. Notice of Right of Dissent and Appraisal
- Sec. 10.356. Procedure for Dissent by Owners as to Actions; Perfection of Right of Dissent and Appraisal
- Sec. 10.357. Withdrawal of Demand for Fair Value of Ownership Interest
- Sec. 10.358. Response by Organization to Notice of Dissent and Demand for Fair Value by Dissenting Owner
- Sec. 10.359. Record of Demand for Fair Value of Ownership Interest
- Sec. 10.360. Rights of Transferee of Certain Ownership Interest
- Sec. 10.361. Proceeding to Determine Fair Value of Ownership Interest and Owners Entitled to Payment; Appointment of Appraisers
- Sec. 10.362. Computation and Determination of Fair Value of Ownership Interest
- Sec. 10.363. Powers and Duties of Appraiser; Appraisal Procedures
- Sec. 10.364. Objection to Appraisal; Hearing
- Sec. 10.365. Court Costs; Compensation for Appraiser
- Sec. 10.366. Status of Ownership Interest Held or Formerly Held by Dissenting Owner
- Sec. 10.367. Rights of Owners Following Termination of Right of Dissent
- Sec. 10.368. Exclusivity of Remedy of Dissent and Appraisal

Subchapter Z. Miscellaneous Provisions

- Sec. 10.901. Creditors; Antitrust
- Sec. 10.902. Nonexclusivity

Chapter 11. Winding Up and Termination of Domestic Entity

Subchapter A. General Provisions

- Sec. 11.001. Definitions

Subchapter B. Winding Up of Domestic Entity

- Sec. 11.051. Event Requiring Winding Up of Domestic Entity
- Sec. 11.052. Winding Up Procedures
- Sec. 11.053. Property Applied to Discharge Liabilities and Obligations
- Sec. 11.054. Court Supervision of Winding Up Process
- Sec. 11.055. Court Action or Proceeding During Winding Up
- Sec. 11.056. Supplemental Provisions for Limited Liability Company
- Sec. 11.057. Supplemental Provisions for Domestic General Partnership
- Sec. 11.058. Supplemental Provisions for Limited Partnership

Sec. 11.059. Supplemental Provisions for Corporations

Subchapter C. Termination of Domestic Entity

- Sec. 11.101. Certificate of Termination for Filing Entity
- Sec. 11.102. Effectiveness of Termination of Filing Entity
- Sec. 11.103. Effectiveness of Termination of Nonfiling Entity
- Sec. 11.104. Action by Secretary of State
- Sec. 11.105. Supplemental Information Required by Certificate of Termination of Nonprofit Corporation

Subchapter D. Revocation and Continuation

- Sec. 11.151. Revocation of Voluntary Winding Up
- Sec. 11.152. Continuation of Business Without Winding Up
- Sec. 11.153. Court Revocation of Fraudulent Termination

Subchapter E. Reinstatement of Terminated Entity

- Sec. 11.201. Conditions for Reinstatement
- Sec. 11.202. Procedures for Reinstatement
- Sec. 11.203. Use of Name Similar to Previously Registered Name
- Sec. 11.204. Effectiveness of Reinstatement of Nonfiling Entity
- Sec. 11.205. Effectiveness of Reinstatement of Filing Entity
- Sec. 11.206. Effect of Reinstatement

Subchapter F. Involuntary Termination of Filing Entity by Secretary of State

- Sec. 11.251. Termination of Filing Entity by Secretary of State
- Sec. 11.252. Certificate of Termination
- Sec. 11.253. Reinstatement by Secretary of State After Involuntary Termination
- Sec. 11.254. Reinstatement of Certificate of Formation Following Tax Forfeiture

Subchapter G. Judicial Winding Up and Termination

- Sec. 11.301. Involuntary Winding Up and Termination of Filing Entity by Court Action
- Sec. 11.302. Notification of Cause by Secretary of State
- Sec. 11.303. Filing of Action by Attorney General
- Sec. 11.304. Cure Before Final Judgment
- Sec. 11.305. Judgment Requiring Winding Up and Termination
- Sec. 11.306. Stay of Judgment
- Sec. 11.307. Opportunity for Cure After Affirmation of Findings by Appeals Court
- Sec. 11.308. Jurisdiction and Venue
- Sec. 11.309. Process in State Action
- Sec. 11.310. Publication of Notice
- Sec. 11.311. Action Allowed After Expiration of Filing Entity's Duration
- Sec. 11.312. Compliance by Terminated Entity
- Sec. 11.313. Timing of Termination
- Sec. 11.314. Involuntary Winding Up and Termination of Partnership or Limited Liability Company
- Sec. 11.315. Filing of Decree of Termination Against Filing Entity

Subchapter H. Claims Resolution on Termination

- Sec. 11.351. Liability of Terminated Entity
- Sec. 11.352. Deposit With Comptroller of Amount Due Owners and Creditors Who are Unknown or Cannot be Located
- Sec. 11.353. Discharge of Liability of Person Responsible for Liquidation
- Sec. 11.354. Payment from Account by Comptroller
- Sec. 11.355. Notice of Escheat; Escheat

- Sec. 11.356. Limited Survival After Termination
- Sec. 11.357. Governing Persons of Entity During Limited Survival
- Sec. 11.358. Accelerated Procedure for Existing Claim Resolution
- Sec. 11.359. Extinguishment of Existing Claim

Subchapter I. Receivership

- Sec. 11.401. Code Governs
- Sec. 11.402. Jurisdiction to Appoint Receiver
- Sec. 11.403. Appointment of Receiver for Specific Property
- Sec. 11.404. Appointment of Receiver to Rehabilitate Domestic Entity
- Sec. 11.405. Appointment of Receiver to Liquidate Domestic Entity; Liquidation
- Sec. 11.406. Receivers: Qualifications, Powers, and Duties
- Sec. 11.407. Court-Ordered Filing of Claims
- Sec. 11.408. Supervising Court; Jurisdiction; Authority
- Sec. 11.409. Ancillary Receiverships of Foreign Entities
- Sec. 11.410. Receivership for All Property and Business of Foreign Entity
- Sec. 11.411. Governing Persons and Owners Not Necessary Parties Defendant
- Sec. 11.412. Decree of Involuntary Termination
- Sec. 11.413. Supplemental Provisions for Application of Proceeds from Liquidation of Nonprofit Corporation
- Sec. 11.414. Filing of Decree of Involuntary Termination Against Filing Entity

Chapter 12. Administrative Powers

Subchapter A. Secretary of State

- Sec. 12.001. Authority of Secretary of State
- Sec. 12.002. Interrogatories by Secretary of State
- Sec. 12.003. Information Disclosed by Interrogatories
- Sec. 12.004. Appeals from Secretary of State

Subchapter B. Attorney General

- Sec. 12.151. Authority of Attorney General to Examine Books and Records
- Sec. 12.152. Request to Examine
- Sec. 12.153. Authority to Examine Management of Entity
- Sec. 12.154. Authority to Disclose Information
- Sec. 12.155. Forfeiture of Business Privileges
- Sec. 12.156. Criminal Penalty

Subchapter C. Enforcement Lien

- Sec. 12.201. Lien for Law Violations

Subchapter D. Enforcement Proceedings

- Sec. 12.251. Receiver
- Sec. 12.252. Foreclosure
- Sec. 12.253. Action against Insolvent Entity
- Sec. 12.254. Suits by District or County Attorney
- Sec. 12.255. Permission to Sue
- Sec. 12.256. Examination and Notice
- Sec. 12.257. Dismissal of Action
- Sec. 12.258. Liquidation of Insolvent Entity
- Sec. 12.259. Extraordinary Remedies; Bond
- Sec. 12.260. Abatement of Suit

Sec. 12.261. Provisions Cumulative

Title 2. Corporations

Chapter 20. General Provisions

- Sec. 20.001. Requirement that Filing Instrument be Signed by Officer
- Sec. 20.002. Ultra Vires Acts

Chapter 21. For-Profit Corporations

Subchapter A. General Provisions

- Sec. 21.002. Definitions

Subchapter B. Formation and Governing Documents

- Sec. 21.051. No Property Right in Certificate of Formation
- Sec. 21.052. Procedures to Adopt Amendment to Certificate of Formation
- Sec. 21.053. Adoption of Amendment by Board of Directors
- Sec. 21.054. Adoption of Amendment by Shareholders
- Sec. 21.055. Notice of and Meeting to Consider Proposed Amendment
- Sec. 21.056. Restated Certificate of Formation
- Sec. 21.057. Bylaws
- Sec. 21.058. Dual Authority
- Sec. 21.059. Organization Meeting

Subchapter C. Shareholders' Agreements

- Sec. 21.101. Shareholders' Agreement
- Sec. 21.102. Term of Agreement
- Sec. 21.103. Disclosure of Agreement; Recall of Certain Certificates
- Sec. 21.104. Effect of Shareholders' Agreement
- Sec. 21.105. Right of Rescission; Knowledge of Purchaser of Shares
- Sec. 21.106. Agreement Limiting Authority of and Supplanting Board of Directors; Liability
- Sec. 21.107. Liability of Shareholder
- Sec. 21.108. Persons Acting in Place of Shareholders
- Sec. 21.109. Agreement Not Effective
- Sec. 21.110. Other Shareholder Agreements Permitted

Subchapter D. Shares, Options, and Convertible Securities

- Sec. 21.151. Number of Authorized Shares
- Sec. 21.152. Classes and Series of Shares
- Sec. 21.153. Designations, Preferences, Limitations, and Rights of a Class or Series
- Sec. 21.154. Certain Optional Characteristics of Shares
- Sec. 21.155. Series of Shares Established by Board of Directors
- Sec. 21.156. Actions with Respect to Series of Shares
- Sec. 21.157. Issuance of Shares
- Sec. 21.158. Issuance of Shares Under Plan of Merger or Conversion
- Sec. 21.159. Types of Consideration for Shares
- Sec. 21.160. Determination of Consideration for Shares
- Sec. 21.161. Amount of Consideration for Issuance of Certain Shares
- Sec. 21.162. Value and Sufficiency of Consideration
- Sec. 21.163. Issuance and Disposition of Fractional Shares or Scrip
- Sec. 21.164. Rights of Holders of Fractional Shares or Scrip
- Sec. 21.165. Subscriptions
- Sec. 21.166. Preformation Subscription

- Sec. 21.167. Commitment to Purchase Shares
- Sec. 21.168. Stock Rights, Options, and Convertible Indebtedness
- Sec. 21.169. Terms and Conditions of Rights and Options
- Sec. 21.170. Consideration for Rights, Options, and Convertible Indebtedness
- Sec. 21.171. Outstanding or Treasury Shares
- Sec. 21.172. Expenses of Organization, Reorganization, and Financing of Corporation
- Sec. 21.173. Supplemental Required Records

Subchapter E. Shareholder Rights and Restrictions

- Sec. 21.201. Registered Holders as Owners; Shares Held by Nominees
- Sec. 21.202. Definition of Shares
- Sec. 21.203. No Statutory Preemptive Right Unless Provided by Certificate of Formation
- Sec. 21.204. Statutory Preemptive Rights
- Sec. 21.205. Waiver of Preemptive Right
- Sec. 21.206. Limitation on Action to Enforce Preemptive Right
- Sec. 21.207. Disposition of Shares Having Preemptive Rights
- Sec. 21.208. Preemptive Right in Existing Corporation
- Sec. 21.209. Transfer of Shares and Other Securities
- Sec. 21.210. Restriction on Transfer of Shares and Other Securities
- Sec. 21.211. Valid Restrictions on Transfer
- Sec. 21.212. Bylaw or Agreement Restricting Transfer of Shares or Other Securities
- Sec. 21.213. Enforceability of Restriction on Transfer of Certain Securities
- Sec. 21.214. Joint Ownership of Shares
- Sec. 21.215. Liability for Designating Owner of Shares
- Sec. 21.216. Liability Regarding Joint Ownership of Shares
- Sec. 21.217. Liability of Assignee or Transferee
- Sec. 21.218. Examination of Records
- Sec. 21.219. Annual and Interim Statements of Corporation
- Sec. 21.220. Penalty for Failure to Prepare Voting List
- Sec. 21.221. Penalty for Failure to Provide Notice of Meeting
- Sec. 21.222. Penalty for Refusal to Permit Examination of Certain Records
- Sec. 21.223. Liability for Obligations
- Sec. 21.224. Preemption of Liability
- Sec. 21.225. Exceptions to Limitations
- Sec. 21.226. Liability for Obligations

Subchapter F. Reductions in Stated Capital; Cancellation of Treasury Shares

- Sec. 21.251. Reduction of Stated Capital by Redemption or Purchase of Redeemable Shares
- Sec. 21.252. Cancellation of Treasury Shares
- Sec. 21.253. Procedures for Reduction of Stated Capital by Board of Directors
- Sec. 21.254. Restriction on Reduction of Stated Capital

Subchapter G. Distributions and Share Dividends

- Sec. 21.301. Definitions
- Sec. 21.302. Authority for Distributions
- Sec. 21.303. Limitations on Distributions
- Sec. 21.304. Redemptions
- Sec. 21.305. Notice of Redemption
- Sec. 21.306. Deposit of Money for Redemption
- Sec. 21.307. Payment of Redeemed Shares
- Sec. 21.308. Priority of Distributions
- Sec. 21.309. Reserves, Designations, and Allocations from Surplus
- Sec. 21.310. Authority for Share Dividends
- Sec. 21.311. Limitations on Share Dividends

- Sec. 21.312. Value of Shares Issued as Share Dividends
- Sec. 21.313. Transfer of Surplus for Share Dividends
- Sec. 21.314. Determination of Solvency, Net Assets, Stated Capital, and Surplus
- Sec. 21.315. Date of Determination of Solvency, Net Assets, Stated Capital, and Surplus
- Sec. 21.316. Liability of Directors for Wrongful Distributions
- Sec. 21.317. Statute of Limitations on Action for Wrongful Distribution
- Sec. 21.318. Contribution from Certain Shareholders and Directors

Subchapter H. Shareholders' Meetings; Notice to Shareholders; Voting and Quorum

- Sec. 21.351. Annual Meeting
- Sec. 21.352. Special Meetings
- Sec. 21.353. Notice of Meeting
- Sec. 21.3531. Notice by Electronic Transmission
- Sec. 21.354. Inspection of Voting List
- Sec. 21.355. Closing of Share Transfer Records
- Sec. 21.356. Record Date for Written Consent to Action
- Sec. 21.357. Record Date for Purpose of Shareholders' Meeting
- Sec. 21.358. Quorum
- Sec. 21.359. Voting in Election of Directors
- Sec. 21.360. No Cumulative Voting Right Unless Authorized
- Sec. 21.361. Cumulative Voting in Election of Directors
- Sec. 21.362. Cumulative Voting Right in Certain Corporations
- Sec. 21.363. Voting on Matters Other than Election of Directors
- Sec. 21.364. Vote Required to Approve Fundamental Action
- Sec. 21.365. Changes in Vote Required for Certain Matters
- Sec. 21.366. Number of Votes Per Share
- Sec. 21.367. Voting in Person or by Proxy
- Sec. 21.368. Term of Proxy
- Sec. 21.369. Revocability of Proxy
- Sec. 21.370. Enforceability of Proxy
- Sec. 21.371. Procedures in Bylaws Relating to Proxies
- Sec. 21.372. Shareholder Meeting List

Subchapter I. Board of Directors

- Sec. 21.401. Management by Board of Directors
- Sec. 21.402. Board Member Eligibility Requirements
- Sec. 21.403. Number of Directors
- Sec. 21.404. Designation of Initial Board of Directors
- Sec. 21.405. Election of Board of Directors
- Sec. 21.406. Special Voting Rights of Directors
- Sec. 21.407. Term of Office
- Sec. 21.408. Special Terms of Office
- Sec. 21.409. Removal of Directors
- Sec. 21.4091. Resignation of Directors
- Sec. 21.410. Vacancy
- Sec. 21.411. Notice of Meeting
- Sec. 21.412. Waiver of Notice
- Sec. 21.413. Quorum
- Sec. 21.414. Dissent to Action
- Sec. 21.415. Action by Directors
- Sec. 21.416. Committees of Board of Directors
- Sec. 21.417. Election of Officers
- Sec. 21.418. Contracts or Transactions Involving Interested Directors and Officers

Subchapter J. Fundamental Business Transactions

- Sec. 21.451. Definitions
- Sec. 21.452. Approval of Merger
- Sec. 21.453. Approval of Conversion
- Sec. 21.454. Approval of Exchange
- Sec. 21.455. Approval of Sale of All or Substantially All of Assets
- Sec. 21.456. General Procedure for Submission to Shareholders of Fundamental Business Transaction
- Sec. 21.457. General Vote Requirement for Approval of Fundamental Business Transaction
- Sec. 21.458. Class Voting Requirements for Certain Fundamental Business Transactions
- Sec. 21.459. No Shareholder Vote Requirement for Certain Fundamental Business Transactions
- Sec. 21.460. Rights of Dissent and Appraisal
- Sec. 21.461. Pledge, Mortgage, Deed of Trust, or Trust Indenture
- Sec. 21.462. Conveyance by Corporation

Subchapter K. Winding Up and Termination

- Sec. 21.501. Approval of Voluntary Winding Up, Reinstatement, or Revocation of Voluntary Winding Up
- Sec. 21.502. Certain Procedures Relating to Winding Up
- Sec. 21.503. Meeting of Shareholders; Notice
- Sec. 21.504. Responsibility for Winding Up

Subchapter L. Derivative Proceedings

- Sec. 21.551. Definitions
- Sec. 21.552. Standing to Bring Proceeding
- Sec. 21.553. Demand
- Sec. 21.554. Determination by Directors or Independent Persons
- Sec. 21.555. Stay of Proceeding
- Sec. 21.556. Discovery
- Sec. 21.557. Tolling of Statute of Limitations
- Sec. 21.558. Dismissal of Derivative Proceeding
- Sec. 21.559. Proceeding Instituted After Demand Rejected
- Sec. 21.560. Discontinuance or Settlement
- Sec. 21.561. Payment of Expenses
- Sec. 21.562. Application to Foreign Corporations
- Sec. 21.563. Closely Held Corporation

Subchapter M. Affiliated Business Combinations

- Sec. 21.601. Definitions
- Sec. 21.602. Affiliated Shareholder
- Sec. 21.603. Beneficial Owner of Shares or Similar Securities
- Sec. 21.604. Business Combination
- Sec. 21.605. Control
- Sec. 21.606. Three-Year Moratorium on Certain Business Combinations
- Sec. 21.607. Application of Moratorium
- Sec. 21.608. Effect on Other Actions
- Sec. 21.609. Conflicting Provisions
- Sec. 21.610. Change in Voting Requirements

Subchapter N. Provisions Relating to Investment Companies

- Sec. 21.651. Definition
- Sec. 21.652. Establishing Class or Series of Shares; Change in Number of Shares
- Sec. 21.653. Required Statement Relating to Shares
- Sec. 21.654. Term of Office of Directors

Sec. 21.655. Meetings of Shareholders

Subchapter O. Close Corporation

- Sec. 21.701. Definitions
- Sec. 21.702. Applicability of Subchapter
- Sec. 21.703. Formation of Close Corporation
- Sec. 21.704. Bylaws of Close Corporation
- Sec. 21.705. Adoption of Amendment for Close Corporation Status
- Sec. 21.706. Adoption of Close Corporation Status through Merger, Exchange, or Conversion
- Sec. 21.707. Existing Close Corporation
- Sec. 21.708. Termination of Close Corporation Status
- Sec. 21.709. Statement Terminating Close Corporation Status; Filing; Notice
- Sec. 21.710. Effect of Termination of Close Corporation Status
- Sec. 21.711. Shareholders' Meeting to Elect Directors
- Sec. 21.712. Term of Office of Directors
- Sec. 21.713. Management
- Sec. 21.714. Shareholders' Agreement
- Sec. 21.715. Execution of Shareholders' Agreement
- Sec. 21.716. Adoption of Amendment of Shareholders' Agreement
- Sec. 21.717. Delivery of Shareholders' Agreement
- Sec. 21.718. Statement of Operation as Close Corporation
- Sec. 21.719. Validity and Enforceability of Shareholders' Agreement
- Sec. 21.720. Persons Bound by Shareholders' Agreement
- Sec. 21.721. Delivery of Copy of Shareholders' Agreement to Transferee
- Sec. 21.722. Effect of Required Statement on Share Certificate and Delivery of Shareholders' Agreement
- Sec. 21.723. Party Not Bound by Shareholders' Agreement on Cessation; Liability
- Sec. 21.724. Termination of Shareholders' Agreement
- Sec. 21.725. Consequences of Management by Persons Other than Board of Directors
- Sec. 21.726. Shareholders Considered Directors
- Sec. 21.727. Liability of Shareholders
- Sec. 21.728. Mode and Effect of Taking Action by Shareholders and Others
- Sec. 21.729. Limitation of Shareholder's Liability
- Sec. 21.730. Lack of Formalities; Treatment as Partnership
- Sec. 21.731. Other Agreements Among Shareholders Permitted
- Sec. 21.732. Close Corporation Share Certificates

Subchapter P. Judicial Proceedings Relating to Close Corporation

- Sec. 21.751. Definitions
- Sec. 21.752. Proceedings Authorized
- Sec. 21.753. Notice; Intervention
- Sec. 21.754. Proceeding Nonexclusive
- Sec. 21.755. Unavailability of Judicial Proceeding
- Sec. 21.756. Judicial Proceeding to Enforce Close Corporation Provision
- Sec. 21.757. Liquidation; Involuntary Winding Up and Termination; Receivership
- Sec. 21.758. Appointment of Provisional Director
- Sec. 21.759. Rights and Powers of Provisional Director
- Sec. 21.760. Compensation of Provisional Director
- Sec. 21.761. Appointment of Custodian
- Sec. 21.762. Powers and Duties of Custodian
- Sec. 21.763. Termination of Custodianship

Subchapter Q. Miscellaneous Provisions

- Sec. 21.801. Shares and Other Securities are Personal Property
- Sec. 21.802. Penalties for Late Filing of Certain Instruments

Chapter 22. Nonprofit Corporations

Subchapter A. General Provisions

- Sec. 22.001. Definitions
- Sec. 22.002. Meetings by Remote Communications Technology

Subchapter B. Purposes and Powers

- Sec. 22.051. General Purposes
- Sec. 22.052. Dental Health Service Corporation
- Sec. 22.053. Dividends Prohibited
- Sec. 22.054. Authorized Benefits and Distributions
- Sec. 22.055. Power to Assist Employee or Officer
- Sec. 22.056. Health Organization Corporation

Subchapter C. Formation and Governing Documents

- Sec. 22.101. Incorporation of Certain Organizations
- Sec. 22.102. Bylaws
- Sec. 22.103. Inconsistency Between Certificate of Formation and Bylaw
- Sec. 22.104. Organization Meeting
- Sec. 22.105. Procedures to Adopt Amendment to Certificate of Formation by Members Having Voting Rights
- Sec. 22.106. Procedures to Adopt Amendment to Certificate of Formation by Managing Members
- Sec. 22.107. Procedures to Adopt Amendment to Certificate of Formation by Board of Directors
- Sec. 22.108. Number of Amendments Subject to Vote at Meeting
- Sec. 22.109. Restated Certificate of Formation

Subchapter D. Members

- Sec. 22.151. Members
- Sec. 22.152. Immunity from Liability
- Sec. 22.153. Annual Meeting
- Sec. 22.154. Failure to Call Annual Meeting
- Sec. 22.155. Special Meetings of Members
- Sec. 22.156. Notice of Meeting
- Sec. 22.157. Special Bylaws Affecting Notice
- Sec. 22.158. Preparation and Inspection of List of Voting Members
- Sec. 22.159. Quorum of Members
- Sec. 22.160. Voting of Members
- Sec. 22.161. Election of Directors
- Sec. 22.162. Greater Voting Requirements Under Certificate of Formation
- Sec. 22.163. Record Date for Determination of Members
- Sec. 22.164. Vote Required to Approve Fundamental Action

Subchapter E. Management

- Sec. 22.201. Management by Board of Directors
- Sec. 22.202. Management by Members
- Sec. 22.203. Board Member Eligibility Requirements
- Sec. 22.204. Number of Directors
- Sec. 22.205. Designation of Initial Board of Directors
- Sec. 22.206. Election or Appointment of Board of Directors
- Sec. 22.207. Election and Control by Certain Entities
- Sec. 22.208. Term of Office

- Sec. 22.209. Classification of Directors
- Sec. 22.210. Ex Officio Member of Board
- Sec. 22.211. Removal of Director
- Sec. 22.211.1. Resignation of Director
- Sec. 22.212. Vacancy
- Sec. 22.213. Quorum
- Sec. 22.214. Action by Directors
- Sec. 22.215. Voting in Person or by Proxy
- Sec. 22.216. Term and Revocability of Proxy
- Sec. 22.217. Notice of Meeting; Waiver of Notice
- Sec. 22.218. Management Committee
- Sec. 22.219. Other Committees
- Sec. 22.220. Action Without Meeting of Directors or Committee
- Sec. 22.221. General Standards for Directors
- Sec. 22.222. Religious Corporation Director's Good Faith Reliance on Certain Information
- Sec. 22.223. Not a Trustee
- Sec. 22.224. Delegation of Investment Authority
- Sec. 22.225. Loan to Director Prohibited
- Sec. 22.226. Director Liability for Certain Distributions of Assets
- Sec. 22.227. Dissent to Action
- Sec. 22.228. Reliance on Written Opinion of Attorney
- Sec. 22.229. Right to Contribution
- Sec. 22.230. Contracts or Transactions Involving Interested Directors, Officers, and Members
- Sec. 22.231. Officers
- Sec. 22.232. Election or Appointment of Officers
- Sec. 22.233. Application to Church
- Sec. 22.234. Religious Corporation Officer's Good Faith Reliance on Certain Information
- Sec. 22.235. Officer Liability

Subchapter F. Fundamental Business Transactions

- Sec. 22.251. Approval of Merger
- Sec. 22.252. Approval of Sale of All or Substantially All of Assets
- Sec. 22.253. Meeting of Members; Notice
- Sec. 22.254. Pledge, Mortgage, Deed of Trust, or Trust Indenture
- Sec. 22.255. Conveyance by Corporation
- Sec. 22.256. Approval of Conversion
- Sec. 22.257. Approval of Exchange

Subchapter G. Winding Up and Termination

- Sec. 22.301. Approval of Voluntary Winding Up, Reinstatement, Revocation of Voluntary Winding Up, or Distribution Plan
- Sec. 22.302. Certain Procedures for Approval
- Sec. 22.303. Meeting of Members; Notice
- Sec. 22.304. Application and Distribution of Property
- Sec. 22.305. Distribution Plan
- Sec. 22.307. Responsibility for Winding Up

Subchapter H. Records and Reports

- Sec. 22.351. Member's Right to Inspect Books and Records
- Sec. 22.352. Financial Records and Annual Reports
- Sec. 22.353. Availability of Financial Information for Public Inspection
- Sec. 22.354. Failure to Maintain Financial Record or Prepare Annual Report; Offense
- Sec. 22.355. Exemptions from Certain Requirements Relating to Financial Records and Annual Reports
- Sec. 22.356. Corporations Assisting State Agencies

- Sec. 22.357. Report of Domestic and Foreign Corporations
- Sec. 22.358. Notice Regarding Report
- Sec. 22.359. Filing of Report
- Sec. 22.360. Failure to File Report
- Sec. 22.361. Notice of Forfeiture
- Sec. 22.362. Effect of Forfeiture
- Sec. 22.363. Revival of Right to Conduct Affairs
- Sec. 22.364. Failure to Revive; Termination or Revocation
- Sec. 22.365. Reinstatement

Subchapter I. Church Benefits Boards

- Sec. 22.401. Definition
- Sec. 22.402. Pensions and Benefits
- Sec. 22.403. Contributions
- Sec. 22.404. Power to Act as Trustee
- Sec. 22.405. Documents and Agreements
- Sec. 22.406. Indemnification
- Sec. 22.407. Protection of Benefits
- Sec. 22.408. Assignment of Benefits
- Sec. 22.409. Insurance Code Not Applicable

Chapter 23. Special-Purpose Corporations

Subchapter A. General Provisions

- Sec. 23.001. Determination of Applicable Law
- Sec. 23.002. Applicability of Filing Requirements
- Sec. 23.003. Domestic Corporation Organized Under Special Statute

Subchapter B. Business Development Corporations

- Sec. 23.051. Definitions
- Sec. 23.052. Organizers
- Sec. 23.053. Purposes
- Sec. 23.054. Powers
- Sec. 23.055. Statewide Operation
- Sec. 23.056. Certificate of Formation
- Sec. 23.057. Management by Board of Directors; Number of Directors
- Sec. 23.058. Election or Appointment of Directors
- Sec. 23.059. Term of Office; Vacancy
- Sec. 23.060. Officers
- Sec. 23.061. Participation as Owner
- Sec. 23.062. Financial Institution as Member of Corporation
- Sec. 23.063. Withdrawal of Member
- Sec. 23.064. Powers of Shareholders and Members
- Sec. 23.065. Voting by Shareholder or Member
- Sec. 23.066. Loan to Corporation
- Sec. 23.067. Prohibited Loan
- Sec. 23.068. Loan Limits
- Sec. 23.069. Surplus
- Sec. 23.070. Depository
- Sec. 23.071. Annual Report; Provision of Required Information

Subchapter C. Grande Lodges

- Sec. 23.101. Formation

- Sec. 23.102. Applicability of Chapter 22
- Sec. 23.103. Duration
- Sec. 23.104. Subordinate Lodges
- Sec. 23.105. Trustees and Directors
- Sec. 23.106. Franchise Taxes
- Sec. 23.107. General Powers
- Sec. 23.108. Authority Regarding Property
- Sec. 23.109. Authority Regarding Loans
- Sec. 23.110. Winding Up and Termination of Subordinate Body

Title 3. Limited Liability Companies

Chapter 101. Limited Liability Companies

Subchapter A. General Provisions

- Sec. 101.001. Definitions
- Sec. 101.002. Applicability of Other Laws

Subchapter B. Formation and Governing Documents

- Sec. 101.051. Certain Provisions Contained in Certificate of Formation
- Sec. 101.0515. Execution of Filings
- Sec. 101.052. Company Agreement
- Sec. 101.053. Amendment of Company Agreement
- Sec. 101.054. Waiver or Modification of Certain Statutory Provisions Prohibited; Exceptions

Subchapter C. Membership

- Sec. 101.101. Members Required
- Sec. 101.102. Qualification for Membership
- Sec. 101.103. Effective Date of Membership
- Sec. 101.104. Classes or Groups of Members or Membership Interests
- Sec. 101.105. Issuance of Membership Interests After Formation of Company
- Sec. 101.106. Nature of Membership Interest
- Sec. 101.107. Withdrawal or Expulsion of Member Prohibited
- Sec. 101.108. Assignment of Membership Interest
- Sec. 101.109. Rights and Duties of Assignee of Membership Interest Before Membership
- Sec. 101.110. Rights and Liabilities of Assignee of Membership Interest After Becoming Member
- Sec. 101.111. Rights and Duties of Assignor of Membership Interest
- Sec. 101.1115. Effect of Death or Divorce on Membership Interest
- Sec. 101.112. Member's Membership Interest Subject to Charging Order
- Sec. 101.113. Parties to Actions
- Sec. 101.114. Liability for Obligations

Subchapter D. Contributions

- Sec. 101.151. Requirements for Enforceable Promise
- Sec. 101.152. Enforceable Promise Not Affected by Change in Circumstances
- Sec. 101.153. Failure to Perform Enforceable Promise; Consequences
- Sec. 101.154. Consent Required to Release Enforceable Obligation
- Sec. 101.155. Creditor's Right to Enforce Certain Obligations
- Sec. 101.156. Requirements to Enforce Conditional Obligation

Subchapter E. Allocations and Distributions

- Sec. 101.201. Allocation of Profits and Losses
- Sec. 101.202. Distribution in Kind

- Sec. 101.203. Sharing of Distributions
- Sec. 101.204. Interim Distributions
- Sec. 101.205. Distribution on Withdrawal
- Sec. 101.206. Prohibited Distribution; Duty to Return
- Sec. 101.207. Creditor Status With Respect to Distribution
- Sec. 101.208. Record Date

Subchapter F. Management

- Sec. 101.251. Governing Authority
- Sec. 101.252. Management by Governing Authority
- Sec. 101.253. Designation of Committees; Delegation of Authority
- Sec. 101.254. Designation of Agents; Binding Acts
- Sec. 101.255. Contracts or Transactions Involving Interested Governing Persons or Officers

Subchapter G. Managers

- Sec. 101.301. Applicability of Subchapter
- Sec. 101.302. Number and Qualifications
- Sec. 101.303. Term
- Sec. 101.304. Removal
- Sec. 101.305. Manager Vacancy
- Sec. 101.306. Removal and Replacement of Manager Elected by Class or Group
- Sec. 101.307. Methods of Classifying Managers

Subchapter H. Meetings and Voting

- Sec. 101.351. Applicability of Subchapter
- Sec. 101.352. General Notice Requirements
- Sec. 101.353. Quorum
- Sec. 101.354. Equal Voting Rights
- Sec. 101.355. Act of Governing Authority, Members, or Committee
- Sec. 101.356. Votes Required to Approve Certain Actions
- Sec. 101.357. Manner of Voting
- Sec. 101.358. Action by Less than Unanimous Written Consent
- Sec. 101.359. Effective Action by Members or Managers With or Without Meeting

Subchapter I. Modification of Duties; Indemnification

- Sec. 101.401. Expansion or Restriction of Duties and Liabilities
- Sec. 101.402. Permissive Indemnification, Advancement of Expenses, and Insurance or Other Arrangements

Subchapter J. Derivative Proceedings

- Sec. 101.451. Definitions
- Sec. 101.452. Standing to Bring Proceeding
- Sec. 101.453. Demand
- Sec. 101.454. Determination By Governing or Independent Persons
- Sec. 101.455. Stay of Proceeding
- Sec. 101.456. Discovery
- Sec. 101.457. Tolling of Statute of Limitations
- Sec. 101.458. Dismissal of Derivative Proceeding
- Sec. 101.459. Allegations if Demand Rejected
- Sec. 101.460. Discontinuance or Settlement
- Sec. 101.461. Payment of Expenses
- Sec. 101.462. Application to Foreign Limited Liability Companies
- Sec. 101.463. Closely Held Limited Liability Company

Subchapter K. Supplemental Recordkeeping Requirements

- Sec. 101.501. Supplemental Records Required for Limited Liability Companies
- Sec. 101.502. Right to Examine Records and Certain Other Information

Subchapter L. Supplemental Winding Up and Termination Provisions

- Sec. 101.551. Persons Eligible to Wind Up Company
- Sec. 101.552. Approval of Voluntary Winding Up, Revocation, Cancellation, or Reinstatement

Subchapter M. Series Limited Liability Company

- Sec. 101.601. Series of Members, Managers, Membership Interests, or Assets
- Sec. 101.602. Enforceability of Obligations and Expenses of Series Against Assets
- Sec. 101.603. Assets of Series
- Sec. 101.604. Notice of Limitation on Liabilities of Series
- Sec. 101.605. General Powers of Series
- Sec. 101.606. Liability of Member or Manager for Obligations; Duties
- Sec. 101.607. Class or Group of Members or Managers
- Sec. 101.608. Governing Authority
- Sec. 101.609. Applicability of Other Provisions of Chapter; Synonymous Terms
- Sec. 101.610. Effect of Certain Event on Manager or Member
- Sec. 101.611. Member Status With Respect to Distribution
- Sec. 101.612. Record Date for Allocations and Distributions
- Sec. 101.613. Distributions
- Sec. 101.614. Authority to Wind Up and Terminate Series
- Sec. 101.615. Termination of Series
- Sec. 101.616. Event Requiring Winding Up
- Sec. 101.617. Procedures for Winding Up and Termination of Series
- Sec. 101.618. Revocation of Voluntary Winding Up
- Sec. 101.619. Cancellation of Event Requiring Winding Up
- Sec. 101.620. Continuation of Business
- Sec. 101.621. Winding Up by Court Order

Title 4. Partnerships

Chapter 151. General Provisions

- Sec. 151.001. Definitions
- Sec. 151.002. Knowledge of Fact
- Sec. 151.003. Notice of Fact
- Sec. 151.004. Officers

Chapter 152. General Partnerships

Subchapter A. General Provisions

- Sec. 152.001. Definitions
- Sec. 152.002. Effect of Partnership Agreement; Nonwaivable and Variable Provisions
- Sec. 152.003. Supplemental Principles of Law
- Sec. 152.004. Rule of Statutory Construction Not Applicable
- Sec. 152.005. Applicable Interest Rate

Subchapter B. Nature and Creation of Partnership

- Sec. 152.051. Partnership Defined
- Sec. 152.052. Rules for Determining if Partnership is Created

- Sec. 152.053. Qualifications to be Partner; Nonpartner's Liability to Third Person
- Sec. 152.054. False Representation of Partnership or Partner
- Sec. 152.055. Authority of Certain Professionals to Create Partnership
- Sec. 152.056 Partnership as Entity

Subchapter C. Partnership Property

- Sec. 152.101. Nature of Partnership Property
- Sec. 152.102. Classification as Partnership Property

Subchapter D. Relationship Between Partners and Between Partners and Partnerships

- Sec. 152.201. Admission as Partner
- Sec. 152.202. Credits of and Charges to Partner
- Sec. 152.203. Rights and Duties of Partner
- Sec. 152.204. General Standards of Partner's Conduct
- Sec. 152.205. Partner's Duty of Loyalty
- Sec. 152.206. Partner's Duty of Care
- Sec. 152.207. Standards of Conduct Applicable to Person Winding Up Partnership Business
- Sec. 152.208. Amendment to Partnership Agreement
- Sec. 152.209. Decision-Making Requirement
- Sec. 152.210. Partner's Liability to Partnership and Other Partners
- Sec. 152.211. Remedies of Partnership and Partners
- Sec. 152.212. Books and Records of Partnership
- Sec. 152.213. Information Regarding Partnership
- Sec. 152.214. Certain Third-Party Obligations Not Affected

Subchapter E. Relationship Between Partners and Other Persons

- Sec. 152.301. Partner as Agent
- Sec. 152.302. Binding Effect of Partner's Action
- Sec. 152.303. Liability of Partnership for Conduct of Partner
- Sec. 152.304. Nature of Partner's Liability
- Sec. 152.305. Remedy
- Sec. 152.306. Enforcement of Remedy
- Sec. 152.307. Extension of Credit in Reliance on False Representation
- Sec. 152.308. Partner's Partnership Interest Subject to Charging Order

Subchapter F. Transfer of Partnership Interests

- Sec. 152.401. Transfer of Partnership Interest
- Sec. 152.402. General Effect of Transfer
- Sec. 152.403. Effect of Transfer on Transferor
- Sec. 152.404. Rights and Duties of Transferee
- Sec. 152.405. Power to Effect Transfer or Grant of Security Interest
- Sec. 152.406. Effect of Death or Divorce on Partnership Interest

Subchapter G. Withdrawal of Partner

- Sec. 152.501. Events of Withdrawal
- Sec. 152.502. Effect of Event of Withdrawal on Partnership and Other Partners
- Sec. 152.503. Wrongful Withdrawal; Liability
- Sec. 152.504. Withdrawn Partner's Power to Bind Partnership
- Sec. 152.505. Effect of Withdrawal on Partner's Existing Liability
- Sec. 152.506. Liability of Withdrawn Partner to Third Party

Subchapter H. Redemption of Withdrawing Partner's or Transferee's Interest

- Sec. 152.601. Redemption if Partnership Not Wound Up
- Sec. 152.602. Redemption Price
- Sec. 152.603. Contribution Obligation
- Sec. 152.604. Setoff for Certain Damages
- Sec. 152.605. Accrual of Interest
- Sec. 152.606. Indemnification for Certain Liability
- Sec. 152.607. Demand or Payment of Estimated Redemption
- Sec. 152.608. Deferred Payment on Wrongful Withdrawal
- Sec. 152.609. Action to Determine Terms of Redemption
- Sec. 152.610. Deferred Payment on Winding Up Partnership
- Sec. 152.611. Redemption of Transferee's Partnership Interest
- Sec. 152.612. Action to Determine Transferee's Redemption Price

Subchapter I. Supplemental Winding Up and Termination Provisions

- Sec. 152.701. Effect of Event Requiring Winding Up
- Sec. 152.702. Persons Eligible to Wind Up Partnership Business
- Sec. 152.703. Rights and Duties of Person Winding Up Partnership Business
- Sec. 152.704. Binding Effect of Partner's Action After Event Requiring Winding up
- Sec. 152.705. Partner's Liability to Other Partners After Event Requiring Winding Up
- Sec. 152.706. Disposition of Assets
- Sec. 152.707. Settlement of Accounts
- Sec. 152.708. Contributions to Discharge Obligations
- Sec. 152.709. Cancellation or Revocation of Event Requiring Winding Up; Continuation of Partnership
- Sec. 152.710. Reinstatement

Subchapter J. Limited Liability Partnerships

- Sec. 152.801. Liability of Partner
- Sec. 152.802. Registration
- Sec. 152.803. Name
- Sec. 152.805. Limited Partnership

Subchapter K. Foreign Limited Liability Partnerships

- Sec. 152.901. General
- Sec. 152.902. Name
- Sec. 152.903. Activities Not Constituting Transacting Business
- Sec. 152.904. Registered Agent and Registered Office
- Sec. 152.905. Registration Procedure
- Sec. 152.906. Withdrawal of Registration
- Sec. 152.907. Effect of Certificate of Withdrawal
- Sec. 152.908. Renewal of Registration
- Sec. 152.909. Action by Secretary of State
- Sec. 152.910. Effect of Failure to Register
- Sec. 152.911. Amendment
- Sec. 152.912. Execution of Application for Amendment
- Sec. 152.913. Execution of Statement of Change of Registered Office or Registered Agent
- Sec. 152.914. Revocation of Registration by Secretary of State

Chapter 153. Limited Partnerships

Subchapter A. General Provisions

- Sec. 153.001. Definition
- Sec. 153.002. Construction
- Sec. 153.003. Applicability of Other Laws

- Sec. 153.004. Nonwaivable Title 1 Provisions
- Sec. 153.005. Waiver or Modification of Rights of Third Parties

Subchapter B. Supplemental Provisions Regarding Amendment to Certificate of Formation

- Sec. 153.051. Required Amendment to Certificate of Formation
- Sec. 153.052. Discretionary Amendment to Certificate of Formation
- Sec. 153.053. Restated Certificate of Formation

Subchapter C. Limited Partners

- Sec. 153.101. Admission of Limited Partners
- Sec. 153.102. Liability to Third Parties
- Sec. 153.103. Actions Not Constituting Participation in Business for Liability Purposes
- Sec. 153.104. Enumeration of Actions Not Exclusive
- Sec. 153.105. Creation of Rights
- Sec. 153.106. Erroneous Belief of Contributor Being Limited Partner
- Sec. 153.107. Statement Required for Liability Protection
- Sec. 153.108. Requirements for Liability Protection Following Expiration of Statement
- Sec. 153.109. Liability of Erroneous Contributor
- Sec. 153.110. Withdrawal of Limited Partner
- Sec. 153.111. Distribution on Withdrawal
- Sec. 153.112. Receipt of Wrongful Distribution
- Sec. 153.113. Powers of Estate of Limited Partner Who is Deceased or Incapacitated

Subchapter D. General Partners

- Sec. 153.151. Admission of General Partners
- Sec. 153.152. General Powers and Liabilities of General Partner
- Sec. 153.153. Powers and Liabilities of Person Who is Both General Partner and Limited Partner
- Sec. 153.154. Contributions by and Distributions to General Partner
- Sec. 153.155. Withdrawal of General Partner
- Sec. 153.156. Notice of Event of Withdrawal
- Sec. 153.157. Withdrawal of General Partner in Violation of Partnership Agreement
- Sec. 153.158. Effect of Withdrawal
- Sec. 153.159. Conversion of Partnership Interest After Withdrawal
- Sec. 153.160. Effect of Conversion of Partnership Interest
- Sec. 153.161. Liability of General Partner for Debt Incurred After Event of Withdrawal
- Sec. 153.162. Liability for Wrongful Withdrawal

Subchapter E. Finances

- Sec. 153.201. Form of Contribution
- Sec. 153.202. Enforceability of Promise to Make Contribution
- Sec. 153.203. Release of Obligation to Partnership
- Sec. 153.204. Enforceability of Obligation
- Sec. 153.205. Requirements to Enforce Conditional Obligation
- Sec. 153.206. Allocation of Profits and Losses
- Sec. 153.207. Right to Distribution
- Sec. 153.208. Sharing of Distributions
- Sec. 153.209. Interim Distributions
- Sec. 153.210. Limitation on Distribution

Subchapter F. Partnership Interest

- Sec. 153.251. Assignment of Partnership Interest
- Sec. 153.252. Rights of Assignor

- Sec. 153.253. Rights of Assignee
- Sec. 153.254. Liability of Assignee
- Sec. 153.255. Liability of Assignor
- Sec. 153.256. Partner's Partnership Interest Subject to Charging Order
- Sec. 153.257. Exemption Laws Applicable to Partnership Interest Not Affected

Subchapter G. Reports

- Sec. 153.301. Periodic Report
- Sec. 153.302. Form and Contents of Report
- Sec. 153.303. Filing Fee
- Sec. 153.304. Delivery of Report
- Sec. 153.305. Action by Secretary of State
- Sec. 153.306. Effect of Filing Report
- Sec. 153.307. Effect of Failure to File Report
- Sec. 153.308. Notice of Forfeiture of Right to Transact Business
- Sec. 153.309. Effect of Forfeiture of Right to Transact Business
- Sec. 153.310. Revival of Right to Transact Business
- Sec. 153.311. Termination of Certificate or Revocation of Registration After Forfeiture
- Sec. 153.312. Reinstatement of Certificate of Formation or Registration

Subchapter H. Limited Partnership as Limited Liability Partnership

- Sec. 153.351. Requirements
- Sec. 153.352. Applicability of Other Requirements
- Sec. 153.353. Law Applicable to Partners

Subchapter I. Derivative Actions

- Sec. 153.401. Right to Bring Action
- Sec. 153.402. Proper Plaintiff
- Sec. 153.403. Pleading
- Sec. 153.404. Security for Expenses of Defendants
- Sec. 153.405. Expenses of Plaintiff

Subchapter K. Supplemental Winding Up and Termination Provisions

- Sec. 153.501. Cancellation or Revocation of Event Requiring Winding Up; Continuation of Business
- Sec. 153.502. Winding Up Procedures
- Sec. 153.503. Powers of Person Conducting Wind Up
- Sec. 153.504. Disposition of Assets
- Sec. 153.505. Approval of Reinstatement

Subchapter L. Miscellaneous Provisions

- Sec. 153.551. Records
- Sec. 153.552. Examination of Records and Information
- Sec. 153.553. Execution of Filings
- Sec. 153.554. Execution, Amendment, or Cancellation by Judicial Order
- Sec. 153.555. Permitted Transfer in Connection With Racetrack License

Chapter 154. Provisions Applicable to Both General and Limited Partnerships

Subchapter A. Partnership Interests

- Sec. 154.001. Nature of Partner's Partnership Interest
- Sec. 154.002. Transfer of Interest in Partnership Property Prohibited

Subchapter B. Partnership Agreement

- Sec. 154.101. Class or Group of Partners
- Sec. 154.102. Provisions Relating to Voting
- Sec. 154.103. Notice of Action by Consent Without a Meeting

Subchapter C. Partnership Transactions and Relationships

- Sec. 154.201. Business Transactions Between Partner and Partnership
- Sec. 154.202. Effect of Partner Change on Relationship Between Partnership and Creditors
- Sec. 154.203. Distributions in Kind

Title 5. Real Estate Investment Trusts

Chapter 200. Real Estate Investment Trusts

Subchapter A. General Provisions

- Sec. 200.001. Definition
- Sec. 200.002. Applicability of Chapter
- Sec. 200.003. Conflict With Other Law
- Sec. 200.004. Ultra Vires Acts
- Sec. 200.005. Supplementary Powers of Real Estate Investment Trust
- Sec. 200.006. Requirement that Filing Instrument be Signed by Officer

Subchapter B. Formation and Governing Documents

- Sec. 200.051. Declaration of Trust
- Sec. 200.052. No Property Right in Certificate of Formation
- Sec. 200.053. Procedures to Adopt Amendment to Certificate of Formation
- Sec. 200.054. Adoption of Amendment by Trust Managers
- Sec. 200.055. Adoption of Amendment by Shareholders
- Sec. 200.056. Notice of and Meeting to Consider Proposed Amendment
- Sec. 200.057. Adoption of Restated Certificate of Formation
- Sec. 200.058. Bylaws
- Sec. 200.059. Dual Authority
- Sec. 200.060. Organization Meeting

Subchapter C. Shares

- Sec. 200.101. Number
- Sec. 200.102. Classification of Shares
- Sec. 200.103. Classes of Shares Established by Trust Managers
- Sec. 200.104. Issuance of Shares
- Sec. 200.105. Types of Consideration for Issuance of Shares
- Sec. 200.106. Determination of Consideration for Shares
- Sec. 200.107. Amount of Consideration for Issuance of Shares With Par Value
- Sec. 200.108. Value of Consideration
- Sec. 200.109. Liability of Assignee or Transferee
- Sec. 200.110. Subscriptions
- Sec. 200.111. Preformation Subscription
- Sec. 200.112. Commitment in Connection With Purchase of Shares
- Sec. 200.113. Supplemental Required Records

Subchapter D. Shareholder Rights and Restrictions

- Sec. 200.151. Registered Holders as Owners
- Sec. 200.152. No Statutory Preemptive Right Unless Specifically Provided by Certificate of Formation

- Sec. 200.153. Characterization and Transfer of Shares and Other Securities
- Sec. 200.154. Restriction on Transfer of Shares and Other Securities
- Sec. 200.155. Valid Restriction on Transfer
- Sec. 200.156. Bylaw or Agreement Restricting Transfer of Shares or Other Securities
- Sec. 200.157. Enforceability of Restriction on Transfer of Certain Securities
- Sec. 200.158. Joint Ownership of Shares
- Sec. 200.159. Liability for Designating Owner of Shares
- Sec. 200.160. Liability Regarding Joint Ownership of Shares
- Sec. 200.161. Limitation of Liability for Obligations
- Sec. 200.162. Preemption of Liability
- Sec. 200.163. Exceptions to Limitations
- Sec. 200.164. Pledges and Trust Administrators

Subchapter E. Distributions and Share Dividends

- Sec. 200.201. Authority for Distributions
- Sec. 200.202. Limitations on Distributions
- Sec. 200.203. Priority of Distributions
- Sec. 200.204. Reserves, Designations, and Allocations From Surplus
- Sec. 200.205. Authority for Share Dividends
- Sec. 200.206. Limitations on Share Dividends
- Sec. 200.207. Value of Shares Issued as Share Dividends
- Sec. 200.208. Transfer of Surplus for Share Dividends
- Sec. 200.209. Determination of Solvency, Net Assets, Stated Capital, and Surplus
- Sec. 200.210. Date of Determination of Surplus
- Sec. 200.211. Split-Up or Division of Shares

Subchapter F. Shareholders' Meetings; Voting and Quorum

- Sec. 200.251. Annual Meeting
- Sec. 200.252. Special Meetings
- Sec. 200.253. Notice of Meeting
- Sec. 200.254. Closing of Share Transfer Records
- Sec. 200.255. Record Date for Written Consent to Action
- Sec. 200.256. Record Date for Purpose Other than Written Consent to Action
- Sec. 200.257. Quorum
- Sec. 200.258. Voting in Election of Trust Managers
- Sec. 200.259. Cumulative Voting in Election of Trust Managers
- Sec. 200.260. Voting on Matters Other than Election of Trust Managers
- Sec. 200.261. Vote Required to Approve Fundamental Action
- Sec. 200.262. Changes in Vote Required for Certain Matters
- Sec. 200.263. Number of Votes Per Share
- Sec. 200.264. Voting in Person or by Proxy
- Sec. 200.265. Term of Proxy
- Sec. 200.266. Revocability of Proxy
- Sec. 200.267. Enforceability of Proxy
- Sec. 200.268. Procedures in Bylaws Relating to Proxies

Subchapter G. Trust Managers

- Sec. 200.301. Management by Trust Managers
- Sec. 200.302. Designation of Trust Managers
- Sec. 200.303. Trust Manager Eligibility Requirements
- Sec. 200.304. Number of Trust Managers
- Sec. 200.305. Compensation
- Sec. 200.306. Term of Trust Manager
- Sec. 200.307. Staggered Terms of Trust Managers

- Sec. 200.308. Vacancy
- Sec. 200.309. Notice of Meeting
- Sec. 200.310. Quorum
- Sec. 200.311. Committees of Trust Managers
- Sec. 200.312. Liability of Trust Managers
- Sec. 200.313. Statute of Limitations on Certain Action Against Trust Managers
- Sec. 200.314. Immunity From Liability for Performance of Duty
- Sec. 200.315. Right of Contribution
- Sec. 200.316. Officers
- Sec. 200.317. Contracts or Transactions Involving Interested Trust Managers and Officers

Subchapter H. Investments

- Sec. 200.351. Investments

Subchapter I. Fundamental Business Transactions

- Sec. 200.401. Definitions
- Sec. 200.402. Approval of Merger
- Sec. 200.403. Approval of Conversion
- Sec. 200.404. Approval of Exchange
- Sec. 200.405. Approval of Sale of All or Substantially All of Assets
- Sec. 200.406. General Procedure for Submission to Shareholders of Fundamental Business Transaction
- Sec. 200.407. General Vote Requirement for Approval of Fundamental Business Transaction
- Sec. 200.408. Class Voting Requirements for Certain Fundamental Business Transactions
- Sec. 200.409. No Shareholder Vote Requirement for Certain Fundamental Business Transactions
- Sec. 200.410. Rights of Dissent and Appraisal

Subchapter J. Supplemental Winding Up and Termination Provisions

- Sec. 200.451. Approval of Voluntary Winding Up
- Sec. 200.452. Approval of Reinstatement, Cancellation, or Revocation of Voluntary Winding Up
- Sec. 200.453. Responsibility for Winding Up

Subchapter K. Miscellaneous Provisions

- Sec. 200.501. Examination of Records
- Sec. 200.502. Joinder of Shareholders Not Required
- Sec. 200.503. Tax Law Requirements

Title 6. Associations

Chapter 251. Cooperative Associations

Subchapter A. General Provisions

- Sec. 251.001. Definitions
- Sec. 251.002. Applicability of Nonprofit Corporation Provisions
- Sec. 251.003. Exemption

Subchapter B. Formation and Governing Documents

- Sec. 251.051. Organization Meeting
- Sec. 251.052. Amendment of Certificate of Formation
- Sec. 251.053. Bylaws
- Sec. 251.054. Restated Certificate of Formation

Subchapter C. Management

- Sec. 251.101. Board of Directors
- Sec. 251.102. Officers
- Sec. 251.103. Removal of Directors and Officers
- Sec. 251.104. Referendum

Subchapter D. Membership

- Sec. 251.151. Eligibility and Admission
- Sec. 251.152. Expulsion
- Sec. 251.153. Subscribers
- Sec. 251.154. Liability

Subchapter E. Shares

- Sec. 251.201. Share and Membership Certificates: Issuance and Contents
- Sec. 251.202. Transfer of Shares and Membership; Withdrawal
- Sec. 251.203. Share and Membership Certificates; Recall
- Sec. 251.204. Certificates; Attachment

Subchapter F. Meetings and Voting

- Sec. 251.251. Meetings
- Sec. 251.252. Notice of Special Meeting
- Sec. 251.253. Meetings by Units of Membership
- Sec. 251.254. One Member--One Vote
- Sec. 251.255. No Proxy
- Sec. 251.256. Voting by Mail
- Sec. 251.257. Voting by Mail or by Delegates

Subchapter G. Capital and Net Savings

- Sec. 251.301. Limitations on Return on Capital
- Sec. 251.302. Allocation and Distribution of Net Savings

Subchapter H. Reports and Records

- Sec. 251.351. Recordkeeping
- Sec. 251.352. Reports to Members
- Sec. 251.353. Annual Report of Financial Condition
- Sec. 251.354. Failure to File Report

Subchapter I. Winding Up and Termination

- Sec. 251.401. Voluntary Winding Up and Termination
- Sec. 251.402. Execution of Certificate of Termination
- Sec. 251.403. Distribution of Assets
- Sec. 251.404. Involuntary Termination

Subchapter J. Miscellaneous Provisions

- Sec. 251.451. Exemption From Taxes
- Sec. 251.452. Use of Name "Cooperative"

Chapter 252. Unincorporated Nonprofit Associations

- Sec. 252.001. Definitions
- Sec. 252.002. Supplementary General Principles of Law and Equity
- Sec. 252.003. Territorial Application

- Sec. 252.004. Real and Personal Property; Nonprofit Association as Beneficiary
- Sec. 252.005. Statement of Authority as to Real Property
- Sec. 252.006. Liability in Tort and Contract
- Sec. 252.007. Capacity to Assert and Defend; Standing
- Sec. 252.008. Effect of Judgment or Order
- Sec. 252.009. Disposition of Personal Property of Inactive Nonprofit Association
- Sec. 252.010. Books and Records
- Sec. 252.011. Appointment of Agent to Receive Service of Process
- Sec. 252.012. Claim Not Abated by Change
- Sec. 252.013. Summons and Complaint; Service
- Sec. 252.014. Uniformity of Application and Construction
- Sec. 252.015. Transition Concerning Real and Personal Property
- Sec. 252.016. Effect on Other Law
- Sec. 252.017. Chapter Controlling

Title 7. Professional Entities

Chapter 301. Provisions Relating to Professional Entities

- Sec. 301.001. Applicability of Title
- Sec. 301.002. Conflicts of Law
- Sec. 301.003. Definitions
- Sec. 301.004. Authorized Person
- Sec. 301.005. Application for Registration of Foreign Professional Entity
- Sec. 301.006. License Required to Provide Professional Service
- Sec. 301.007. Certain Requirements to be Owner, Governing Person, or Officer
- Sec. 301.008. Duties and Powers of Owner or Managerial Official who Ceases to be Licensed; Purchase of
Ownership Interest
- Sec. 301.009. Transfer of Ownership Interest
- Sec. 301.010. Liability
- Sec. 301.011. Exemption From Securities Laws
- Sec. 301.012. Joint Practice by Certain Professionals

Chapter 302. Provisions Relating to Professional Associations

- Sec. 302.001. Applicability of Certain Provisions Governing For-Profit Corporations
- Sec. 302.002. Duration of Professional Association
- Sec. 302.003. Amendment of Certificate of Formation
- Sec. 302.004. Adoption of Bylaws; Delegation of Authority
- Sec. 302.005. Governing Authority
- Sec. 302.006. Members' Voting Rights
- Sec. 302.007. Election of Officers
- Sec. 302.008. Officer and Governing Person Eligibility Requirements
- Sec. 302.009. Employment of Agents and Employees
- Sec. 302.010. Limitation on Member's Power to Bind Association
- Sec. 302.011. Division of Profits
- Sec. 302.012. Annual Statement Required
- Sec. 302.013. Winding Up and Termination; Certificate of Termination

Chapter 303. Provisions Relating to Professional Corporations

- Sec. 303.001. Applicability of Certain Provisions Governing For-Profit Corporations
- Sec. 303.002. Authority and Liability of Shareholder
- Sec. 303.003. Notice of Restriction on Transfer of Shares
- Sec. 303.004. Redemption of Shares; Price and Terms

- Sec. 303.005. Existence of Professional Corporation Before Winding Up and Termination
- Sec. 303.006. Execution of Certificate of Termination

Chapter 304. Provisions Relating to Professional Limited Liability Companies

- Sec. 304.001. Applicability of Certain Provisions Governing Limited Liability Companies

Title 8. Miscellaneous and Transition Provisions

Chapter 401. General Provisions

- Sec. 401.001. Definitions

Chapter 402. Miscellaneous and Transition Provisions

- Sec. 402.001. Applicability Upon Effective Date
- Sec. 402.002. Early Effectiveness of Fees
- Sec. 402.003. Early Adoption of Code by Existing Domestic Entity
- Sec. 402.004. Early Adoption of Code by Registered Foreign Filing Entity
- Sec. 402.005. Applicability to Existing Entities
- Sec. 402.0051. Effect of References to Prior Law and Use of Synonymous Terms
- Sec. 402.006. Applicability to Certain Acts, Contracts, and Transactions
- Sec. 402.007. Indemnification
- Sec. 402.008. Meetings of Owners and Members; Consents; Voting of Interests
- Sec. 402.009. Meetings of Governing Authority and Committees; Consents
- Sec. 402.010. Sale of Assets, Mergers, Reorganizations, Conversions
- Sec. 402.011. Winding Up and Termination
- Sec. 402.012. Registration of Certain Foreign Entities
- Sec. 402.013. Reinstatement of Entities Canceled, Revoked, Dissolved, Involuntarily Dissolved, Suspended, or Forfeited Under Prior Law
- Sec. 402.014. Maintenance of Prior Action

**AN INTRODUCTION TO THE
TEXAS BUSINESS LAW FOUNDATION (2013)**

The Texas Business Law Foundation is a non-profit corporation organized in 1988 and supported by businesses, law firms, professors of business law and individuals throughout Texas. The Foundation's objective is to promote a favorable business climate in Texas through the maintenance of a modern system of business laws. To achieve this goal, the Foundation sponsors Texas legislation that advances the law and solves problems, monitors state legislative and administrative proposals of interest to Foundation members, endorses or opposes those proposals and serves as a source of advice and consultation to the legislative, judicial and executive branches of Texas government.

Whether sponsoring a uniform state business statute or a modernization of usury and organizational laws, the Foundation can be relied on to provide a package of progressive and sound business law legislation at each biennial session of the Texas Legislature. The Foundation has also been vigilant in monitoring bills that are adverse to the interests of business in Texas and in mobilizing opposition where appropriate. Among the proposed laws successfully opposed by the Foundation were those that would regulate the compensation of management, impose at a state level regulations similar to but beyond those in the Sarbanes-Oxley Act of 2002, and void certain indemnification arrangements. Your contribution to the Foundation assures your firm or company a voice in the future direction of Texas business law and the chance to participate in promoting an environment that is advantageous to your company or clients.

In supporting or opposing legislation, the Foundation has both acted as the primary advocate or opponent and partnered with or provided support to other like-minded organizations in its effort to achieve the desired outcome. The Foundation avoids active sponsorship of legislation that is not viewed favorably by its members or that is more high profile and controversial (for example, tort reform). In addition to its legislative efforts, the Foundation has drafted and filed amicus briefs and position papers with the courts and regulatory bodies in support of or opposition to litigation, regulation or legislation.

The directors of the Foundation are lawyers in private practice, general counsels of major corporations, and distinguished professors of law and corporate executives who concentrate on governmental relations and public affairs. The current officers of the Foundation and their affiliations are as follows:

Chairman: Byron Egan, Jackson Walker L.L.P., Dallas
Vice Chairman: Scott Night, Haynes and Boone, LLP, Dallas
Secretary-Treasurer: Mike Laussade, Jackson Walker L.L.P., Dallas

The Foundation's Sustaining and Contributing Members include:

Americredit/GMFinancial	Hunton & Williams LLP
Andrews Kurth LLP	Jackson Walker L.L.P.
Atkins, Hollmann, Jones, Peacock, Lewis & Lyon, Inc.	Jones Day
Baker Botts L.L.P.	Kelly Hart & Hallman LLP
Ben E. Keith Co.	Lidji, Dorey & Hooper
Exxon Mobil Corporation	Locke Lord Bissell & Liddell LLP
Freebird Investments L.L.C.	Mayer Brown LLP
Fulbright & Jaworski L.L.P.	Occidental Petroleum Corporation
Gardere Wynne Sewell LLP	Scheef & Stone, LLP
Greenberg Traurig, LLP	Skadden, Arps, Slate, Meagher & Flom LLP
Haynes & Boone, LLP	Thompson & Knight LLP
Hunt Oil Company	Total Petrochemicals USA, Inc.
	Vinson & Elkins, L.L.P.
	Weil, Gotshal & Manges LLP

For further information regarding the purposes, history and successes of the Foundation, see Alan R. Bromberg, Byron F. Egan, Dan L. Nicewander and Robert S. Trotti, "*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), available at <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1239>.

For more information on how to join the Foundation and to assist in its efforts, please contact:

Byron Egan, Chair	or	Scott Night, Vice Chair
Jackson Walker, L.L.P.		Haynes and Boone, LLP,
901 Main Street, Suite 6000		2323 Victory Avenue, Suite 700
Dallas, Texas 75201		Dallas, Texas 75219
Telephone: 214-953-5727		Telephone: 214-651-5523
email: began@jw.com		email: scott.night@haynesboone.com

LEGISLATION SPONSORED BY TEXAS BUSINESS LAW FOUNDATION
83RD TEXAS LEGISLATURE (2013)

The Texas Business Law Foundation is sponsoring the following bills in the 83rd Texas Legislature which commenced January 11, 2013:

1. Business Organizations Code Updating [HB 1929 (Olivera)/SB 847 (Carona)]. Amends the Texas Business Organization Code (“*TBOC*”) to update its provisions relating to corporations, partnerships and limited liability companies (“*LLCs*”), including (i) simplification of the required contents for amended and restated certificates of formation, (ii) requiring limited partnerships to give winding up notices to potential claimants much like corporations are currently required to do, (iii) clarifying that the governing documents of partnerships and LLCs may eliminate monetary liability of their governing persons to the same extent that a corporate certificate of formation can do so for directors and to the further extent permitted by the specific partnership and LLC provisions of the *TBOC*, (iv) clarification that partnership agreements and LLC company agreements may provide rights to persons who are not parties thereto (e.g., officers, managers or creditors), and (v) clarification of the powers of an LLC series and that a series is not a separate entity; the same bill also amends Section 24.003 of the Texas Business and Commerce Code (“*TB&CC*”) to eliminate a subsection that provided that a general partner’s nonpartnership assets are considered in determining the solvency of the partnership for fraudulent transfer purposes.
2. Social Purpose Corporations [HB 1928 (Olivera)/SB 849 (Carona)]. Amends the *TBOC* to allow for-profit corporations to include “social purposes” in their certificates of formation and to specify that their governing persons are entitled to consider those social purposes in making decisions on behalf of the corporations.
3. Finance Code [HB 1979 (Villarreal)/SB 952 (Carona)]. Amends Section 306.003 of the Finance Code to allow parties to commercial loans to agree that (i) interest is to be computed on the basis of actual days over a year of 360 days or twelve 30-day months, (ii) accrued interest may be paid on a periodic basis (not more often than monthly) by adding it to the principal balance of the loan, and (iii) confirm that the provisions in Chapter 306 are meant to be safe harbors and do not create a negative implication for other transactions.
4. Amendments to Section 4A.108, Texas Business & Commerce Code [HB 702 (Deshotel)/SB 230 (Carona)]. Amends Texas Business & Commerce Code (“*TB&CC*”) Section 4A.108 so that international consumer wire transfers will remain covered by *TB&CC* Section 4A.108; the amendment is necessitated by an amendment to the federal Electronic Funds Transfer Act effected by the Dodd-Frank Wall Street Reform and Consumer Protection Act that would have removed the statutory framework for such transfers.
5. Amendments to Section 9.516(b), Texas Business & Commerce Code [HB 1970 (Villarreal)/SB 474 (Carona)]. Technical change to *TB&CC* Section 9.516(b) to eliminate organization information from financing statements that is not otherwise required by the *TB&CC*.
6. Uniform Trade Secrets Act [HB 1894 (Elkins)/SB 953 (Carona)]. Proposes to have Texas join the other 46 states that have adopted the Uniform Trade Secrets Act (“*UTSA*”); the

proposed UTSA generally modernizes existing Texas common law relating to misappropriation of trade secrets, but makes the following changes: (i) does not require that information have been in “continuous use”, resulting in a broader class of trade secrets, (ii) provides that injunctive relief is a proper remedy, (iii) provides that attorneys’ fees are available to a plaintiff where misappropriation was willful and malicious, and are available to a defendant where a claim of misappropriation was made in bad faith, and (iv) provides that damages for misappropriation can include both actual loss and unjust enrichment, or alternatively imposition of a reasonable royalty, plus exemplary damages not exceeding twice any damage award.

LEGISLATION SPONSORED BY TEXAS BUSINESS LAW FOUNDATION
82ND TEXAS LEGISLATURE (2011)

The Texas Business Law Foundation sponsored and shepherded the following bills through the 82nd Texas Legislature from their introduction to their passage:

1. LLC Veil Piercing Limits. Senate Bill 323 amended the Texas Business Organizations Code (“TBOC”) to provide that the TBOC provisions limiting the liability of shareholders of Texas corporations apply equally to managers and members of Texas limited liability companies (“LLCs”) if or to the extent LLC veil piercing becomes recognized in Texas. SB 323 is available at:

<http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=HB521>

2. Derivative Plaintiff Qualification. Senate Bill 1568 deleted a TBOC provision that was ambiguous and inconsistent with other TBOC provisions and court holdings relating to standing to bring a derivative action on behalf of a corporation after a merger. Now it is clear that a derivative plaintiff must own stock at the time of the act complained of and continuously to the completion of the lawsuit. SB 1568 is available at:

<http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB1568>

3. Business Entity Statute Updating. Senate Bill 748 is a 58-page package of amendments to the corporation, non-profit corporation, partnership and LLC provisions of the TBOC that addresses issues that have arisen in recent experience under the TBOC and makes the statute more user friendly for Texas entities. SB 748 is available at:

<http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB748>

4. More Flexibility to Choose Law Applicable to Large Transactions. House Bill 2991 amended chapter 271 of the Texas Business and Commerce Code to add additional flexibility in choosing the law of a particular jurisdiction to govern large business transactions. HB 2991 is available at:

<http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=HB2991>

5. Secured Transactions. Senate Bill 782 amended Texas Business and Commerce Code Chapter 9 to adopt changes approved and recommended by the National Conference of Commissioners on Uniform State Laws for enactment in all states. The majority of the changes

are for enhanced clarity or to reflect advances in technology or changes in business practice. SB 782 is available at:

<http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB782>

In 2011 the Foundation also successfully opposed proposed legislation that, if enacted, would have been generally unfavorable to the conduct of business. Among the bills the Foundation opposed in 2011 that did not pass were bills restricting the choice of foreign law and adding requirements for powers of attorney that could affect commercial transactions.

OTHER LEGISLATION SPONSORED BY
TEXAS BUSINESS LAW FOUNDATION

During its history, the Texas Business Law Foundation has been extremely successful in obtaining the passage of its legislative program by the Texas Legislature. Most of the laws that the Foundation has sponsored and passed are listed below:

Amendments to Texas Business Corporation Act in 1985, 1989, 1991, 1993, 1995, 1997, 2003 and 2005

Revised Limited Partnership Act of Texas in 1991, and amendments in 1993, 1995, 1997, 2003 and 2005

Revised Partnership Act of Texas, and amendments in 2003 and 2005

Limited Liability Partnership Amendments to Uniform Partnership Act and to Revised Partnership Act of Texas

Limited Liability Company Act of Texas in 1991, amendments in 1993, 1995, 1997, 2003, 2005, and 2007

Business and Commerce Code Amendments (i.e., Revised UCC Articles 1, 2A, 3, 4, 4A, 5, 6, 7, 8 and 9) in 1991, 1995, 1997, 1999, 2003 and 2005, technical amendments to UCC Article 9 in 2001, 2003, and 2007, and amendments to UCC Articles 3 and 4 in 2005

Uniform Unincorporated Non-Profit Association Act in 1995

Amendments to Non-Profit Corporation Act in 1993 and 1995

Texas Environmental and Safety and Health Audit Privilege Act in 1995

Amendments to Real Estate Investment Trust Act in 1995 and 1997

Contractual Choice of Law in 1993

Covenants Not to Compete Amendments in 1989, 1991 and 1993

Professional Service Negligence Bill in 1995

Usury Reform Amendments in 1993, 1997, 1999 and 2005

Contractual Choice of Venue Bill in 1999
Euro Conversion Bill in 1999

Uniform Electronic Transactions Act in 2001

Texas Business Organizations Code in 2003, and amendments thereto in 2005, 2007 and 2009.

Anti-Botnet Bill in 2009

Amendments to Certificate of Title Statutes in 2009

In addition, the Foundation has in each legislative session monitored and either endorsed or opposed any number of other bills, all from the standpoint of their benefit to the conduct of business in the State of Texas. The Foundation's efforts have also resulted in the modification of legislation to reduce its negative effect on business.

TEXAS BUSINESS LAW FOUNDATION
Sustaining Membership Form

The Texas Business Law Foundation is a non-profit organization dedicated to the improvement and implementation of laws favorable to organizations doing business in the State of Texas. The Foundation's activities include the drafting and support of pro-business legislation, the filing of amicus briefs and position papers with the courts and regulatory bodies on significant issues affecting Texas businesses and other activities associated with the enactment of pro-business legislation and regulations.

Membership dues are used to further the mission of the Foundation and are used primarily to pay lobbying expenses. Dues and other contributions to the Foundation are not deductible as charitable contributions for federal income tax purposes. In addition, the Foundation estimates that approximately 100 percent of the dues collected by the Foundation will be allocable to the Foundation's activities with respect to "influencing legislation," as the term is defined in section 162(e) of the Internal Revenue Code, and thus will not be deductible as a trade or business expense under section 162(a) of the Internal Revenue Code. No funds are used for political contributions.

Membership may be either on an individual basis or through an organization. Dues are payable annually at \$2,500 a year for sustaining members and cover the fiscal year period from September 1 to August 31. We also have participating organizational memberships for small law firms and small businesses (called Contributing Memberships).

Sustaining members will receive regular updates on the Foundation's legislative, judicial and other efforts and will also be entitled to the appointment of a director to the Board of Directors of the Foundation.

Please complete the following and return this form and your check payable to The Texas Business Law Foundation at the address provided below:

Membership:	Sustaining Membership	\$2,500
Name/Organization:		
Organizational Contact:		
Address:		
Telephone Number:		
Fax Number:		
Email Address:		

TEXAS BUSINESS LAW FOUNDATION
Michael L. Laussade, Secretary/Treasurer
c/o Jackson Walker L.L.P.
901 Main Street, Suite 6000
Dallas, Texas 75202
Telephone: 214-953-5805
mlaussade@jw.com

TEXAS BUSINESS LAW FOUNDATION
Membership Form

The Texas Business Law Foundation is a non-profit organization dedicated to the improvement and implementation of laws favorable to organizations doing business in the State of Texas. The Foundation’s activities include the drafting and support of pro-business legislation, the filing of amicus briefs and position papers with the courts and regulatory bodies on significant issues affecting Texas businesses and other activities associated with the enactment of pro-business legislation and regulations.

Membership dues are used to further the mission of the Foundation and are used primarily to pay lobbying expenses. Dues and other contributions to the Foundation are not deductible as charitable contributions for federal income tax purposes. In addition, the Foundation estimates that approximately 100 percent of the dues collected by the Foundation will be allocable to the Foundation’s activities with respect to “influencing legislation,” as the term is defined in section 162(e) of the Internal Revenue Code, and thus will not be deductible as a trade or business expense under section 162(a) of the Internal Revenue Code. No funds are used for political contributions.

Membership may be either on an individual basis or through an organization. Dues are payable annually and cover the fiscal year period from September 1 to August 31. Individual memberships are \$100 per year (called “Fellows”) and organizational memberships are \$2,500 per year (called “Sustaining Memberships”). We also have participating organizational memberships for small law firms and small businesses (called “Contributing Memberships”) for \$1,000 per year.

All members will receive regular updates on the Foundation’s legislative, judicial and other efforts. Sustaining members will also be entitled to the appointment of a director to the Board of Directors of the Foundation.

Please complete the following and return this form and your check payable to Texas Business Law Foundation at the address provided below:

Membership:	[_____] Sustaining Membership	\$2,500
	[_____] Contributing Membership	\$1,000
	[_____] Fellow Membership	\$ 100
Name/Organization:		
Organizational Contact:		
Address:		
Telephone Number:		
Fax Number:		
Email Address:		

TEXAS BUSINESS LAW FOUNDATION
Michael L. Laussade, Secretary/Treasurer
c/o Jackson Walker L.L.P.
901 Main Street, Suite 6000
Dallas, Texas 75202

**Legislation Sponsored by the Texas Business Law Foundation in the
2011 Legislative Session**

AMENDMENTS TO TEXAS BUSINESS ORGANIZATIONS CODE

The TBOC was amended in the 2011 Legislative Session by the following bills:¹

- S.B. 748 by Sen. John J. Carona is a 58-page package of amendments to the corporation, non-profit corporation, partnership and LLC provisions of the TBOC to address issues that have arisen in recent experience under the TBOC and to make the statute more user friendly for Texas entities, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB748>.² S.B. 748 amended the TBOC generally as follows:

OVERVIEW OF S.B. 748

S.B. 748 made both technical and substantive amendments to the TBOC. The technical amendments corrected errors, clarified certain provisions, filled gaps in coverage, clarified the transition rules on how provisions in governing documents should be interpreted, and eliminated some antiquated provisions.

Important technical amendments that make explicit what was implicit in the existing TBOC include the following: (1) clarifying how a membership interest in an LLC is treated on the divorce of a member or the death of a member or member’s spouse based on similar provisions for partnerships; (2) clarifying the effects in governing documents of references to prior law and synonymous terms; (3) clarifying that certain provisions in TBOC Chapter 101 which specify the requirements for establishment of a series limited liability company may not be waived by the company agreement; (4) clarifying the power to reinstate an entity pursuant to the TBOC if the entity was formed as a domestic entity or registered as a foreign entity under prior law; and (5) clarifying that a director, officer or member that has a conflict of interest in a transaction or due to a relationship cannot be subject to a claim for breach of duty if the director, officer or member follows the statutory procedure for approval of the conflict of interest transaction or relationship.

Some other important correcting or clarifying technical amendments include the following: (1) expressly acknowledging that a domestic entity may reimburse its present officers their reasonable expenses in advance of final disposition of a proceeding; (2) clarifying that written consents of governing persons, owners or members may be executed through the use of counterpart signature pages; (3) clarifying that a plan of merger may provide for the cancellation

¹ The descriptions of legislation described below are based on the text of the respective bills, bill analyses prepared by the Codification Committee of the Business Law Section of the State Bar of Texas or staff of the Legislature.

² S.B. 748 was drafted by the Codification Committee of the Business Law Section and supported in the Legislature by the Texas Business Law Foundation.

of ownership or membership interests in any entity that is party to the merger; (4) eliminating outmoded references to the National Association of Securities Dealers, Inc. and “interdealer quotation system;” (5) clarifying the applicability of provisions in Chapter 21 relating to statutory preemptive rights and shareholder agreements; (6) correcting the record date provisions for actions by shareholders to limit the 10-day advance requirement to meetings of shareholders; (7) clarifying when an obligation is deemed to have been incurred by an LLP; (8) clarifying that the record date for an adjourned meeting of shareholders continues to apply to the date of adjournment, unless a new record date is set; (9) amending the notice and demand requirements in the dissenters’ rights provisions to conform them to the source provisions in the TBCA; and (10) clarifying that the definition of beneficial owner contained in TBOC § 21.603 only applies to Subchapter M of Chapter 21 relating to affiliated business combination transactions.

Substantive amendments effected by S.B. 748 include the following: (1) eliminating the antiquated requirement for liability insurance or posting of a cash deposit or bond as a condition to the registration of an LLP, thereby conforming to the Uniform Partnership Act (1997) and most other states; (2) conforming the vicarious liability provisions relating to LLPs to the approach taken in the Uniform Partnership Act (1997) and the trend in other states; (3) adding charging order provisions for partnership interests in general partnerships that are similar to the charging order provisions applicable to partnership interests in limited partnerships and membership interests in LLCs; (4) allowing the company agreement of an LLC and the partnership agreement of a limited partnership reasonably to restrict access by a member or limited partner, respectively, to the entity’s books and records; and (5) amending the time periods for certain notices and other actions in the dissenters’ rights provisions to make them more uniform and, like the historical pattern in the source provisions of the TBCA, to establish a time limit on the procedure before recourse to a court.

PROVISIONS OF GENERAL APPLICATION

TBOC § 1.002 (Definitions) was amended to add new definitions for “national securities exchange,” “plan of conversion,” “plan of exchange” and “plan of merger.” [S.B. 748 § 1] The first new defined term is a cross-reference to the provisions relating to registration as a national securities exchange under the Securities Exchange Act of 1934, as amended (the “1934 Act”). The latter three defined terms are used extensively in TBOC Chapter 10 (Mergers, Interest Exchanges, Conversions and Sales of Assets) and elsewhere, and are defined simply to mean a written document that conforms with the requirements applicable to the type of plan in specified sections in Chapter 10. The definitions do not specify any particular form or format for any such plan.

TBOC § 6.101(b) (Record Date for Purpose Other than Written Consent to Action) was clarified to specify that a record date for determining the owners or members of the entity for purposes of a vote or other entity action must be a date that is not earlier than the 60th day before the date the action requiring the determination of owners or members is originally to be taken. [S.B. 748 § 2] It was unclear under the prior language whether adjournments of a meeting to a date later than 60 days after the record date would require the setting of a new record date and, therefore, a new notice to the owners or members of the entity. As a result of the change, the same record date will apply to any adjournments of a meeting unless the governing documents or governing authority otherwise provide.

TBOC § 6.205(a) (Reproduction or Electronic Transmission of Consent) was amended to eliminate the requirement that the reproduction of a written consent consist of a complete reproduction of the entire original writing. [S.B. 748 § 3] In practice, written consents in lieu of meetings are often provided through the use of counterpart signature pages, and it might have been argued that the deleted language was inconsistent with this common practice.

TBOC § 8.001 (Definitions applicable to indemnification and insurance) was clarified to specify that, in the definition of “delegate” used in TBOC indemnification provisions, a person who serves at the request of an enterprise as a representative of another enterprise or another organization or of an employee benefit plan is a delegate. [S.B. 748 § 4] The definition of “enterprise” was amended to clarify that it includes a “predecessor enterprise,” which is a phrase defined in clause (7) of TBOC § 8.001 but not otherwise used in Chapter 8.

TBOC §§ 8.103(d) (Manner for Determining Permissive Indemnification), 8.104(d) (Advancement of Expenses to Present Governing Persons or Delegates) and 8.151 (Insurance and Other Arrangements) were amended to specify that a vote of a majority in interest of the limited partners constitutes approval of the owners for the purposes of authorization of indemnification and advancement of expenses under TBOC §§ 8.103(d), 8.104(d) and 8.151 with respect to a limited partnership. [S.B. 748 §§ 5, 6 and 8] This provision parallels similar provisions contained in except that the exclusion in those provisions for the interest of a general partner that is not disinterested and independent is unnecessary in relation to approval of any liability insurance, self-insurance arrangement or indemnity agreement.

TBOC § 8.105(d) (Indemnification of and Advancement of Expenses to Persons Other than Governing Persons) was clarified to expressly name current and former officers as persons who may be reimbursed reasonable expenses in advance of the final disposition of a proceeding. [S.B. 748 § 7]

TBOC § 10.002 (Plan of Merger: Required Provisions) was clarified by adding references to “or exchanging,” “or exchange” or “or exchanged” in subsections (a)(5) and (c). [S.B. 748 § 10] A new clause (6) was added to TBOC § 10.002(a) to clarify that a plan of merger can include the cancellation of ownership or membership interests since ownership interests are often canceled as part of a merger in lieu of issuance of any consideration for those ownership interests. Similarly, a sentence was added to TBOC § 10.002(c) to clarify that an ownership or membership interest of a particular series or class may be canceled while other ownership or membership interests of the same class or series are converted or exchanged for other consideration as a result of a merger.

TBOC § 10.008(a)(8) (Effect of Merger) was given additional language to clarify that ownership or membership interests of an organization may be cancelled in connection with a plan of merger and to conform to the changes made to TBOC § 10.002. [S.B. 748 § 11]

TBOC § 10.354(b) (Rights of Dissent and Appraisal) was amended to remove references to the “Nasdaq Stock Market or a successor quotation system” as well as the reference to a “national market security on an interdealer quotation system by the National Association of Securities Dealers, Inc.” because those references have become outdated. [S.B. 748 § 14] The Nasdaq interdealer quotation system was the primary interdealer quotation system sponsored by the

National Association of Securities Dealers, Inc. (the “NASD”). In 2000, the Nasdaq system underwent a major recapitalization and became an independent entity from the NASD. The NASD was merged in 2007 with the enforcement arm of the New York Stock Exchange, NYSE Regulation, Inc., and renamed the Financial Industry Regulatory Authority, or “FINRA”. The Nasdaq Stock Market has since registered as a national securities exchange under the 1934 Act, which is already included in TBOC § 10.354(b)(1)(A). In addition, the vague reference to “or a similar system” was eliminated because it was undefined and added uncertainty to the provision.

TBOC § 10.355(c)(2) (Notice of Right of Dissent and Appraisal) was amended to refer to TBOC §§ 10.356(b)(1) and (b)(3), which, as amended by S.B. 748, describe the notices required by an owner desiring to exercise dissenters’ rights. [S.B. 748 § 15]

TBOC § 10.356 (Procedure for Dissent by Owners as to Actions; Perfection of Right of Dissent and Appraisal) was amended to conform the notice and demand provisions more closely to their source provisions in the TBCA, and to correct and make uniform the time period for the demand. [S.B. 748 § 16] TBOC § 10.356(b)(1) was added to require a notice from an owner, to the domestic entity of which he is an owner, stating his intent to exercise dissenters’ rights. This notice was required by the TBCA, but was combined in the existing TBOC § 10.356(b) with a second required notice, typically given only after the entity action giving rise to dissenters’ rights, in a manner that is impractical. The notice in TBOC § 10.356(b)(3) is redesignated, in accordance with historical and common practice, as a “demand” to differentiate it from the notice described in clause TBOC § 10.356(b)(1). The time periods for the demand in TBOC § 10.356(b)(3)(E) are amended to reflect that the demand is made after, and not before, the entity action (such as a merger) has become effective; that the time periods begin when the entity action is effective, and not upon the owners’ vote or consent regarding that action; and that the length of time is 20 days after the action was effective regardless of whether the owners acted at a meeting or by written consent. Cross-references were appropriately modified. TBOC § 10.356(d) was amended to refer specifically to the provision under which a dissenting owner’s demand is made.

TBOC § 10.358 (Response by Organization to Notice of Dissent and Demand for Fair Value by Dissenting Owner) was amended to conform certain language to that of the TBCA, and to change the time periods for action on a responsible organization’s offer of fair value to a dissenting owner and for payment of fair value to the dissenting owner. [S.B. 748 § 17] TBOC § 10.358(d) was amended to establish a time limit on the dissenters’ rights procedure before either party applies to a court for determination of fair value of the dissenting owner’s interest. It provides that the dissenting owner may consider the responsible organization’s offer of fair value for a period extending until 90 days after the date on which the entity action was effective. This 90-day period is shorter than the existing TBOC § 10.358 period, which was an indefinite time extending for at least 60 days after the offer was made, but it is also longer than the period specified in the source statute. TBOC § 10.358(e) was amended to include a reference to the 90-day period set forth in TBOC § 10.358(d) and to require payment of the agreed amount of fair value by the responsible organization within 120 days after the date on which the entity action was effective. This period shortens to as few as 30 days the existing 60-day period for payment to the dissenting owner.

TBOC § 11.402 (Jurisdiction to Appoint Receiver) was amended to clarify the relationship of its provisions to the provisions of TBOC §§ 11.403 (Appointment of Receiver for Specific Property), 11.404 (Appointment of Receiver to Rehabilitate Domestic Entity) and 11.405 (Appointment of Receiver to Liquidate Domestic Entity; Liquidation). [S.B. 748 § 14] When the provisions of TBOC § 11.402 were contained in the TBCA, this relationship was clearer. As a standalone section, the provisions could be misconstrued. TBOC § 11.402(a) relates to the appointment of a receiver for specific property of a domestic or foreign entity in accordance with TBOC § 11.403. TBOC § 11.402(b)(1) directly relates to an appointment of a receiver for the property and business of a domestic entity for the purpose of rehabilitating an entity in accordance with TBOC § 11.404. [S.B. 748 § 19] Finally, TBOC § 11.402(b)(2) directly relates to an appointment of a receiver to liquidate the property and business of a domestic entity in accordance with TBOC § 11.405.

TBOC § 11.404(b)(3) (Appointment of Receiver to Rehabilitate Domestic Entity) was amended to cross-reference properly to TBOC § 11.402(a) dealing with Jurisdiction for receiverships for specific property of a domestic entity. [S.B. 748 § 20]

TRANSITION PROVISIONS

To address transition concerns, S.B. 748 § 62 added a new TBOC § 402.0051 (Effect of References to Prior Law and Use of Synonymous Terms) to clarify circumstances in which a governing document is not considered nonconforming with the TBOC by providing that references to prior law or use of synonymous terminology contained in prior law are not nonconforming and, therefore, not required by TBOC § 402.005(a)(3) or (4) (Applicability to Existing Entities) to be updated in an entity's next amendment. This clarification addresses concerns whether TBOC § 402.005(a)(3) or (4) required an amendment to a governing document or filing instrument to update references to prior law or replace prior terminology with TBOC terminology.

TBOC § 402.003 (Early Adoption of Code by Existing Domestic Entity) was amended by S.B. 748 § 59 to add a new TBOC § 402.003(b) providing that an entity formed prior to January 1, 2006 that elected to be governed by the TBOC prior to January 1, 2010 did not fail to comply with the requirements of TBOC § 402.003(a) that it amend its governing documents to conform to the TBOC because its governing document do not state the type of entity formed or the circumstances specified in new TBOC § 402.0051 (Effect of References to Prior Law and Use of Synonymous Terms).

TBOC § 402.004 (Early Adoption of Code by Registered Foreign Filing Entity) was amended in S.B. 748 § 60 to add new TBOC § 402.004(b) which is the foreign-entity counterpart to new TBOC § 402.003(b) and likewise clarifies the circumstances in which an application for registration that was governed by prior law when filed is not considered noncomplying with the TBOC. New TBOC § 402.003(b) provides that certain information contained in or absent from an application for registration do not cause the application for registration to be noncomplying. Therefore, the inclusion or absence of that information does not require amendment to the entity's application for registration under TBOC § 402.004(a)(2). Specifically, new TBOC § 402.003(b) clarifies that an entity's application for registration is not noncompliant with the TBOC based on a failure to state the type of entity, on a failure to appoint the secretary of state

as agent for service of process under the circumstances provided by TBOC § 5.251, on continued references to prior law, or on use of synonymous terminology contained in prior law.

TBOC § 402.005 (Applicability to Existing Entities) was amended to add new subsection (c) to clarify that the ideas expressed in new TBOC §§ 402.003(b) (Early Adoption of Code by Existing Domestic Entity) and 402.004(b) (Early Adoption of Code by Registered Foreign Filing Entity) extend to the TBOC § 402.005(a)(3) and (4) amendment requirements for nonconforming terms. New TBOC § 402.005(c) clarifies that none of the following are nonconforming when contained in governing documents or an application for registration that were governed by prior law when drafted: failure to state the type of entity in a certificate of formation or application for registration, failure to appoint the secretary of state as agent for service of process under the circumstances provided by TBOC § 5.251 (Failure to Designate Registered Agent), continued references to prior law, or use of synonymous terminology contained in prior law. Therefore, such items are not required by TBOC §§ 402.005(a)(3) or (4) to be updated in an entity's next amendment to registration. This clarification addresses amendment concerns raised by practitioners.

TBOC § 402.013 (Reinstatement of Entities Canceled, Revoked, Dissolved, Involuntarily Dissolved, Suspended, or Forfeited Under Prior Law) was amended to expressly provide that, in addition to addressing reinstatement of entities canceled, revoked, involuntarily dissolved, suspended, or forfeited under prior law, TBOC § 402.013 addresses dissolutions as well. The amendment also extends TBOC § 402.013 to address reinstatement after January 1, 2010 of entities terminated under prior law. Finally, the amendment to TBOC § 402.013 corrects a mistake in subsection (b) by deleting the incorrect terminology “involuntarily dissolved” from the list of termination reasons for registrations of foreign filing entities.

PROVISIONS APPLICABLE TO FOR PROFIT CORPORATIONS

TBOC § 21.001 (Applicability of Chapter), which contained provisions specifying the applicability of TBOC Chapter 21, was deleted as unnecessary. Similar provisions are not contained in the TBOC Chapters relating to other types of entities. [S.B. 748 § 66(1)]

TBOC § 21.109(a) (Agreement Not Effective) was amended to eliminate the outmoded reference to “interdealer quotation system of a national securities association” and the vague reference to “or similar system.” [S.B. 748 § 21] The reasons for these changes are explained above with respect to the amendments to TBOC § 10.354(b).

A new TBOC § 21.110 (Other Shareholder Agreements Permitted) was added by S.B. 748 § 22 to clarify that subchapter C of Chapter 21 relating to shareholder agreements is not intended to prohibit or impair any agreements between two or more shareholders or between a for-profit corporation and one or more of its shareholders. In other words, Subchapter C only applies to the types of shareholder agreement described in TBOC § 21.101 (Shareholders' Agreement).

The denial of statutory preemptive rights in TBOC § 21.203 (No Statutory Preemptive Right Unless Provided by Certificate of Formation) was clarified by adding a new subsection (c), which specifies that TBOC §§ 21.203 through 21.208 do not impair or invalidate a for-profit corporation's right or power to grant an enforceable non-statutory preemptive right in a contract

between the corporation and a shareholder or other person or in the governing documents of the corporation. [S.B. 748 § 23]

TBOC § 21.206(a) (Limitation on Action to Enforce Preemptive Right) was clarified to specify that the statute of limitations created by the section only applies to violations of a preemptive right of a shareholder under TBOC §§ 21.203 (No Statutory Preemptive Right Unless Provided by Certificate of Formation) and 21.204 (Statutory Preemptive Rights). [S.B. 748 § 24] As a result, the statute of limitations applicable to a violation of a nonstatutory preemptive right of a shareholder arising under a contract with a corporation or a governing document of the corporation would be the general residual statute of limitations for breaches of contract contained in Texas Civil Practice and Remedies Code § 16.051.

TBOC § 21.222(b)(1) (Penalty for Refusal to Permit Examination of Certain Records) was corrected to remove the superfluous phrase “in consideration.” [S.B. 748 § 25] The list of shareholders or list of voting trust certificate holders referenced in clause (1) could apply to the shares of the corporation or any other corporation.

TBOC § 21.357 (Record Date for Purpose of Shareholders’ Meeting) was clarified to conform with the source law contained in TBCA Article 2.26.B, which required a record date for a meeting of shareholders to be at least ten days before the date of the meeting. [S.B. 748 § 26] This source provision was inadvertently expanded to cover any “actions” requiring the determination of shareholders by TBOC § 21.357. The ten-day minimum time period should only apply to meetings of shareholders and not other actions, such as determining shareholders for purposes of dividends or sending notices of other types of actions. As revised, this TBOC § 21.357 only applies to record dates for the purpose of determining shareholders entitled to notice or to vote at any meeting of shareholders or any adjournment of the meeting.

TBOC § 21.415(a) (Action by Directors) was amended to expressly indicate that the quorum of directors must be present at a meeting of directors “at the time of the act” of a majority of the directors present at the meeting. [S.B. 748 § 27] That is implicit in the current provision.

TBOC § 21.418 (Contracts or Transactions Involving Interested Directors and Officers) was restructured by S.B. 748 § 28 to make more clear its intent. TBOC § 21.418(a) was amended to clarify that it also applies to affiliates or associates of directors or officers that have the conflicting relationship or interest. TBOC § 21.418(b) was further amended to clarify that the contract or transaction is not void or voidable, and is valid and enforceable, notwithstanding the conflicting relationship or interest if the requirements of the Section are satisfied. Provisions formerly located in TBOC § 21.418(b) permitting the execution of a consent of directors, or the presence, participation or voting in the meeting of the board of directors, by the director or officer having the conflicting relationship or interest are moved to a new TBOC § 21.418(d). Finally, a new TBOC § 21.418(e) was added specifying that neither the corporation nor any of its shareholders have any cause of action against any of the conflicted officers or directors for breach of duty in respect of the contract or transaction because of such relationship or interest or the taking of any actions described by TBOC § 21.418(d). S.B. 748 § 28 reads as follows:

SECTION 28. Section 21.418, Business Organizations Code, is amended by amending Subsections (a) and (b) and adding Subsections (d) and (e) to read as follows:

(a) This section applies [~~only~~] to a contract or transaction between a corporation and:

(1) one or more [~~of the corporation's~~] directors or officers, or one or more affiliates or associates of one or more directors or officers, of the corporation; or

(2) an entity or other organization in which one or more [~~of the corporation's~~] directors or officers, or one or more affiliates or associates of one or more directors or officers, of the corporation:

(A) is a managerial official; or

(B) has a financial interest.

(b) An otherwise valid and enforceable contract or transaction described by Subsection (a) is valid and enforceable, and is not void or voidable, notwithstanding any relationship or interest described by Subsection (a), if any one of the following conditions is satisfied [~~notwithstanding that the director or officer having the relationship or interest described by Subsection (a) is present at or participates in the meeting of the board of directors, or of a committee of the board that authorizes the contract or transaction, or votes or signs, in the person's capacity as a director or committee member, a unanimous written consent of directors or committee members to authorize the contract or transaction, if~~]:

(1) the material facts as to the relationship or interest described by Subsection (a) and as to the contract or transaction are disclosed to or known by:

(A) the corporation's board of directors or a committee of the board of directors, and the board of directors or committee in good faith authorizes the contract or transaction by the approval of the majority of the disinterested directors or committee members, regardless of whether the disinterested directors or committee members constitute a quorum; or

(B) the shareholders entitled to vote on the authorization of the contract or transaction, and the contract or transaction is specifically approved in good faith by a vote of the shareholders; or

(2) the contract or transaction is fair to the corporation when the contract or transaction is authorized, approved, or ratified by the board of directors, a committee of the board of directors, or the shareholders.

(d) A person who has the relationship or interest described by Subsection (a) may:

(1) be present at or participate in and, if the person is a director or committee member, may vote at a meeting of the board of directors or of a committee of the board that authorizes the contract or transaction; or

(2) sign, in the person's capacity as a director or committee member, a unanimous written consent of the directors or committee members to authorize the contract or transaction.

(e) If at least one of the conditions of Subsection (b) is satisfied, neither the corporation nor any of the corporation's shareholders will have a cause of action against any of the persons described by Subsection (a) for breach of duty with respect to the making, authorization, or performance of the contract or transaction because the person had the relationship or interest described by Subsection (a) or took any of the actions authorized by Subsection (d).

TBOC § 21.453 (Approval of Conversion) was amended by S.B. 748 § 29 to add new subsections (f) and (g) relating to a possible recommendation by a board of directors that shareholders not approve a plan of conversion that has been authorized. Subsections (f) and (g) are parallel to similar subsections contained in TBOC § 21.452 (Approval of Merger) with respect to a plan of merger and TBOC § 21.454 (Approval of Exchange) with respect to a plan of exchange.

TBOC § 21.601(1)(c) (Definitions) was amended by S.B. 748 § 30 to refer to a “national securities exchange,” for which a new definition is added to TBOC § 1.002 by S.B. 748 § 1, in lieu of the current undefined term “national market system.”

TBOC § 21.603 (Beneficial Owner of Shares or Similar Securities) was amended by S.B. 748 § 31 to provide that the concept of “beneficial owner,” as defined therein, applies only to Subchapter M of TBOC Chapter 21 relating to affiliated business combination transactions. The current language purports to apply that concept to the entire TBOC Chapter 21, which was a departure from the source provisions in TBCA Arts. 13.01-13.05. The broad concept of “beneficial owner” in TBOC § 21.603 (Beneficial Owner of Shares or Similar Securities) did not fit well in many of the other contexts in which that phrase or similar words are used in other parts of TBOC Chapter 21. The confusing reference to “similar securities” has been revised to refer to “other securities” throughout the text of the Section. As a result of that change, it is clear that convertible or exchangeable debt securities could result in the application of the provisions of Subchapter M. Redundant language between current TBOC §§ 21.603(a) and (b) is eliminated by combining the subsections and re-lettering TBOC § 21.603(c) to be TBOC § 21.603(b). Existing TBOC § 21.603(c)(2)(B) is clarified so that an agreement, arrangement or understanding that would be reportable on Schedule 13D under the 1934 Act, whether or not it is reported on a Schedule 13D or would not be required to be reported because the “issuing public corporation” (as defined in TBOC § 21.601(1)) is a private company not subject to the 1934 Act. Other wording changes in TBOC § 21.603 were made in the interests of clarity. S.B. 748 § 31 provided as follows:

SECTION 31. Section 21.603, Business Organizations Code, is amended to read as follows:

Sec. 21.603. BENEFICIAL OWNER OF SHARES OR OTHER ~~[SIMILAR]~~ SECURITIES. (a) For purposes of this subchapter ~~[chapter]~~, a person is a beneficial owner of shares or other ~~[similar]~~ securities if the person individually, or through an affiliate or associate, ~~[beneficially owns,]~~ directly or indirectly beneficially owns the shares or other securities or has the right~~[, shares or similar securities.~~

~~[(b) A beneficial owner of shares or similar securities is entitled, individually or through an affiliate or associate,] to:~~

(1) acquire the shares or other ~~[similar]~~ securities ~~[that may be exercised]~~ immediately or after the passage ~~[of a certain amount]~~ of time according to an oral or written agreement, arrangement, or understanding, or on the exercise of conversion rights, exchange rights, warrants, or options;

(2) vote the shares or other ~~[similar]~~ securities according to an oral or written agreement, arrangement, or understanding; or

(3) ~~[subject to Subsection (c),]~~ acquire, hold or dispose of, or vote the shares or other ~~[similar]~~ securities with another person who individually, or through an affiliate or associate, beneficially owns, directly or indirectly, the shares or other ~~[similar]~~ securities.

~~(b) [(c)]~~ A person, however, is not considered a beneficial owner of shares or other ~~[similar]~~ securities for purposes of this subchapter if:

(1) the shares or other ~~[similar]~~ securities are:

(A) tendered under a tender or exchange offer made by the person or an affiliate or associate of the person before the tendered shares or securities are accepted for purchase or exchange; or

(B) subject to an agreement, arrangement, or understanding that expressly conditions the acquisition or purchase of shares or securities on the approval of the acquisition or purchase under Section 21.606 if the person has no direct or indirect rights of ownership or voting with respect to the shares or other securities until the time the approval is obtained; or

(2) the agreement, arrangement, or understanding to vote the shares:

(A) arises solely from an immediately revocable proxy that authorizes the person named in the proxy to vote at a meeting of the shareholders that has been called when the proxy is delivered or at an adjournment of the meeting; and

(B) would [~~is~~] not be reportable on a Schedule 13D under the Securities Exchange Act of 1934 (15 U.S.C. Section 77b et seq.), as amended, or a comparable or successor report.

TBOC § 21.701(1) (Definitions) was clarified by S.B. 748 § 32 to indicate that a “close corporation” can include a corporation that becomes governed by Subchapter O of TBOC Chapter 21 as a close corporation as a result of TBOC §§ 21.705, 21.706 or 21.707.

PROVISIONS APPLICABLE TO NONPROFIT CORPORATIONS

TBOC § 22.230 (Contracts or Transactions Involving Interested Directors, Officers, and Members) was amended by S.B. 748 § 33 to restructure its provisions to parallel the changes effected by S.B. 748 § 28 to TBOC § 21.418 relating to contracts or transactions involving interested directors and officers of for profit corporations.

PROVISIONS APPLICABLE TO LLCs

TBOC § 101.054 (Waiver or Modification of Certain Statutory Provisions Prohibited; Exceptions) was amended by S.B. 748 § 34 to provide that TBOC §§ 101.602(b) (Enforceability of Obligations and Expenses of Series Against Assets) and 101.613 (Distributions) relating to series LLCs cannot be waived or modified in the company agreement.

In addition, new TBOC § 101.054(e) was added, and the reference to TBOC § 101.502 was deleted from TBOC § 101.054(a), to clarify that a company agreement may reasonably restrict the right of access of a member or manager to records and information, which results in a provision that is more consistent with TBOC § 152.002(b)(1) for general partnerships. The laws of many other states such as Delaware allow for this kind of flexibility.

TBOC § 101.106 (Nature of Membership Interest) was amended by S.B. 748 § 35 to clarify the relationship of a membership interest and a member’s right to participate in the management and conduct of the business of the limited liability company for marital property purposes. The provisions are modeled after existing provisions applicable to partnerships contained in TBOC §§ 152.203(a) (Rights and Duties of Partner) and 154.001(b) (Nature of Partner’s Partnership Interest). The new provisions explicitly state rules that are implicit in the existing statutory provisions defining and describing a membership interest, specifying the consequences of a transfer of a membership interest, and addressing admission of a member.

New TBOC § 101.1115 (Effect of Death or Divorce on Membership Interest) was added by S.B. 748 § 36 to clarify how a membership interest is treated on the divorce of a member or the death of a member or member’s spouse. The provision explicitly states rules that are implicit in existing statutory provisions (as further clarified by TBOC § 101.106 (Nature of Membership Interest) as amended by S.B. 748 § 35) defining and describing a membership interest, specifying the consequences of a transfer of a membership interest, and addressing admission of a member. TBOC § 101.1115 is modeled after existing TBOC § 152.406 (Effect of Death or Divorce on Partnership Interest) in the partnership context. The provision makes clear that a non-member who, under other applicable law, succeeds to or retains an interest in a membership interest upon the death or divorce of a member acquires only the rights of an assignee of the membership interest. In other words, member status and the appurtenant rights of the member to

participate in the conduct and management of the business are not subject to inheritance or division on divorce.

TBOC § 101.254(a) (Designation of Agents; Binding Acts) was clarified by deleting the reference “or agent” to eliminate the circularity of the existing provision. [S.B. 748 § 37] TBOC § 101.254(a) specifies that each governing person, and each officer of the limited liability company vested with actual or apparent authority by the company’s governing authority, is an agent of the company for purposes of carrying out the company’s business.

S.B. 748 § 38 amended TBOC § 101.255 (Contracts or Transactions Involving Interested Governing Persons or Officers) to restructure its provisions as S.B. 748 §§ 28 and 33 had restructured the comparable TBOC provisions relating to for-profit and non-profit corporations, respectively.

S.B. 748 § 39 corrected TBOC § 101.357(b) (Manner of Voting) to move the phrase “if authorized by the accompanying agreement” from the preamble of subsection (b) to its proper position in clause (2). As a result, it would be clear that managers and committee members may vote in person, even if not specified by a company agreement, and that a company agreement may authorize managers or committee members of limited liability companies to act by written proxy.

S.B. 748 § 40 corrected an erroneous cross-reference in TBOC § 101.611(b) (Member Status With Respect to Distribution) from “Section 101.207” to read “Section 101.206.”

PROVISIONS APPLICABLE TO ALL PARTNERSHIPS

S.B. 748 § 41 clarifies TBOC § 151.001(4) (Definitions) to specify that the definition of “majority-in-interest” with respect to all or a specified group of partners also applies to TBOC §§ 8.103(d) (Manner for Determining Permissive Indemnification), 8.104(d) (Advancement of Expenses to Present Governing Persons or Delegates) and 11.057 (Supplemental Provisions for Domestic General Partnership). This interpretation was not otherwise clear because the defined terms in TBOC § 151.001 are only applicable to Title 4 “Partnerships.”

TBOC § Section 151.003(d) (Notice of Fact) was clarified by S.B. 748 § 41 to specify that notice must be received by a general partner of a limited partnership, and not a limited partner, to constitute effective notice to the partnership.

PROVISIONS APPLICABLE TO GENERAL PARTNERSHIPS

TBOC § 152.304(a) (Nature of Partner’s Liability) was amended by S.B. 748 § 42 to eliminate the redundancy in the phrase “debt or obligation,” thus conforming TBOC § 152.304(a) to the Uniform Partnership Act (1997) and making the provision consistent with other provisions of TBOC Chapter 152 where the word “obligation,” rather than the phrase “debt or obligation,” is used. In the Uniform Partnership Act (1997) and other provisions of TBOC Chapter 152, the term “obligation” is used to encompass all kinds of debts and liabilities of the partnership.

A new TBOC § 152.308 (Partner’s Partnership Interest Subject to Charging Order) was added by S.B. 748 § 43 to provide charging-order provisions applicable to partnership interests in general

partnerships that are similar to those contained in TBOC § 153.256 for limited partnerships and in TBOC § 101.112 for LLCs. There did not appear to be any reason that the partnership interest in a general partnership should be treated differently than a limited partnership interest or a membership interest in an LLC. The vast majority of other states have provisions relating to charging orders for a partnership interest in a general partnership. A judgment creditor may charge the partnership interest of the judgment debtor to satisfy the judgment. The charging order constitutes a non-foreclosable lien on the partnership interest. The entry of the charging order is the exclusive judicial remedy of the judgment creditor with respect to the partnership interest beyond enforcement of TB&CC security interests and agreements, partnership agreements and other contractual arrangements.

TBOC § 152.406 (Effect of Death or Divorce on Partnership Interest) was amended to clarify and modernize its provisions in certain respects. The phrase “if any” was added to TBOC §§ 152.406(a)(1) and (a)(3) to make clear that the divorce of a partner or death of a partner’s spouse does not necessarily result in anyone other than the partner having a partnership interest. TBOC § 152.406(a)(3) was also amended by substituting the more modern term “devisee” for “legatee” and adding the phrase “or other successor” to encompass non-testamentary transfers permitted under modern laws. TBOC § 152.406(a)(2) was amended to make clear the interaction of the provision with the redemption provisions of Subchapter H of TBOC Chapter 152. The death of a partner is an event of withdrawal of the partner, and unless otherwise provided by the partnership agreement, the partnership interest of a withdrawn partner is automatically redeemed as of the date of withdrawal under Subchapter H of TBOC Chapter 152. Thus, unless the partnership agreement negates the automatic redemption of the partnership interest on the death of a partner, there are no transferees of the partnership interest, but merely successors of the deceased partner who are entitled to be paid the redemption price of the partnership interest. If the partnership agreement negates the automatic redemption of the partnership interest on the death of a partner, the successors of the deceased partner are transferees unless otherwise provided by the partnership agreement.

TBOC § 152.707(b) (Settlement of Accounts) was amended to change the cross-reference from “Subchapter H” to the correct cross-reference of “Section 152.610” and to clarify that the provision applies to a partnership interest of a partner that is redeemed under such Section. [S.B. 748 § 47]

PROVISIONS APPLICABLE TO LLPS

S.B. 748 § 46 amended TBOC § 152.801 (Liability of Partner) relating to the liability of a partner in an LLP to more closely conform the Texas LLP provisions to the approach taken in the Uniform Partnership Act (1997) and the trend in other jurisdictions. The amendment eliminates the redundancy in the phrase “debt or obligation” by referring simply to an “obligation,” which is the term used in the Uniform Partnership Act (1997) and which encompasses all types of debts and liabilities. The amendment also eliminates language that specifies when a partner in a limited liability partnership is liable for an error, omission, negligence, incompetence, or malfeasance of another partner or representative of the partnership. Such language is not found in the uniform law or the statutes of most other jurisdictions. A partner, however, is always liable for the partner’s own tortious conduct. A provision specifying when an obligation is “incurred” with regard to limited liability partnership status is added to

eliminate confusion created by the recent case *Evanston Ins. Co. v. Dillard Dept. Stores, Inc.*, 602 F.3d 610 (5th Cir. 2010). S.B. 748 § 46 reads as follows:

SECTION 46. Section 152.801, Business Organizations Code, is amended to read as follows:

Sec. 152.801. LIABILITY OF PARTNER. (a) Except as provided by ~~[Subsection (b) or]~~ the partnership agreement, a partner ~~[in a limited liability partnership]~~ is not personally liable to any person, including a partner, directly or indirectly, by contribution, indemnity, or otherwise, for any ~~[a debt or]~~ obligation of the partnership incurred while the partnership is a limited liability partnership.

~~(b) [A partner in a limited liability partnership is not personally liable for a debt or obligation of the partnership arising from an error, omission, negligence, incompetence, or malfeasance committed by another partner or representative of the partnership while the partnership is a limited liability partnership and in the course of the partnership business unless the first partner:~~

~~[(1) was supervising or directing the other partner or representative when the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative;~~

~~[(2) was directly involved in the specific activity in which the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative; or~~

~~[(3) had notice or knowledge of the error, omission, negligence, incompetence, or malfeasance by the other partner or representative at the time of the occurrence and then failed to take reasonable action to prevent or cure the error, omission, negligence, incompetence, or malfeasance.~~

~~[(e)]~~ Sections 2.101(1), 152.305, and 152.306 do not limit the effect of Subsection (a) in a limited liability partnership.

(c) For purposes of this section, [(d) In this section, “representative” includes] an obligation is incurred while a partnership is [agent, servant, or employee of] a limited liability partnership if:

(1) the obligation relates to an action or omission occurring while the partnership is a limited liability partnership; or

(2) the obligation arises under a contract or commitment entered into while the partnership is a limited liability partnership.

(d) Subsection [(e) Subsections] (a) does [and (b) do] not affect:

(1) the liability of a partnership to pay its [debts and] obligations from partnership property;

(2) the liability of a partner, if any, imposed by law or contract independently of the partner's status as a partner; or

(3) the manner in which service of citation or other civil process may be served in an action against a partnership.

(e) [(f)] This section controls over the other parts of this chapter and the other partnership provisions regarding the liability of partners of a limited liability partnership, the chargeability of the partners for the [~~debts and~~] obligations of the partnership, and the obligations of the partners regarding contributions and indemnity.

TBOC § 152.802(a) (LLP Registration) was amended (i) by S.B. 748 § 47 to delete the cross-reference to TBOC § 152.804 (Insurance or Financial Responsibility), which is repealed by S.B. 748 § 48, and (ii) by S.B. 748 § 66(2) to delete old TBOC § 152.802(i) (Liability of Partner in LLP), which references the same repealed TBOC § 152.804(a).

S.B. 748 § 48 repeals TBOC § 152.804 (Insurance or Financial Responsibility) which required LLPs to provide \$100,000 of liability insurance or a \$100,000 cash deposit, bank letter of credit or insurance company bond. Although this type of provision was not uncommon in early LLP statutes, there are no such requirements in the Uniform Partnership Act (1997) or the current LLP statutes of most jurisdictions. It is impractical to impose a one-size-fits-all insurance requirement for LLPs because LLPs vary widely in size and activities. Many LLPs are professional partnerships, and the insurance requirement in repealed TBOC § 152.804 was drafted from the perspective of malpractice and other tort liabilities typical of professional partnerships. Other types of partnerships are permitted to, and do, register as LLPs as well, and the insurance needed by, and available to them, is different from that available to professional partnerships and which the TBOC § 152.804 statutory wording appeared to contemplate. The type of liability insurance that is appropriate and desirable will vary depending upon the nature of the business. Even among professional firms, variations in the size and nature of the professional practice make it infeasible to generalize as to the appropriate type and amount of insurance. Neither the general business entity statutes nor the professional entity statutes (i.e., the professional corporation, professional association, and professional LLC statutes) in Texas include an insurance requirement. The difficulties in interpreting and applying the insurance requirement under the Texas LLP provisions caused LLPs in Texas to suffer an unnecessary and undesirable disadvantage compared to LLPs formed in other states and other types of business entities formed in Texas.

TBOC § 152.910(b) (relating to the effect of a failure to register a foreign LLP in Texas) was amended by S.B. 748 § 48 to eliminate the reference to “debt” in favor of only the broader term “obligation.” This revision makes the language parallel to other references to the obligations of the partnership for which the partner of a limited liability partnership is not liable.

PROVISIONS APPLICABLE TO LIMITED PARTNERSHIPS

TBOC § 153.004(a) (Nonwaivable Title 1 Provisions) was clarified by S.B. 748 § 51 to indicate that a limited partnership agreement may reasonably restrict a partner's right to access to books

and records under TBOC § 153.552 (Examination of Records and Information), which results in a provision that is more consistent with TBOC § 152.002(b)(1) (Effect of Partnership Agreement; Nonwaivable and Variable Provisions) for general partnerships.

TBOC § 153.103(9)(N) (Actions Not Constituting Participation in Business for Liability Purposes) was amended by S.B. 748 § 52 by clarifying that an interest exchange with respect to a limited partnership will be treated in the same manner as a merger or conversion with respect to the right of limited partner to vote for or against such a transaction without incurring personal liability.

TBOC § 153.158(b) (Effect of Withdrawal) was amended by S.B. 748 § 53 to remove erroneous cross-references to TBOC §§ 153.113 (Powers of Estate of Limited Partner Who is Deceased or Incapacitated) and 153.555 (Permitted Transfer in Connection With Racetrack License).

TBOC § 153.501(b)(2)(A) (Cancellation or Revocation of Event Requiring Winding Up; Continuation of Business) was amended by S.B. 748 § 54 to eliminate a duplicative reference to “in writing.”

TBOC § 153.504(1) (Disposition of Assets) was amended by S.B. 748 § 55 to add a comma for purposes of clarifying its meaning.

TBOC § 153.551(a)(5)(c) (Records) was amended by S.B. 748 § 56 to clarify that the written statement of the agreed value of non-cash contributions must be of the event requiring the additional contributions to be made rather than the date of such event.

PROVISIONS APPLICABLE TO REAL ESTATE INVESTMENT TRUSTS

TBOC § 200.317 (Contracts or Transactions Involving Interested Trust Managers and Officers) was amended by S.B. 748 § 57 to restructure its provisions as S.B. 748 §§ 28, 33 and 39 had restructured the comparable TBOC provisions for for-profit corporations, non-profit corporations and LLCs, respectively.

- S.B. 323 by Sen. John J. Carona amends the TBOC to provide that the TBOC provisions that limit the liability of shareholders of Texas corporations apply to managers and members of Texas LLCs if LLC “veil piercing” becomes recognized in Texas, *available at* <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB323>.³

TBOC § 101.114 (Liability for Obligations) provides that a member or manager is not liable for the debts, obligations or liabilities of an LLC, except as and to the extent the company agreement or regulations specifically provide otherwise. This language prohibits a court from holding the members or managers liable for the debts, obligations and liabilities of an LLC. However, some recent judicial opinions have failed to follow this express statutory mandate and have applied corporate veil piercing principles to LLCs, causing uncertainty as to the proper standards to be applied if LLC veil piercing is to be recognized. Some Texas opinions have applied corporate veil piercing standards in disregarding the statutory liability shield. *See, e.g., McCarthy v. Wani*

³ S.B. 323 was drafted by the Codification Committee of the Business Law Section and supported in the Legislature by the Texas Business Law Foundation.

Venture, A.S., 251 S.W.3d 573, (Tex. App. – Houston [1st Dist.] 2007, pet. denied); *In re JNS Aviation, LLC (Nick Corp. v. JNS Aviation, Inc.)*, 376 B.R. 500 (Bankr. N.D. Tex. 2007). When applying corporate veil piercing standards to limited liability companies, these courts recognized that the provisions of TBCA Article 2.21 (Liability of Subscribers and Shareholders), which are carried over in TBOC §§ 21.223 (Liability for Obligations) through 21.226 (Liability for Obligations), were controlling with respect to such standards.

S.B. 323 clarified 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 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) apply to an LLC and its members, owners, assignees and subscribers, subject to the limitations contained in TBOC § 101.114 (Liability for Obligations). TBOC § 101.002, as added by 2011 S.B. 323 effective September 1, 2011, provides as follows:

Sec. 101.002. APPLICABILITY OF OTHER LAWS. (a) Subject to Section 101.114, Sections 21.223, 21.224, 21.225, and 21.226 apply to a limited liability company and the company’s members, owners, assignees, affiliates, and subscribers.

(b) For purposes of the application of Subsection (a):

- (1) a reference to “shares” includes “membership interests”;
- (2) a reference to “holder,” “owner,” or “shareholder” includes a “member” and an “assignee”;
- (3) a reference to “corporation” or “corporate” includes a “limited liability company”;
- (4) a reference to “directors” includes “managers” of a manager-managed limited liability company and “members” of a member-managed limited liability company;
- (5) a reference to “bylaws” includes “company agreement”; and
- (6) the reference to “Sections 21.157-21.162” in Section 21.223(a)(1) refers to the provisions of Subchapter D of this chapter.

- S.B. 1568 by Sen. Craig Estes clarifies that a derivative plaintiff must own stock at the time of filing the derivative action and continuously to the completion of the action, *available at* <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB1568>.⁴

⁴ S.B. 1568 was drafted by the Codification Committee of the Business Law Section and supported in the Legislature by the Texas Business Law Foundation.

A “derivative action” is an action brought in the right of a corporation by a shareholder against directors or officers for breach of fiduciary duty. To bring a derivative action, TBOC § 21.552(a) (Approval of Voluntary Winding Up, Revocation, Cancellation, or Reinstatement) requires that a person must have been a shareholder at the relevant times and must fairly represent the interest of the corporation in the action. In apparent conflict with this requirement, TBOC § 21.552(b) stated that Chapter 10 or Subchapter J of Chapter 21 may not be construed to limit or terminate a shareholder’s standing after a merger to the extent that the shareholder had standing immediately before the merger. This provision had caused confusion in the Texas legal community about whether a shareholder has standing to institute or maintain a derivative proceeding after a corporation’s shares are converted into cash or securities of another entity pursuant to a merger.

Case law in Texas and elsewhere requires that the derivative plaintiff must be a shareholder both at the time of the action complained of and at the time of judgment. In *Somers v. Crane*, 295 S.W.3d 5, 13 (Tex. App.—Houston [1st Dist.] Mar. 26, 2009), a Texas appellate court clarified that “a shareholder must own stock at the time of filing a derivative suit and continuously through the completion of the suit to have derivative standing.” S.B 1568 deleted TBOC § 21.552(b), thereby eliminating this ambiguity and aligning the TBOC with the current state of the law on derivative proceedings.

Other TBLF Sponsored Legislation

AMENDMENTS TO TEXAS BUSINESS AND COMMERCE CODE

1. **Choice of Law.** A “choice of law” clause is a contract provision stating that any dispute arising under the contract shall be handled in accordance with the law of the particular jurisdiction specified in the contract. Prior to September 1, 1993, Texas relied on two principles for determining the enforceability of a choice of law provision in a contract: (i) the Uniform Commercial Code (“UCC”) § 1.301 (formerly UCC § 1.105) governed transactions covered by the UCC and required a “reasonable relationship” between the parties and the chosen jurisdiction to exist for that jurisdiction’s law to be applied⁵ and (ii) all remaining transactions were governed

⁵ TB&CC § 1.301 provides as follows:

Sec. 1.301. TERRITORIAL APPLICATION OF THE TITLE; PARTIES' POWER TO CHOOSE APPLICABLE LAW. (a) Except as provided hereafter in this section, when a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties. Failing such agreement this title applies to transactions bearing an appropriate relation to this state.

(b) Where one of the following provisions of this title specifies the applicable law, that provision governs and a contrary agreement is effective only to the extent permitted by the law (including the conflict of laws rules) so specified:

Rights of creditors against sold goods. Section 2.402.

Applicability of the chapter on Leases. Sections 2A.105 and 2A.106.

Applicability of the chapter on Bank Deposits and Collections. Section 4.102.

Governing law in the chapter on Funds Transfers. Section 4A.507.

Letters of Credit. Section 5.116.

Applicability of the chapter on Investment Securities. Section 8.110.

by the common law Restatement (Second) of Conflict of Laws, Section 187, which provided that, with certain exceptions, a contractual choice of law will be enforced unless there is no reasonable basis for the choice.

Effective September 1, 1993, Section 35.51 (now located in Chapter 271) was added to the Texas Business and Commerce Code (“TB&CC”) to govern certain choice of law provisions. Under this provision, with certain exceptions, the parties to a transaction involving more than \$1 million (a “qualified transaction”) may agree that the law of a particular jurisdiction governs a particular issue relating to the transaction, including the validity or the enforceability of an agreement relating to the transaction or a provision of the agreement. If the transaction bears a reasonable relation to the chosen jurisdiction, then the laws of that jurisdiction (other than conflict laws rules) shall govern the particular issue. In addition, the statute contains specific factual criteria or “safe harbors,” the presence of any one of which will satisfy the “reasonable relation” test.

In the 2011 Legislative Session, TB&CC Chapter 271 (Rights of Parties to Choose Law Applicable to Certain Transactions) was updated to reflect modern business practices in large transactions by H.B. 2991⁶ by Rep. Joe Deshotel to add additional safe harbors for choosing the law of a particular jurisdiction to govern transactions involving at least \$1 million.⁷

Law governing perfection, the effect of perfection or nonperfection, and the priority of security interests and agricultural liens. Sections 9.301-9.307.

(c) If a transaction that is subject to this title is a "qualified transaction," as defined in Section 271.001, then except as provided in Subsection (b) of this section, Chapter 271 governs the effect of an agreement by the parties that the law of a particular jurisdiction governs an issue relating to the transaction or that the law of a particular jurisdiction governs the interpretation or construction of an agreement relating to the transaction or a provision of the agreement.

⁶ Available at <http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=82R&Bill=HB2991>.

⁷ H.B. No. 2991 amended TB&CC § 271.004, effective for transactions entered into on or after September 1, 2011, by amending Subsection (b) and adding Subsection (c) to read as follows:

(b) A transaction bearing [bears] a reasonable relation to a particular jurisdiction includes [if]:

(1) a transaction in which:

(A) a party to the transaction is a resident of that jurisdiction;

(B) [~~2~~] a party to the transaction has the party's place of business or, if that party has more than one place of business, the party's chief executive office or an office from which the party conducts a substantial part of the negotiations relating to the transaction, in that jurisdiction;

(C) [~~3~~] all or part of the subject matter of the transaction is located in that jurisdiction;

(D) [~~4~~] a party to the transaction is required to perform in that jurisdiction a substantial part of the party's obligations relating to the transaction, such as delivering payments; [~~or~~]

(E) [~~5~~] a substantial part of the negotiations relating to the transaction occurred in or from that jurisdiction and an agreement relating to the transaction was signed in that jurisdiction by a party to the transaction; or

(F) all or part of the subject matter of the transaction is related to the governing documents or internal affairs of an entity formed under the laws of that jurisdiction, such as:

(i) an agreement among members or owners of the entity, an agreement or option to acquire a membership or ownership interest in the entity, and the conversion of debt or other securities into an ownership interest in the entity; and

The 2011 changes to TB&CC Chapter 271 related to (a) transactions in which a substantial part of the negotiations were conducted from the chosen jurisdiction; (b) agreements governing the internal affairs of an entity; (c) agreements for multi-lender financing transactions involving at least \$25 million; and (d) whether there is a qualifying reasonable relationship to the law chosen is to be determined at time of transaction and is not affected by subsequent events:

(a) Negotiations From Chosen Jurisdiction. TBOC § 271.004(b)(1)(E) was amended to provide that a transaction bears a reasonable relation to the chosen jurisdiction if a substantial part of the negotiations relating to the transaction occurred from the chosen jurisdiction, as well as in the chosen jurisdiction or an agreement relating to the transaction was signed in that jurisdiction by a party to the transaction.

(b) Internal Affairs. TB&CC § 271.004(b)(1) was amended to add a new subsection (F) providing that a transaction bears a reasonable relation to the chosen jurisdiction if “all or part of the subject matter of the transaction is related to the governing documents or internal affairs of an entity formed under the laws of that jurisdiction, such as: (i) an agreement among members or owners of the entity, an agreement or option to acquire a membership or ownership interest in the entity, and the conversion of debt or other securities into an ownership interest in the entity; and (ii) any other matter relating to rights or obligations with respect to the entity’s membership or ownership interests.”

(c) \$25 Million Syndicated Loans. TB&CC § 271.004(b) was amended to add a new subsection (2) providing that a transaction bears a reasonable relation to the chosen jurisdiction if (A) all or part of the subject matter of the transaction is a loan or other extension of credit in which a party lends, advances, borrows, or receives, or is obligated to lend or advance or entitled to borrow or receive, money or credit with an aggregate value of at least \$25 million; (B) at least three financial institutions or other lenders or providers of credit are parties to the transaction; (C) the particular jurisdiction is in the United States; and (D) a party to the transaction has more than one place of business and has an office in that particular jurisdiction.”

(ii) any other matter relating to rights or obligations with respect to the entity's membership or ownership interests; and

(2) a transaction in which:

(A) all or part of the subject matter of the transaction is a loan or other extension of credit in which a party lends, advances, borrows, or receives, or is obligated to lend or advance or entitled to borrow or receive, money or credit with an aggregate value of at least \$25 million;

(B) at least three financial institutions or other lenders or providers of credit are parties to the transaction;

(C) the particular jurisdiction is in the United States; and

(D) a party to the transaction has more than one place of business and has an office in that particular jurisdiction.

(c) If a transaction bears a reasonable relation to a particular jurisdiction at the time the parties enter into the transaction, the transaction shall continue to bear a reasonable relation to that jurisdiction regardless of:

(1) any subsequent change in facts or circumstances with respect to the transaction, the subject matter of the transaction, or any party to the transaction; or

(2) any modification, amendment, renewal, extension, or restatement of any agreement relating to the transaction.

(d) Reasonable Relationship Determined at Time of Transaction. TB&CC § 271.004 was further amended to add a new subsection (c) providing: “If a transaction bears a reasonable relation to a particular jurisdiction at the time the parties enter into the transaction, the transaction shall continue to bear a reasonable relation to that jurisdiction regardless of: (1) any subsequent change in facts or circumstances with respect to the transaction, the subject matter of the transaction, or any party to the transaction; or (2) any modification, amendment, renewal, extension, or restatement of any agreement relating to the transaction.”

2. Uniform Commercial Code Article 9. TB&CC Chapter 9 (Secured Transaction) is the body of law that controls secured transactions, including security agreements for real and personal property and related agreements between creditors and debtors. Since the current version of Chapter 9 took effect in 2001, a number of its provisions have proven cumbersome or problematic. S.B. 782⁸ by Sen. John Carona amended TB&CC Chapter 9 to adopt changes to Uniform Commercial Code Article 9 approved and recommended by the National Conference of Commissioners on Uniform State Laws for enactment in all states. The majority of the changes are in the nature of language adjustments for clarity or to update Article 9 to reflect advances in technology or business practices and become effective July 1, 2013.

⁸ Available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB782>.



EGAN ON ENTITIES

Byron Egan is a partner in the Dallas office of Jackson Walker L.L.P. specializing in corporate, financing, mergers and acquisitions, and securities related matters. He is also a prolific speaker and writer, having penned approximately 300 papers relating to business entities. Mr. Egan writes about the issues that he deals with every day as a seasoned corporate lawyer: corporation, partnership and limited liability company formation, entity governance, financing transactions, mergers and acquisitions, and securities laws.

This bulletin, called Egan on Entities, contains introductions to Mr. Egan's recent significant writings in four areas of the law relating to business entities, including how they are formed, governed and combined with other entities.¹ These writings contain practical insights regarding these subjects developed from his law firm practice and his interaction with others, as well as a thorough analysis of statutory and case law from which these practical insights have been developed.

Full versions of the writings referenced below can be found in the links identified below.

For further information or to provide your suggestions for additional bulletins, feel free to contact Mr. Egan directly at 214 953-5727, or by email at began@jw.com. Additionally, a listing of Mr. Egan's writings available online may be accessed at: <http://www.jw.com/site/jsp/attyinfo.jsp?id=77>.

More about Byron Egan: In addition to practicing corporate, financing, mergers and acquisitions, and securities law at Jackson Walker L.L.P. and making himself available as a resource to other lawyers, Mr. Egan currently serves as Senior Vice Chair and Chair of Executive Council of the ABA Business Law Section's Mergers & Acquisitions Committee and was Co-Chair of its Asset Acquisition Agreement Task Force, which published the ABA Model Asset Purchase Agreement with Commentary. A former Chair of both the Texas Business Law Foundation and the Business Law Section of the State Bar of Texas, as well as that Section's Corporation Law Committee, Mr. Egan has been involved in the drafting and enactment of many Texas business entity statutes, and that experience continues to enrich his current law practice. Four of Mr. Egan's law journal articles have received the Burton Award for excellence in legal writing presented at the Library of Congress. His paper 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. A profile of Mr. Egan published in The M&A Journal is available at: <http://www.jw.com/site/jsp/publicationinfo.jsp?id=540>.

¹ Copyright ©2013 by Byron F. Egan. All rights reserved.

1.

CHOICE OF ENTITY AND FORMATION

EXCERPTED FROM: "Choice of Entity Decision Tree" – prepared for a May 25, 2012 program in San Antonio at the TexasBarCLE & Business Law Section of State Bar of Texas Choice and Acquisition of Entities in Texas Course. Published on the JW website and full text available at: <http://images.jw.com/com/publications/1744.pdf>

Key Issues Covered:

- Key factors in entity selection
- Summaries of key provisions of Texas and Delaware laws relating to
 - Corporations
 - General Partnerships
 - Limited Partnerships
 - Limited Liability Partnerships
 - Limited Liability Companies
- Summaries of U.S. and Texas tax treatment of entities

In selecting a form of business entity in which to engage in business in the United States, the organizer or initial owners should consider the following five business entity forms:

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

The form of business entity most advantageous in a particular situation depends on the objectives of the business for which the entity is being organized. In most situations, the focus will be on how the entity and its owners will be taxed and the extent to which the entity will shield the owners of the business from liabilities arising out of its activities.

The Texas Legislature has enacted the Texas Business Organizations Code (the “TBOC”) to codify the Texas statutes relating to business entities referenced above, together with the Texas statutes governing the formation and operation of other for-profit and non-profit private sector entities. The TBOC is applicable for entities formed or converting under Texas law after January 1, 2006. Entities in existence on January 1, 2006 were required to conform to TBOC from and after January 1, 2010, but could continue to be governed by the Texas source statutes until then.

Federal and state taxation of an entity and its owners for entity income is a major factor in the selection of the form of entity for a particular situation. Under the Internal Revenue Code of 1986 and the “Check-the-Box” regulations promulgated by the Internal Revenue Service, an unincorporated business entity may be classified as an “association” taxable as a corporation subject to income taxes at the corporate level ranging from 15% to 35% of taxable net income, absent a valid S-corporation status election, which is in addition to any taxation which may be imposed on the owner as a result of distributions from the business entity. Alternatively, the entity may be classified as a partnership, a non-taxable “flow-through” entity in which taxation is imposed only at the ownership level. Although generally a corporation may be classified only as a corporation for federal income tax purposes, an LLC or partnership may elect whether

to be classified as a partnership. A single-owner LLC is disregarded as a separate entity for federal income tax purposes unless it elects otherwise.

Texas does not have a state personal income tax. The Texas Legislature has replaced the Texas franchise tax on corporations and LLCs with a novel business entity tax called the “Margin Tax,” which is imposed on all business entities other than general partnerships wholly owned by individuals and certain “passive entities.” Essentially, the calculation of the Margin Tax is based on a taxable entity’s, or unitary group’s, gross receipts after deductions for either (x) compensation or (y) cost of goods sold, provided that the “tax base” for the Margin Tax may not exceed 70% of the entity’s total revenues. This “tax base” is apportioned to Texas by multiplying the tax base by a fraction of which the numerator is Texas gross receipts and the denominator is aggregate gross receipts. The tax rate applied to the Texas portion of the tax base is 1% for all taxpayers, except a narrowly defined group of retail and wholesale businesses that will pay a ½ of 1% rate.

The enactment of the Margin Tax changes the calculus for entity selections, but not necessarily the result. The LLC has become more attractive as it can elect to be taxed as a corporation or partnership for federal income tax purposes and has the same Margin Tax treatment as most limited partnerships, but the uncertainties as to an LLC’s treatment for self-employment purposes continue to restrict its desirability in some situations.

2.

CORPORATE GOVERNANCE

EXCERPTED FROM: “Fiduciary Duties of Corporate Directors and Officers in Texas” – 43 Texas Journal of Business Law 45 (Spring 2009). Published on the JW website and full text available at: <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1230>

Key Issues Covered:

- Fiduciary duties of directors and officers generally in both Texas and Delaware
- Fiduciary duties in insolvency situations
- Fiduciary duties regarding compensation
- Fiduciary duties regarding mergers and acquisitions
- Fiduciary duties regarding alternative entities

See also “*How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*” – prepared for a February 8, 2013 program in Austin at the University of Texas School of Law 35th Annual Conference on Securities Regulation and Business Law. Published on the JW website and full text available at: <http://www.jw.com/publications/article/1830>.

The conduct of corporate directors and officers is subject to particular scrutiny in the context of executive compensation and other affiliated party transactions, business combinations (whether friendly or hostile), when the corporation is charged with illegal conduct, and when the corporation is insolvent or in the zone of insolvency. The high profile stories of how much corporations are paying their executive officers, corporate scandals, bankruptcies and related developments have further focused attention on how directors and officers discharge their duties, and have caused much reexamination of how corporations are governed and how they relate to their shareholders and creditors. Where the government intervenes (by investment or otherwise) or threatens to do so, the scrutiny intensifies, but the courts appear to resolve

the controversies by application of traditional principles while recognizing the 800-pound gorilla in the room.

The individuals who serve in leadership roles for corporations are fiduciaries in relation to the corporation and its owners. These troubled times make it appropriate to focus upon the fiduciary and other duties of directors and officers, including their duties of care and loyalty. Increasingly the courts are applying principals articulated in cases involving mergers and acquisitions (“*M&A*”) to cases involving executive compensation, perhaps because both areas often involve conflicts of interest and self-dealing or because in Delaware, where many of the cases are tried, the same judges are writing significant opinions in both areas. Director and officer fiduciary duties are generally owed to the corporation and its shareholders, but when the corporation is insolvent, the constituencies claiming to be beneficiaries of those duties may expand to include the entity’s creditors.

While federal securities laws and stock exchange listing requirements have mandated changes in corporate governance practices, our focus will be on state corporate statutes and common law. Our focus is in the context of entities organized under the applicable Delaware and Texas statutes.

3.

MERGERS & ACQUISITIONS

EXCERPTED FROM: “Acquisition Agreement Issues” – prepared for a September 21, 2012 program in New York at the Penn State Law and City Bar Center for CLE, New York City Bar, Ninth Annual Institute on Corporate, Securities, and Related Aspects of Mergers and Acquisitions. Published on the JW website and full text available at:

<http://images.jw.com/com/publications/1776.pdf>

Key Issues Covered:

- Alternative structures for sales of businesses
- Successor liability
- Form of asset purchase agreement with commentary

See also:

◆ “*Private Company Acquisitions: A Mock Negotiation*” – 116 Penn State Law Review 743 (2012)

◆ “*Asset Acquisitions: Assuming and Avoiding Liabilities*” – 116 Penn State Law Review 913 (2012)

◆ “*Joint Venture Formation*” – 44 Texas Journal of Business Law 129 (2012).

◆ “*Contractual Limitations on Seller Liability in M&A Agreements*” – prepared for an October 18, 2012 program in Dallas at the University of Texas School of Law 8th Annual Mergers and Acquisitions Institute. Published on the JW website and full text available at:

<http://images.jw.com/com/publications/1790.pdf>

Buying or selling a business, including the purchase of a division or a subsidiary, revolves around a purchase agreement between the buyer and the selling entity and sometimes its owners. Purchases of assets are characterized by the acquisition by the buyer of specified assets from an entity, which may or may not represent all or substantially all of its assets, and the assumption by the buyer of specified

liabilities of the seller, which typically do not represent all of the liabilities of the seller. When the parties choose to structure an acquisition as an asset purchase, there are unique drafting and negotiating issues regarding the specification of which assets and liabilities are transferred to the buyer, as well as the representations, closing conditions, indemnification and other provisions essential to memorializing the bargain reached by the parties. There are also statutory (e.g., bulk sales and fraudulent transfer statutes) and common law issues (e.g., de facto merger and other successor liability theories) unique to asset purchase transactions that could result in an asset purchaser being held liable for liabilities of the seller which it did not agree to assume.

A number of things can happen during the period between the signing of an acquisition agreement and the closing of the transaction that can cause a buyer to have second thoughts about the transaction. For example, the buyer might discover material misstatements or omissions in the seller's representations and warranties, or events might occur, such as the filing of litigation or an assessment of taxes, that could result in a material liability or, at the very least, additional costs that had not been anticipated. There may also be developments that could seriously affect the future prospects of the business to be purchased, such as a significant downturn in its revenues or earnings or the adoption of governmental regulations that could adversely impact the entire industry in which the target operates.

The buyer initially will need to assess the potential impact of any such misstatement, omission or event. If a potential problem can be quantified, the analysis will be somewhat easier. However, the impact in many situations will not be susceptible to quantification, making it difficult to determine materiality and to assess the extent of the buyer's exposure. Whatever the source of the matter, the buyer may want to terminate the acquisition agreement or, alternatively, to close the transaction and seek recovery from the seller. If the buyer wants to terminate the agreement, how strong is its legal position and how great is the risk that the seller will dispute termination and commence a proceeding to seek damages or compel the buyer to proceed with the acquisition? If the buyer wants to close, could it be held responsible for the problem and, if so, what is the likelihood of recovering any resulting damage or loss against the seller? Will closing the transaction with knowledge of the misstatement, omission or event have any bearing on the likelihood of recovering? The dilemma facing a buyer under these circumstances seems to be occurring more often in recent years.

The issues to be dealt with by the parties to an acquisition transaction will depend somewhat on the structure of the transaction and the wording of the acquisition agreement. Regardless of the wording of the agreement, however, there are some situations in which a buyer can become responsible for a seller's liabilities under successor liability doctrines. The analysis of these issues is somewhat more complicated in the acquisition of assets, whether it be the acquisition of a division or the purchase of all the assets of a seller. The paper has the following topics:

This paper includes:

- An overview of the three basic forms of business acquisitions:
 - Statutory business combinations (e.g., mergers, consolidations and share exchanges);
 - Stock purchases; and
 - Asset purchases.
- Introductory matters concerning the reasons for structuring the transaction as an asset purchase.
- Forms of confidentiality agreement and letter of intent.

- A discussion of the various successor liability doctrines and some suggested means of minimizing the risk.
- An initial draft of certain key provisions of an Asset Purchase Agreement which focuses on the definition and solution of the basic issues in any asset purchase: (1) what assets are being acquired and what liabilities are being assumed, (2) what assets and liabilities are being left behind, (3) what are the conditions of the obligations of the parties to consummate the transaction and (4) what are the indemnification obligations of the parties. While these matters are always deal specific, some generalizations can be made and common problems identified.
- Joint venture formation overview.

4.

SECURITIES LAWS

EXCERPTED FROM: “Major Themes of the Sarbanes-Oxley Act” – 42 Texas Journal of Business Law 339 (Winter 2008). Published on the JW website and full text available at: <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1186>

Key Issues Covered:

- Effects of the Sarbanes-Oxley Act of 2002 (“SOX”) on issuers, directors and professionals generally
- SOX audit committee provisions
- SOX auditor independence provisions
- SOX prohibitions on misleading statements to auditors
- SOX internal controls provisions
- Attorney responsibilities under SOX
- Letters to auditors regarding loss contingencies
- Attorney-client and work product privilege considerations

See also “*Responsibilities of M&A Professionals After the Sarbanes-Oxley and Dodd-Frank Acts*” – prepared for a November 5, 2010 program in Las Vegas at the ABA 15th Annual National Institute on Negotiating Business Acquisitions. Published on the JW website and full text available at: <http://images.jw.com/com/publications/1498.pdf>

The Sarbanes-Oxley Act of 2002 (“SOX”) was trumpeted by the politicians and in the media as a “tough new corporate fraud bill” in response to the corporate scandals that preceded it and as a means to protect investors by improving the accuracy and reliability of corporate disclosures. Among other things, SOX amended the Securities Exchange Act of 1934 (the “1934 Act”) and the Securities Act of 1933. Although SOX does have some specific provisions, and generally establishes some important public policy changes, it has been implemented in large part through rules adopted and to be adopted by the Securities and Exchange Commission (“SEC”) and the Public Company Accounting Oversight Board (“PCAOB”), which have impacted auditing standards and have increased scrutiny on auditors’ independence and procedures to verify company financial statement positions and representations. Further, while SOX is by its terms generally applicable only to public companies, its principles are being applied by the marketplace to privately held companies and nonprofit entities.

Following the enactment of SOX and the adoption of rules thereunder, the role of independent auditors in detecting financial statement fraud within public companies has received enhanced scrutiny. In turn, companies are expected both to implement controls for dealing with alleged fraud internally and to provide their auditors with detailed information on a wide range of corporate issues. Companies involve legal counsel, both inside and outside, for a wide variety of tasks, from conducting investigations of alleged fraud to dealing with employee issues (including whistleblower complaints) and advising directors on their duties in connection with corporate transactions. Auditors are increasingly asking for information regarding these often privileged communications to supplement their reliance on management representations. Making such privileged information available to auditors, however, subjects companies to the risk of loss of attorney client and work product privileges, which can provide a road-map to success for adversaries in civil litigation.

Further, in providing such information to auditors, the provider must comply with the requirements of Section 303 of SOX and expanded Rule 13b2-2 under the 1934 Act adopted pursuant to SOX §303. The SOX §303 requirements specifically prohibit officers and directors, and “persons acting under [their] direction,” from coercing, manipulating, misleading or fraudulently influencing an auditor “engaged in the performance of an audit” of the issuer’s financial statements when the officer, director or other person “knew or should have known” that the action, if successful, could result in rendering the issuer’s financial statements filed with the SEC materially misleading. Since attorneys and other mergers and acquisitions professionals representing a corporation are usually engaged by, and are acting at the direction of, its directors or officers, they are subject to the SOX §303 Requirements. The SEC has demonstrated its willingness to bring sanction proceedings against lawyers when they have been perceived to have failed in their responsibilities.

The SOX §303 requirements should influence an attorney in communicating with accountants, and reinforce the importance of providing meaningful information to auditors and clients. The SOX §303 requirements, however, should not be viewed as repudiating or supplanting the ABA Statement of Policy regarding Lawyers’ Responses to Auditors’ Requests for Information regarding client loss contingencies. Resulting from a compromise reached in 1976 between the lawyers and the accountants, this ABA Statement of Policy provides a framework under which lawyers can provide information to auditors regarding client loss contingencies in connection with their examination of client financial statements, while minimizing the risk of loss of attorney-client privilege in the process.

In addition, the requirements of SOX §307 are specifically applicable to attorneys. The SEC rules under SOX §307 generally provide that, in the event that an attorney has “credible evidence based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation [of any U.S. law or fiduciary duty] has occurred, is ongoing, or is about to occur,” the attorney has a duty to seek to remedy the problem by “reporting up the ladder” within the issuer to the issuer’s chief legal officer, or to both the chief legal officer and the chief executive officer, or if those executives do not respond appropriately, to the issuer’s board of directors or an appropriate committee thereof. SEC rulemaking and enforcement actions post-SOX attempt to place lawyers in the role of “gatekeepers” or “sentries of the marketplace” whose responsibilities include “ensuring that our markets are clean.” These SEC actions will directly affect the role of the lawyer in dealing with clients, auditors, M&A professionals and others.

Byron F. Egan is a partner of Jackson Walker L.L.P. in Dallas, Texas, where he practices corporate, financing, mergers and acquisitions, and securities law.

Additionally, a more complete listing of Mr. Egan's recent writings is available online and may be accessed at: <http://www.jw.com/site/jsp/attyinfo.jsp?id=77>.