CHOICE OF ENTITY DECISION TREE AFTER MARGIN TAX AND TEXAS BUSINESS ORGANIZATIONS CODE

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I. GENERAL

A. Introduction

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.

Until the 1990s, the spectrum of business entity forms available in Texas was not so broad. In 1991, the Texas Legislature passed legislation allowing for the creation of the LLP and the LLC, which changed the business organization landscape in Texas and nationwide. In 1991, Texas adopted 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 made after September 1, 1997. 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]

In 2003, 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. The TBOC became effective for entities formed under Texas law after January 1, 2006. Entities in existence on January 1, 2006 may continue to be governed by the Texas source statutes in effect prior to January 1, 2006 or elect to be governed by the TBOC.

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[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 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).

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, 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.[3] 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. Generally, a corporation is taxed only as a corporation, but an LLC or partnership may elect whether to be taxed as a partnership. A single-owner LLC may elect to be disregarded as a separate entity for federal income tax purposes.

Texas does not have a state personal income tax. Until January 1, 2007, corporations and LLCs were subject to the Texas franchise tax, which was equal to the greater of (i) 0.25% of its "taxable capital," generally owners' equity, and (ii) 4.5% of its "net taxable earned surplus." Although labeled a "franchise tax," the tax on "net taxable earned surplus" was really a 4.5% income tax levied at the entity level and computed by determining the entity's reportable federal taxable income and adding to that amount the compensation of officers and directors. Limited and general partnerships, including the LLP, were not subject to this franchise tax.[4]

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 ("H.B. 3"), which replaced the current Texas franchise tax on corporations and LLCs with a new and 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."[5] Essentially, the calculation of the new 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, 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 who will pay a ½ of 1% rate. For calendar year taxpayers, the Margin Tax applies to entity income commencing January 1, 2007, and is payable annually commencing May 15, 2008.

The enactment of the Margin Tax changes the calculus for entity selections, but not necessarily the result. The LLC becomes 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.[6]

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[3] *See infra* notes 73–86 and accompanying text.

[4] *See infra* notes 99–102 and accompanying text.

[5] *See infra* notes 105–84 and accompanying text.

[6] *See infra* notes 489–501 and accompanying text.

B. Statutory Updating

Texas' entity statutes are continually being updated and improved through the efforts of the Texas Business Law Foundation and the Business Law Section of the State Bar of Texas.[7] 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.[8] 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 ("S.B. 555"), which became effective September 1, 1997, making numerous changes in Texas' business entity statutes, some of which are quite innovative.[9] 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 passed,[10] and significant changes were made to Texas' other entity statutes.[11] 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,[12] including the TBOC.[13] 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

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7 *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).

8 *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.

9 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).

10 Tex. H.B. 1156, 78th Leg., R.S. (2003) by Rep. Helen Giddings *available at* http://www.capitol.state.tx.us/home.aspx (select the "78(R) - 2003" Legislature, select Bill Number, then fill in "HB 1156" in the space below). The Revisor's Report for the TBOC is available 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 current and proposed law, is available at http://www.house.state.tx.us.

11 *See* Tex. H.B. 1165, 78th Leg., R.S. (2003) by Rep. Burt R. Solomons, *available at* http://www.capitol.state.tx.us/home.aspx (select the "78(R) - 2003" Legislature, select Bill Number, then fill in "HB 1165" in the space below); *see also* Tex. H.B. 1637, 78th Leg., R.S. (2003) by Rep. Rene Oliveira *available at* http://www.capitol.state.tx.us/home.aspx (select the "78(R) - 2003" Legislature, select Bill Number, then fill in "HB 1637" in the space below).

12 Tex. H.B. 1507, 79th Leg., R.S. (2005) by Rep. Burt Solomons, *available at* http://www.capitol.state.tx.us/home.aspx (select the "79(R) - 2005" Legislature, select Bill Number, then fill in "HB 1507" in the space below); Tex. H.B. 1154, 79th Leg., R.S. (2005) by Rep. Gary Elkins, *available at* http://www.capitol.state.tx.us/home.aspx (select the "79(R) - 2005" Legislature, select Bill Number, then fill in "HB 1154" in the space below); Tex. H.B. 1319, 79th Leg., R.S. (2005) by Rep. Helen Giddings, *available at* http://www.capitol.state.tx.us/home.aspx (select the "79(R) - 2005" Legislature, select Bill Number, then fill in "HB 1319" in the space below) ("H.B. 1319").

13 Tex. H.B. 1319.

statutes affecting business entities.[14]

C. Texas Business Organizations Code

1. Background

In the 2003 Legislative Session, the TBOC, which was previously introduced and not passed in the 1999[15] and 2001 Legislative Sessions, was again introduced and this time it passed.[16] The TBOC in its current form[17] also includes amendments made during the 2005 Legislative Session and the 2007 Legislative Session.[18] The TBOC is still a work in progress, and additional amendments will be made in the future 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 substantive modifications to existing law.[19] These statutes consist of the following: the Texas Business Corporation Act (the "TBCA"),[20] the Texas Non-Profit Corporation Act (the "TNPCA"),[21] the Texas Miscellaneous Corporation Laws Act (the "TMCLA"),[22] the Texas Limited Liability Company Act (the "LLC Act"),[23] the Texas Revised Partnership Act (the "TRPA"),[24] the Texas Revised Limited Partnership Act (the "TRLPA"),[25] the Texas Real Estate Investment Trust Act (the "TREITA"),[26] the Texas Uniform Unincorporated Nonprofit Associations Act (the "TUUNA"),[27] the Texas

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14 *See* Tex. H.B. 1737, 80th Leg., R.S. (2007) by Rep. Helen Giddings, *available at* http://www.capitol.state.tx.us/home.aspx (select the "80(R) - 2007" Legislature, select Bill Number, then fill in "HB 1737" in the space below) ("H.B. 1737") , which became effective September 1, 2007.

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

16 Tex. H.B. 1156.

17 TEX. BUS. ORGS. CODE. ANN. (Vernon 2008), *available at* http://tlo2.tlc.state.tx.us/statutes/bo.toc.htm (hereinafter TBOC).

18 Tex. H.B. 1319 (2005); H.B. 1737 (2007).

19 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).

20 TEX. BUS. CORP. ACT ANN. arts. 1.01 et. seq. (Vernon Supp. 2008) (hereinafter TBCA).

21 TEX. REV. CIV. STAT. ANN. art. 1396-1 (Vernon Supp. 2008) (hereinafter TNPCA).

22 TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon Supp. 2008) (hereinafter TMCLA).

23 TEX. REV. CIV. STAT. ANN. art. 1528n (Vernon Supp. 2008) (hereinafter LLC Act).

24 TEX. REV. CIV. STAT. ANN. art. 6132b (repealed 1999) (hereinafter TRPA).

25 TEX. REV. CIV. STAT. ANN. art. 6132a-1 (Vernon Supp. 2008) (hereinafter TRLPA).

26 TEX. REV. CIV. STAT. ANN. art. 6138A (Vernon Supp. 2008) (hereinafter TREITA).

27 TEX. REV. CIV. STAT. ANN. art. 1396-1B (Vernon Supp. 2008) (hereinafter TUUNA).

Professional Corporation Act (the "TPCA"),[28] the Texas Professional Associations Act (the "TPAA"),[29] the Texas Cooperative Associations Act (the "TCAA"),[30] 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"[31] 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.[32] Generally entities organized under Texas special statutes prior to January 1, 2006 would be subject to the transition rules applicable to other Texas entities and would continue to generally reference the source law rather than the TBOC until January 1, 2010.[33]

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 Title 1, separate "spokes" contain provisions governing different types of entities which are not 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.[34]

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.[35] Domestic entities already in existence on January 1, 2006 will continue to be governed by then existing entity statutes until January 1, 2010,[36] at which time the old laws will be repealed. However, such entities may 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

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[28] TEX. REV. CIV. STAT. ANN. art. 1528e (Vernon Supp. 2008) (hereinafter TPCA).

[29] TEX. REV. CIV. STAT. ANN. art. 1528f (Vernon Supp. 2008) (hereinafter TPAA).

[30] TEX. REV. CIV. STAT. ANN. art. 1396-1A (Vernon Supp. 2008) (hereinafter TCAA).

[31] TEX. BUS. ORG. CODE ANN. § 2.003 (Vernon 2008).

[32] TBOC § 23.001.

[33] TBOC § 402.005. Note that the Texas Finance Code has been amended by 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, sections 12 and 68, 80th Leg., R.S. (2007), *available at* http://www.capitol.state.tx.us/home.aspx (select the "80(R) - 2007" Legislature, select Bill Number, then fill in "HB 1962" in the space below).

[34] TBOC § 1.106(c).

[35] TBOC § 402.001(a).

[36] TBOC § 402.005.

necessary.[37]

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,[38] 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 main entity as that entity's "governing authority."[39] Similarly, the name of the document an entity must file 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.[40] One other significant vocabulary change is that the Regulations of a limited liability company are now referred to as its "Company Agreement."[41] Other changes include the shift in the titles of filings from "Application for Certificate of Authority to Transact Business"[42] to "Application for Registration,"[43] from "Articles of Amendment"[44] to "Certificate of Amendment,"[45] and from "Articles of Dissolution"[46] to "Certificate of Termination."[47] Under the TBOC, a "domestic entity" is a corporation, partnership, LLC, or other entity formed under the TBOC or whose

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[37] TBOC § 402.003.

[38] Codification Comm. Report, *supra* note 19. The Bar Committee was primarily responsible for drafting the TBOC in collaboration with the Secretary of State and the Texas Legislative Council.

[39] TBOC § 1.002(35).

[40] 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.

[41] *See* TBOC § 101.052.

[42] *See* TBCA art. 8.01.

[43] *See* TBOC § 9.004.

[44] *See* TBCA art. 4.04.

[45] *See* TBOC § 3.053.

[46] *See* TBCA art. 6.06.

[47] *See* TBOC § 11.101.

internal affairs are governed by the TBOC,[48] 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.[49]

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.[50] However, it adds the requirement that the document state what type of entity shall be formed upon its filing.[51] Other requirements differ slightly for each entity.[52]

c. Filing procedures

In addition to changing the form of the document required to organize a Texas business entity, the TBOC streamlines the filing fees for a number of documents.[53] For example, the filing fees for a certificate of formation for all domestic entities are now set forth in TBOC Chapter Four, Subchapter D.[54] Additionally, the TBOC now authorizes a filing fee of $50 for the pre-clearance of any document, whereas before, the Secretary of State was only authorized to charge such fee for pre-clearance of limited partnership documents.[55] 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).[56] 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.[57] Filings are generally effective when filed, not when the Secretary of State acknowledges them.[58] Additionally, documents with delayed effective dates may now be abandoned at any time prior to effectiveness.[59]

d. Entity Names

The TBOC relaxes the requirements for indicating the business entity form in the entity's

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48 TBOC § 1.002(18).

49 TBOC § 1.002(28).

50 TBOC §§ 3.003, 3.005, and the related Revisor's Report, *supra* note 10.

51 TBOC § 3.005 and the related Revisor's Report, *supra* note 10.

52 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.

53 *See* TBOC Chapter 4, Subchapter D.

54 *See id.* and the related Revisor's Report, *supra* note 10.

55 TBOC § 4.151 and the related Revisor's Report, *supra* note 10.

56 *See* TBCA art. 3.03.

57 *See* TBOC § 4.002 and the related Revisor's Report, *supra* note 10.

58 TBOC § 4.051.

59 TBOC § 4.057.

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.[60] 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.[61] 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.[62]

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.[63] 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.[64] 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.[65]

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.[66] 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.[67]

f. Construction

The TBOC incorporates the provisions of the Code Construction Act[68] to assist in its interpretation.[69] 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.

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[60] *See* TBOC §§ 5.054–.063.

[61] TRLPA § 1.03.

[62] TBOC §§ 5.055, 153.102, and the related Revisor's Report, *supra* note 10.

[63] TBOC § 3.104; TBCA art. 2.43; TNPCA art. 1396–2.21.

[64] TBOC § 3.102. This default right previously existed for certain entities (*see, e.g.,* TBCA 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 10.

[65] TBOC § 3.152, and the related Revisor's Report, *supra* note 10.

[66] *See* TBOC § 6.002.

[67] TBOC § 6.002.

[68] TEX. GOV'T CODE ANN. § 311 (Vernon Supp. 2008).

[69] TBOC § 1.051.

g. *Transition Rules*[70]

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 will continue to be governed by the old Texas statutes. During that period, they may 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.[71] However, limited liability partnerships are only entitled to continue following the registration requirements of the TRPA and TRLPA until their current registrations expire,[72] at which point they must renew under the TBOC (although until January 1, 2010 they will continue to be substantively governed by the TRPA and TRLPA).

D. Federal "Check-the-Box" Tax Regulations

1. *Classification*

Under the IRC, and the associated Treasury regulations promulgated, 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, it may be disregarded as a separate entity for federal income tax purposes.

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

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[70] For more detailed rules governing the transition period, *see* TBOC Title 8.

[71] To illustrate, a corporation that was incorporated in Texas prior to January 1, 2006 may still amend its Articles of Incorporation by filing Articles of Amendment to its Articles of Incorporation, rather than a Certificate of Amendment. The Articles of Amendment would only need to conform to the current version of the Texas Business Corporation Act.

[72] TBOC § 402.001(b).

replaced the former classification regulations.[73] Entities will now have the assurance of either partnership or corporate classification under a set of default rules or the ability to make an election to obtain the desired classification.[74] Although the four factor technical analysis of the IRS's 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:[75]

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")).[76] 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.[77] 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).[78] Among the entities that the Check-the-Box Regulations automatically classify as corporations are over 85 specific types of foreign business entities.[79] 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.[80]

b. The Default Rules

The default rules under Treas. Reg. § 301.7701-3(b)(1) provide that a domestic eligible entity, 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, (ii) an association taxable as a corporation if no member has unlimited liability, or (iii) disregarded as a separate entity if it has a single owner with unlimited liability.

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[73] T.D. 8697, 1997-1 C.B. 215.

[74] Treas. Reg. § 301.7701-3(a) (as amended in 2006).

[75] § 301.7701-3(a).

[76] *Id.* § 301.7701-2(a), -4.

[77] *Id.* § 301.7701-1(a)(2).

[78] *Id.* § 301.7701-2.

[79] *Id.* § 301.7701-2(b)(8)

[80] *Id.* § 301.7701-3(a).

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).[81] 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.[82]

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 if (i) the entity had a reasonable basis[83] 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.[84] 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.[85] 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.[86] If an entity elects to change its classification, there can be severe adverse consequences, and tax counsel should be consulted.

3. Former Classification Regulations

Prior to January 1, 1997, under former Treasury Regulation section 301.7701-2,[87] 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

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[81] *Id.* § 301.7701-3(c).

[82] *Id.* § 301.7701-3(g)(2).

[83] The term "reasonable basis" has the same meaning as under I.R.C. § 6662, which addresses the accuracy-related penalties. *See* I.R.C. § 6662 (West Supp. 2008). The "reasonable basis" standard is far from clear; however, it is significantly stronger than "not frivolous" and may be at least as high a standard as "more likely than not." *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).

[84] Treas. Reg. § 301.7701-3(h)(2).

[85] *Id.* § 301.7701-3(b)(3).

[86] *Id.* § 301.7701-3(f)(2).

[87] 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).

of the four corporate characteristics, it would have been classified as a corporation for purposes of federal income taxation; however, 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 they may be embodied in existing partnership and LLC agreements and may be encountered in drafts of new documents based on old precedent for years to come. 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 a dissolution of the organization (hereinafter, "Dissolution Event").[88] If the occurrence of a Dissolution Event causes 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.[89] Some states, including Texas, allow the partners of a partnership or members of an LLC to provide in the partnership agreement or articles of organization for a self-executing "right to continue" the business in the event of a Dissolution Event.[90] 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 classification of the entity as a partnership for federal income tax purposes.[91] Because

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[88] 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).

[89] 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).

[90] *See, e.g.*, LLC Act arts. 3.02(9), 6.01(B); TBOC § 101.052.

[91] *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.

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.[92] 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.[93] 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.[94] To negate the characteristic of limited liability under the Former Classification Regulations, tax lawyers advised that the general partner should have substantial assets. The capitalization of the general partner is of reduced importance from a tax standpoint under the Check-the-Box Regulations.[95]

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.[96] Free transferability does not exist if, under local law, the transfer of a member's interest results in the dissolution of the old entity and the formation of a new entity.[97] 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

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[92] 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 87, at § 2.02.

[93] Former Treas. Reg. § 301.7701-2(d)(1).

[94] Former Treas. Reg. § 301.7701-2(d)(2).

[95] In contrast to the Former Classification Regulations in the Former Treas. Reg. § 301.7701 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.

[96] 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, 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).

[97] Former Treas. Reg. § 301.7701-2(d)(2).

transfer.[98] 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.

E. Texas Entity Taxation

1. Corporations and LLCs, but not Partnerships, Subject to Pre-2007 Franchise Tax

Through December 31, 2006, corporations and LLCs were subject to the former version of the Texas franchise tax,[99] which was equal to the greater of (i) 0.25% of its "taxable capital" (generally owners' equity) and (ii) 4.5% of its "net taxable earned surplus." "Net taxable earned surplus" was computed by determining the entity's reportable federal taxable income, 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,[100] or (y) the LLC has not more than 35 members.[101] 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 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. 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.[102]

2. Franchise Tax Change Proposals

Efforts to reduce Texas' dependence on property taxes to fund the 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 franchise tax.[103] The 2005 Texas Legislature

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[98] 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.

[99] TEX. TAX CODE § 171.001 (Vernon 2002 & Supp. 2004).

[100] *Id.* § 171.110(b).

[101] 34 TEX. ADMIN. CODE § 3.558(b)(10) (2002) (Public Finance, Franchise Tax, Earned Surplus: Officer and Director Compensation).

[102] *See, e.g.,* Comptroller Taxpayer Response Letter Accession No. 9811328L (Nov. 30, 1998).

[103] *See* Tex. H.B. 3146, 78th Leg., R.S. (2003), *available at* http://www.legis.state.tx.us/home.aspx (select the "78(R) - 2003" Legislature, select Bill Number, then fill in "HB 3146" in the space below). House Bill 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/home.aspx (select "79(R) - 2005" Legislature, select Bill Number, then fill in "HB 3" in the space below). House Bill 3, as passed by the House on March 14, 2005, would enact a Reformed Franchise Tax which would apply to most business entities, including most corporations, LLCs and partnerships, and allow them to

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*, 176 S.W.3d 746 (Tex. 2005). 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. Reductions for the 2006 tax year sufficient to comply with the Supreme Court's mandate must be provided immediately[, and]
>
> [(2)] The Legislature should reform the state's franchise 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[%] . . . [,]

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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 requires 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 include most corporations, LLCs and partnerships as "taxable entities," and would allow 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.

> [(c)] Basing the franchise tax on a business' margin by allowing each business to choose between two calculations: 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)] Doubling the small-business exemption from $150,000 to $300,000 in total revenue and exempting sole proprietors and non-corporate general partnerships.[104]

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 ("H.B. 3").[105] H.B. 3 amends Texas Tax Code Chapter 171[106] 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 H.B. 3928.

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.[107] Thus, corporations, limited partnerships, certain general

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[104] 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/TTRC_report.pdf.

[105] Tex. H.B. 3, 79th Leg., 3d C.S. (2006) (hereinafter H.B. 3); the text of H.B. 3 can be viewed in its entirety at the following link: http://www.legis.state.tx.us/tlodocs/793/billtext/pdf/HB00003I.pdf.

[106] Chapter 171 of the Texas Tax Code was modified and largely replaced by the provisions of 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 H.B. 3 and in 2007 by H.B. 3928. H.B. 3928 by Rep. Jim Keffer, 80th Leg., R.S. (2007), *available at* http://www.capitol.state.tx.us/home.aspx (select the "80(R) - 2007" Legislature, select Bill Number, then fill in "HB 3928" in the space below).

[107] Texas Tax Code section 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:
>
> (1) a sole proprietorship;
>
> (2) a general partnership:

partnerships, LLPs, LLCs, business trusts, and professional associations are subject to the Margin Tax. The Margin Tax is <u>not</u> imposed on sole proprietorships, general partnerships that are owned 100% by natural persons,[108] certain narrowly defined passive income entities[109]

(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.

[108] Since an LLP is classified under both the TRPA and the TBOC as a species of general partnership, under a literal reading of 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. H.B.3928 resolved this issue by amending Texas Tax Code section 171.0002 to expressly provide that an LLP is subject to the Margin Tax.

[109] TEX. TAX CODE ANN. section 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 (including certain real estate investment trusts ("REITs")),[110] grantor trusts,[111] estates of a

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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 section 171.004 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.

[110] 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(a)(8).

[111] An interpretative question under 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

natural person, an escrow,[112] or a REMIC.

b. Passive Entities

Passive entities must have at least 90% of their federal gross income[113] from partnership allocations from downstream non-controlled flow through entities, dividends, interest, royalties, or capital gains from the sale of (i) real estate,[114] (ii) securities, or (iii) commodities. It is important to note that real estate rentals as well as other rent and income from 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."[115] In addition, only non-business trusts, general partnerships, and limited partnerships can qualify as passive entities. LLCs and 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 isolate the passive income sources into an entity that will qualify as a tax exempt passive entity.[116]

New Comptroller Rule 3.582, effective January 1, 2008, 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.[117] So for example, if an LLC with substantial real estate rents plans to convert to an LP for a year in which it will

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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 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.)

112 TEX. TAX. CODE ANN. § 171.0002(c).

113 34 Texas Administrative Code section 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)."

114 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).

115 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.")

116 H.B. 3 section 22 raises some question about whether or to what extent partnership divisions will be honored. For example, H.B. 3 section 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* H.B. 3 § 22.

117 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*).

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.[118] 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,[119] but the passive entity owner will still have to independently pass the 90% passive source test.

c. LLPs

The 2007 Texas Legislature clarified (or expanded) the scope of the Margin Tax to apply to LLPs, but the Comptroller has determined that LLPs can qualify to be passive entities if they otherwise meet the 90% test for passive revenue.[120]

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 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.[121]

e. Small Business Phase-In

Taxable entities that have $300,000 (with CPI adjustments for later years) or less in gross revenue in a year, or whose Margin Tax liability is less than $1,000, are also exempt for that year.[122] Taxable entities that have less than $900,000 in gross revenue[123] in a year become subject to the Margin Tax on the following schedule:

$0 ≥ $300K	100% discount
$300K ≥ $400K	80% discount
$400K ≥ $500K	60% discount
$500K ≥ $700K	40% discount
$700K ≥ $900K	20% discount

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[118] 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.")

[119] 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.")

[120] 34 TEX. ADMIN. CODE § 3.582(c)(1)(C).

[121] *See, e.g.,* TEX. TAX CODE ANN. § 171.088.

[122] *Id.* § 171.0002(d)(2).

[123] *Id.* § 171.0021.

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 deductions for either (x) compensation or (y) cost of goods sold ("COGS"). 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. There is a safety net so that the "tax base" for the Margin Tax may not exceed 70% of a business's total revenues.[124] 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.

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 "***7. Internal Partnerships Will Not Work Under Margin Tax***" would no longer work as described.

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)[125] or IRS Form 1065 (for partnerships and other pass-through entities)[126] <u>plus</u> dividends, interest, gross rents and royalties, and net capital gain income,[127] <u>minus</u> bad debts, certain foreign items, and income from related entities to the extent already included in the margin tax base.[128]

h. Gross Revenue

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 <u>law</u> or <u>fiduciary duty</u> to be distributed to other entities (such as sales and other taxes collected from a third party and remitted to a taxing authority); [129] (B) the following flow-through funds that are required by <u>contract</u> to be distributed to other entities: (i) sales commissions paid to non-employees (including split-fee real estate commissions);[130] (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";[131] and (iii) law firms may exclude the amounts they are obligated to pay over to

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[124] *See id.* § 171.101.

[125] *Id.* § 171.1011(c)(1).

[126] *Id.* § 171.1011(c)(2).

[127] *Id.* § 171.1011(c)(1)(A).

[128] *Id.* § 171.1011(c)(1)(B).

[129] *Id.* § 171.1011(f).

[130] *Id.* § 171.1011(g)(1).

[131] *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

clients and referring attorneys, matter specific expenses, and pro-bono out-of-pocket expenses not to exceed $500 per case;[132] (C) the federal tax basis of securities and loans underwritten or sold;[133] (D) lending institutions may exclude loan principal repayment proceeds;[134] (E) dividends and interest received from federal obligations;[135] (F) reimbursements received by a "management company"[136] 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.[137]

Health care providers[138] may generally exclude payments received under the Medicaid, Medicare, Children's Health Insurance Program ("CHIP"), workers' compensation, the

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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.

[132] Texas Tax Code section 171.1011(g-3) allows legal service providers to exclude flow-through receipts as follows:

> A taxable entity that provides legal services shall exclude from its total revenue:
>
> (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.

[133] TEX. TAX CODE § 171.1011(g)(2), (g-2).

[134] *Id.* § 171.1011(g-1).

[135] *Id.* § 171.1011(m). "Federal obligations" are defined in Texas Tax Code section 171.1011(p)(1) to include stocks and other direct obligations of, or obligations unconditionally guaranteed by, the U.S. and U.S. government agencies.

[136] *Id.* § 171.1011(m)(1). "Management company" is defined in Texas Tax Code section 171.1001(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.

[137] "Staff leasing services company" for these purposes has the meaning set forth in section 91.001 of the Texas Labor Code. TEX. LAB. CODE ANN. § 91.001 (Vernon 2008).

[138] "Health care providers" are defined in Texas Tax Code section 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."

TRICARE military health system, the Indigent Health Care and Treatment Act, as well as the actual costs of "uncompensated care."[139] Health care institutions[140] may exclude 50%[141] 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.[142] 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).[143]

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. It also includes "net distributive income" from partnerships, limited liability companies, and S Corporations to natural persons,[144] 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.[145] The deduction for wages and cash compensation may not exceed $300,000 plus benefits that are deductible for federal income tax purposes for any single person.[146] Compensation apparently does not include social security or Medicare contributions, and such amounts apparently are not otherwise deductible for Margin Tax purposes.

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;[147] 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.

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[139] TEX. TAX CODE § 171.1011(n).

[140] *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; a hospital system; an certain intermediate care facilities for mentally retarded persons; birthing centers; nursing homes; end stage renal facilities; and pharmacies.

[141] *Id.* § 171.1011(o).

[142] *Id.* § 171.1011(r).

[143] *Id.* § 171.1011(s).

[144] *Id.* § 171.1013(a)(1)–(2).

[145] *Id.* § 171.1013(a)(3).

[146] *Id.* § 171.1013(c).

[147] *Id.* § 171.1012(a)(1).

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.[148] 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.[149] 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.[150] 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.[151] The "cost of goods sold" must be capitalized to the extent required by I.R.C. §263A.[152]

k. Transition and Filing

The Margin Tax is being 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 May 2008 Margin Tax payment is based on business in calendar year 2007.

Regular annual Margin Tax returns are due on May 15[153] of each year, and are based on financial data from the previous calendar year. The first Margin Tax returns are due on May 15, 2008,[154] and they are based on financial data beginning January 1, 2007. For state revenue estimating purposes, the 1000 largest businesses paying the Texas franchise tax were required to file an information return with their franchise tax filing indicating what the taxpayer's "Margin Tax" liability would have been.[155]

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 on a unitary and combined basis. An affiliated group of entities in a "unitary business"[156] must file a combined return including

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148 *Id.* § 171.1012(c).

149 *Id.* § 171.1012(c)–(d).

150 *Id.* § 171.1012(e).

151 *Id.* § 171.1012(f).

152 *Id.* § 171.1011(g).

153 *Id.* § 171.151(c).

154 *See* Tex. H.B. 3, § 22.

155 *See* Tex. H.B. 3, § 23.

156 Texas Tax Code section 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."

all taxable entities within the group.[157] The unitary group includes all affiliates[158] with a common owner (i.e., greater than 50% owned),[159] and the group includes entities with no nexus in Texas.[160]

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."[161] The application of this standard proved unworkable, and the Comptroller's Rule 3.590[162] 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.[163]

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.
>
> (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

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[157] *Id.* § 171.1014.

[158] 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] *Id.* § 171.0001(1).

[159] *Id.* § 171.0001(8).

[160] *See id.* § 171.1014(c).

[161] *Id.* § 171.0001(1).

[162] 34 TEX. ADMIN. CODE § 3.590 (Public Finance, Margin: Combined Reporting) (Effective January 1, 2008).

[163] *Id.* § 3.590 (b)(4)(E).

Liability Company C.[164]

The combined group does not include entities with 80% or more of their property and payroll outside the United States.[165] Passive entities or exempt entities are not part of the group.[166]

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.[167] 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.[168]

n. Apportionment

The Margin Tax is apportioned using a single-factor gross receipt formula (Texas gross receipts divided by aggregate gross receipts).[169] Receipts that are excluded from the tax base must also be excluded from gross receipts for apportionment purposes.[170]

Texas gross receipts includes 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.[171] 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).[172] 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).[173]

Aggregate gross receipts shall 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.[174] 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.[175]

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164 *Id.* § 3.590.

165 TEX. TAX CODE § 171.1014(a).

166 An affiliated group may elect to include an exempt entity that is not required to be included. *See id.* § 171.1014(g).

167 *Id.* § 171.1014(d).

168 *Id.* § 171.1014(c)(3).

169 *Id.* § 171.106(a).

170 *Id.* § 171.1055(a).

171 *Id.* § 171.103(a).

172 *Id.* § 171.103(b).

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

174 *Id.* § 171.105(c).

175 *Id.* § 171.105(b).

o. Credits / NOL's

Comptroller Rule 3.594 (effective January 1, 2008) describes the limited ability of a taxpayer to utilize NOL's as a credit against the Texas margin tax.[176] One initial qualification is that any business losses upon which NOL's are based must have been used to offset any positive amount of earned surplus even in years when no tax was due.[177] In addition, taxpayers must submit a notice of intent to preserve the right to claim the temporary credit for business loss carryforwards with the first report due from a taxable entity after January 1, 2008, on a form prescribed by the Comptroller.[178] A taxable entity may only claim the credit if the entity was subject to franchise tax on May 1, 2006.[179] 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.[180]

"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."[181] 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%.[182] For report years 2018–2027: the credit for the business loss carryforward amount x 7.75% x 4.5%.[183]

p. Administration and Enforcement

The Comptroller will have rulemaking authority with respect to the Margin Tax. The former Comptroller, Carole Keeton Strayhorn, requested an Attorney General's Opinion on whether the new margin tax safely avoids classification as an income tax that could be in violation of the Bullock amendment in the Texas Constitution.[184]

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.[185]

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[176] 34 TEX. ADMIN. CODE § 3.594 (2007) (Public Finance, Franchise Tax, Margin: Temporary Credit).

[177] *Id.*

[178] *Id.*

[179] *Id.*

[180] *Id.*

[181] *Id.*

[182] *Id.*

[183] *Id.*

[184] *See* discussion *infra* Part 4. Constitutionality of Margin Tax.

[185] *See* discussion *infra* Part V. Limited Liability Company—B. Taxation—2. Other Tax Issues Relating to LLCs—(e) Self-Employment Tax.

4. Constitutionality of Margin Tax

Proponents of the Margin Tax claim that it is not an income tax because its name and deduction scheme differ from the income tax imposed by the IRC, although revenue, cost of goods sold and other computations would be based on amounts from specified lines in a federal income tax return, and it is imposed at the entity rather than the individual level. On August 3, 2006, however, the Financial Accounting Standards Board ("FASB") found that the Margin Tax is an income tax for the purposes of financial statements prepared in accordance with generally accepted accounting principles for financial reporting in the U.S. ("GAAP").[186] Others also disagree, particularly in the case of a partnership providing professional services (e.g., accounting, engineering, law, or medical), and refer to Texas Constitution article 8, section 24(a) (often referred to as the "Bullock Amendment"), which 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*]

Former Comptroller Strayhorn has written that portions of 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."[187] In a letter to the Attorney General of Texas requesting a formal opinion[188] whether H.B. 3 requires voter approval under the Bullock Amendment, Comptroller Strayhorn wrote: [189]

> 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."

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186 *See* discussion *infra* Part 5. Classification of Margin Tax Under GAAP.

187 Letter from Carole Keeton Strayhorn, Texas Comptroller of Public Accounts, to Rick Perry, Texas Governor (May 2, 2006), http://www.cpa.state.tx.us/news/60502taxplan.pdf.

188 Letter from Barry McBee, First Assistant Attorney General, to Deirdre Delisi, the Chief of Staff of Texas Governor Rick Perry (April 17, 2006) (on file with author) (stating that, "although a court may disagree," the Margin Tax would not be subject to the Bullock Amendment because it is an entity level tax.) The Comptroller's request did not view the First Assistant Attorney General's letter as an Attorney General opinion.

189 Letter from Carole Keeton Strayhorn, Texas Comptroller of Public Accounts, to Greg Abbott, Texas Attorney General (April 21, 2006) (on file with author).

"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.

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

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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.

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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 1/2 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.

As former Comptroller Strayhorn contended, the Bullock Amendment's language encompasses an income tax on a partnership interest attributable to a natural person, whether imposed at the partnership or individual level, by its reference to "a person's share of partnership and unincorporated association income." This plain language makes no distinction between general partnerships, limited partnerships and limited liability partnerships, and applies even if the partnership is viewed as a separate legal entity.[190]

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[190] *See* Bishop v. District of Columbia, 401 A.2d 955 (D.C. 1979), in which the imposition of the District of Columbia tax on unincorporated businesses at the partnership level was challenged by partners in District of Columbia law firms who were residents of surrounding states on the basis that it was actually a prohibited tax on the personal incomes of non-residents under the District of Columbia Home Rule Act, D.C. CODE ANN. § l-206.02(a)(5), which prohibited a tax on the personal income of non-residents; the District of Columbia Court of Appeals held that "as to the characterization of the tax, it is fundamental that the nature and effect of the tax, not its label, determine if it is an income tax or not" and concluded that "since the tax is on unincorporated business, [it] is therefore in reality a tax on the associates or partners who run the business."

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.[191] The minutes of its 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

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[191] *See* Peggy Fikac, *'Income tax' is a loaded label for business levy—Perry opponents get fired up after accounting board calls it just that*, (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 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.

Texas-sourced.[192] 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 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 under the Margin Tax, transforming a corporate entity into a limited partnership structure previously was an expensive and time consuming procedure 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 has evolved, utilizing the Check-the-Box Regulations and the conversion procedures added in recent years to the TBCA, the TRLPA, and the TRPA.[193] 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,[194] released by the IRS in December 1999, 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).

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

193 *See* discussion *infra* Part E. Business Combinations and Conversions—2. Conversions.

194 Rev. Proc. 99-51, 1999-52 I.R.B. 761 (December 27, 1999).

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.[195] However, in Revenue Procedure 99-51 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 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.

F. 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).[196] 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.

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

[196] TBCA art. 5.01, § A; LLC ACT art. 10.01, § A; TRLPA § 2.11; TRPA § 9.02; TBOC § 10.001.

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 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.[197] 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.[198]

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.[199] 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."[200]

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[197] TBCA art. 5.02 § A; LLC Act arts. 10.01, 10.06; TRLPA § 2.11; TRPA § 9.03; TBOC § 10.051.

[198] TBCA art. 5.02 § A; LLC Act arts. 10.01, 10.06; TRLPA § 2.11; TRPA § 9.03; TBOC §§ 10.151–.153.

[199] *See* TBCA arts. 5.09, 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, 287–88 (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 (1987).

[200] *See* Gimbel v. The Signal Cos, 316 A.2d 599 (Del. Ch. 1974) (holding that assets representing 41% of net worth but only 15% of gross revenues were not to be "substantially all"); Katz v. Bregman, 431 A.2d 1274 (Del. Ch. 1981) (holding that 51% of total assets, generating approximately 45% of net sales, to be "substantially all"); and Thorpe v. CERBCO, Inc., 676 A.2d 436 (Del. 1996) (holding that the sale of subsidiary with 68% of assets, which was primary income generator, is "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 denied*, 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;

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

Difficulties in determining when a shareholder vote is required in Delaware led Texas to adopt a bright line test. TBCA arts. 5.09 and 5.10 provide, 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.[201] Under TBCA art. 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 vote against the sale can perfect appraisal rights. TBCA art. 5.09(A) provides 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 art. 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.[202]

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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"), and (4) that the "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* 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, section10.2 (3d ed. Supp. 2008). To address the uncertainties raised by dicta in Vice Chancellor Strine's opinion in *Hollinger*, DGCL section 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").

[201] *See* Egan and Huff, *supra* note 199, at 287–90.

[202] 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 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

TBOC sections 21.451 and 21.455 carry forward TBCA arts. 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.[203] 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.[204]

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.[205]

Texas has legislatively repealed the *de facto* merger doctrine in TBCA art. 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."[206] TBOC section 10.254 carries

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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*, *supra* note 200, at 855–60.

[203] *See* TBOC § 153.152.

[204] 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.

[205] *See* Knapp v. N. Am. Rockwell Corp., 506 F.2d 361 (3d Cir. 1974); Phila. Elec. Co. v. Hercules, Inc., 762 F.2d 303 (3d Cir. 1985); SmithKline Beecham Corp. v. Rohm & Haas Corp., 89 F.3d 154 (3d Cir. 1996); Cargo Partner AG v. Albatrans Inc., 352 F.3d 41 (2d Cir. 2003).

[206] 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.

forward TBCA art. 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.[207] 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. The TBOC and the older Texas entity statutes all 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,[208] a Texas corporation may convert into another corporation or other entity if (i) the conversion is 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.[209] Partnerships, limited partnerships, and LLCs are

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> [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 Egan & Huff, *supra* note 199, at 287–90.

[207] 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 (2002).

[208] TBCA arts. 5.17–.20; TBOC §§ 10.101–.151, 10.154–.203.

[209] TBOC § 10.101. Under TBOC section 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, or 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;

afforded comparable rights.[210]

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.[211]

1. Conversions of Entities Classified as Partnerships

There generally should be no federal income tax consequences arising from the conversion of an entity classified as a domestic partnership for federal income tax 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,

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(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.

[210] *See* TBOC § 10.101. The comparable provisions for such entities governed by pre-TBOC law are found for LLCs at LLC Act sections 10.08–.11, for limited partnerships at TRLPA section 2.15, and for general partnerships at TRPA sections 9.01, 9.05 and 9.06.

[211] *See* Monte A. Jackel & Glen E. Dance, *Selected Federal Income Tax Aspects of Changing the Tax Status of Business Entities*, 3 PLI/TAX STRATEGIES 255 (1997).

and the entity's business and assets remain substantially unchanged.[212] 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 when 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.[213] 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.[214] 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.[215]

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.[216] Nevertheless, with careful planning, most conversions of this type can be accomplished without recognition of gain.[217]

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.[218] A corporation cannot be 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

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212 *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.

213 Rev. Rul. 99-6, 1999-1 C.B. 432.

214 *See* I.R.C. § 731 (1997); I.R.C. § 736 (1993); I.R.C. § 751(b) (2004); Treas. Reg. § 301.7701-3(g) (2006).

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

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

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

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

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.[219] 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.[220] 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.[221] 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."[222]

G. 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.[223]

H. 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.

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[219] I.R.C. § 336 (1988).

[220] I.R.C. § 331(a) (1982).

[221] 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).

[222] Op. Tex. Att'y Gen. No. JC-0126 (1999).

[223] *See* William H. Hornberger & James R. Griffin, Stock Options and Equity Compensation, Address at the 47th Annual Texas CPA Tax Institute (Nov. 14–16, 2000), *available at* http://images.jw.com/com/publications/56.pdf.

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,[224] which was amended in 1997 by S.B. 555,[225] in 2003 by H.B. 1165, in 2005 by H.B. 1507, and in 2007 by 1737. However, corporations formed after January 1, 2006 are organized under and governed by the TBOC. For entities formed before that date, only the ones voluntarily opting into the TBOC, or converting to a Texas entity on or after January 1, 2006, will be governed by the TBOC, until January 1, 2010, at which time all Texas corporations will be governed by the TBOC.[226]

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."[227] However, because until 2010 some Texas for-profit corporations will be 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.

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[224] TBCA arts. 1.01 *et. seq.*

[225] Tex. S.B. 555, 75th Leg., R.S. (1997).

[226] 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).

[227] 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 marginal corporate tax rates, based on taxable income for 2006 are generally as follows:

Taxable Income	Marginal Tax Rate
$0–50,000	15%
$50,001–75,000	25%
$75,001–100,000	34%
$100,001–335,000	39%
$335,001–10,000,000	34%
$10,000,001–15,000,000	35%
$15,000,001–18,333,333	38%
> $18,333,333	34%

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.[228] There can also be corporate level taxes on excessive accumulations of earnings.

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; however, a C-corporation's shareholders are not subject to self-employment tax on distributions they receive. Additionally, a C-corporation can carry forward any unused losses and credits. 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,[229] 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.

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[228] *See* Pediatric Surgical Assocs., P.C. v. Comm'r of Internal Revenue, T.C.M. 2001-81 (2001) (disallowing 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).

[229] *See* I.R.C. § 336 (1988); I.R.C. 337 (1988).

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. 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,[230] 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.[231]

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 to him.[232] To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year.[233]

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),[234] (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),[235] (iii) have no more than one class of stock,[236] and (iv) have no shareholders other than individuals who are residents or citizens of the United States and certain trusts, estates, or exempt organizations (e.g., qualified employee benefit plans and I.R.C. § 501(c)(3) organizations).[237] 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

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[230] I.R.C. § 1374 (1989); Treas. Reg. § 1.1374-1 (2005).

[231] I.R.C. § 1374 (1989).

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

[233] I.R.C. § 1366(d)(2)(A) (2007).

[234] I.R.C. § 1361(b)(1), (c).

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

[236] I.R.C. § 1361(b)(1)(D) (2005); *see* discussion *supra* Part I. General: E. Texas Entity Taxation—7. Conversions (discussing the single class of stock requirement as applied to limited partnerships electing corporation status under Check-the-Box Regulations).

[237] I.R.C. § 1361(b)(1)(B)–(C), (c)(6) (2005).

QSSS.[238] 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.[239]

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 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.[240]

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 control 80% of the voting power and 80% of the total shares of the corporation immediately after the transfer.[241]

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.[242] 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.[243]

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[238] Paul G. Klug & Jay Nathanson, *Small Business Job Protection Act of 1996 Increases the Attractiveness of S Corporations*, 53 J. MO. B. 219, 221 (1997).

[239] I.R.C. § 1362(d)(1)–(3) (2005).

[240] *See* BITTKER & EUSTICE, *supra* note 87, at § 6.04.

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

[242] *See* discussion *supra* Part I. General—E. Texas Entity Taxation—3. Margin Tax.

[243] TEX. TAX CODE ANN. § 171.001 (Vernon 2002).

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.[244]

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.[245] 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.[246] While this general rule of nonliability is given great deference by the courts, 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*,[247] the Texas Supreme Court enumerated circumstances under which the corporate entity will 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.[248] Under TBCA article 2.21, as

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[244] 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 & William L. Raby, *Attempting to Avoid FICA and Self-Employment Tax*, 93 TAX NOTES 803, 803–06 (2001).

[245] 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).

[246] *Id.*; Sutton v. Reagan & Gee, 405 S.W.2d 828 (Tex. Civ. App.—San Antonio 1966, writ ref'd n.r.e.).

[247] Castleberry v. Branscum, 721 S.W.2d 270, 272 (Tex. 1986).

[248] 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.

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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.).[249]

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.[250] Shareholders elect directors, who are given the power to manage the affairs of the corporation generally, as well as to formulate policies and objectives.[251] Shareholders retain the power to vote on certain major matters.[252] Directors appoint officers, who are delegated the authority to

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> 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.

[249] TBCA art. 2.21 (emphasis added); TBOC § 21.223; S. Union Co. v. City of Edinburg, 2003 WL 22495756 (Tex. 2003) (repudiating the single business enterprise doctrine, and holding that "[s]ince 1993 . . . [S]ection A of [A]rticle 2.21 is the exclusive means for imposing liability on a corporation for the obligations of another corporation in which it holds shares" and that actual fraud is required to be plead and proved in a veil piercing case based on a contract claim); *See* Egan & Huff, *supra* note 199, at 301–02; *see also* Bromberg et al., *Role of the Business-Updated*, *supra* note 7, at 64, 67 and 72 (2005); Bromberg et al., *Role of the Business-Original*, *supra* note 7, at 2, 19, 22; James G. Gaspard, III, *A Texas Guide to Piercing and Preserving the Corporate Veil*, 31 BULL. OF BUS. L. SEC. OF THE ST. B. OF TEX. 24 (Sept. 1994). The later two articles were written prior to, and thus do not reflect, the changes to TBCA article 2.21 effected in 1997. Some courts, however, continue to ignore TBCA article 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 Chihuahua, S.A. de C.V. v. Intermodal Sales Corp., 162 S.W.3d 581, 586–87 (Tex. App.—El Paso 2005, no pet.).

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

[251] 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.").

[252] TBCA art. 2.28 and TBOC section 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 section 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 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.[253] 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.[254] 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 the articles of incorporation, the certificate of formation, or the bylaws approved by all of the shareholders, or in a written agreement signed by all of the shareholders.[255] Thus, the

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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.

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, 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).

[253] *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).

[254] TBCA arts. 12.11, 12.13, 12.31; TBOC §§ 3.008, 21.703, 21.713.

[255] TBCA art. 2.30-1 and TBOC section 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;

management structure of corporations is generally flexible enough to allow both centralized management and decentralized management, depending on the needs of the corporation's owners.

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(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 Article 2.38 (or TBOC section 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 Article 6.02 or TBOC sections 21.501–.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 Article 2.30-1 or TBOC section 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 Article 2.30-1 or Section 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.

Article 2.30-1(G) and TBOC Section 21.107 provide that the existence or performance of an Article 2.30-1 or Section 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, Article 2.30-1 and TBOC Section 21.107 provide protection beyond Article 2.21 and TBOC Section 21.223 on shareholder liability.

E. Fiduciary Duties

1. General

Directors of a corporation owe fiduciary duties of care, loyalty, and obedience to the corporation.[256] The duty of care requires directors to exercise the degree of care that an ordinarily prudent person would exercise under similar circumstances.[257] 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.[258] 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.[259] Generally the duty of loyalty prohibits a director from usurping business opportunities that otherwise might be pursued by the corporation;[260] however, Texas law permits 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.[261] The duty of obedience requires directors to obey the law and the articles of incorporation.[262] Controlling shareholders owe a fiduciary duty to the minority shareholders to deal fairly with them.[263]

2. Business Judgment Rule

The business judgment rule provides a degree of protection to decisions made by

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[256] Gearhart Indus., Inc. v. Smith Intern. Inc., 741 F.2d 707 (5th Cir. 1984); *see* Byron F. Egan, *Governance Principles for Board Committee Members*, *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=717; Egan & Huff, *supra* note 199, at 259–70.

[257] Gearhart, 741 F.2d at 720.

[258] *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); *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).

[259] *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).

[260] 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).

[261] TBCA art. 2.02(20), TBOC § 2.101(21).

[262] *Gearhart*, 741 F.2d at 719.

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

corporate directors. Under the business judgment rule, directors are presumed to have satisfied their fiduciary duties in making a business decision.[264] 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.[265] Under Texas law, the business judgment rule appears to be more favorable to directors than under Delaware law, because directors' actions are presumed to be valid if no conflict of interest exists, and the action is not *ultra vires* or tainted by fraud.[266]

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.[267]

4. Limitation of Director Liability

Texas Miscellaneous Corporation Laws Act (the "TMCLA") article 1302-7.06 provides that a Texas corporate entity governed in whole or in part by the TBCA, the Texas Non-Profit Corporation Act, the Finance Code, or the TMCLA may provide in its articles of incorporation, as initially filed or by amendment, that a director shall not be liable to the corporation or its shareholders for an act in the director's capacity as a director, except to the extent that the director is found liable for (i) a breach of the duty of loyalty to the corporation or its shareholders, (ii) an act or omission not in good faith that constitutes a breach of duty to the corporation, or that involves intentional misconduct, or a knowing violation of law, (iii) a transaction from which the director received an improper personal benefit, or (iv) an act or omission for which the liability of the director is expressly provided by statute.[268] Sections 7.001(b) and (c) of the TBOC allow for similar such limitation of director liability for corporate entities governed by the TBOC. Neither the TMCLA nor the TBOC authorizes the limitation of liability of an officer or a director acting in the capacity of an officer.[269]

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

265 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, *Fiduciary Duty Update: Delaware and Texas*, *available at* http://images.jw.com/com/publications/855.pdf; Egan & Huff, *supra* note 199, at 263–70.

266 *See Gearhart*, 741 F.2d at 719–21; Egan & Huff, *supra* note 199, at 260–63.

267 *Gearhart*, 741 F.2d at 720.

268 *See* Egan & Huff, *supra* note 199, at 272–73; Egan & French, *supra* note 199, at 16–21.

269 *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 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. Ch. 193l); Hollaway 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 & Cindy A. Schipani, *The Intersection of State*

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.[270] Different classes and series of common stock and preferred stock may be utilized to accommodate the desires of various types of investors.[271] Equity can be raised at the base level by common stock as well as at levels ranking above the common stock by preferred stocks.[272] 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.

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.[273] The Tex. Corp. Stats. provide that, among other restrictions, rights of first refusal and limitations on transfer necessary to maintain S-corporation status or other tax advantages are reasonable restrictions on transfer.[274] 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.[275] Because 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.

Corporation Law and Employee Compensation Programs: Is it Curtains for Veil Piercing?, 1996 U. ILL. L. REV. 1059, 1078–79 (1996); *cf.* Centurion Planning Corp.. v. Seabrook Venture II, 176 S.W.3d 498, 509 (Tex. App.—Houston [1st Dist.] 2004). The corporation may also be liable under *respondeat superior*.

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

271 *See id.* at 357–59.

272 *See id.*

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

274 TBCA art. 2.22(D), (H); TBOC § 21.211.

275 TBCA art. 2.22(B), (C); TBOC §§ 21.210, 21.213.

2. Securities Law Restrictions

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

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.[276] Because 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.[277] 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 because 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 $300 filing fee.[278] Under the TBOC, a certificate of formation is the proper filing document.[279] The articles of incorporation or certificate of formation (either of them being hereinafter referred to as the "corporation's governing document") establishes the initial board of directors and capital structure of the corporation. After the Secretary of State officially acknowledges the filing of the corporation's governing document,[280] there should be an organizational meeting of the initial board of

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[276] 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."

[277] TBOC § 3.003.

[278] TBCA arts. 3.02–.03.

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

[280] TBOC § 4.002. Under pre-TBOC law, the Secretary of State would issue a Certificate of Incorporation once

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.[281] 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 governing document.[282] Although the initial bylaws 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.[283] In the absence of a contrary provision in the corporation's governing document, the TBCA or the TBOC, bylaws may be adopted or amended either orally or by acts evidenced by a uniform course of proceeding or usage and acquiescence.[284]

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.[285]

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.[286] 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.,[287] 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

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a corporation properly filed its Articles of Incorporation.

[281] TBCA art. 3.06; TBOC § 21.059.

[282] TBCA art. 2.33A; TBOC § 21.057.

[283] TBCA art. 2.23; TBOC § 21.058.

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

[285] *See* CT CORPORATION, WHAT CONSTITUTES DOING BUSINESS (2008).

[286] *See* TBCA Part Five; TBOC Chapter 10.

[287] TBCA arts. 5.17–.20. Comparable provisions are found for LLCs at LLC Act §§ 10.08–.11, for limited partnerships at TRLPA § 2.15, and for general partnerships at TRPA §§ 9.01, 9.05–.06. The TBOC contains substantially similar provisions, all consolidated in Chapter 10, Subchapter C.

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. The Texas Corporate Statutes require shareholder approval of the sale of all or substantially all of the assets of the corporation in certain circumstances.[288]

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.[289] These anti-takeover provisions (i) apply only to an "issuing public corporation,"[290] and (ii) prohibit a "business combination,"[291] which includes a merger, share exchange, sale of assets, reclassification, conversion, or other transaction between the issuing public corporation and any "affiliated shareholder"[292] 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.[293] 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.[294]

III. GENERAL PARTNERSHIP

A. General

Texas law will only recognize an association or organization as being a "partnership" if it

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[288] *See supra* notes 202–03 and accompanying text.

[289] TBCA arts. 13.01–.08; TBOC §§ 21.601–.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 Am., 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).

[290] "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).

[291] TBCA art. 13.02(A)(4); TBOC § 21.604.

[292] "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.

[293] TBCA art. 13.03 is based on DGCL § 203. *See also* TBOC § 21.606.

[294] TBCA art. 13.06; TBOC § 21.401(b).

was created under (1) the TBOC, (2) the TRPA, (3) the older Texas Uniform Partnership Act ("TUPA"),[295] (4) the Texas Revised Limited Partnership Act ("TRLPA"),[296] or (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.[297] 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.[298] The definition of a partnership is crucial in litigation in which a person is arguing that he is not a partner, and that the partnership disadvantages (e.g., individual, and joint and several liability of the obligations of the partnership) should not be imposed upon him.

The TBOC governs all Texas general partnerships formed on or after January 1, 2006,[299] as well as those formed before that date which voluntarily opt in to TBOC governance.[300] 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."[301] Until January 1, 2010, at which time all partnerships will be governed by the TBOC,[302] all other Texas general partnerships will be governed by the TRPA.[303] Because until 2010 some general partnerships will be 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."[304] The definition of "person" under the new TBOC comes from the Government Code,[305] which provides that "'[p]erson' includes corporation, organization,

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295 *See* statutes cites *supra* note 1.

296 Tex. Rev. Civ. Stat. Ann. art. 6132a-1 (Vernon Supp. 2008).

297 TRPA § 2.02; TBOC § 152.051(c).

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

299 TBOC § 402.001.

300 TBOC § 402.003.

301 TBOC § 1.008(f).

302 TBOC § 402.005.

303 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. B. J. 828 (1994).

304 TRPA § 1.01(14).

305 *See* TEX. GOV'T CODE ANN. § 311.002 (Vernon 2005) (regarding application of the Government Code to construction of other Texas laws).

government or governmental subdivision or agency, business trust, estate, trust, partnership, association, and any other legal entity."[306]

2. *Factors Indicating Partnership*

Under the Tex. GP Stats., the following factors indicate that persons have created a partnership:[307]

- 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.

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:[308]

- 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 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.[309]

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[306] TEX. GOV'T CODE ANN. § 311.005.

[307] TRPA § 2.03(a); TBOC § 152.052(a).

[308] TRPA § 2.03(b); TBOC § 152.052(b).

[309] The statement in TRPA section 2.03(b)(4) and TBOC section 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 35–36 (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

4. *Joint Venture*

The definition of a partnership under Tex. GP Stats. includes a "joint venture" or any other named association that satisfies the definition of "partnership."[310] A joint venture is legally nothing more than a limited purpose partnership, although a joint venture may be organized as a corporation, limited partnership, LLP or LLC.[311] Because a joint venture is a type of partnership and loss sharing is not necessary to form a partnership, Tex. GP Stats. effectively overrule cases in the line represented by *Coastal Plains Development Corp. v. Micrea, Inc.*[312] They also resolve old questions about whether an agreement to share losses was necessary to create a partnership by providing that it is unnecessary.[313]

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.

> 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.
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> * * *
>
> 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.
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> * * *
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> 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.

[310] TRPA § 2.02; TBOC § 152.051(b).

[311] *See* ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP § 2.06 (Aspen Publishers 2003).

[312] *See* Coastal Plains Dev. Corp. v. Micrea, Inc., 572 S.W.2d 285, 287–88 (Tex. 1978).

[313] TRPA § 2.03(c); TBOC § 152.052(c).

2. Joint Venture/Tax Implications

A joint venture is commonly thought of as a limited duration partnership formed for a specific business activity.[314] 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.[315]

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.[316] 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.[317] 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.

4. Texas Entity Taxes

A general partnership was not obligated to pay Texas franchise taxes before January 1, 2007.[318]

The Margin Tax is not applicable to a general partnership if all of its partners are individuals.[319] The Margin Tax is imposed on a general partnership which has a business entity as a partner.[320]

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.[321]

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[314] *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).

[315] I.R.C. § 7701(a)(2) (2006).

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

[317] I.R.C. § 722 (1984); I.R.C. § 723 (1984).

[318] TEX. TAX CODE ANN. § 17.001(a)(1) (Vernon 2002 & Supp. 2004). *But see* discussion *supra* Part I. General—D. Federal "Check-the-Box" Tax Regulations"—2. Check-the-Box Regulations.

[319] *See* discussions *supra* Part I. General—E. Texas Entity Taxation—3. Margin Tax and Part VI. Limited Liability Partnership—D. Requirements for LLP Status—2. Filing with the Secretary of State of Texas.

[320] *See* discussions *supra* Part I. General—E. Texas Entity Taxation—3. Margin Tax and Part VI. Limited Liability Partnership—D. Requirements for LLP Status—2. Filing with the Secretary of State of Texas.

[321] I.R.C. § 1402(a) (2004).

C. Owner Liability Issues

Under Tex. GP Stats.,[322] 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.[323] Provisions in a partnership agreement that serve to allocate liability among the partners are generally ineffective against third-party creditors.[324] 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.[325]

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.[326]

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.[327] A withdrawn general partner may also be liable for actions committed by the 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.[328]

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.[329] Previously, a creditor could obtain a judgment enforceable against an individual partner's assets without suing the

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[322] TRPA § 3.03; TBOC § 152.303.

[323] TRPA § 3.04; TBOC § 152.304.

[324] 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).

[325] TRPA §§ 4.01(c), 8.06(c); TBOC §§ 152.203(d), 152.708.

[326] TRPA § 3.07; TBOC § 152.304(b).

[327] TRPA § 6.02(c).

[328] *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 (2002) (describing reactions to the *Keck* decision).

[329] TRPA § 3.05; TBOC § 152.306.

partnership.[330] 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.[331]

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.

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.[332] 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. Because 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.[333] 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.[334]

E. Fiduciary Duties

1. General

Under Tex. GP Stats., a partner 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.[335] These duties are fiduciary in nature although not so labeled.[336]

2. Loyalty

The duty of loyalty requires a general partner to place the interests of the partnership ahead of his own interests.[337] It requires a partner to account to the partnership for any

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[330] *See* statutes cited *supra* note 1.

[331] TRPA § 3.05(c); TBOC § 152.306(a).

[332] TRPA § 4.01(d); TBOC § 152.203(a).

[333] TRPA § 3.02; TBOC §§ 152.301–.302.

[334] TRPA § 4.05; TBOC §§ 152.210, 152.302.

[335] TRPA § 4.04; TBOC § 152.204.

[336] *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).

[337] Meinhard v. Salmon, 249 N.Y. 458, 463–64, 164 N.E. 545, 546 (1928), in which Justice Cardozo wrote:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty

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.[338]

3. Care

The duty of care requires a partner to act as an ordinarily prudent person would act under similar circumstances.[339] 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.[340]

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.[341]

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.[342] 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,[343] which represents a change from cases under TUPA.[344] A managing partner stands in a higher fiduciary relationship to other partners than

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> 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.

338 *See* TRPA § 4.04(b); TBOC § 152.205; BROMBERG & RIBSTEIN, *supra* note 311, at § 6.07.

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

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

341 BROMBERG & RIBSTEIN, *supra* note 311, at §§ 6.05(c) and 6.06.

342 TRPA § 4.05 ; TBOC § 152.210.

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

344 *See* Huffington v. Upchurch, 532 S.W.2d 576, 579 (Tex. 1976); Crenshaw v. Swenson, 611 S.W.2d 886, 890

partners typically occupy.[345]

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, (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, (v) vary the power to withdraw as a partner, except to require the notice be in writing, or (vi) vary certain other requirements.[346]

F. Ability To Raise Capital

Because 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, in 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; however, a partner's right to participate in the management of the partnership may not be assigned without the consent of the other partners.[347] 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.[348] A transfer of a partnership interest is not considered an event of withdrawal; therefore, transfer alone will not cause the winding up of the partnership business.[349] The partnership agreement will often contain a provision

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(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).

[345] *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), *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.

[346] TRPA § 1.03(b); TBOC § 152.002.

[347] *See* TRPA § 5.03; TBOC §§ 152.401, 152.402(3).

[348] *See* TRPA §§ 5.02–.04; TBOC §§ 152.402(3), 152.404(a), (c).

[349] TRPA § 5.03(a); TBOC § 152.402(1), (2).

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.[350] General partnership interests may be evidenced by transferable certificates, but ordinarily no such certificates are issued.[351]

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."[352] 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.[353] 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*,[354] 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.[355]

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 by evidence that it is not possible for the partners to exercise those powers."[356] The results should not be affected by the fact that some of the general partners may have remained

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[350] TRPA § 4.01(g); TBOC § 152.201.

[351] TRPA § 5.02(b); TBOC § 3.201.

[352] 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).

[353] *See* S.E.C. 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), *aff'd*, 64 F.2d 323 (5th Cir. 1981) (stating that the issue is whether the limited partnership interest meets the test of an investment contract).

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

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

[356] *Id.* at 241.

passive,[357] or that the general partnership had made an LLP election.[358]

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.[359] The statutes provide for "events of withdrawal" and "events of winding up."[360] Upon the occurrence of an event of withdrawal, the business of the partnership is not required to be wound up.[361] 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.[362] Except for the partner's right to withdraw, the statutory events of withdrawal may be modified by the partnership agreement,[363] and in view of the Check-the-Box Regulations, modification may become increasingly 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.[364] Unless the partnership agreement provides otherwise,[365] the interest of a withdrawing partner, except for a partner who wrongfully withdraws, must be redeemed by the partnership at fair market value.[366] 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.[367]

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, rather, a partnership depends on the existence of an association of two or more persons carrying on, as co-owners, a business for profit.[368] The factors discussed in Part

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357 *Id.*

358 *Cf.* S.E.C. v. Merchant Capital, LLC, 400 F. Supp.2d 1336 (N.D. Ga. 2005).

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

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

361 TRPA § 2.06(a), TBOC § 152.502.

362 TRPA § 6.01; TBOC § 152.501(b).

363 TRPA § 1.03; TBOC § 152.002.

364 TRPA § 6.02; TBOC § 152.503.

365 TRPA § 1.03; TBOC § 152.002.

366 TRPA § 7.01; TBOC §§ 152.601–.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–.602.

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

368 TRPA § 2.02(a); TBOC § 152.051.

III.A. are used to determine whether or not a general partnership exists.[369] Thus, it is not necessary that any written partnership agreement exists or that any significant expenses be incurred in the formation of a partnership.[370] 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. governs those relationships.[371] 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.[372] 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.[373]

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 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.[374]

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[369] TRPA § 2.03(a); TBOC § 152.052(a).

[370] *See* Pappas v. Gounaris, 301 S.W.2d 249, 254 (Tex. Civ. App.—Galveston 1957, writ ref'd n.r.e.).

[371] TRPA § 1.03(a); TBOC § 152.002(a).

[372] TRPA § 1.03(b); TBOC § 152.002(b).

[373] *See* TRPA § 4.01(b); TBOC § 152.202(c).

[374] *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.[375] 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.[376]

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.[377] 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, domestic limited partnerships are governed by either the TRLPA or the TBOC.[378] Because until 2010 some limited partnerships will be 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.

Similarly to other entities under Texas law, limited partnerships formed prior to January 1, 2006 which do not voluntarily opt into the TBOC will continue to be governed by the TRLPA until January 1, 2010.[379] All other Texas limited partnerships, including those resulting from a conversion that is effective on or after January 1, 2006, are governed by the TBOC.[380]

B. Taxation

1. Federal Income Taxation

A domestic limited partnership would 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.[381]

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[375] TRPA §§ 9.01–.06; TBOC Chapter 10.

[376] TBOC §§ 10.001–.009; 10.101–.151; 10.154–.201.

[377] TRLPA § 1.02(6); TBOC § 1.002(50).

[378] 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).

[379] TRLPA § 13.10.

[380] TBOC §§ 401.001, 402.003.

[381] *See* Treas. Reg. § 301.7701-2(c)(1) (as amended in 2003).

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.[382] 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.[383] Under certain circumstances, a partner's contribution of property may result in a net reduction in liability[384] 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.[385] 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.[386]

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.[387]

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.[388] 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. 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,

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382 I.R.C. § 721(a) (1997). *But see* Treas. Reg. § 1.707-3 (1992) (discussing disguised sales).

383 I.R.C. § 722 (1986); I.R.C. § 723 (1986).

384 I.R.C. § 752 (1986).

385 I.R.C. § 731 (1997).

386 *See* TEX. TAX CODE ANN. § 171.001 (Vernon 2002 & Supp. 2004).

387 *See* discussion *supra* Part I. General—E. Texas Entity Taxation—3. Margin Tax.

388 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 (1996).

> (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.[389]

The proposed regulations would also allow 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.[390]

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.[391] The legislative history indicates that Congress wants the IRS to withdraw the controversial proposed regulation discussed above, which would impose a tax on limited partners.[392] 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.[393]

C. Owner Liability Issues

A general partner of a limited partnership has the same unlimited liability as does a partner of a general partnership.[394] 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 amounts agreed to be contributed).[395] A limited partner may lose this limited liability, however, if he or she participates in the management of partnership business.[396] 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 agent or employee of the limited partnership 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

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389 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).

390 Prop. Treas. Reg. 1.1402(a)-2(h).

391 Taxpayer Relief Act of 1997, Pub. L. 105–34, 111 Stat. 788 (1997) (enacted).

392 Taxpayer Relief Act of 1997, H.R. 2014, 105th Cong. § 734 (1997) (enacted).

393 S. 949, 105th Cong. § 734 (1997).

394 *See* TRLPA §§ 4.01(d), 4.03(a); TBOC § 153.152. *See* KAO Holdings, L.P. v. Young, 214 S.W.3d 504 (Tex. App.—Houston [14th Dist.] 2006), in which a court held that "in a suit against a partnership (general or limited), citation may be served on any general partner of the partnership" and, quoting TRLPA § 3.05(c), "a judgment may be entered against a [general] partner who has been served with process in a suit against a partnership" even though the general partner was neither named or served individually in the lawsuit.

395 *See* TRLPA § 3.03; TBOC § 153.102.

396 TRLPA § 3.03; TBOC § 153.102.

obligations of the limited partnership.[397] 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.[398] 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.[399] 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 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.[400]

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 section3.08(a) or TBOC section 152.801.[401]

D. 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.[402] 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.[403] 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.[404]

E. Fiduciary Duties

Case law has adopted fiduciary standards for general partners of limited partnerships mirroring the unbending fiduciary standards espoused in general partnership cases.[405] Because

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[397] TRLPA § 3.03(b); TBOC § 153.103.

[398] TRLPA § 3.03(a); TBOC § 153.102(b).

[399] TRLPA § 3.03(d); Revisor's Note to TBOC § 153.102.

[400] *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).

[401] TRPA § 3.08(e); TRLPA §2.14; TBOC §§ 152.805, 153.351, 153.353.

[402] TRLPA § 4.03(a); TBOC § 153.152.

[403] TRLPA § 3.03; TBOC §§ 153.102, 153.103.

[404] TRLPA § 3.02; TBOC § 154.101.

[405] *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.

of their control over partnership affairs, general partners may be subjected to an even higher fiduciary standard with respect to limited partners.[406] Those in control of the general partner have been held to the same high standards.[407]

Because 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 otherwise, a general partner in a limited partnership has the duties of care and loyalty set forth in TRPA section4.04 and TBOC section 152.204, which basically codify those duties without giving them the "fiduciary" appellation.[408] 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.[409] Courts, however, continue to refer to the trustee standard.[410]

A partner owes the duties of care and loyalty to the partnership and the other partners.[411] 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.[412] An error in judgment does not by itself constitute a breach of the duty of care.[413] Further, 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.[414] 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 partner will not be held liable for mere negligent mismanagement.[415]

In Texas, the duty of loyalty is defined as including[416]:

1. accounting to the partnership and holding for it any property, profit, or

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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.).

406 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]."

407 *See* In re Bennett, 989 F.2d 779, 790 (5th Cir. 1993) (explaining that when a partner is in complete control of the partnership, the partner owes the highest level of fiduciary duty).

408 TRLPA §§ 4.03(b), 13.03; TBOC §§ 153.003, 153.152.

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

410 *See* Hughes v. St. David's Support Corp., 944 S.W.2d 423, 425–26 (Tex. App.—Austin 1997, writ denied).

411 TRPA § 4.04(a); TBOC § 152.204(a).

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

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

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

415 *See* Ferguson v. Williams, 670 S.W.2d 327, 331 (Tex. App.—Austin 1984, writ ref'd n.r.e.).

416 TRPA § 4.04(b); TBOC § 152.205.

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.

These provisions mirror the common areas traditionally encompassed by the duty of loyalty (e.g., self-dealing, conflicts of interest and usurpation of partnership opportunity).[417] 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.[418] 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.[419]

The TBOC makes it clear that *limited* partners, as limited partners, generally do not owe fiduciary duties to the partnership or to other partners.[420] Previously, a literal reading of the TRPA and TRLPA suggested that limited partners owed such duties by virtue of the linkage of TRPA to TRLPA under TRLPA section 13.03. 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.[421] An exception is made to this general rule in the case where a limited partner actually has or exercises 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). In such situations, the limited partner's conduct may be judged by fiduciary principles.[422]

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[417] 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.).

[418] TRPA § 4.04(e)–(f); TBOC § 152.204(c)–(d).

[419] TRPA § 4.04(d); TBOC § 152.204(b).

[420] TBOC § 153.003(b), (c).

[421] *See, e.g., 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).

[422] *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

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."[423] 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.[424] Delaware expressly allows the limitation or elimination of partner fiduciary duties in the partnership agreement.[425]

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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* Restatement (Second) of Agency (1958) §§ 13 (stating that "[a]n agent is a fiduciary with respect to matters within the scope of his agency"), 387 (stating that "[u]nless 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 (stating that "[u]nless otherwise agreed, an agent is subject to a duty not to compete with the principal concerning the subject matter of his agency"), 394 (stating that "[u]nless 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 (stating that "[u]nless 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).

[423] 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.

[424] *See* TRPA § 1.03(b); TBOC § 152.002(b). One additional point applies to limited partnerships that continue to be governed by the TRLPA. When originally drafted, it was the intent of the Partnership Law Committee of the Business Law Section of the State Bar of Texas that the TRLPA be subject to variation by agreement *only* if expressly permitted by the TRLPA; otherwise, the parties were *not* free to agree to provisions in the partnership agreement that differ from those contained in the TRLPA. TRLPA § 4.03 bar committee's cmt. Given the subsequent adoption of the TRPA, with its more flexible approach to contractual modifications of the statutory provisions, and the linkage provision contained in section 13.03 of the TRLPA, there is some question as to whether the more restrictive approach of the TRLPA to contractual modifications continues to have any application. *Cf.* TRPA § 1.03 bar committee's cmt. Thus, a prudent course for limited partnerships formed before January 1, 2006 was to draft the partnership agreement as if the flexibility afforded by the TRPA applied, but to be aware that any provisions of the partnership agreement that varied the requirements of the TRLPA without express statutory authority were subject to challenge.

"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 section 4.03(a) and TBOC section 153.152 concerning restrictions on a general partner *with* TRLPA section 11.02 and TBOC section 8.103(c) concerning indemnification of a general partner.

[425] Section 17-1101(b)–(f) of the Delaware Revised Limited Partnership Act ("DRLPA"), DEL. CODE ANN. tit. 6, section 17-[1101](b)–(f) (Supp. 2007), provide 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.
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> (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.
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> (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

Although limitations on fiduciary duty in a partnership agreement may be respected by courts when they are expressly set forth in the four corners of the partnership agreement, "a topic as important as this should not be addressed coyly."[426]

> 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.
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> (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 of 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 an other 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. 2007).

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 553 regarding Chief Justice Steele's views in respect of fiduciary duties in the LLC context.

[426] Miller v. American Real Estate Partners, L.P., No. CIV.A.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.
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> * * *
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> 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*, section 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 section 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, section 6.13(d) merely states that other standards in the Agreement or agreements contemplated by the agreement give way to the sole discretion standard. By its own terms, section 6.13(d) says nothing about default principles of law being subordinated when the sole discretion standard applies.
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> * * *
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> 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

Unlike DRLPA, under 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.[427] For example, the partnership agreement may not eliminate the 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."[428] 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.[429]

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."[430] 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."[431] 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.[432] 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.[433]

F. Indemnification

A limited partnership is required to indemnify a general partner who is "wholly successful

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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.

427 TRLPA §§ 4.03(b), 13.03(a); TRPA § 1.03(b); TBOC §§ 152.002(b); 153.003(a).

428 TRLPA §§ 4.03(b), 13.03(a); TRPA § 1.03(b); TBOC § 152.002(b)(3).

429 Grider v. Boston Co., Inc., 773 S.W.2d 338, 343 (Tex. App.—Dallas 1989, writ denied).

430 TRLPA §§ 4.03(b), 13.03(a); TRPA § 1.03(b)(2); TBOC §§ 152.002(b)(2), 153.003(a).

431 TRLPA §§ 4.03(b), 13.03(a); TRPA § 1.03(b)(4); TBOC §§ 152.002(b)(4), 153.003(a).

432 TRLPA §§ 1.07; TBOC § 153.551–.552.

433 *See* TRPA § 4.03; TBOC §§ 153.551–.552.

on the merits or otherwise" unless indemnification is limited or prohibited by a written partnership agreement.[434] 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.[435] 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; and, if the conduct was in an official capacity, then the general partner reasonably believed the conduct was in the best interest of the partnership, or, in cases of conduct outside the general partner's official capacity, that the conduct was not opposed to the partnership's best interest; however, in the case of a criminal proceeding, the general partner must have had no reasonable cause to believe the conduct was unlawful.[436] 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.[437] General partners may only be indemnified to the extent consistent with the statute.[438] 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.[439] Insurance providing coverage for unindemnifiable areas is expressly permitted.[440]

G. 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.[441] 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.[442]

Although a general partner is personally liable for all of the debts and obligations of the

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434 TRLPA §§ 11.08, 11.21; TBOC §§ 8.003, 8.051.

435 TRLPA §§ 11.03, 11.05; TBOC § 8.102(b).

436 TRLPA § 11.02; TBOC § 8.101(a).

437 TRLPA §§ 11.03, 11.05; TBOC § 8.102(b).

438 TRLPA § 11.13; TBOC § 8.004.

439 TRLPA §§ 11.15, 11.17; TBOC § 8.105.

440 TRLPA § 11.18; TBOC § 8.151.

441 TRLPA § 5.01; TBOC § 153.201.

442 TRLPA § 5.02(d); TBOC § 153.202.

limited partnership,[443] 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 (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.[444]

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.[445] 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.[446]

H. 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.[447] 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.[448] 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.[449] 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.[450] Until an assignee of a partnership interest becomes a partner, the assignee has no liability as a partner solely by reason of the assignment.[451]

I. 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.[452] A limited partnership is dissolved under TRLPA or required to commence winding up under the

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443 TRLPA §§ 4.01(d), 4.03(b); TBOC § 153.152.

444 TRLPA § 4.01(c); TBOC § 153.151(c)–(d).

445 *See* TRLPA § 5.03; TBOC § 153.206.

446 *See* TRLPA § 5.04; TBOC § 153.208.

447 TRLPA § 7.02; TBOC § 153.251.

448 TRLPA § 7.02(a)(2); TBOC § 153.251(b)(2).

449 TRLPA § 7.02(a)(3); TBOC § 153.251(b)(3).

450 TRLPA § 7.02(a)(4); TBOC § 153.252(b).

451 TRLPA § 7.02(b); TBOC § 153.254(a).

452 TRLPA §§ 8.01, 8.02; TBOC §§ 11.051, 11.058.

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 writing to dissolve the limited partnership, (iii) an event of withdrawal of a general partner under Tex. LP Stats. (i.e., death, removal, voluntary withdrawal and, unless otherwise provided in the partnership agreement, bankruptcy of a general partner)[453] absent certain circumstances[454] 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.[455]

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.[456] However, upon the withdrawal of a general partner (unless the limited partnership agreement otherwise provides),[457] the limited partnership may continue its business without being would 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.[458]

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 new 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.

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[453] TRLPA § 4.02; TBOC § 153.155.

[454] Under TRLPA section 6.02 and TBOC section 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 section 6.03 and TBOC section 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 section 11.058(b), as amended in 2007 by 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.

[455] TRLPA § 8.02; TBOC §§ 11.051, 11.314.

[456] TRLPA § 8.04; TBOC § 11.052.

[457] TRLPA § 8.01(3); TBOC §§ 11.051(4), 11.058(b).

[458] 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 section 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.

J. 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.[459] Additionally, a filing fee of $750 must be paid upon filing the certificate of formation.[460]

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.[461] 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 partnership agreement, but allow the agreement to be either written or oral. The name of the limited partnership must contain the word "limited," the phrase "limited partnership," or an abbreviation of either.[462]

Unless the partnership agreement provides otherwise, unanimity is required to amend a limited partnership agreement.[463] 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 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

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459 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, no pet.); 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).

460 TBOC § 4.155(1). The fee is the same as it was under the TRLPA. *See* TRLPA §§ 2.01(a); 12.01(1).

461 *See* TRPA § 1.03; TBOC §§ 152.002, 153.003.

462 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," or "Ltd." as the last words or letters of its name.

463 TRPA § 4.01(i); TBOC § 152.208.

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.

K. 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.[464] 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 NewYork 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 NewYork 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.[465]

L. 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.[466] The Tex. LP Stats. 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 arts. 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.[467] Requirements for limited partner

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[464] *See* TRLPA article 9; *see generally* TBOC title 1, chapter 9.

[465] N.Y. REV. LTD. P'SHIP ACT § 121-902 (McKinney Supp. 2006). N.Y. REV. LTD. P'SHIP ACT § 121-201 (McKinney Supp. 2006) contains similar publication requirements for newly formed domestic limited partnerships.

[466] 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), (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.

[467] *See supra* notes 202–03 and accompanying text regarding the requirements of TBCA arts. 5.09–.10 and the

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 or converting into a Texas LLC after January 1, 2006, those formed prior to that date but voluntarily opting in, and all limited liability companies after January 1, 2010 will be governed by Title 3 and pertinent provisions of Title 1 of the TBOC.[468] Older LLCs not opting in will continue to be governed by the LLC Act until January 1, 2010.[469] Because until 2010 some LLCs will be governed by the LLC Act 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 Act.[470]

"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."[471] 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.[472] An LLC is subject to Texas Margin Tax.[473]

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

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parallel TBOC provisions.

468 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).

469 The Texas Limited Liability Company Act, as amended, is found at Article 1528n of the 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. 2006); TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon 2003 & Supp. 2004); TEX. REV. CIV. STAT. ANN. art. 6132a-1, arts. 1–13 (Vernon Supp. 2006).

470 *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).

471 PB Real Estate, Inc. v. DEM Properties, 719 A.2d 73, 74 (Conn. App. Ct. 1998).

472 *See* discussion *supra* Part I. General—C. Federal 'Check-the-Box' Regulations.

473 *See* discussion *supra* Part I. General—E. Texas Entity Taxation—3. Margin Tax. 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 (1999).

determine the internal structure and operation of the LLC. Thus the Tex. LLC Stats. would be classified as "flexible" LLC statutes.[474] 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.[475]

The Tex. LLC Stats. in many cases provide "default" provisions[476] 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.[477] Examples of provisions that were often included in an LLC structure because of the Former Classification Regulations and which are required by neither the Tex. LLC Stats. nor the Check-the-Box Regulations:

(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.[478] A single 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.[479]

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474 *See* Robert B. Keatinge, *New Gang in Town—Limited Liability Companies: An Introduction*, 4 BUS. L. TODAY 5 (1995).

475 *See* Robert F. Gray et al., *Corporations*, 45 SW. L. J. 1525, 1537 (1992).

476 *See* HOUSE COMM. ON BUS. & INDUS., BILL ANALYSIS, Tex. H.B. 1239, 73d Leg., R.S. (1993) at 1 [hereinafter 1993 LLC Bill Analysis].

477 *See* William D. Bagley, *The IRS Steps Back—Entity Classification Rules are Relaxed*, 6 BUS. L. TODAY 41 (1997).

478 Treas. Reg. § 301.7701-3(b)(i) (as amended in 2003).

479 Treas. Reg. § 301.7701-3(b)(ii).

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.[480] 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."[481] Unless the LLC had more than one Member but does 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.[482] 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.[483] Texas administrative regulations provided that a single Member LLC could not deduct compensation paid to the Member in computing "net taxable earned surplus."[484] 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.[485]

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. Because 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.[486]

b. Flexible Statute

In Revenue Ruling 88-76, 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.[487] The Wyoming LLC 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.[488] By contrast, the Tex. LLC Stats. are considered "flexible" statutes because they allow the Members to vary the Regulations to

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480 TEX. TAX CODE ANN. §§ 171.001, 171.002(d) (Vernon 2002 & Supp. 2004).

481 *Id.* § 171.002(a).

482 *See* Brandon Janes & Steven D. Moore, *The New Texas Franchise Tax*, TEX. B.J., Nov. 1991, at 1108.

483 TEX. TAX CODE ANN. § 171.110(a)(1).

484 34 TEX. ADMIN. CODE § 3.562(f)(2) (2003) (Public Finance, Franchise Tax, Limited Liability Companies).

485 *See* discussion *supra* Part I. General—E. Texas Entity Taxation—3. Margin Tax.

486 David G. Dietze, *The Limited Liability Company: Latest Strategy and Developments*, 6 No. 1 INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR, Jan. 1992, at 7.

487 Rev. Rul. 88-76, 1988-2 C.B. 360, *obsoleted by* Rev. Rul. 98-37, 1998-2 C.B. 133.

488 Rev. Rul. 88-76; WYO. STAT. ANN. §§ 17-15-101–17-15-147 (Michie 2003).

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).[489]

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.[490] 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.[491] Many state LLC statutes do not authorize single Member LLCs.[492]

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.[493] 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.[494] Under certain circumstances, a Member's contribution of property may result in a net reduction in liability[495] 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.[496] In addition, certain contributions can be treated as "disguised sales" of all or a portion of the 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.

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[489] LLC ACT art. 3.02(A), 6.01(B); TBOC § 101.052.

[490] Treas. Reg. § 301.7701-2(a), (c)(2) (as amended in 2003).

[491] In I.R.S. Priv. Ltr. Rul. 2001-18023 (Jan. 31, 2001), the issue was the application of Section 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 Section 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).

[492] *See* Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 7 (1995).

[493] I.R.C. § 721(a). *But see* 26 C.F.R. § 1.707-3 (2003) (discussing disguised sales).

[494] I.R.C. §§ 722–23.

[495] I.R.C. § 752.

[496] I.R.C. § 731.

e. *Self-EmploymentTax*

Individuals are subject to a self-employment tax on self-employment income.[497] 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 2008 contribution base of $102,000 (adjusted annually for inflation) plus (ii) a 2.9% Medicare tax on all self-employment income (there is no ceiling).[498] An individual's wage income is applied against the contribution base.[499] Self-employment income generally means an individual's net earnings from the individual's trade or business.[500] 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.[501]

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.[502] 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.[503] 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 the proliferation of new business entities such as the LLC as well as the evolution of state limited partnership statutes.[504] 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 § 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

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[497] *See* I.R.C. § 1401; SSA Pub. No. 05-10022 (2008), *available at* http://www.ssa.gov/pubs/10022.pdf.

[498] I.R.C. § 1401.

[499] *Id.*

[500] I.R.C. § 1402(a).

[501] I.R.C. § 1402.

[502] *See* 26 C.F.R. § 1.1402(a)-18, 59 Fed. Reg. 67,253-01 (proposed Dec. 29, 1994).

[503] Prop. 26 C.F.R. § 1.1402(a)-2, 62 Fed. Reg. 1702 (proposed Jan. 13, 1997).

[504] *See id.*

> 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.[505]

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.[506] The legislative history indicates that Congress wants the IRS to withdraw the controversial proposed regulation discussed above, which would impose a tax on limited partners.[507] 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.[508] Congress may again consider ways to rationalize the self-employment tax treatment of LLCs, partnerships and S-corporations.[509]

C. Members; Managers

The owners of an LLC are called "Members,"[510] and are analogous to shareholders in a corporation or limited partners of a limited partnership.[511] 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.[512] Under the Tex. LLC Stats., however, an LLC may be structured so that management shall be by the Members as in the

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[505] *Id.*

[506] H.R. CONF. REP. NO. 105-220, at 765 (1997).

[507] *Id.*

[508] *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.

[509] *See* "*Options to Improve Tax Compliance and Reform Tax Expenditures*" prepared by the Staff of the Joint Committee on Taxation (January 27, 2005).

[510] LLC ACT art. 4.01; TBOC §§ 1.002(53), 101.101–.102.

[511] 1991 Bill Analysis Summary at 41.

[512] *See* LLC ACT art. 2.13; TBOC § 101.302; 1991 Bill Analysis Summary at 41.

case of a close corporation or a general partnership,[513] and in that case the Members would be analogous to general partners in a general or limited partnership but without personal liability.[514] For an LLC to be taxed as a partnership, it must have at least two Members, although Texas law would permit an LLC to have only one Member; 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).[515]

Under the Tex. LLC Stats., any "person" may become a Member or Manager.[516] Because of the broad construction given to "person" by the Tex. LLC Stats., any individual, corporation, partnership, LLC or other person may become a Member or Manager.[517] Thus, it is possible to have an LLC with a corporation as the sole Manager just as it is possible to have a limited partnership with a sole corporate general partner.

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.[518] It has all of the

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[513] LLC ACT art. 2.12; TBOC §§ 1.002(35), 101.251.

[514] 1991 Bill Analysis Summary at 41.

[515] *See* discussions *supra* I. C. Federal 'Check-the-Box' Tax Regulations—2. Check-the-Box Regulations and V. Limited Liability Company: B. Taxation—2. Other Tax Issues Relating to LLCs—(c) One Member LLC. 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.

[516] LLC ACT art. 4.01C; TBOC § 101.102(a).

[517] "Person" is defined in LLC ACT article 1.02(4) as follows:

> (4) "Person" includes an individual, corporation, business trust, estate, trust, custodian, trustee, executor, administrator, nominee, partnership, registered limited liability partnership, limited partnership, association, limited liability company, government, governmental subdivision, governmental agency, governmental instrumentality, and any other legal or commercial entity, in its own or representative capacity. Any of the foregoing entities may be formed under the laws of this state or any jurisdiction.

The definition afforded to "person" in the TBOC comes from the Code Construction Act, which states that "'Person' includes corporation organization, government or governmental subdivision or agency, business trust, estate, trust, partnership, association, and any other legal entity." TEX. GOV'T CODE § 311.005(2).

[518] LLC ACT article 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 article 2.01 provides that a limited liability company "may engage in any lawful business." The term "business," as defined in LLC Act art. 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.").

powers of a Texas corporation or limited partnership, subject to any restrictions imposed by statute or its governing documents.[519]

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.[520] 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.[521] 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.[522] 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.[523]

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.[524] 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.[525] 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.[526]

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.[527] Any such amendment must include a

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[519] Governing documents, as used here, includes an LLC's Articles of Organization, Certificate of Formation, Regulations, or Company Agreement. LLC ACT art. 2.02; *see* TBOC § 101.402.

[520] 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 arts. 3.01, 9.01.

[521] TBOC §§ 3.005, 3.010, 3.014.

[522] TBOC §§ 4.051, 4.052.

[523] TBOC § 3.006(b).

[524] 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).

[525] TBOC § 5.053.

[526] *Id.*

[527] LLC ACT art. 2.23H; TBOC §§ 101.356(d), 101.051–.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.

statement that it was approved in accordance with the proper provisions of governing laws,[528] or for entities governed by the LLC Act, alternately as provided in the articles of organization or Regulations, along with the date of approval.[529]

LLC Act section 2.23G provides 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.[530]

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, which will typically contain provisions similar to those in limited partnership agreements and corporate bylaws.[531] A Company Agreement is the same as the document referred to as the "Regulations" for LLCs still governed by the LLC Act. Under the TBOC, the Company Agreement controls the majority of LLC governance matters and generally trumps the default TBOC provisions relating to LLCs.[532] For example, the TBOC provides that the Company Agreement or certificate of formation may only be amended by unanimous member consent,[533] but if either document provides otherwise, such as for amendment by manager consent, then it may be amended pursuant to its own terms.[534] The only statutory provisions not subject to contrary agreement are enumerated in TBOC section 101.054. While the structure and wording of the TBOC relating to these matters differs from the source LLC Act, the rule has not substantively changed.[535]

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[528] LLC ACT art. 3.06(3); TBOC § 3.053(4).

[529] LLC ACT art. 3.06(3).

[530] *See* TBOC §§ 101.051–.052.

[531] LLC ACT art. 2.09A; TBOC § 101.052.

[532] *See* TBOC § 101.052 and Revisor's Note thereto.

[533] TBOC §§ 101.053, 101.356(d).

[534] *See* TBOC §§ 101.052, 101.054.

[535] *See* Revisor's Note to TBOC § 101.052; LLC ACT arts. 2.09B, 2.23H. With respect to LLCs that continue to be governed by the LLC Act, the default provision in LLC Act art. 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 art. 2.23H), issue additional membership interests (LLC ACT art. 4.01B-1, as amended by H.B. 1637 effective September 1, 2003) or take action beyond the stated purposes of the LLC (LLC ACT art. 2.02B). The general default voting provision is in LLC Act art. 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

Although the Company Agreement will ordinarily contain the capital account and other financial and tax provisions found in a typical limited partnership agreement,[536] 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.[537] 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.[538] 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."[539]

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 officers and other agents to act on behalf of the LLC.[540] 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.[541] 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.[542] 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

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parties. Also, Paragraph F of LLC ACT article 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.

[536] 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 arts. 2.22, 5.01-1, 5.03; TBOC §§ 3.151, 101.203, 101.501.

[537] The agreement to be contractually bound could be through signing the Company Agreement directly or indirectly through a subscription agreement or power of attorney.

[538] Philip M. Kinkaid, Dra*fting 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).

[539] *See, e.g.,* OHIO REV. CODE ANN. § 1705.01(J) (West 2003) ("operating agreement"); DEL. CODE ANN. tit. 6, § 18-101(7) (1999 & Supp. 2005) ("LLC agreement").

[540] LLC ACT arts. 2.12, 2.21; TBOC §§ 101.251–.253.

[541] LLC ACT arts. 2.12, 1.02(4); TBOC § 101.302; TEX. GOV'T CODE § 311.005(2).

[542] LLC ACT art. 2.12; *see* TBOC § 101.251.

and affairs.[543] 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.[544] 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 section2.21C 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.[545] 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.[546]

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[547]; if the Company Agreement is silent as to the term, the default provision is retention of the Managers. Tex. LLC Stats. allow any number 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.[548]

H. Fiduciary Duties

The Tex. LLC Stats. do not address specifically whether Manager or Member fiduciary duties exist or attempt to define them,[549] but implicitly recognize that they may exist in statutory provisions which permit them to be expanded or restricted in the Company Agreement.[550] The duty of Managers in a Manager-managed LLC and Members in a Member-

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[543] TBOC § 101.252. Along the same lines, LLC Act section 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.

[544] LLC ACT art. 2.21C; TBOC §§ 1.002(35), (37), 101.254(a).

[545] LLC ACT art. 2.21D; TBOC § 101.254(b).

[546] *See* Water, Waste & Land, Inc. v. Lanham, 955 P.2d 997, 1001 (Colo. 1998).

[547] *See* TBOC § 101.303.

[548] *See* LLC ACT art. 2.14; TBOC § 101.307.

[549] *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).

[550] LLC ACT article 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

managed LLC to the LLC is generally assumed to be fiduciary in nature, measured by reference to the fiduciary duties of corporate directors. By analogy to corporate directors, Managers would have the duties of obedience, care and loyalty and should have the benefit of the business judgment rule. Much like a corporate director who, in theory, represents all of the shareholders of the corporation rather than those who are responsible for his being a director, a Manager should be deemed to have a fiduciary duty to all of the Members. Whether Members owe a fiduciary duty to the other Members or the LLC will likely be determined by reference to corporate principles in the absence of controlling provisions in the Certificate of Formation or Company Agreement.[551]

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.[552] This provision of Texas law was designed, in the same vein as the Delaware Limited Liability Company Act (the "DGLLCA") from which it drew inspiration, to allow LLCs the flexibility to address fiduciary duties through contract principles.[553] Although the Tex. LLC Stats., unlike their Delaware

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> (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 section 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.

551 Suntech Processing Sys., L.L.C. v. Sun Commc'ns, Inc., No. 05-99-00213-CV, 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.

552 *See* LLC ACT art. 2.20B; TBOC § 101.401. Prior to the effectiveness of S.B. 555 on September 1, 1997, LLC Act section 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 Articles (now, the Certificate of Formation) to the extent permitted for a director under TMCLA 1302-7.06. S.B. 555 deleted such incorporation by reference of TMCLA 1302-7.06 in favor of the broader authorization now in LLC Act section 2.20B.

553 DEL. CODE ANN. tit. 6, § 18-1101(a)–(f) (2007). The Delaware Limited Liability Company Act aggressively adopts a "contracterian approach" (i.e., the bargains of the parties manifested in LLC agreements are to be respected and rarely trumped by statute or common law) and does not have any provision which itself creates or negates Member or Manager fiduciary duties, but instead allows modification of fiduciary duties by an LLC agreement 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

counterpart, do not include provisions that expressly emphasize the principles of freedom of contract and enforceability of LLC Company Agreements limiting liability for breach of fiduciary duties, the legislative history and scope of LLC Act section2.20B, the precursor to TBOC section 101.401, indicates 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.

> 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.

DLLCA sections 18-1101(a)–(f) are counterparts of, and virtually identical to, sections 17-1101(a)–(f) of the Delaware Revised Limited Partnership Act. *See* DEL. CODE ANN. tit. 6, § 17-1101 (2007). Thus, Delaware cases regarding partner fiduciary duties should be helpful in the LLC context.

See Myron T. Steele, *supra* note 425, at 25, 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 425 and accompanying text regarding Chief Justice Steele's views in respect of fiduciary duties in the limited partnership context.

Provisions in Company Agreements purporting to limit fiduciary duties need to be explicit and conspicuous as coyness can lead to unenforceability.[554] 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.

While courts may be tempted to find contractual limitations on fiduciary duties ambiguous in particular situations where it appears that the provision is allowing a fiduciary to get away with something egregious, they should generally recognize the ability of LLCs to contractually limit fiduciary duties. In *McConnell v. Hunt Sports Enterprises*,[555] the court stated that Members (of what was apparently a Member-managed LLC) are generally in a fiduciary relationship and would ordinarily be prohibited from competing with the LLC. The court, however, recognized the validity of a provision in the Ohio LLC's operating agreement (the equivalent of a Texas LLC's Company Agreement) providing:

> Members may Compete. Members shall not in any way be prohibited from or restricted in engaging or owning an interest in any other business venture of any nature, including any venture which might be competitive with the business of the Company.

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[554] 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 Mangers. 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.

[555] 725 N.E.2d 1193 (Ohio App. 1999).

The Ohio court in *McConnell* found that this provision clearly and unambiguously permitted a Member to compete against the LLC to obtain a hockey franchise sought by the LLC.[556] The court noted the trial court's finding that the competing Members had not engaged in willful misconduct, misrepresentation or concealment.[557]

Persons who control Members can be held responsible for fiduciary duty breaches of the Members.[558] A legal claim exists for aiding and abetting a breach of fiduciary duty, whether arising under statute, contract, common law or otherwise.[559]

The Tex. LLC Stats., which are based on TBCA article 2.35-1, provide that, unless the articles, certificate of formation, Regulations, or Company Agreement provides otherwise, a transaction between an LLC and one or more of its Managers or officers, or between an LLC and any other LLC or other entity in which one or more of its Managers or officers are Managers, directors or officers or have a financial interest, shall be valid notwithstanding the fact that the Manager or officer is present or participates in the meeting of Managers 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 affirmative vote 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 entitled to vote thereon, 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.[560]

In a joint venture, the duty of a Manager to all Members could be an issue because the Managers would often have been selected to represent the interests of particular Members. The issue could be addressed by structuring the LLC to be managed by Members who would then appoint representatives to act for them on an operating committee which would run the business in the name of the Members. In such a situation, the Members would likely have

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556 *Id.* at 1215.

557 *Id.* at 1214. *But see* Dragt v. Dragt/DeTray, LLC, 161 P.3d 473 (Wash. App. 2007) (holding that non-managing members of a Washington LLC do not owe fiduciary duties to other members unless fiduciary duties are imposed under the operating agreement).

558 *See* In re USACafes, Inc., 600 A.2d 43, 48 (Del. Ch. 1991); Carson v. Lynch Multimedia Corp., 123 F. Supp. 2d 1254, 1264 (D. Kan. 2000).

559 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.

560 LLC ACT art. 2.17; TBOC § 101.255.

fiduciary duties analogous to partners in a general partnership.[561]

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.[562] The restrictions on indemnification applicable to regular corporations are not applicable to LLCs.[563] This approach is similar to the approach taken under Delaware law, but could be subject to public policy limitations.[564] 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.[565] 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.[566] If the Company Agreement does not otherwise provide, allocations and distributions are made on the basis of the agreed value of the contributions made by each Member.[567] A Member is not entitled to receive distributions from an LLC prior to its winding up unless specified in the Company

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[561] *Id.*; *see* TRPA § 4.04; *see also* TBOC § 152.204.

[562] LLC ACT art. 2.20A; TBOC § 101.402.

[563] *See generally* Chapter 8 of the TBOC, specifically § 8.002(a).

[564] *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).

[565] LLC ACT art. 5.01; TBOC § 1.002(9). LLC Act section 5.02 and TBOC sections 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 section 4.07 and TBOC section 101.111(b) provide that an obligation to make a contribution will survive the assignment of the membership interest. LLC Act section 5.02 and TBOC section 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.

[566] LLC ACT arts. 5.02-1, 5.03; TBOC §§ 101.052, 101.201.

[567] LLC ACT arts. 5.02-1, 5.03; TBOC §§ 101.052, 101.201.

Agreement if the LLC is governed by the TBOC.[568] 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.[569] 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.[570]

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.[571] Members may participate in the management of the LLC without forfeiting this

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568 TBOC section 101.204 provides this as a new default rule, subject to contrary agreement under section 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 art. 5.04.

569 LLC ACT art. 5.09A; TBOC § 101.206.

570 LLC ACT art. 5.09B; TBOC § 101.206(d).

571 LLC ACT arts. 4.03, 5.02A; TBOC §§ 101.114; 101.151. LLC Act section 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.

TBOC Section 101.114 provides for substantially the same protection of Members and Managers as LLC Act Section 4.03A. *See* Part "VII. Extraterritorial Recognition of LLC and LLP Limited Liability" 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 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.

The clear and unequivocal limitation of personal liability wording of LLC Act section 4.03A is to be contrasted with the more complicated and narrow wording of TBCA article 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. Intending that corporate veil piercing principles not be applicable to 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.

liability shield, but may be liable for their own torts.[572] Because the LLC Act deals 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.[573]

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[572] The LLC Act does not contain any provision comparable to TRLPA section 3.03 or TBOC section 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." *See* Weber v. U.S. Sterling Sec., Inc., 924 A.2d 816 (Conn. 2007) (holding that liability protection of managers and members under Delaware LLC statute does not protect members or managers from direct liability for their own torts).

[573] Two Texas cases have suggested that piercing the veil concepts from corporation law are applicable to LLCs. McCarthy v. Wani Venture, A.S., ___ S.W.3d ___, 2007 WL 1845088 (Tex. App.—Houston [1st Dist] 2007) (holding that corporate veil piercing principles apply to Texas LLCs notwithstanding the wording of LLC Act art. 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"); Pinebrook Props., Ltd. v. Brookhaven Lake Prop. Owners Ass'n, 77 S.W.3d 487, 500 (Tex. App.—Texarkana 2002, pet. denied) (Texarkana Court of Appeals assumed that corporate veil piercing rules must be applicable to an LLC because the LLC is a limited liability entity, citing *Castleberry*, 721 S.W.2d at 272 [holding that alter ego is a basis for disregarding the corporate fiction] even though *Castleberry* was decided five years before the LLC Act was passed and made no reference to the LLC or any entity other than a business corporation after analyzing the facts before it under *Castleberry*—which has been repudiated by the legislature in amendments to TBCA art. 2.21A, and under TBCA art. 2.21A, which applies only to corporations and does not apply to LLCs, the court held that veil piercing was not appropriate in the case *sub judice*).

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 article 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 article 8.12 were expressly incorporated into the TBOC, but still without reference to piercing the corporate veil.

Even if corporate veil piercing theories were not applicable in Texas, 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) the LLC including in its Company 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); Shapolsky v. Brewton, 56 S.W.3d 120, 133 (Tex. App.—Houston [14th Dist.] 2001, pet. denied). Thus, the LLC shield would be effective as to vicarious torts arising out of LLC activities, but not against a member's own miscreant conduct. For example, in a negligence action, the complaint would be against the member qua actor for his own negligent acts rather than *qua* member for the LLC's acts. *See* Murdock, *supra* note 470, at 504. A complaint could state a cause of action against a member for his individual negligence *qua* actor, but could not state a cause of action against a member for negligence attributed to the LLC due to the act of someone else.

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 Commc'n 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 Article 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

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 veil[574] or that the Members will have the same liabilities as corporate shareholders.[575]

M. Nature and Classes of Membership Interests

A membership interest in an LLC is personal property.[576] It does not confer upon the Member any interest in specific LLC property.[577] A membership interest may be evidenced by a certificate if the Company Agreement so provides.[578]

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.[579] The Company Agreement could provide for different classes of Members, each authorized to elect a specified number or percentage of the Managers.[580] 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.[581]

Whether an LLC membership interest is considered a "security" for the purposes of the Securities Act of 1933, as amended, and state securities or blue sky laws turns on the rights of the Members as set forth in the Company Agreement and other governing documents and the ability of the investor to exercise meaningful control over his investment.[582] The offer and sale

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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. *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).

[574] *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).

[575] *See* W. VA. CODE § 31-B-3-303(b) (2003).

[576] LLC ACT art. 4.04; TBOC § 101.106.

[577] LLC ACT art. 4.04; TBOC § 101.106.

[578] LLC ACT art. 4.05B; TBOC § 3.201(e).

[579] LLC ACT art. 4.02; TBOC § 101.104.

[580] *See* LLC ACT art. 2.13; TBOC § 101.104.

[581] *See* 1993 LLC Bill Analysis at 2; see also TBOC §§ 21.152, 101.104.

[582] 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); S.E.C. v. Vision Commnc'ns, Inc., CIV. No. 94-0615, 1944 WL 855061, at *1 (D.D.C. May 11, 1994) (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 of an interest must either be registered under applicable federal and state securities laws[583] or effected in a private[584] or other transaction structured to be exempt from those requirements.[585]

BLUE SKY LAW HANDBOOK § 2.01 (1988 revision).

583 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).

584 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

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").[586] 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.[587] 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

> (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 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.

[585] 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).

[586] 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.

[587] Pre 9/1/95 B&CC § 8.321.

B&CC section 9.[588]

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 ("H.B. 3200" and "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.[589] 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.[590]

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.[591] 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.

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.[592] 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.[593] 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.[594] Until the assignee becomes a Member, the assignor continues to be a Member and to have the power to exercise

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588 A membership interest not represented by an instrument would be a "general intangible" under Pre 9/1/95 B&CC section 9.106. A security interest therein would attach as provided in Pre 9/1/95 B&CC section 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 section 9.302.

589 Post 9/1/95 B&CC §§ 8.102, 8.103(c).

590 Post 9/1/95 B&CC §§ 9.106, 9.302(a). 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 sections 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 sections 9.106 and 9.115.

591 LLC ACT article 4.06A, as amended in 2007 by H.B. 1737, provides:

> On application by a judgment creditor of a member or of any other owner of a membership interest, the court may charge the membership interest of the judgment debtor to satisfy the judgment. To the extent that the membership interest is charged in this manner, the judgment creditor has only the right to receive any distribution to which the judgment debtor would otherwise have been entitled in respect of the membership interest.

See LLC ACT art. 7.03. TBOC § 101.112 provides substantially the same.

592 LLC ACT art. 4.05A; TBOC § 101.108.

593 *Id.*

594 LLC ACT art. 4.05A; TBOC § 101.109.

any rights or powers of a Member, except to the extent those rights or powers are assigned.[595] 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.[596] Until an assignee is admitted as a Member, the assignee does not have liability as a Member solely as a result of the assignment.[597]

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.[598]

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;[599]

(2) any event specified in the Articles or Company Agreement to cause dissolution, or to require the winding up or termination, of the LLC;[600]

(3) the action of the Members to dissolve the LLC (in the absence of a specific provision in the Articles or Company Agreement, the vote will be by a majority of the Members);[601]

(4) the occurrence of any event that terminates the continued membership of the last remaining Member of the LLC, absent certain circumstances;[602] or

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595 LLC ACT art. 4.05A; TBOC § 101.111.

596 LLC ACT art. 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 art. 4.07B; TBOC §§ 101.110; 101.111(b).

597 LLC ACT art. 4.05C; TBOC § 101.109(c).

598 Tex. LLC Stats. provide that a membership interest is assignable unless otherwise provided by the Company Agreement. LLC ACT art. 4.05A; TBOC § 101.108(a). There is no statutory requirement of "reasonableness" with respect to LLC transfer restrictions as is found in TBCA section 2.22 and TBOC sections 21.211 and 21.213.

599 LLC ACT arts. 3.02A(2), 6.01A(1); TBOC § 11.051(1); *see* 1993 LLC Bill Analysis at 4.

600 LLC ACT art. 6.01A(2); TBOC § 11.051(3).

601 LLC ACT arts. 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 art. 6.01A(4); *see* Revisor's Note to TBOC § 101.552.

602 LLC ACT art. 6.01A(5), as amended by 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

(5) entry of decree of judicial dissolution under the Tex. LLC Stats.[603]

However, 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.[604] Under the LLC Act and the TBOC, revocation of a voluntary dissolution simply requires the written consent of all its members,[605] 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 the Articles of Organization or Company Agreement).[606]

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.[607] 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.[608] 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.[609] For other circumstances requiring termination under the TBOC, LLCs are permitted one year to cancel the event of termination.[610]

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

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become a Member of the LLC as of the date of the termination. LLC ACT art. 6.01C as amended by H.B. 1637 effective September 1, 2003; TBOC § 11.056.

[603] LLC ACT art. 6.01A(6), 6.02A; TBOC § 11.051(5).

[604] TBOC §§ 101.054, 101.552.

[605] LLC ACT art. 6.06A; TBOC § 101.552.

[606] LLC ACT art. 6.01B; TBOC § 101.552.

[607] LLC ACT art. 6.01B; TBOC § 11.152(b).

[608] LLC ACT art. 6.06A; TBOC § 11.151.

[609] LLC ACT art. 6.01B; TBOC § 11.152(a).

[610] TBOC § 11.152(a).

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.

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.[611] Before filing a certificate of termination with the Secretary of State,[612] 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,[613] and (iii) collect its assets, discharge its obligations or make provisions thereof, and distribute the remaining assets to its Members.[614] 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.[615] 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.[616]

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.[617] The merger must be pursuant to a written plan of merger containing certain provisions,[618] 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.[619]

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[611] LLC ACT art. 6.03A; TBOC § 101.551.

[612] 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.

[613] Under Article 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.

[614] LLC ACT art. 6.05; TBOC § 11.052.

[615] LLC ACT art. 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).

[616] LLC ACT art. 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 art. 6.08B.

[617] However, the TBOC does impose restrictions on mergers involving nonprofit corporations. *See* TBOC § 10.010.

[618] The LLC Act's requirements appear in its Article 10.02. The TBOC's requirements are in its Sections 10.002 and 10.003.

[619] LLC ACT arts. 9.03, 10.03; TBOC § 10.007 and Revisor's Note thereto.

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.[620] The Tex. LLC Stats. grant broad authority for who can execute merger documents on a company's behalf.[621] 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.[622]

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.[623]

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.[624] 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.[625]

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.[626] 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.[627]

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

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620 LLC ACT art. 10.01A; TBOC §§ 10.001, 101.356, 101.052.

621 LLC ACT art. 10.03A; TBOC §§ 10.001(b), 10.151(b).

622 *See* LLC ACT art. 10.05; TBOC § 10.006.

623 LLC ACT arts. 10.08–.09; TBOC §§ 10.101–.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.

624 *See supra* notes 202–03 and accompanying text regarding the requirements of TBCA arts. 5.09–.10 and the parallel TBOC provisions.

625 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.

626 1991 LLC ACT art. 8.12.

627 *Id.*

with the concept of limited liability for Members in the LLC Act and was not intended to be carried over.[628] 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.

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–.05 (correction of defective filings with Secretary of State)

TMCLA articles 2.03, 2.04, 2.09 and 2.09A were repealed by H.B. 1165 effective September 1, 2003, but LLC Act section8.12B 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

[628] *See* LLC Act § 4.03; *see also supra* notes 576–80 and accompanying text.

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.[629] 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.[630] However, under 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.[631] 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.[632] 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.[633]

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.[634] However, for matters affecting intrastate business in Texas, a Foreign LLC is subject to the same duties, restrictions, and liabilities as a domestic LLC.[635] 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.[636]

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[629] LLC Act Part Seven; TBOC chapter 101.

[630] "Foreign limited liability company" is broadly defined in LLC ACT art. 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 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.

[631] *See* TBOC §§ 9.001, 101.001 and the Revisor's Notes thereto.

[632] LLC ACT arts. 7.01A, 7.05; TBOC §§ 9.001, 9.004.

[633] LLC ACT art. 7.01B; TBCA § 8.01B; TBOC § 9.251.

[634] LLC ACT article 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).

[635] LLC ACT art. 7.02A; TBOC § 9.203.

[636] LLC ACT art. 7.13B; TBOC § 9.051(c).

S. Professional LLCs

Tex. LLC Stats. expressly provide for the formation of professional LLCs and specify the statutory requirements for such entities.[637] The pertinent provisions of the LLC Act (a predecessor to the TBOC), including the definition of "professional service," were based upon the Texas Professional Corporation Act ("TPCA").[638] Physicians, surgeons, and other doctors of medicine are excluded from forming professional LLCs.[639]

A professional limited liability company (a "PLLC") is required to contain in its name the words 'Professional Limited Liability Company' or an abbreviation thereof.[640] Only a "professional individual"[641] or a "professional organization"[642] may be a governing person[643] of a PLLC.[644] 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.[645]

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.[646] Where corporate precedent is applied, an

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[637] *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 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).

[638] TEX. REV. CIV. STAT. ANN. art. 1528e, §3(a) (Vernon 2002).

[639] 1993 LLC Bill Analysis at 6; LLC ACT art. 11.01; TBOC §§ 301.003, 301.012.

[640] LLC ACT art. 11.02; TBOC § 5.059.

[641] 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 art. 11.01B(3); TBOC § 301.003(5).

[642] TBOC § 301.003(7). The LLC Act uses the alternate term "professional entity," LLC ACT art. 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.

[643] "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.

[644] LLC ACT art. 11.03A; TBOC §§ 301.007(a), 301.004(2).

[645] LLC ACT art. 11.05; TBOC § 301.010.

[646] Int'l Flavors & Textures, LLC v. Gardner, 966 F.Supp. 552 (W.D. Mich. 1997).

LLC is a citizen of its state of incorporation and the state where its principal place of business is located.[647]

VI. LIMITED LIABILITY PARTNERSHIP[648]

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.[649] The LLP Provisions were refined and carried forward as section 3.08 of the TRPA[650] passed in 1993, and then were substantially expanded by S.B. 555 effective September 1, 1997.[651]

The LLP provisions appearing in the new TBOC[652] took effect on January 1, 2006 and govern all LLPs formed on or after that date.[653] The source LLP Provisions will govern LLPs formed before that date which do not voluntarily opt in to TBOC governance until their registrations expire, unless they are revoked or withdrawn prior to expiration.[654] Registration renewal, however, will be governed by the TBOC.[655] 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. Background

The LLP Provisions of TUPA originated in a separate bill, Senate Bill 302 ("S.B. 302") (by Sen. John Montford). That bill was conceived as an alternate means for allowing professionals the limitation of liability already available to them under the Texas Professional

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647 SMS Fin. II, LLC v. Stewart, 1996 WL 722080 (N.D. Tex. 1996); Carlos v. Adamany, 1996 WL 210019 (N.D. Ill. 1996).

648 The discussion of LLPs herein, insofar as it relates to LLP's under 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*, 55 TEX. B. J. 728 (July 1992).

649 Tex. H.B. 278, 72d Leg., R.S. (1991).

650 TRPA §1.01 et seq.

651 Tex. S.B. 555, 75th Leg., R.S. (1997). Under TRPA section 11.03(b), TRPA section 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 section 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 section 11.03 provides that, except for section 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).

652 *See* TBOC tit. 1, §§ 152.801–.805.

653 TBOC §§ 401.001, 402.003, 402.005.

654 TBOC § 402.001(b).

655 TBOC § 402.001(c).

Corporation Act.[656] 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 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.[657] Thus, the proposed amendments to TUPA that were contained in 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. S.B. 302 passed the Senate but encountered criticism in hearings before the House Business and Commerce Committee on grounds, among others, that the Bill was discriminatory against non-professional partnerships, that the Bill did not tell persons dealing with a partnership whether the partnership had the liability shield, and that the Bill did not require any substitute source of recovery for a person injured by partnership misconduct.[658] 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, 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 H.B. 278 in the Senate, and the House concurred in H.B. 278 as so amended. With the adoption of TRPA in House Bill 273 ("H.B. 273"), 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 H.B. 278, (iii) the passage of TRPA in H.B. 273, maintaining the LLP entity created by 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.

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.[659] 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 such liability would exist solely by reason of their being partners, rendering professional services, or participating in the

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[656] TEX. REV. CIV. STAT. ANN. art. 1528e (Vernon Supp. 2006).

[657] *See* Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065 (1995).

[658] *See* TEX. LAW. 7 (May 13,1991); TEX. LAW. 1 (Oct. 2, 1991).

[659] *See, e.g.,* N.Y. Partnership Law § 26(b) (McKinney 1988 & Supp.); Hamilton, *supra* note 657, at 1097.

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.[660]

Although Texas was the first jurisdiction in the nation to permit the creation of limited liability partnerships, TRPA lagged behind other jurisdictions in providing partners of limited liability partnerships with protection from liabilities of the partnership. To address this deficiency, S.B. 555 amended TRPA section 3.08 to bring the Texas statute more in line with the laws of other jurisdictions relating to limited liability partnerships, in particular the liability of partners of a limited liability partnership for contractual obligations. TRPA section 3.08(a), as amended, provides that, except for liability for errors, omissions, negligence, incompetence or malfeasance committed by, or attributed to, a partner in a registered limited liability partnership, 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 a registered limited liability partnership.[661] The new TBOC affords LLP partners the same protection.[662] This provision, however, does 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.

A new subsection (5) was added to TRPA section 3.08(a)[663] to provide that in the case of a registered limited liability partnership, the limitations of liability provided in subsection (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 a limited liability partnership does not impair the obligations under a contract existing before the effective date of S.B. 555.[664] Thus, the partners of an LLP which was subject to a long-term lease entered into prior to September 1, 1997 remain 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.[665]

TRPA section 8.06 was amended by S.B. 555 to clarify that the obligations of a partner to

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660 N.Y. Partnership Law § 26(c), (d) (McKinney 1988 & Supp.).

661 TRPA § 3.08

662 TBOC § 152.801.

663 The TBOC's parallel provision is in § 152.801(f).

664 S.B. 555 section 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.

665 TBOC § 402.006.

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 section 3.07 and 3.08 relating to LLPs and the liability of incoming partners. TBOC section 152.707 provides substantially the same.

C. Liability Shielded

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.[666] 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.

1. LLP Shield

The essence of the Tex. LLP Stats. shield is 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 is set forth in TBOC section152.801 as follows:

> Sec. 152.801. Liability of Partner.
>
> (a) Except as provided by Subsection (b), a partner in a limited liability partnership is not personally liable, 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.
>
> (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,

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[666] TRPA § 3.05(a), (d)–(e); TBOC § 152.306(b). *See* BROMBERG & RIBSTEIN, *supra* note 311, § 1.01 and ch. 5 for a general discussion of the liabilities of general partners.

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.

These provisions are substantially the same as those found in TRPA section 3.08(a).

2. Limits to LLP Shield

The Tex. LLP Stats. expressly do not relieve a partner for any liability imposed by law or contract independently of his status as a partner, including torts committed by him while acting on behalf of the partnership.[667] In addition, there are three situations in which the statutes do not shield a partner from liability for a partnership obligation arising from the specified misconduct of a copartner or representative of the partnership:

(1) The miscreant copartner or representative is working under the supervision or direction of the partner.[668]

(2) The partner is directly involved in the specific activity in which the copartner or representative commits the misconduct.[669]

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[667] TRPA § 3.08(a)(3)(B); TBOC § 152.801(e).

[668] TRPA § 3.08(a)(2); TBOC § 152.801(b)(1).

[669] TRPA § 3.08(a)(2)(A); TBOC § 152.801(b)(2).

(3) The partner has "notice" or "knowledge" of the misconduct at the time of occurrence and fails to take reasonable steps to prevent the misconduct.[670]

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.[671] 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. This means that exception (1) would not be applicable. Further, the real estate lawyer would not ordinarily be viewed as "involved in the specific activity" in which the misconduct occurred (i.e., advising with respect to environmental law), which means that exception (2) would not apply.

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, name and insurance 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.

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[670] TRPA § 3.08(a)(2)(B); TBOC § 152.801(b)(3). Tex. LLP Stats. provide 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.

[671] *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).

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.[672] 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.[673] 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.[674]

5. Shielded vs. Unshielded Obligations

The LLP shield only applies to the liability of partners for the covered partnership obligations incurred while the partnership is an LLP.[675] The partners remain jointly and severally liable for all other partnership obligations. A partnership at any time may have both shielded and unshielded obligations.

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. Contractual Obligations Incurred Prior to September 1, 1997

The amendment to TRPA section3.08 making Texas a full shield state does not apply to contractual obligations incurred prior to the September 1, 1997 effective date of S.B. 555 by virtue of S.B. 555 section125(d), which 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."

Such obligations are similarly unshielded for partnerships governed by the TBOC.[676] Thus, the partners of an LLP which was subject to a long term lease entered into prior to September 1, 1997 remain personally liable for those lease obligations notwithstanding the amendment of TRPA section3.08, although the same obligation incurred thereafter would be shielded unless the partners had agreed to be liable therefor.

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672 TRPA section 3.08(a)(3)(A) and TBOC section 152.801(e)(1) provide that the other Texas LLP provisions "do not affect . . . the liability of a partnership to pay its debts and obligations [out of] partnership property."

673 TEX. R. CIV. P. 28.

674 TRPA § 3.08(a)(3)(C) (Vernon Supp. 2008).

675 *See* Elmer v. Santa Fe Properties, Inc., 2006 WL 3612359 (Tex. App.—San Antonio 2006, no pet. h.) (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).

676 TBOC § 402.006.

7. 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,[677] perhaps in recognition that some malpractice claims could be pled in contract as well as in tort.[678] Under most LLP statutes, including that of Delaware,[679] 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.[680] 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.[681]

D. Requirements for LLP Status

Each of the three 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.[682]

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677 *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).

678 Miller, *Procedural and Conflict Laws Issues Arising In Connection With Multi-State Partnerships* (ABA BUS. L. SEC. 1996 Spring Meeting).

679 DEL. CODE ANN. tit. 6, § 1515 (1999 & Supp. 2005).

680 MD. CORP. & ASS'N. CODE ANN. § 9A-306(d)(1) (1999).

681 *See* KY. REV. STAT. ANN. § 362.220 (Michie 2002); UTAH CODE ANN. § 48-1-12(2) (2002).

682 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, <u>except that the names of a professional </u>corporation<u> or professional association may contain "P.C." or "P.A." or similar symbols indicating the nature of the organization</u> . . .

[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

2. Filing with the Secretary of State of Texas

LLPs are considered to be non-filing entities under the TBOC.[683] Nonetheless, to achieve domestic LLP status, a partnership must file with the Secretary of State of Texas[684] an application accompanied by a fee for each partner of $200.[685] 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,[686] and (b) be executed by a majority in interest[687] 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.[688]

If the required information is supplied in the application and the fee is paid, the LLP registration becomes effective upon filing.[689] 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.[690]

Registration remains effective for a year,[691] regardless of changes in the partnership, unless the registration is earlier withdrawn or revoked or unless renewed.[692] 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

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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.

683 *See* TBOC §§ 1.002(57), (34).

684 The rules of the Secretary of State dealing with LLP filings may be found at TEX. ADMIN. CODE tit. 1, §§ 80.1–.7 (2003) as well as TRPA § 3.08(b) and TBOC § 152.802.

685 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 section 3.08(b)(3) and TBOC section 4.158(1). For a foreign LLP, the fee is $200 per partner in Texas, not to exceed $750, under TRPA section 10.02(c) and TBOC section 4.158(1).

686 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.

687 "Majority in interest" is defined in TRPA section 1.01(10), TRLPA section 1.02(7), and TBOC section 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.

688 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, *supra* note 677, at 114–15.

689 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.

690 TRPA § 3.08(b)(16); TBOC § 4.001(a)(2).

691 TRPA § 3.08(b)(5); TBOC § 152.802(e).

692 TRPA §§ 3.08(b)(6)–(7); TBOC § 152.802(e).

refiling with the Secretary of State until the next renewal filing.[693] Caution suggests an amendment to the application if the partnership changes its name. LLP's should arrange their own reminders, since the Secretary of State is not obliged to send renewal notices.

3. Insurance or Financial Responsibility

The third requirement for LLP status under Tex. LLP Stats. is 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.[694]

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) is intended to provide some source of recovery as a substitute for the assets of partners who are shielded from liability by the Tex. LLP Stats. The $100,000 figure is arbitrary and may or may 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 is incurred is a requirement for the liability to be shielded, and it is not sufficient that a partner individually maintains insurance in such amount.[695]

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[693] *See* TRLPA § 3.08(b)(4); TEX. ADMIN. CODE tit. 1, §§ 80.1, 80.4 (2008); *see also* TBOC § 152.802(d).

[694] TBOC § 152.804(a). TRPA section 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.

[695] In Elmer v. Santa Fe Props., Inc., 2006 WL 3612359 (Tex. App.—San Antonio 2006), 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 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

The $100,000 requirement refers to the liability limit of the insurance, above any deductibles, retentions or similar arrangements; thus, deductibles, retentions and the like are permitted so long as the coverage would allow aggregate proceeds of at least $100,000. The statute is not explicit about the effect on one claim of exhaustion of the policy limits by a prior claim. The intent is 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 is shielded by Tex. LLP Stats.[696] The quoted phrase contains some flexibility; actual coverage of the misconduct that occurs is not an absolute necessity. The partner claiming the shield from liability, however, has 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) allow 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 is on the partner claiming the liability shield of TBOC section 152.801 or TRPA section 3.08(a).[697]

The Tex. LLP Stats. provide 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."[698] These provisions are intended to keep the existence of insurance from influencing a jury decision on liability or damages. Tex. LLP Stats. specifically state that if compliance with their insurance or fund provisions is disputed, "compliance must be determined separately from the trial or proceeding" to determine liability or damages.[699]

E. Taxation

1. Federal Tax Classification

If a domestic LLP has two or more members, then it can be classified as a partnership for federal income tax purposes under the Check-the-Box Regulations.

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rather than the kind of tort liability for which the statutorily required insurance would provide coverage.

[696] TRPA § 3.08(d)(1)(A); TBOC § 152.804(a)(1).

[697] *See* TRPA § 3.08(d)(3); TBOC § 152.804(c).

[698] TRPA § 3.08(d)(2); *see also* TBOC § 152.804(b).

[699] TRPA § 3.08(d)(3); *see also* TBOC § 152.804(c).

2. *Texas Entity Taxes*

As a species of general partnership, an LLP was not subject to the Texas franchise tax.[700] 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 is not applicable.[701]

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.[702]

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 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.[703]

2. *Assumed Name Certificate*

Since an LLP is a species of general partnership, prior to House Bill ("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")[704] like any other

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700 TEX. TAX CODE ANN. § 171.001 (Vernon 2002 and Supp. 2004).

701 *See* discussions *supra* Part I. General—E. Texas Entity Taxation—3. Margin Tax and Part I. General—E. Texas Entity Taxation—4. Constitutionality of Margin Tax.

702 Burgess J. W. Raby & William L. Raby, *Partners, LLC Members, and SE Tax*, 87 TAX NOTES 665, 668 (April 26, 2000).

703 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).

704 TEX. BUS. & COM. CODE § 36.01ff (Vernon 2002).

general partnership. H.B. 1239 sections1.29–.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. 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.[705] 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.[706] 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.[707] 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 order to raise the liability shield. Texas law explicitly states that the shielded partners are not liable for misconduct incurred while the partnership is a limited liability partnership.[708]

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.[709] 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.[710] 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 before dissolution.

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[705] TEX. BUS. & COM. CODE § 36.02(7) as amended by H.B. 1239.

[706] TEX. BUS. & COM. CODE § 36.10 as amended by H.B. 1239.

[707] TEX. BUS. & COM. CODE §§ 36.25 and 36.26.

[708] TBOC § 152.801(a); *see also* TRPA § 3.08(a)(1). This result is buttressed by the Bar Committee Bill Analysis of H.B. 273 which at 14 states that TRPA section 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."

[709] 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.).

[710] *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).

4. *Effect on Pre-LLP Liabilities*

An LLP is the same partnership that existed before it became an LLP.[711] 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.*,[712] 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."[713] However, there is nothing in the court's opinion suggesting that registration as an LLP is enough to make the partnership a different partnership.[714]

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 "LLLP."[715] 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,[716] 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.,[717] and (iii) contains in its name "limited liability partnership" or an abbreviation thereof.[718][719]

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.[720] Under Tex. LLP Stats., a limited partner in an LLLP whose conduct would otherwise render it liable as a general partner has the

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711 *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).

712 922 S.W.2d 626 (Tex. App.—Fort Worth 1996, writ denied).

713 *Id.* at 629.

714 For an analysis of the Shannon, Gracey case, *see* Elizabeth S. Miller, Th*e 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.

715 *See* TRPA § 3.08(e); TBOC §§ 152.805, 1.002(47).

716 TRPA § 3.08(b); TBOC § 152.802.

717 TRPA § 3.08(d); TBOC § 152.804.

718 TBOC § 5.055(b). The name requirements differ slightly for entities still governed by the TRLPA. *See* TRLPA § 2.14(a)(3).

719 TRLPA § 2.14; TBOC § 153.351.

720 TRLPA § 3.03; TBOC § 153.102.

benefit of the LLP shield.[721]

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.[722] It seems inconsistent with the Tex. LLP Stats. to allow a partner to recover, directly or indirectly, from copartners who are shielded from liability by the same statutes, absent a specific agreement of indemnification. 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.[723] 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 with those described above,[724] a creditor could argue that the partnership agreement supersedes the shield afforded by the Tex. LLP Stats.[725] 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

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[721] TRLPA § 2.14(c); TBOC § 153.353.

[722] TRPA § 3.08; TBOC § 152.801.

[723] *See, e.g.,* Flynn v. Reaves, 218 S.E.2d 661 (Ga. App. 1975).

[724] 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.
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> . . . .
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> 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 Indus., 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).

[725] Bishop, *supra* note 677, at 118–20.

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.[726] The partnership 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,[727] 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.[728]

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*,[729] 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 Texas[730] may qualify to do business in Texas like a

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726 *See* Banoff, *Alphabet Soup: A Navigator's Guide*, 4 BUS. L. TODAY 10, 12 (1995).

727 TRPA § 1.01(12); TBOC § 151.001(4).

728 Bishop, *supra* note 677, at 120.

729 1997 WL 20881, 6 (Tex. App.—Amarillo 1997, no writ) (not designated for publication).

730 Texas law does not define what constitutes "transacting business in Texas" for the purposes of the requirement of TBOC section 152.905 (and the substantially similar TRPA section 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 section 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

foreign LLC[731] (the filing fee would be the lesser of $200 per resident partner[732] or $750);

(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 depositary 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;

(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.

731 *See* TRPA article X; TBOC Chapter 9 and §§ 152.901–.914 & 402.001(e).

732 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, section 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

(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.

(Emphasis added).

however, the failure of the foreign LLP to qualify would not affect its LLP shield in Texas.[733] Under the Tex. LLP Stats., the laws of the state under which a foreign LLP is formed will govern its organization and internal affairs and the liability of partners for obligations of the partnership.[734]

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.[735] 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."[736]

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,[737] 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.[738]

10. Bankruptcy

Section 723 of the Bankruptcy Code[739] 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.[740]

11. Federal Diversity Jurisdiction

An LLP is a citizen of every state in which one of its partners resides for the purposes of

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733 TRPA § 10.03(c); TBOC §§ 9.051, 152.910.

734 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.

735 TRPA § 10.01; TBOC §§ 1.101–.105.

736 TRPA § 1.05(a)(1). *See* TBOC § 1.002(43)(C)(i), providing substantively the same. *See also* TEX. BUS. & COM. CODE § 35.51.

737 DEL. CODE ANN., tit. 6, §§ 1515, 1547 (1999 & Supp. 2002).

738 N.Y. P'SHIP LAW § 121-1502 (McKinney Supp. 2006); MD. CODE ANN. CORPS. & ASS'NS § 9A-1101 (1999).

739 11 U.S.C. § 723, as amended by Pub.L. 103-394, Title II, § 212, Oct. 22, 1994, 108 Stat. 4125 (the "Bankruptcy Code").

740 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.

Federal court diversity jurisdiction.[741] As a result, large accounting firms with offices in most states are likely beyond the reach of the diversity jurisdiction of the Federal courts.[742]

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.[743] The principal case that did not follow this doctrine was a Texas case, which has been effectively overturned by H.B. 278. 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.[744]

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."[745]

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.[746] Texas has thus codified the internal affairs doctrine recognized by the courts of other states, as

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[741] Reisman v. KPMG Peat Marwick LLP, 965 F. Supp. 165 (D. Mass. 1997), relying on Carden v. Arkoma Assoc., 494 U.S. 185 (1990).

[742] 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."

[743] TBOC § 1.101–.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).

[744] *See* Herbert B. Chermside, 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.").

[745] LLC Act § 4.03B.

[746] TRPA § 1.05; TBOC §§ 1.101–.105.

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.[747] In *Means v. Limpia Royalties*,[748] 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."[749]

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[747] 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).

[748] 115 S.W.2d 468, 475 (Tex. Civ. App.—Ft. Worth 1938, writ dism'd).

[749] 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

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.[750] The Bill Analysis[751] used by the Legislature in connection with the consideration of 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.[752]

> association of two or more persons to carry on as co-owners a business for profit." Section 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.

[750] H.B. 278 § 46 Part Seven. Prior to the enactment of 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 section 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–.105.

[751] Bill Analysis of H.B. 278 by Wolens at 10 (1991). *See* 1991 Bill Analysis Summary at 41.

[752] "Foreign Limited Liability Company" is broadly defined in LLC Act section 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 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.

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.[753] 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 Spain[754] and that the liability of Sarria and the extent of the authority of his partners to bind him[755] were to

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See also discussion *supra* Part V. R.—Foreign LLCs and TBOC §§ 9.001–.003.

H.B. 278 section 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 H.B. 278 section 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–.105.

[753] King v. Sarria, 69 N.Y. 24 (Ct. of App. 1877).

[754] 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, 298 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).

[755] 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

be determined by those laws. The court stated:

> [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.[756]

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.[757] However, in reaching this conclusion, the court noted that the Spanish statute resembled New York's own statute for the formation of limited partnerships.[758]

The 1982 New York case of *Downey v. Swan*[759] 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.[760] 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.[761]

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, L.L.P.*,[762] 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

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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 sections 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.

756 *Sarria*, 69 N.Y. at 34.

757 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 (Sup. Ct. Bronx Co. 1918).

758 The court indicated that the same reasoning would apply to contract and tort claims.

759 Downey v. Swan, 454 N.Y.S.2d 895 (N.Y. App. Div. 1982).

760 *Cf.* Schneider v. Schimmels, 64 Cal. Rptr. 273 (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).

761 *Cf.* Abu-Nassar v. Elders Fututes, Inc., No. 88-Civ. 7906, U.S. Dist. LEXIS 3794 (S.D.N.Y. Mar. 28, 1991), in which an LLC organized under Lebanese law was treated as though it were a foreign corporation for purposes of analyzing choice of law and veil piercing liability.

762 Liberty Mutual Insurance Co. v. Gardere & Wynne, L.L.P., 1994 WL 707133, Civ. A. No. 94-10609-MLW (D. Mass. Dec. 6 1994).

status[763] 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.

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763 *Liberty Mutual Ins. 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 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.

> 109, section48 (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. Mfs. Co.*, 313 U.S. 487, 496 (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.[764]

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.[765] 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.[766] Likewise, since all states 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.[767]

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764 *Gardere & Wynne*, 1994 WL 707133 at *6 n.7.

765 Miller, *Procedural and Conflict of Laws Issues Arising In Connection With Multi-State Partnerships*, ABA BUS. L. SEC. (1996).

766 LLC Act §§ 7.01–.02; N.Y. LLC Law §§ 801–802 (2006); 6 DEL. CODE §§ 18-901–18-902 (2006). N.Y. LLC Law section 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 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.

767 DEL. CODE ANN. tit. 6 § 15-1101 et seq (2005); 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

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.[768]

VIII. DECISION MATRIX

Key elements in deciding among business entities are (1) how the entity will be taxed and (2) who will be liable for its obligations. The entity itself will always be liable to the extent of its assets, so the question is who will be liable, if anyone, if the entity's assets are not sufficient 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 and then pay taxes on earnings distributed to them, the choice is easy—regular business corporation without an S-corporation election.

If the owners do not want the entity's earnings to be taxed twice, the entity selection process becomes more complicated and the choices are:

- General partnership
- LLP
- Limited partnership
- LLC
- S-corporation

A. If limited liability of the owners is unimportant and all of them are individuals, the choice is a general partnership in which partners are jointly and severally liable for all partnership liabilities.

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.

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, but has its own limitations:

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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.

768 *See* Rogers, *supra* note 637, at 411; Meyer v. Okla. Alcoholic Laws Enforcement Comm'n, 890 P.2d 1361 (Okla. Ct. App. 1995) (finding that an LLC is not permitted to hold liquor license).

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 LLP which has the effect of limiting the liability of the general partner

2. limited partners who participate in management of business may become liable as general partners, but statutes generally allow a degree of participation and no liability unless reliance upon the limited partner as a general partner

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.[769]

D. The LLC can be structured to have tax flow through and 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.[770]

(ii) self-employment tax issues

(iii) questions regarding

- state income taxation issues

- 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

E. The <u>S-corporation</u> 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. S-corporation status is not available where the entity:

1. has more than <u>100</u> equity holders;

2. has more than <u>one</u> class of stock;

3. has among its shareholders any:

    - general or limited partnership

    - trust (certain exceptions)

    - non resident alien

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[769] *See* discussions *supra* Part I. General—E. Texas Entity Taxation—3. Margin Tax and Part I. General—E. Texas Entity Taxation—4. Constitutionality of Margin Tax.

[770] *See* discussion *supra* Part I. General—E. Texas Entity Taxation—3. Margin Tax.

- corporation (exception for "qualified subchapter S subsidiary").

IX. TAX COSTS IN CHOICE OF ENTITY DECISION

The following chart compares the taxes that would be paid by different entities and their owners based on assumed gross receipts, gross margin and net income in 2008. 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 section171.101(a)(1) and all of which is apportioned to Texas under Tex. Tax Code section171.101(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 distributed (after taxes) to its owners. It is also assumed that the owners will have earned income or wages in excess of the base amount for the tax year and will therefore be subject to only the 2.9% Medicare tax (and not the 12.40% social security equivalent tax to a base of $102,000 in 2008).

Item	**C-Corporation**	**S-Corp or Limited Liability Company**[(a)]	**General Partner in General or Limited Partnership**[(a)]	**Limited Partner in Limited Partnership**[(a)]
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 [(b)]	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[(c)]	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[(d)]	2.90	0
Taxable Income of Owner	60.45	90.10[(e)]	90.10[(e)]	93.00
Fed. Income Tax on Dividends (at 15%)	9.07			
Fed. Tax on Income Allocation (at 35%)		31.54	31.54	32.55
Amount Received After Taxes	**51.38**	**58.56**	**58.56**	**60.45**

(a) Assumes that (i) the entity is treated as a partnership for federal income tax purposes and (ii) one of its owners is a business entity.

(b) Assumes that (i) Margin Tax is applicable since gross receipts are all in 2008, (ii) the gross margin for Margin Tax purposes is $700, which would be the maximum taxable margin under Tex. Tax Code section 171.101(a)(1), and all of it is apportioned to Texas under Tex. Tax Code section 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 section 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* discussion *supra* Part I. General—E. Texas Entity Taxation—3. Margin Tax.

(c) Post Margin Tax, 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.

(d) 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 actual or constructive dividends but would be subject to self-employment tax on compensation received.

(e) One-half of the self-employment tax is deductible against the individual's income for federal income tax purposes.

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

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

Item	**Sole Proprietorship**	**General Partnership**	**Limited Liability Partnership**	**Limited Partnership**	**Limited Liability Company**	**"C" Corp.**	**"S" Corp.**
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
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

Item	Sole Proprietorship	General Partnership	Limited Liability Partnership	Limited Partnership	Limited Liability Company	"C" Corp.	"S" Corp.
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

Texas Law Entity	Check-the-Box	Federal Taxation	TX Franchise Tax until 1/1/07[771]	TX Margin Tax 1/1/07
Proprietorship	Not Applicable	Form 1040, Schedule C or E	None	None
LLC / single individual member	Disregarded[772]	Form 1040, Schedule C or E (Proprietorship)	Yes	Yes
LLC / single entity member	Disregarded[773]	Division of Member Entity	Yes	Yes
General Partnership or LLP	Partnership[774]	Partnership	None	Depends
General Partnership or LLP	Corporation	C or S-Corp[775]	None	Depends
Limited Partnership	Partnership[776]	Partnership	None	Yes
Limited Partnership	Corporation	C or S-Corp[777]	None	Yes[778]
LLC / multi-members	Partnership[779]	Partnership	Yes	Yes[780]
LLC / multi-members	Corporation	C or S-Corp[781]	Yes	Yes
Corporation	Not Applicable	C or S-Corp[782]	Yes	Yes

771 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* discussion *supra* Part I. General—E. Texas Entity Taxation—3. Margin Tax.

772 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.

773 *See supra* note 772.

774 Unless a partnership or multi-member LLC affirmatively makes an election on 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).

775 To be taxed as an S Corp, the entity and all 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).

776 *See supra* note 774.

777 *See supra* note 775.

778 Unless LP qualifies as a "passive" entity. TEX. TAX CODE § 171.0003.

779 *See supra* note 774.

780 *See supra* note 778.

781 *See supra* note 775.

782 *See supra* note 775.