

PARTNERSHIPS, LLCs AND OTHER BUSINESS ENTITY AGREEMENTS: DRAFTING CONSIDERATIONS

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REAL ESTATE DOCUMENTS, WORKOUTS AND CLOSINGS

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APPENDIX A – Entity Comparison Chart

PARTNERSHIPS, LLCs, AND OTHER BUSINESS ENTITY AGREEMENTS: DRAFTING CONSIDERATIONS

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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 must consider the following five forms of business entities:

- Corporation
- General Partnership
- Limited Partnership
- Registered 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 entity selection focus will be on (i) how the entity and its owners will be taxed and (ii) the extent to which the entity will shield the owners of the business from liabilities arising out of its activities.

In 1991, the Texas Legislature passed legislation allowing for the creation of the LLP and the LLC, which has 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 through a filing with the Secretary of State and compliance with certain other statutory requirements. 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 for corporate obligations is limited. Now all 50 states plus the District of Columbia have adopted LLP and LLC statutes. Both the LLP and the LLC can be treated as partnerships for federal income tax purposes.

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Texas business 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. In 1997, there were major changes in the laws and regulations under which these business entities are organized, governed and taxed. The 75th Session of the Texas Legislature (the “1997 Legislative Session”), which adjourned *sine die* on June 2, 1997, brought Senate Bill 555, which became effective September 1, 1997 (“SB 555”) and made numerous changes in Texas’ business entity statutes, some of which are quite innovative. The changes effected in 1999 and 2001 were limited.

B. 2001 Legislative Session Actions. During the 77th Session of the Texas Legislature, which convened January 9, 2001 and adjourned *sine die* on May 28, 2001 (the “2001 Legislative Session”), the entity statute focus of the Legislature and the Texas Business Law Foundation was on the proposed Texas Business Organizations Code (H.B. 327 by Fred Bosse; S.B. 967 by John Carona) (the “Entity Code”). This proposed new Entity Code¹ was intended to provide maximum flexibility to organizations in establishing their capital structures, effecting business combination transactions and governing their internal affairs, and would have become a model for future statutes and solidified Texas’ position as a leader in corporate law. The Entity Code was amended by, and passed out of, the House Committee on Business and Industry, but was never set by the House Calendars Committee for a vote by the House of Representatives. The Senate did not act on the Entity Code.

The Entity Code was intended to be a substantive codification of the existing Texas statutes governing non-profit and for-profit, private-sector entities. These statutes consist of the following: Texas Business Corporation Act (“TBCA”), Texas Non-Profit Corporation Act, Texas Miscellaneous Corporation Laws Act (“TMCLA”), Texas Limited Liability Company Act, Texas Revised Partnership Act (“TRPA”), Texas Revised Limited Partnership Act (“TRLPA”), Texas Real Estate Investment Trust Act, Texas Uniform Unincorporated Nonprofit Associations Act, Texas Professional Corporation Act, Texas Professional Associations Act, Cooperative Associations Act and other existing provisions of Texas statutes governing private entities.

The proposed Entity Code adopted a “hub and spoke” organizational approach under which provisions common to all entities are included in a central “hub” of the Entity Code found in Title 1. These common provisions are collected in and include the provisions governing (i) indemnification of directors and partners, (ii) mergers among entities and (iii) purposes and powers of entities. Outside Title 1, separate “spokes” contain provisions governing different types of entities which are not common or similar among the different entities.

The Entity Code, 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.² In the codification process, the objective is generally not to

¹ Tex. H.B. 327 77th Leg., R.S. (2001), available at <http://www.capitol.state.tx.us/tlo/77r/billtext/HB00327L.HTM> (Rep. Fred Bosse).

² Ad Hoc Codification Committee of the Business Law Section, *Report of the Codification Committee of the Section of Business Law of the State Bar of Texas on the Proposed Business Organizations Code*. The Bar Committee was primarily responsible for drafting the Code in collaboration with the Office of the Texas Secretary of State and the Texas Legislative Council.

make any substantive revisions to the Texas statutes. As a result, the principles of Texas law discussed below were carried forward into the Entity Code.

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

1. Classification. Under the Internal Revenue Code of 1986, as amended (the “Code”), and the Treasury regulations promulgated thereunder, 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) 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, or, if it is a single-owner entity, it may be disregarded as a separate entity for federal income tax purposes. For many years, the Internal Revenue Service (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 “check-the-box” regulations discussed below that effectively allow a partnership or LLC to elect whether to be taxed as a corporation.

2. Check-the-Box Regulations. On December 17, 1996 the IRS issued Treas. Regs. § 301.7701-1, -2 and -3 (the “Check-the-Box Regulations”), which completely replaced the Former Classification Regulations (discussed hereinafter) and became effective as of January 1, 1997. 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. Although the four factor technical analysis of the IRS’ former classification regulations has been completely replaced, the IRS still requires certain prerequisites to be fulfilled prior to either qualification under the default rules or making a valid election:

(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 Code, e.g., real estate mortgage investment conduits (“REMICs”). 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. 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). Among the entities that the Check-the-Box Regulations automatically classify as corporations are over 80 specific types of foreign business entities. 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.

(b) The Default Rules. The default rules under Treas. Reg. § 301.7701-3(b)(1) provide that a domestic eligible entity 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 that has unlimited liability.

(c) The Election Rules. An eligible entity that is desirous of classification as something other than its default classification or changing its classification may file an election with the IRS on Form 8832 (Entity Classification Election). For example, 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, then an election will be necessary. The Treasury Regulations require that Form 8832 be signed by each member of an entity or any officer, manager or member of the entity who is authorized to make the election and who represents to having such authorization under penalties of perjury.

(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 basis³ 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. Therefore, unless an existing eligible entity elects 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. 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. 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 Treas. Reg. § 301.7701-2⁴ (the "Former Classification Regulations"), an unincorporated organization would have been treated by the IRS as an "association" (taxable as a corporation) if the organization had more corporate characteristics than non-corporate characteristics. Thus, if an entity possessed more than two of the four corporate characteristics, it would have been classified as a corporation for purposes of Federal income taxation and, if it had two or less of the corporate characteristics, it would be classified as a partnership. These four characteristics are still important for they will be embodied in existing partnership and LLC agreements and

³ The term "reasonable basis" has the same meaning as under IRC §6662, which addresses the accuracy-related penalties. 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".

⁴ This regulation is a codification of the test first set forth in *Morrissey v. CIR*, 296 U.S. 344 (1935). See B. BITTKER AND J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS §2.02 (5th ed. (1987)) for a discussion of classification of associations as corporations for federal income tax purposes.

likely will be encountered in drafts of new documents for years to come. The four corporate characteristics were:

(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 (“Dissolution Event”).⁵ If the occurrence of a Dissolution Event causes a dissolution of the organization, continuity of life does not exist, even if the remaining members have the ability to opt, by unanimous or majority consent, to continue the business.⁶ 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. 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.⁷ Since 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

⁵ 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).

⁶ *Id.* 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 Priv. Ltr. Rul. 9010027 (December 7, 1989), in which the IRS, considering an LLC’s tax status, ruled that “because 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.” (Even if a majority vote to continue the business were insufficient to preclude continuity of life, the IRS should have based its ruling on the Regulations governing the LLC, not on the Act under which the LLC was formed.) 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. Rev. Rul. 93-91 and Rev. Proc. 95-10 confirm the applicability of this standard to LLC’s.

⁷ Priv. Ltr. Rul. 90-30013 (April 5, 1993) (“[N]o 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 partners. 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.”); Priv. Ltr. Rul. 90-29019 (April 9, 1990); Priv. Ltr. Rul. 89-37010 (June 6, 1989). Former Treas. Reg. § 301.7701(c)(1) provides that “An 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.

authority to act on behalf of the organization independent of its members.⁸ The key to this characteristic is the ability to bind the entity while in the role of a representative as opposed to that of 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 if the organization's assets are insufficient to satisfy such debts or obligations.⁹ In the case of a limited partnership, the IRS deems the entity to have limited liability where the general partner has no substantial assets (other than his interest in the partnership) which could be reached by creditors of the entity and is merely a "dummy" acting as agent of the limited partners.¹⁰ To negate the characteristic of limited liability under the Prior Classification Regulations, tax lawyers advised that the general partner should have substantial assets. The capitalization of the general partner is no longer relevant from a tax standpoint under the Check-the-Box Regulations.

(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 profits but cannot assign his rights to participate in the management of the organization.¹¹ 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. Partnership and LLC agreements traditionally have contained provisions intended to negate free transferability by giving a general partner or manager the discretion to decide whether to approve a proposed transfer. These provisions are no longer appropriate except to the extent needed to achieve the parties business objectives or to facilitate compliance with securities laws.

D. Texas Franchise Tax.

1. Currently. Corporations and LLCs are subject to the Texas franchise tax,¹² which is 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" is computed by determining the entity's reportable federal taxable income, adding to that amount the compensation of officers and directors (unless the corporation has not more than 35 shareholders or is an S corporation for federal tax purposes, in which case the add-back is not required),¹³ making certain other adjustments, and then apportioning the adjusted amount 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" is really a 4.5% income tax levied at the entity level.

Limited and general partnerships (including the LLP) are not presently subject to the franchise tax, but there have been proposals to subject them to the franchise tax or some other measure of tax on their income. The Texas Comptroller of Public Accounts has issued private

⁸ See Rev. Proc. 95-10 and Rev. Rul. 93-6, 1993-3 I.R.B. 9-10. See also Bittker and Eustice at ¶2.02.

⁹ Former Treas. Reg. § 301.7701-2(d)(1).

¹⁰ Former Treas. Reg. § 301.7701-2(d)(2).

¹¹ Former Treas. Reg. § 301.7701-2(e)(1). See also Texas Uniform Partnership Act § 27.

¹² TEX. TAX CODE § 171.001 (West 2001).

¹³ TEX. TAX CODE § 171.110(6) (West 2001).

letter rulings stating that it will 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.¹⁴

Effective January 1, 2000, the Texas Tax Code was amended to provide that a corporation or limited liability company is not required to pay Texas franchise tax for a given year if the amount of the corporation's gross receipts from its entire business is less than \$150,000 (including any non-unitary income of corporations with a commercial domicile in Texas).¹⁵ The Comptroller may require a corporation or limited liability company that does not owe any tax because of this exemption to file an abbreviated information report stating the corporation's gross receipts from its entire business.

2. The Future. Efforts to reduce Texas' dependence on property taxes to fund the schools have in the past led, and may in the future lead, the Texas Legislature to consider proposed changes in the Texas tax system which would subject partnerships to the franchise tax. Since the absence of a franchise tax on partnerships is a factor to be considered in deciding whether to form a corporation, LLC or partnership, the uncertainty regarding future tax legislation itself is a consideration in the entity selection analysis.

3. Internal Partnerships Still Work. 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 is based upon Federal taxable income (computed on a separate company basis, for there is no consolidation for Texas franchise tax purposes), the corporate partner would be subject to franchise taxes to the extent that its distributive share of the partnership's income (whether or not distributed) is Texas-sourced.¹⁶ If the limited partnership were structured such that the Texas parent is a 1% general partner and the 99% limited partner is incorporated in a state without an income tax (assume Nevada) and does 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 does 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 the income from the limited partnership to its Texas parent, that dividend income would not be subject to the Texas franchise/income tax, either because the dividend is deducted in arriving at Federal taxable income or it is 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, becomes very fact specific and there are a number of structure variations available depending upon the objectives and the source of the income.

4. Conversions. Transforming an entity subject to the Texas franchise/income tax 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

¹⁴ See e.g., Comptroller Taxpayer Response Letter Accession No. 9811328L (Nov. 30, 1998).

¹⁵ TEX. TAX CODE § 171.102(d) (West 2001).

¹⁶ TEX. TAX CODE § 171.1032(c); Tex. S.B. 1125, §57, 77th Leg. (2001).

Texas), and consents of lenders, lessors and others. More recently, a simpler “conversion” method for reducing Texas franchise taxes has evolved, utilizing the Check-the-Box Regulations and the conversion procedures added in recent years to the TBCA, TRLPA and TRPA.¹⁷ The conversion method requires converting an existing corporate entity subject to Texas franchise tax to a Texas limited partnership or LLP. The converted entity then files 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 ceases to be subject to Texas franchise tax when the conversion becomes effective but continues to be treated as the same corporate entity for federal income tax purposes. The conversion method should prove suitable primarily for closely held corporations. Conversions will require individual analysis and due diligence (for example, various consents may be necessary).

A Revenue Procedure¹⁸ released by the IRS in December 1999 has added an additional note of caution to the practice of using Texas’ conversion statutes to convert an existing corporation (with a valid S corporation election but subject to Texas franchise taxes pre-conversion) into a limited partnership (with a check-the box-election to be treated as a corporation for federal tax purposes but not subject to Texas franchise taxes post-conversion). The issue is whether the converted entity’s prior S corporation election remains valid after its metamorphosis into a state law limited partnership due to the Internal Revenue Code’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 had 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 liquidations proceeds.¹⁹ However, in Revenue Procedure 99-51 the IRS states 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 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 to avoid Texas franchise taxes may want to consider the alternative of using a subsidiary LLP (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.

5. Mergers. Senate Bill 1689 from the 2001 Legislature codifies Comptroller’s policy that NOL’s do not survive a merger unless they belong to the entity that survives the merger. The disappearing entity loses its NOL’s.²⁰

¹⁷ See footnotes 25 through 35 and related text.

¹⁸ Rev. Proc. 99-51, 1999-52 I.R.B. 761 (December 27, 1999).

¹⁹ See e.g., Priv. Ltr. Rul. 1999-42-009 (July 16, 1999).

²⁰ TEX. TAX CODE § 171.110(e) (West 2001); Tex. S.B. 1689, §2, 77th Leg. (2001).

E. 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. The Texas Business Corporation Act (“TBCA”) and Texas’ other business entity statutes allow corporations, LLCs and partnerships to merge with each other (e.g., a limited partnership can merge into a corporation).²¹ The respective entity statutes each have provisions providing the mechanics of the adoption of a plan of merger, for owner approval, for filings with the Secretary of State, and for the protection of creditors.

(b) Share Exchange. A business combination may be effected by a transfer of shares or other ownership interests in which either (i) all of the owners agree to the sale or exchange of their interests or (ii) there is 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.²² The respective entity statutes each have provisions providing the mechanics of the adoption of the plan of exchange for owner approval and for filings with the Secretary of State.²³

(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.²⁴

2. Conversions.

(a) General. The TBCA and Texas’ other business entity statutes allow corporations, LLCs and partnerships to convert from one form of entity into another without going through a transfer of assets or merger.²⁵ A conversion is not a combination of entities; rather it is only a change in the statutory form and nature of an existing entity. 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 respective Texas entity statutes each have 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. Those Texas statutes and the federal income tax consequences of conversions are summarized below.

²¹ TEX. BUS. CORP. ACT. ANN. (“TBCA”) art. 5.01, § A (Vernon Supp. 1999); TEX. REV. CIV. STAT. ANN. art. 1528n (“LLC Act”), art. 10.01, § A (Vernon 2001); TEX. REV. CIV. STAT. ANN. art. 6132a-1 (“TRLPA”), § 2.11 (Vernon Supp. 2001); TEX. REV. CIV. STAT. ANN. art. 6132b (“TRPA”), § 9.02 (Vernon Supp. 2001).

²² TBCA art. 5.02 § A; LLC Act § 10.06; TRLPA § 2.11; TRPA § 9.03.

²³ TBCA art. 5.02 § A; LLC Act § 10.06; TRLPA § 2.11; TRPA § 9.03.

²⁴ See TBCA Arts. 5.09 and 5.10; see Egan and Huff, *Choice of State of Incorporation - Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 287-288 (Winter 2001); Egan and French, *1987 Amendments to the Texas Business Corporation Act and Other Texas Corporation Laws*, 25 Bull. of Sec. on Corp., Bank. & Bus. L. 1,11-12 (No. 1, Sept. 1987).

²⁵ TBCA Part Five.

(b) Texas Entity Statutes. Under the conversion provisions of the TBCA,²⁶ 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, (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 the shareholder exercises his dissenters' rights under the TBCA or he 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). The LLC Act, TRLPA and TRPA have comparable provisions.²⁷

(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. Following is a brief summary of some of the federal income tax consequences of certain conversion transactions.²⁸

(1) Conversions of Entities Classified as Partnerships. There generally should be no federal income tax consequences arising from conversion of an entity classified as a domestic partnership for federal income tax purposes (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 profits interests and shares of entity liabilities do not change as a result of the conversion and the entity's business and assets continue substantially unchanged.²⁹ These transactions are viewed as tax-free contributions under Section 721 of the Code 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 all or any of the partners or members. A new taxpayer identification number is not required. Careful attention should be paid to determining the partners' or members' correct share of the entity's liabilities before and after the conversion because a decrease in a partner's or member's share of those liabilities that exceeds the partner's or member's adjusted basis in its interest will result in recognition of gain.

The conversion of an entity classified as a partnership to an entity that is ignored for federal income tax purposes (for example, one member of a two member LLC withdraws as a member) will be treated as a liquidation of the partnership. 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 its partnership interest.³⁰ Note that distributions of property contributed to the partnership within seven years of

²⁶ TBCA Arts. 5.17, 5.18, 5.19 and 5.20.

²⁷ The comparable provisions are found for LLCs at LLC Act §§ 10.08-10.11, for limited partnerships at TRLPA § 2.15, and for general partnerships at TRPA §§ 9.01, 9.05 and 9.06.

²⁸ 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).

²⁹ See e.g., Rev. Ruls. 95-37, 1995-17 I.R.B.10; 86-101, 1986-2 C.B. 94; 84-52, 1984-1 C.B. 157.

³⁰ See I.R.C. §§ 731, 736, 751(b); Prop. Reg. § 301.7701-3(g).

the date of the deemed distribution may result in recognition of gain pursuant to Code Sections 704(c)(1)(B) and 737.

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. Nevertheless, with careful planning, most conversions of this type can be accomplished without recognition of gain.³¹

(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. 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 will potentially be subject to tax at both the corporate and shareholder levels. The corporation will recognize gain or loss equal to the difference between the fair market value of each tangible and intangible asset of the corporation and the corporation's adjusted basis in the asset.³² 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.³³ 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. Careful tax analysis should be undertaken in converting a corporation (with an otherwise valid pre-conversion S election) into partnership form (electing post-conversion Check-the-Box treatment as a corporation) in order to comply with the one class of stock requirement.³⁴

(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."³⁵

F. Choice of Entity. Set forth below is a summary comparison of the respective business entities, followed by a Decision Matrix in Part IX and an Entity Comparison Chart in Appendix A, to facilitate the entity choice analysis.

³¹ See Rev. Rul. 84-111, 1984-2 C.B. 88; Prop. Reg. § 301.7701-3(g).

³² I.R.C. § 336.

³³ I.R.C. § 331(a).

³⁴ See the discussion of Rev. Proc. 99-51 at footnotes 18 and 19 *supra*.

³⁵ Tex. Atty. Gen. Op. No. JC-0126 (Oct. 13, 1999).

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

Texas business corporations are organized under and governed by the Texas Business Corporation Act, as amended (the "TBCA"),³⁶ which was significantly amended in 1997 by SB 555.

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.

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. 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 2001 are:

<u>Taxable Income</u>	<u>Marginal Tax Rate</u>
\$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%
over \$18,333,333	35%

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, although unreasonable compensation may be recharacterized by the

³⁶ TEX. BUS. CORP. ANN. arts. 1.01 *et. seq.* (Vernon Supp. 2001).

IRS as a constructive dividend, which is not deductible by the corporation and is also taxed as income to the officer, director or employee.³⁷ 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), net operating losses or capital losses to a C-corporation's shareholders. A C-corporation's shareholders are not subject to self-employment tax on distributions they receive. 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. A C-corporation will generally recognize gain or loss on its liquidation, 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. Both S- and C-corporations may be parties to a tax free reorganization in which neither the corporations involved nor their shareholders are subject to taxation.

2. Taxation of S-Corporations.

(a) Effect of S-Corporation Status. S-corporation status is achieved by an eligible C-corporation making an election to be so treated. All shareholders (including their spouses, if their stock is community property) must consent to such election. 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 may be subject to a corporate level tax 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.³⁸

(b) Eligibility for S-Corporation Status. Several provisions of the Small Business Job Protection Act of 1996 affected the federal income tax treatment of S-corporations. To be eligible for S-corporation status for tax years beginning after December 31, 1996, a corporation must (i) be a domestic corporation (i.e., organized under the laws of a state of the United States), (ii) have no more than 75 shareholders, (iii) have no more than one class of stock³⁹ and (iv) have no shareholders other than individuals who are residents or citizens of the United States and certain trusts, estates and exempt organizations, e.g., qualified employee benefit plans and IRC § 501(c)(3) organizations. S-corporations may now have a C-corporation as a subsidiary if the S-corporation owns 80% or more of the C-corporation. Additionally, an S-corporation may now own a qualified subchapter S subsidiary ("QSSS"). A QSSS includes any domestic corporation that qualifies as an S-corporation and is owned 100% by an S-corporation that elects to treat its subsidiary as a QSSS. A QSSS is not treated as a corporation separate from the parent S-corporation; all of the assets, liabilities, and items of income, deduction and credit

³⁷ See *Pediatric Surgical Associates, P.C. v. Commissioner of Internal Revenue*, T.C. Memo 2001-81 (2001), in which the Tax Court disallowed claimed deductions for salaries paid to shareholder surgeons because it found that the salaries exceeded reasonable allowances for services actually rendered and were disguised nondeductible dividends.

³⁸ IRC § 1374; Treas. Reg. § 1.1374-1.

³⁹ See footnotes 18 and 19, and related text for discussion of the single class of stock requirement as applied to limited partnerships electing corporation status under "Check-the-Box Regulations."

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. 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.⁴⁰

(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 shareholders are treated when a shareholder disposes of its interest or the S-corporation is liquidated or is a party to a nontaxable reorganization.

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.⁴¹

4. Texas Franchise Tax. Both S and C-corporations with gross receipts of \$150,000 or more must pay a Texas franchise tax equal to the greater of (i) 0.25% of “taxable capital” or (ii) 4.5% of the entity’s taxable income as reported for federal income tax purposes, with the compensation of officers and directors being added back (unless the corporation does not have more than 35 shareholders or is an S corporation) and certain other adjustments. Both S-corporations and C-corporations with 35 or less shareholders can zero out of the Texas franchise tax with owner compensation, subject to limits on unreasonable compensation and to an analysis of whether the resulting self-employment tax burden will be greater than the franchise tax burden. Professional corporations, but not professional associations, are subject to the Texas franchise tax.

5. Self-Employment Tax. Shareholders of an S-corporation will not be subject to self-employment tax on their share of the net earnings of trade or business income of the S-corporation.⁴²

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

⁴⁰ IRC § 1362(d)(1), (2), and (3).

⁴¹ IRC § 351(a), 358(a), 362(a), 368(c).

⁴² Rev. Rul. 59-221, 1959-1 C.B. 225; see also PLR 8716060.

the activities of the corporation.⁴³ 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.⁴⁴ 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*,⁴⁵ 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. Under TBCA Article 2.21, as amended, 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.).⁴⁶

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. Shareholders elect directors, who are given the power to manage the affairs of the corporation generally and to formulate policies and objectives therefor. Shareholders retain the power to vote on certain major matters.⁴⁷ Directors appoint officers, who are delegated the

⁴³ *Delaney v. Fidelity Lease Ltd.*, 517 S.W. 420, 423 (Tex. Civ. App.--El Paso 1974).

⁴⁴ *Id.*; *Sutton v. Reagan & Gee*, 405 S.W.2d 828 (Tex. Civ. App.--San Antonio 1966).

⁴⁵ 721 S.W.2d 270, 272 (Tex. 1986).

⁴⁶ See Egan and Huff, *Choice of State of Incorporation – Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 301-302 (Winter 2001); see also Bromberg, Egan, Nicewander and Trotti, *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 31 BULL. OF BUS. L. SEC. 2, 19 and 22 (No. 2, June 1994); Gaspard, “A Texas Guide to Piercing and Preserving the Corporate Veil,” 31 BULL. OF BUS. L. SEC. 24 (No. 3, Sept. 1994). The later two articles were written prior to, and do not reflect the changes to TBCA Art. 2.21 effected in 1997.

⁴⁷ TBCA art. 2.28 provides 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

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

Most corporate statutes, including the TBCA and the Delaware General Corporation Law (the "DGCL"), also provide for "close corporations" which may be managed by the shareholders directly. A Texas corporation elects "close corporation" status by including a provision to such effect in its articles of incorporation⁴⁸ and may provide in the articles of incorporation 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.⁴⁹ Under TBCA Article 2.30-1 any Texas corporation (except a corporation whose shares are publicly traded), by an agreement set forth in articles of incorporation or bylaws approved by all of the shareholders or in a written agreement signed by all of the shareholders, may modify how the corporation is to be managed and operated much in the same way as a close corporation.⁵⁰ Thus, the management

provided in the articles of incorporation. Once there is a quorum of shareholders at a meeting of shareholders, there is a quorum for all matters to be acted on that meeting.

The vote required for approval of certain matters varies depending on the matter requiring action. The vote required for the election of directors is a plurality of votes cast unless otherwise provided in the charter or bylaws of the corporation. 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. TBCA arts. 4.02A(3), 5.03E and 6.03A(3). The articles of incorporation 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.

Unless otherwise provided in the corporation's articles of incorporation 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.

Unless expressly prohibited by the articles of incorporation, shareholders will 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. TBCA art. 2.29D(2).

Each outstanding share is entitled to one vote unless otherwise provided in the corporation's articles of incorporation. TBCA art. 2.29A(1). Shares of the same class are required to be identical unless divided into one or more series. TBCA art. 2.12(A). Limitations on the voting rights of holders of the same class or series of shares are premitted, depending on the characteristics of the shares. TBCA art. 2.29(A)(2).

The voting of shares by proxy is permitted. No proxy will be valid eleven months after execution unless otherwise provided in the proxy. Proxies may be made irrevocable if coupled with an interest. TBCA art. 2.29(C).

⁴⁸ TBCA Arts. 12.11 and 12.13.

⁴⁹ TBCA Art. 12.31.

⁵⁰ TBCA Art. 2.30-1 in effect extends 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 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. The agreement is not required to be filed with the Secretary of State unless it is part of the articles of incorporation. An agreement so adopted may:

- (1) restrict the discretion or powers of the board of directors;
- (2) eliminate the board of directors and permit management of the business and affairs of the corporation by its shareholders, or in whole or in part by one or more of its shareholders, or by one or more persons not shareholders;

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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- (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, even if not in proportion to ownership of shares, subject to the limitations in TBCA Article 2.38, 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
 - (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.

The existence of an Article 2.30-1 agreement must be conspicuously noted on the certificates representing the shares or on the information statement required for uncertificated shares under TBCA Article 2.19. 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. An agreement permitted under Article 2.30-1 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.

An Article 2.30-1 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 person 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 or other law on directors to the extent that the discretion or powers of the directors are limited or supplanted by the agreement.

Article 2.30-1G provides that the existence or performance of an Article 2.30-1 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 provides protection beyond Article 2.21 on shareholder liability.

E. Fiduciary Duties.

1. General. Directors of a corporation owe fiduciary duties of care, loyalty and obedience to the corporation.⁵¹ The duty of care requires directors to exercise the degree of care that an ordinarily prudent person would exercise under similar circumstances. 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. Directors violate their duty of loyalty if they engage in or approve transactions that involve self-dealing and are unfair to the corporation.⁵² The duty of loyalty prohibits a director from usurping business opportunities that otherwise might be pursued by the corporation.⁵³ The duty of obedience requires directors to obey the law and the articles of incorporation. Controlling shareholders owe a fiduciary duty to the minority shareholders to deal fairly with them.

2. Business Judgment Rule. The business judgment rule provides a degree of protection to decisions made by corporate directors. Under the business judgment rule, directors are presumed to have satisfied their fiduciary duties in making a business decision. 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.⁵⁴ Under Texas law, the business judgment rule appears to be more favorable to directors than under Delaware law, since directors' actions are presumed to be valid if no conflict of interest exists and the action is not *ultra vires* or tainted by fraud.⁵⁵

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

⁵¹ *Gearhart Industries, Inc. v. Smith Intern. Inc.*, 741 F.2d 707 (5th Cir. 1984); see Egan and Huff, *Choice of State of Incorporation - Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 259-270 (Winter 2001).

⁵² TBCA Art. 2.35-1A validates director transactions if (i) disinterested directors, after disclosure, approve the transaction, (ii) shareholders of the corporation, after disclosure, approve the transaction, or (iii) the transaction is otherwise fair.

⁵³ The basic framework of the corporate opportunity doctrine was laid down by the Delaware Supreme Court in *Guth v. Loft, Inc.*, as follows:

if 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.*, Del. Supr., 5 A.2d 503, 511 (1939).

See also Kohls v. Duthie, 2000 WL 1041219, at *8 (Del. Ch.).

⁵⁴ *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 Egan and Huff, *Choice of State of Incorporation - Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 263-270 (Winter 2001).

⁵⁵ *See Gearhart Industries, Inc. v. Smith Intern. Inc.*, 741 F.2d 707 (5th Cir. 1984); Egan and Huff, *supra*, 54 SMU L. Rev. at 260-263.

to apply, then the burden shifts to the director to justify the fairness of the transaction to the corporation.

4. **Limitation of Director Liability.** The 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.⁵⁶ *TMCLA* Article 1302-7.06 does not authorize the limitation of liability of an officer or a director acting in the capacity of an officer.

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. Different classes and series of common stock and preferred stock may be utilized to accommodate the desires of various types of investors. Equity can be raised at the base level by common stock and at levels ranking above the common stock by preferred stocks. 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:

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. The TBCA provides that, among other restrictions, rights of first refusal and limitations on transfer necessary to maintain S-corporation status are reasonable restrictions on transfer.⁵⁷ The TBCA specifies 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.⁵⁸ Since shares in a closely-held business typically lack an established trading market, those shares may be

⁵⁶ See Egan and Huff, *supra*, 54 SMU L. Rev. at 272-273; Egan and French, *1987 Amendments to the Texas Business Corporation Act and Other Texas Corporation Laws*, 25 BULL. OF SEC. ON CORP., BANK. & BUS. L. 1, 16-21 (No. 1, Sept. 1987).

⁵⁷ TBCA Art. 2.22D.

⁵⁸ TBCA Arts. 2.22B and C.

nontransferable as a practical matter. If the owners of the business enterprise desire to conduct an initial public offering for its shares, the corporate form of entity is the best option except in certain limited circumstances.

2. **Securities Law Restrictions.** Shares in a corporation are generally considered “securities” within the meaning of 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. The corporation’s articles of incorporation may, and typically do, provide for its perpetual existence. Since a corporation is treated as a separate entity with life continuity, 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 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. Expense and trouble of multiple probate is avoided in a corporation because corporate shares are personal property subject to probate only in the deceased shareholder’s state of domicile. With respect to other types of entity, the problems associated with a finite lifetime or unanticipated dissolution may be solved in many cases by careful drafting of the entity’s constituent documents, and 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.

I. Formation. The formation of a corporation requires certain legal formalities and the preparation of certain documents. Articles of incorporation must be prepared and filed with the Secretary of State, along with the payment of a \$300 filing fee.⁵⁹ The articles of incorporation establish the initial board of directors and capital structure of the corporation. Bylaws, which control the governance of the corporation by its board of directors and officers, must be adopted by the board of directors at a meeting or by unanimous written consent of the directors.⁶⁰ An employer tax identification number must be obtained from the IRS, which necessitates the filing of an IRS Form SS-4. If the corporation is to be a close corporation, the shareholders may adopt a shareholders’ agreement, which is similar in effect to a partnership agreement. Certain non-corporate forms of business entity may not require the preparation of any documents in their simplest forms (e.g., an informal partnership of two or three partners). On the other hand, compared to a corporation with a relatively simple capital structure, the formation of a partnership or limited liability company may prove expensive, since it may require the drafting of a complicated contract rather than the relatively simple corporate charter documents.

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

⁵⁹ TBCA Arts. 3.02 and 3.03.

⁶⁰ TBCA Art. 2.23.

Eight and subject to taxation by those states. Over the years there has evolved a substantial body of law for analyzing these questions.⁶¹

K. Business Combinations; Conversions. The TBCA and Texas' other business entity statutes 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.⁶² The respective 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 TBCA,⁶³ 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 TBCA or he otherwise agrees, (d) no shareholder will become personally liable for the obligations of the resulting entity without his consent, and (e) the resulting entity is a new entity formed as a result of the conversion rather than an existing entity (which would be a merger).

L. Anti-Takeover. TBCA Part Thirteen deals with business combinations involving public companies in which 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.⁶⁴ TBCA Part Thirteen (i) applies only to an "issuing public corporation" (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)⁶⁵ and (ii) in Article 13.03 prohibits a "business combination" (defined to include a merger, share exchange, sale of assets, reclassification, conversion or other transaction between the issuing public corporation and any "affiliated shareholder" (defined as a shareholder beneficially owning 20% or more of the corporation's voting shares and certain of its related persons)) for three years after the affiliated shareholder became such unless (iii) the "business combination" is approved by the holders of not less than 2/3 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

⁶¹ See CT Corporation, *What Constitutes Doing Business* (2000).

⁶² TBCA Part Five.

⁶³ TBCA Arts. 5.17, 5.18, 5.19 and 5.20; comparable provisions are found for LLCs at LLC Act §§ 10.08-10.11, for limited partnerships at TRLPA § 2.15, and for general partnerships at TRPA §§ 9.01, 9.05 and 9.06.

⁶⁴ State corporation statutes intended to restrain some of the abuses associated with hostile takeovers were validated by the United States Supreme Court in *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 95 L. Ed. 2d 67, 107 S. Ct. 1637 (1987). See *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496 (7th Cir. 1989), *cert. denied*, 110 S. Ct. 367 (1989) (upholding Wisconsin 3-year moratorium statute); Egan and Whitlock, *State Shareholder Protection Statutes*, UT 11th Ann. Conf. on Sec. Reg. and Bus. L. Problems (March 10, 1989).

⁶⁵ Part Thirteen does 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 of Part Thirteen. See, e.g., *Tyson Foods, Inc. v. McReynolds*, 700 F. Supp. 906 (M.D. Tenn. 1988) and *TLX Acquisition Corp. v. Telex Corp.*, 679 F. Supp. 1022 (W.D. Okla. 1987).

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.⁶⁶ TBCA Part Thirteen also confirms 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.⁶⁷

III. GENERAL PARTNERSHIP.

A. General. Under § 2.02 of the Texas Revised Partnership Act ("TRPA"),⁶⁸ a partnership may be created under (1) TRPA, (2) the older Texas Uniform Partnership Act ("TUPA"),⁶⁹ (3) the Texas Revised Limited Partnership Act ("TRLPA")⁷⁰ or (4) under a statute of another jurisdiction which is comparable to any the Texas statutes referred to in (1), (2) or (3) above. If an association is created under a law other than any of such statutes, then it is not a partnership. Under TRPA, 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.⁷¹ The definition of a partnership is crucial in litigation in which a person is arguing that he is not a partner and that the disadvantages of partnership (usually individual, and joint and several liability of the obligations of the partnership) should not be imposed upon him.

TRPA governs all partnerships formed on or after January 1, 1994 and those partnerships organized before that date that make a voluntary election to be governed by TRPA.⁷² On or after January 1, 1999, TRPA applies to all Texas general partnerships.⁷³

1. Definition of "Person" Under TRPA. Any person may be a partner unless the person lacks capacity apart from TRPA. Under TRPA, a "person" is defined to include individuals, corporations, business trusts, estates, trusts, custodians, trustees, executors, administrators, nominees, partnerships of any sort, associations, limited liability companies, governments, governmental subdivisions, governmental agencies, etc. and any other legal or commercial entity.⁷⁴

2. Factors Indicating Partnership. Under § 2.03(a) of TRPA, the following factors indicate that persons have created a partnership:

- Receipt or right to receive a share of profits;
- Expression of an intent to be partners;

⁶⁶ TBCA Art. 13.03 is based on DGCL § 203.

⁶⁷ TBCA Art. 13.06.

⁶⁸ TEX. REV. CIV. STAT. ANN. art. 6132b-1.01 et seq (Vernon Supp. 2001)

⁶⁹ TEX. REV. CIV. STAT. ANN. art. 6132b (Vernon Supp. 2001).

⁷⁰ TEX. REV. CIV. STAT. ANN. art. 6123a-1 (Vernon Supp. 2001).

⁷¹ TEX. REV. CIV. STAT. ANN. art. 6132a § 6(a)(1) (Vernon 1970); TRPA § 2.02(a).

⁷² TRPA § 11.03(a); see Cooper, *The Texas Revised Partnership Act and the Texas Uniform Partnership Act: Some Significant Differences*, 57 Tex. B. J. 828 (Sept. 1994).

⁷³ TRPA § 11.03(c).

⁷⁴ TRPA § 1.01.

- 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, pursuant to TRPA § 2.03(b), the following circumstances do not individually indicate that a person is a partner in a business:

- 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 entirety, 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.⁷⁵

⁷⁵ The statement in TRPA § 2.03(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 Godfrey, *Mining Partnerships: Liability Based on Joint Ownership and Operations in Texas*, XXXVII Landman 35-48 (No. 6 Nov.-Dec. 1993), which states:

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

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

* * *

The disclaimer of partnership between joint oil and gas interest owners became an accepted and trusted principle of oil and gas law. If there were any doubts about the contract provision, one only had to refer to the Texas Uniform Partnership Act, which stated that “operation of a mineral property under a joint operating agreement does not of

4. Joint Venture. The definition of a partnership under TRPA § 2.02 includes a “joint venture” or any other named association that satisfies the definition of “partnership.” 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.⁷⁶ Because a joint venture is a type of partnership and loss sharing is not necessary to form a partnership, TRPA effectively overrules cases in the line represented by *Coastal Plains Dev. Corp. v. Micrea, Inc.*⁷⁷ and resolves old questions about whether an agreement to share losses was necessary to create a partnership by providing that it is unnecessary.⁷⁸

B. Taxation.

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

2. Joint Venture/Tax Implications. A joint venture is commonly thought of as a limited duration partnership formed for a specific business activity.⁷⁹ 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.

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.⁸⁰ 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.⁸¹ Under certain circumstances, a partner’s contribution of property may result in a

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. * * *

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.

⁷⁶ See 2 Alan R. Bromberg & Larry E. Ribstein, *Bromberg & Ribstein on Partnership*, § 2.06 (1988 & Supp. 1998).

⁷⁷ 572 S.W.2d 285 (Tex. 1978).

⁷⁸ TRPA §2.03(c).

⁷⁹ See e.g., *Tompkins v. Comr.*, 97 F.2d (4th Cir. 1938); and *United States v. The United States Nat’l. Bank of Portland (Oregon)*, 239 F.2d 475 (9th Cir. 1956).

⁸⁰ IRC § 721(a); but see Treas. Reg. § 1.707-3 (disguised sales).

⁸¹ IRC § 722, 723.

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.

4. Texas Franchise Tax. A general partnership is not obligated to pay any Texas franchise taxes.

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.

C. Owner Liability Issues. Under TRPA § 3.03, and typically under common law, a general partnership as an entity is liable for loss or injury to a person, or a penalty caused by or incurred as a result of a wrongful act or omission of any of its partners acting (1) in the ordinary course of the business of the partnership or (2) with authority of the partnership. TRPA sets forth the general rule of partnership law that, except as provided for a *registered limited liability partnership* (which is hereinafter discussed), all partners of a general partnership are liable jointly and severally for all debts and obligations of the partnership unless otherwise agreed by a claimant or otherwise provided by law.⁸² Provisions in a partnership agreement that serve to allocate liability among the partners are generally ineffective against third-party creditors. A partner who is, however, forced to pay more than his allocable share of a particular liability should have a right of contribution under TRPA §§ 4.01(c) and 8.06(c) from the partnership or the other partners who did not pay their allocable share.

Under TRPA § 3.07, a person admitted as a new partner into an existing general partnership 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 the obligation arises before or after his admission under a contract or commitment entered into before his admission.

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.⁸³ A withdrawn general partner may also be liable for actions (including malpractice) committed by the partnership while he was a partner, even though the action was not adjudicated to be wrongful until after the partner withdrew from the firm.⁸⁴

In a change from TUPA, a creditor under TRPA must exhaust partnership assets before collecting a partnership debt from an individual partner on his joint and several liability, except in limited circumstances.⁸⁵ Under TUPA, a creditor could obtain a judgment enforceable against

⁸² TRPA § 3.04.

⁸³ TRPA § 6.02(c).

⁸⁴ "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 . . . the general rule under Illinois law is that dissolution of the partnership does not in itself discharge the existing liability of partners . . . partners cannot release one another from liability to [non-consenting] third parties." *Keck, Mahin & Cate v. Billauer*, Adv. No. 99 A 01635, U.S. Bankruptcy Court (Chicago, Illinois 2002); ABA Journal Report (March 8, 2002).

⁸⁵ TRPA § 3.05.

an individual partner's assets without suing the partnership. Generally, TRPA requires that there also be a judgment against the partnership and that the individual partner have been served in that action; a judgment against a partnership is not automatically a judgment against its partners.⁸⁶

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

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.⁸⁷ In such a situation, management of the partnership is decentralized. Often, however, partners will designate a managing partner or partners who will have the authority to manage the business of the partnership, creating a more centralized management structure. Since a partner is an agent of the partnership, he or she may bind the partnership in the ordinary course of its business unless the partner has no authority to so act and the third party with whom the partner is dealing has knowledge that the partner has no authority to so act.⁸⁸ 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.

E. Fiduciary Duties.

1. General. Under TRPA § 4.04, a partner owes the partnership and the other partners duties of loyalty and care, which are fiduciary in nature although not so labeled by TRPA.

2. Loyalty. The duty of loyalty requires a general partner to place the interests of the partnership at the forefront.⁸⁹ It requires a partner to account to the partnership for any partnership asset received or used by the partner and prohibits a partner from competing with the partnership or dealing with the partnership in an adverse manner. The following fact patterns may evidence a breach of the fiduciary duty of loyalty in the general partnership context on the part of general partners, creating liability to the partnership or the other partners:

⁸⁶ TRPA § 3.05.

⁸⁷ TRPA § 4.01(d).

⁸⁸ TRPA § 3.02.

⁸⁹ *Meinhard v. Salmon*, 249 NY 458, 164 N.E. 545 (1928), Justice Cardozo wrote:

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

- Self-dealing or profiting from dealing with the partnership in ways not contemplated by the partnership agreement;
- Appropriation of partnership opportunities;
- A refusal to distribute profits to other members of the partnership;
- Diversion of an asset of the partnership for a non-intended use; and
- Failure to disclose plans and conflicts to partners, and a general lack of candor with partners.⁹⁰

3. Care. The degree of care required is to act as an ordinarily prudent person would act under similar circumstances.⁹¹ 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.⁹²

4. Candor. In addition to the duties of loyalty and care, a partner owes his copartners a fiduciary duty of candor, sometimes referred to as a duty of disclosure.⁹³

5. Liability. A partner is liable to the partnership and the other partners for violation of a TRPA duty that results in harm to the partnership or the other partners and for a breach of the partnership agreement.⁹⁴ TRPA provides that a partner, in that capacity, is not a trustee and is not held to the same standards as a trustee,⁹⁵ which represents a change from cases under TUPA.⁹⁶ A managing partner stands in a higher fiduciary relationship to other partners than partners usually occupy.⁹⁷

6. Effect of Partnership Agreement. Under TRPA § 1.03 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

⁹⁰ See TRPA § 4.04(b); *Bromberg & Ribstein on Partnership* § 6.07 (1997).

⁹¹ TRPA § 4.04(c).

⁹² TRPA §§ 4.04(c) and (d).

⁹³ *Bromberg & Ribstein on Partnership* §§ 6.05(c) and 6.06 (1997).

⁹⁴ TRPA § 4.05.

⁹⁵ TRPA § 4.04(f).

⁹⁶ *Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex.Civ.App.--Austin 1980).

⁹⁷ See e.g., *Hughes v. St. David's Support Corp.*, 944 S.W.2d 423 (Tex. Civ. App.--Austin 1997); *Conrad v. Judson*, 465 S.W.2d 819, 828 (Tex. Civ. App.--Dallas 1971, writ ref'd n.r.e.); *Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976); see also, *Brazosport Bank of Texas v. Oak Park Townhouses*, 837 S.W.2d 652, 659 (Tex.App.--Houston 1992); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex.Civ.App.--Austin 1980).

withdraw as a partner, except to require the notice be in writing, or (vi) vary certain other requirements.⁹⁸

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

G. Transferability of Ownership Interests.

1. Generally. A partnership interest is transferable by a partner, but a partner's right to participate in the management of the partnership may not be assigned without the consent of the other partners.⁹⁹ TRPA and partnership law in general differentiate 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 is entitled to receive, to the extent transferred, distributions to which the transferor would otherwise be entitled.¹⁰⁰ A transfer of a partnership interest is not considered an event of withdrawal and will therefore not by itself cause the winding up of the partnership business. The partnership agreement will often contain a provision prohibiting a partner from assigning even 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 the new partner. Under TRPA § 5.02, general partnership interests may be evidenced by transferable certificates, but ordinarily there is no certificate issued to evidence general partnership interests.

2. Partnership Interests as Securities. Under the Securities Act of 1933 and the Securities Exchange Act of 1934 (and under most state blue sky laws), the term "security" is defined to include "investment contract." Neither federal securities act defines a partnership interest, whether general or limited, as a "security." However, by overwhelming precedent, limited partnership interests are investment contracts for purposes of securities laws. The question 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, though 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*,¹⁰¹ the court stated that a general partnership or joint venture interest may be categorized a security if the investor can show that

(i) 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 (ii) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising

⁹⁸ TRPA § 1.03(b).

⁹⁹ See TRPA § 5.03.

¹⁰⁰ See TRPA §§ 5.02, 5.03 and 5.04.

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

his partnership or venture powers; or (iii) 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.¹⁰²

While quoting from the *Williamson* case, the *Rivanna* court stated further 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” and the fact that some of the general partners may have remained passive or lacked financial sophistication or business expertise does not affect the result. The general rule is that no security is involved when a typical general partnership agreement is used.

H. Continuity of Life. Under TRPA, 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. TRPA provides for “events of withdrawal” and “events of winding up.” Upon the occurrence of an event of withdrawal, the business of the partnership is not required to be wound up. 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.¹⁰³ Except for the partner’s right to withdraw, the statutory events of withdrawal may be modified by the partnership agreement and, in view of the Check-the-Box Regulations, modification may become increasingly appropriate and common.¹⁰⁴ 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.¹⁰⁵ Unless the partnership agreement provides otherwise,¹⁰⁶ the interest of a withdrawing partner (except for a partner who wrongfully withdraws) must be redeemed by the partnership at the lesser of its fair market value or liquidation value.¹⁰⁷ 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.¹⁰⁸

I. Formation. A partnership can be one of the simplest, least expensive business entities to form. This is because the existence or not of a partnership depends not on the

¹⁰² *But cf., Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236 (4th Cir. 1988).

¹⁰³ TRPA § 6.01.

¹⁰⁴ TRPA § 1.03.

¹⁰⁵ TRPA § 6.02.

¹⁰⁶ TRPA § 1.03(b).

¹⁰⁷ TRPA § 7.01.

¹⁰⁸ TRPA § 8.01.

existence or filing of any particular document, but on the existence of an association of two or more persons carrying on as co-owners a business for profit. The factors discussed in section III.A. above are used to determine whether or not a partnership exists. Thus, it is not necessary that any written partnership agreement exist, or that any significant expenses be incurred in the formation of a partnership. However, most of the time partners will wish to have their relationship governed by a partnership agreement rather than rely on the default provisions of TRPA, and partnership agreements can be very complex.

Under TRPA a partnership agreement, which does not have to be in writing, governs the relations of the partners and between the partners and the partnership and, only to the extent the partnership agreement does not otherwise provide, TRPA governs those relationships.¹⁰⁹ 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 (v) vary certain other requirements.¹¹⁰ 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.¹¹¹

Because partners are granted wide contractual freedom to specify the terms of their partnership, "standard" partnership agreements are less likely to be useful and 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.

K. Business Combinations. TRPA Article IX, like Texas' other business entity statute merger provisions, now authorizes a partnership to merge with a corporation, LLC or another partnership and to convert from one form of entity into another without going through a merger or transfer of assets. Article IX has 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.

¹⁰⁹ TRPA § 1.03(a).

¹¹⁰ TRPA § 1.03(b).

¹¹¹ *See* TRPA § 4.01(b).

IV. LIMITED PARTNERSHIP.

A. General. 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, limited partnerships are governed by the Texas Revised Limited Partnership Act (“TRLPA”).¹¹² A limited partnership is a partnership formed by two or more persons and having one or more general partners and one or more limited partners.¹¹³

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 different persons as partners.

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.¹¹⁴ The tax basis of the transferor in the partnership interest thereof, and of the partnership in the transferred property, is the basis the transferor had in the transferred property at the time of the transfer.¹¹⁵ 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.

3. Texas Franchise Tax. A limited partnership is not subject to the Texas franchise tax.

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.¹¹⁶ Guaranteed payments made to a limited partner by the partnership 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 10, 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:

“Generally, an individual will be treated as a limited partner under the proposed regulations unless the individual (1) has personal liability (as defined in section 301.7701-3(b)(2)(ii) of the Procedure and Administration Regulations) for the debts of or claims against the partnership by reason of being a partner; (2) has

¹¹² TEX. REV. CIV. STAT. ANN. art. 6123a-1 (Vernon Supp. 1999).

¹¹³ TRLPA § 1.02(6).

¹¹⁴ IRC § 721(a); *but see* Treas. Reg. § 1.707-3 (disguised sales).

¹¹⁵ IRC § 722, 723.

¹¹⁶ IRC § 1402(a)(13); *see Self-Employment Tax, Family Limited Partnerships and the Partnership Anti-Abuse Regulations*, 74 Taxes 689 (No. 11, Nov. 1996).

authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or, (3) participates in the partnership's trade or business for more than 500 hours during the taxable year. If, however, substantially all of the activities of a partnership involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides services as part of that trade or business will not be considered a limited partner."

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.

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. 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. 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.¹¹⁷

C. Owner Liability Issues. A general partner of a limited partnership has the same unlimited liability as does a partner of a general partnership.¹¹⁸ 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).¹¹⁹ A limited partner may lose this limited liability if he or she participates in the management of partnership business.¹²⁰ The safe harbor provisions of TRLPA § 3.03(b) 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 obligations of the limited partnership. Even if the limited partner 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 participation and control and reasonably believe that the limited partner is a general partner based on the limited partner's conduct.¹²¹ A limited partner who knowingly permits his or her 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.¹²² 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

¹¹⁷ S. 949, Sec. 734, offered as Senate Floor Amendment No. 584.

¹¹⁸ See TRLPA § 4.03(a).

¹¹⁹ See TRLPA § 3.03.

¹²⁰ TRLPA § 3.03(a).

¹²¹ TRLPA § 3.03(a).

¹²² TRLPA § 3.03(d).

known and contingent liabilities) may be applied to hold the shareholders of such a corporate general partner liable in certain factual contexts.

TRLPA and TRPA authorize a limited partnership to register as an LLP, by complying with the LLP Provisions of TRPA 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 § 3.08(a).¹²³

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.¹²⁴ 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 acts give limited partners greater latitude in certain matters of management of limited partnership than was given previously. Under TRLPA, the partnership agreement may provide for multiple classes or groups of limited partners having various rights or duties, including voting rights.¹²⁵

E. Fiduciary Duties. Case law has adopted for general partners of limited partnerships¹²⁶ the unbending fiduciary standards espoused in general partnership cases.¹²⁷ Because of their control over partnership affairs, general partners may be subjected to an even higher fiduciary standard with respect to limited partners.¹²⁸ Those in control of the general partner have been held to the same high standards.¹²⁹

Since a general partner in a limited partnership has the powers, duties and liabilities of a partner in a general partnership unless TRLPA or the partnership agreement provides otherwise,¹³⁰ a general partner in a limited partnership has the duties of care and loyalty set forth in TRPA § 4.04, which basically codifies those duties without giving them the “fiduciary” appellation. As TRPA provides that a general partner’s conduct is not to be measured by trustee

¹²³ TRPA § 3.08(e); TRLPA §2.14.

¹²⁴ TRLPA § 4.03(a).

¹²⁵ TRLPA § 3.02.

¹²⁶ See *Hughes v. St. David's Support Corp.*, 944 S.W.2d 423 (Tex.App.-Austin 1997, writ denied) (“[I]n a limited partnership, the general partner stands in the same fiduciary capacity to the limited partners as a trustee stands to a trust.”); *McLendon v. McLendon*, 862 S.W.2d 662 (Tex.App.-Dallas 1993, writ denied) (“In a limited partnership, the general partner acting in complete control stands in the fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of a trust.”); *Crenshaw v. Swenson*, 611 S.W.2d 886 (Tex.Civ.App.-Austin 1980, writ ref’d n.r.e.) (same); *Watson v. Limited Partners of WCKT*, 570 S.W.2d 179 (Tex.Civ.App.-Austin 1978, writ ref’d n.r.e.(same)); Hamilton, *Corporate General Partners of Limited Partnerships*, 1 J. of Small and Emerging Bus. L. 73 (Spring 1997).

¹²⁷ See *Huffington v. Upchurch*, 532 S.W.2d 576 (Tex. 1976; *Johnson v. Peckham*, 132 Tex. 148, 120 S.W.2d 786 (1938); *Kunz v. Huddleston*, 546 S.W.2d 685 (Tex.App.-El Paso 1977, writ ref’d n.r.e.).

¹²⁸ 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].”

¹²⁹ See *In re Bennett*, 989 F.2d 779 (5th Cir. 1993).

¹³⁰ TRLPA §§ 4.03(b), 13.03.

standards,¹³¹ it may no longer be appropriate to measure general partner conduct in terms of trustee fiduciary standards. Courts, however, continue to refer to the trustee standard.¹³²

TRPA § 4.04(a) states that a partner has the duties of care and loyalty to the partnership and the other partners. TRPA § 4.04(c) defines the duty 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. An error in judgment does not by itself constitute a breach of the duty of care. 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.¹³³ These provisions draw on the corporate business judgment rule in articulating the duty of care. Nevertheless, TRPA does not specify whether the standard of care is one of simple or gross negligence. The sparse case law in this area (pre-dating TRPA) indicates that a partner will not be held liable for mere negligent mismanagement.¹³⁴

In TRPA § 4.04(b), the duty of loyalty is defined as including:

1. accounting to the partnership and holding for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or from use 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). To temper some of the broader expressions of partner duties in the pre-TRPA case law and permit a balancing analysis as in the corporate cases, TRPA 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.¹³⁵ TRPA 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.¹³⁶

Whether or to what extent limited partners owe fiduciary duties to the partnership or other partners is not settled. A literal reading of TRPA and TRLPA suggests that limited partners have the duties enumerated in TRPA § 4.04 (by virtue of the linkage of TRPA to TRLPA under TRLPA § 13.03). That literal interpretation of the statutes, however, is contrary to the general concept that limited partners are merely passive investors and should not be

¹³¹ TRPA § 4.04(f).

¹³² See *Hughes v. St. David's Support Corp.*, *supra*.

¹³³ TRPA § 4.04(c), (d).

¹³⁴ See *Ferguson v. Williams*, 670 S.W.2d 327 (Tex.App.-Austin 1984, writ ref'd n.r.e.).

¹³⁵ TRPA § 4.04(e), (f).

¹³⁶ TRPA § 4.04(d).

subjected to liability for their actions as limited partners. There is some case law to the effect that limited partners do not have fiduciary duties.¹³⁷ In the case where a limited partner actually has or exercises control in management matters (e.g., because of control of the general partner or contractual veto powers over partnership actions), the limited partner's conduct may be judged by fiduciary principles.¹³⁸

The duties of a general partner in a limited partnership may be limited by the partnership agreement. TRLPA § 4.03(b) provides:

. . . Except as provided by this Act *or in 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 the other partners. [emphasis added]

This language indicates that the partnership agreement may modify the liabilities of a general partner, but it is not clear whether it is an authorization without express limits or would link to the provisions in TRPA § 1.03(b) of TRPA that prohibit elimination of duties and set a “manifestly unreasonable” floor for contractual variation.¹³⁹ Delaware also allows the limitation of partner fiduciary duties in the partnership agreement.¹⁴⁰ Although limitations on fiduciary

¹³⁷ See *Villa West Associates v. Kay*, 146 F.3d 798 (10th Cir. 1998); *In re Kids Creek Partners*, 212 B.R. 898 (N.D. Ill. 1997, no pet.).

¹³⁸ See *RJ Associates, Inc. v. Health Payors' Organization Ltd. Partnership*, 1999 WL 550350 (Del. Ch. 1999)(certain dicta in this case suggests that, unless a partnership agreement provides to the contrary, any limited partner owes fiduciary duties to the partnership); *KE Property Management v. 275 Madison Management*, 1993 WL 285900 (Dell.Ch.1993).

¹³⁹ 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. 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. A prudent course would be to draft the partnership agreement as if the flexibility afforded by the TRPA applies, but to be aware that any provisions of the partnership agreement that vary the requirements of the TRLPA without express statutory authority are 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(11).

Some provisions of the TRLPA permit modification by either a written or oral partnership agreement, while others require the modification to be included in a written partnership agreement. Compare TRLPA § 4.03(a) concerning restrictions on a general partner *with* § 11.02 concerning indemnification of a general partner.

¹⁴⁰ Section 17-1101(d) of the Delaware Revised Limited Partnership Act (“DRLPA”) provides as follows:

(d) To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) and liabilities relating thereto 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, (1) any such partner or other person acting under the partnership agreement shall not be liable to the limited partnership or to any such other partner or to any such other person for the partner's or other person's good faith reliance on the provisions of the partnership agreement, and (2) the partner's or other person's duties and liabilities may be expanded or restricted by provisions in the partnership agreement.

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”.¹⁴¹

¹⁴¹ *Miller v. American Real Estate Partners, L.P.* 2001 WL 1045643 (Del. Ch. September 6, 2001). 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 § 6.13(d) of the partnership agreement, which reads as follows:

Whenever in this Agreement the General Partner is permitted or required to make a decision (i) in its “sole discretion” or “discretion”, with “absolute discretion” or under a grant of similar authority or latitude, the General Partner shall be entitled to consider only such interests and factors as it desires and shall have no duty or obligation to give any consideration to any interest of or factors affecting the Partnership, the Operating Partnership or the Record Holders, or (ii) in its “good faith” or under another express standard, the General Partner shall act under such express standard and shall not be subject to any other or different standards imposed by this Agreement or any other agreement contemplated herein.

In finding that the foregoing provision was not adequate to eliminate the general partner’s fiduciary duty of loyalty, Vice Chancellor Strine wrote:

This is yet another case in which a general partner of a limited partnership contends that the partnership agreement eliminates the applicability of default principles of fiduciary duty, and in which this court finds that the drafters of the agreement did not make their intent to eliminate such duties sufficiently clear to bar a fiduciary duty claim. Here, the drafters of the American Real Estate Partners, L.P. partnership agreement did not clearly restrict the fiduciary duties owed to the partnership by its general partner, a defendant entity wholly owned by defendant Carl Icahn. Indeed, the agreement seems to contemplate that the general partner and its directors could be liable for breach of fiduciary duty to the partnership if they acted in bad faith to advantage themselves at the expense of the partnership.

* * *

Once again, therefore, this court faces a situation where an agreement which does not expressly preclude the application of default principles of fiduciary is argued to do so by implication. Indeed, this case presents the court with an opportunity to address a contractual provision similar to the one it interpreted on two occasions in *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, and contemporaneously with this case in *Gelfman v. Weeden Investors, L.P.* In each of those cases, this court held that the traditional fiduciary entire fairness standard could not be applied because it was inconsistent with a contractual provision providing a general partner with sole and complete discretion to effect certain actions subject solely to a contract-specific liability standard. The court’s decision was based on two factors. First, the court noted the difference between the sole and complete discretion standard articulated in the agreements, which explicitly stated that the general partner had no duty to consider the interests of the partnership or the limited partner in making its decisions, and the traditional notion that a fiduciary acting in a conflict situation has a duty to prove that it acted in a procedurally and substantively fair manner. Second, and even more critically, however, each of the agreements indicated that when the sole and complete discretion standard applied, any other conflicting standards in the agreements, other contracts, or under law (including the DRULPA) were to give way if it would interfere with the general partners’ freedom of action under the sole and complete discretion standard. That is, in each case, the agreement expressly stated that default principles of fiduciary duty would be supplanted if they conflicted with the operation of the sole and complete discretion standard.

Under TRPA § 1.03(b), 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. With respect to a partner's duty of care, TRPA provides that 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 measure, if the standards are not "manifestly unreasonable."¹⁴² In one case decided prior to the passage of TRPA, 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.¹⁴³

With respect to a partner's duty of loyalty, TRPA provides 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."¹⁴⁴ The level of specificity required of provisions in the partnership agreement limiting duties pursuant to TRPA 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.

TRPA provides 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

This case presents a twist on *Gotham Partners* and *Gelfman*. Like the provisions in *Gotham Partners* and *Gelfman*, § 6.13(d) sets forth a sole discretion standard that appears to be quite different from the duty of a fiduciary to act with procedural and substantive fairness in a conflict situation. What is different about § 6.13(d), however, is that it does not expressly state that default provisions of law must give way if they hinder the General Partner's ability to act under the sole discretion standard. Rather, § 6.13(d) merely states that other standards in the Agreement or agreements contemplated by the agreement give way to the sole discretion standard. By its own terms, § 6.13(d) says nothing about default principles of law being subordinated when the sole discretion standard applies.

* * *

This court has made clear that it will not be tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties. The DRULPA puts investors on notice that fiduciary duties may be altered by partnership agreements, and therefore that investors should be careful to read partnership agreements before buying units. In large measure, the DRULPA reflects the doctrine of *caveat emptor*, as is fitting given that investors in limited partnerships have countless other investment opportunities available to them that involve less risk and/or more legal protection. For example, any investor who wishes to retain the protection of traditional fiduciary duties can always invest in corporate stock.

But just as investors must use due care, so must the drafter of a partnership agreement who wishes to supplant the operation of traditional fiduciary duties. In view of the great freedom afforded to such drafters and the reality that most publicly traded limited partnerships are governed by agreements drafted exclusively by the original general partner, it is fair to expect that restrictions on fiduciary duties be set forth clearly and unambiguously. A topic as important as this should not be addressed coyly.

¹⁴² TRPA § 1.03(a)(3).

¹⁴³ *Grider v. Boston Co., Inc.*, 773 S.W.2d 338, 343 (Tex.App.-Dallas 1989, writ denied).

¹⁴⁴ TRPA § 1.03(a)(2).

measured if not “manifestly unreasonable.”¹⁴⁵ 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. TRLPA § 1.07 provides that a limited partnership shall keep in its registered office, and make available to the partners for copying and inspection, certain minimum books and records of the partnership. This provision 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 TRPA § 4.03, which should apply to limited partnerships.

F. Indemnification. TRLPA indemnification provisions are based in large part on the TBCA provisions.¹⁴⁶ A limited partnership is required to indemnify a general partner who is “wholly successful on the merits or otherwise” unless indemnification is limited or prohibited by a written partnership agreement. 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. A limited partnership is permitted, if provided in a written partnership agreement, to indemnify a general partner who is determined to meet certain standards. These standards require that the general partner conducted himself in good faith, reasonably believed the conduct was in the best interest of the partnership (if the conduct was in an official capacity) or that the conduct was not opposed to the partnership’s best interest (in cases of conduct outside the general partner’s official capacity), and, in the case of a criminal proceeding, had no reasonable cause to believe the conduct was unlawful. 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. General partners may only be indemnified to the extent consistent with the statute. 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. Insurance providing coverage for unindemnifiable areas is expressly permitted.

G. Flexibility In Raising Capital. Limits on liability and more centralized management make the limited partnership a better entity for raising capital than the general partnership. However, the limited partnership usefulness with respect to raising capital is limited by restrictions on the ability of owners to deduct passive losses.

Under TRLPA §5.01 contributions to a limited partnership 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. Under TRLPA §5.02(d), 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.

Absent a different 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

¹⁴⁵ TRPA § 1.03(a)(4).

¹⁴⁶ See TRLPA §§ 11.01-11.21.

records that the partnership is required to maintain under TRLPA §1.07 or, in the absence of such records, in proportion to capital accounts.¹⁴⁷ Absent a different provision in the written partnership agreement, distributions that are 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.¹⁴⁸

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 dissolve a limited partnership.¹⁴⁹ 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.¹⁵⁰ Instead, the assignment will entitle the assignee to be allocated income, gain, loss, deductions, credits or similar items and to receive distributions to which the assignor was entitled. Under TRLPA § 7.02(a)(4), 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. Until an assignee of a partnership interest becomes a partner, the assignee has no liability as a partner solely by reason of the assignment.

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. A limited partnership is dissolved under TRLPA § 8.01 upon the first to occur of the following events: (i) any event specified in the partnership agreement as causing dissolution, (ii) all of the partners of the limited partnership agree in writing to dissolve the limited partnership, (iii) an event of withdrawal of a general partner under TRLPA § 4.02 (death, removal, voluntary withdrawal¹⁵¹ and, unless otherwise provided in the partnership agreement, bankruptcy of a general partner) unless at least one other general partner remains or is appointed and the partnership agreement so permits or (iv) a court of competent jurisdiction dissolves the partnership pursuant to TRPA § 8.02 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, (c) it is not reasonably practicable to carry on the business of the limited partnership in conformity with the partnership agreement, (d) the economic purpose of the partnership is likely to be unreasonably frustrated, or (e) another partner has engaged in conduct relating to the limited partnership business that makes it not reasonably practical to carry on the business in limited partnership with that partner. If the limited partnership is dissolved, the limited partnership's affairs must be wound up as soon as reasonably practicable unless it is reconstituted or the partnership agreement provides

¹⁴⁷ See TRLPA § 5.03.

¹⁴⁸ See TRLPA § 5.04.

¹⁴⁹ TRPA § 7.02.

¹⁵⁰ TRPA § 7.02(a)(4).

¹⁵¹ Under TRLPA § 6.02 a general partner has a right to withdraw which cannot be eliminated by the partnership agreement although the partnership may prohibit withdrawal and violation thereof can result in the general partner being liable for damages. TRLPA § 6.03 provides 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.

otherwise.¹⁵² Upon dissolution as a result of the withdrawal of a general partner, the limited partnership may be reconstituted and its business continued without being wound up if (i) at least one general partner remains and the partnership agreement permits the business of the limited partnership to be carried on by the remaining general partner or general 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 90 days after the occurrence of the event of dissolution and agree to the appointment, if necessary, of one or more new general partners.¹⁵³

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 and, if not, they should be amended. The lenders to these limited partnerships (and the lenders' lawyers) may also have an interest in the wording of the limited partnership dissolution provisions.

J. Formation. The cost of forming a limited partnership is usually greater than that of forming a general partnership. A certificate of limited partnership containing the mailing and street address of each general partner, the address of the registered office and name and address of the registered agent for service of process, and the address of the principal office where books and records are to be kept must be filed with the Secretary of State.¹⁵⁴ A filing fee of \$750 must be paid upon filing the certificate of limited partnership.

TRLPA contains a number of default provisions which govern the limited partnership in the absence of any relevant provision of the partnership agreement. Except as provided in TRLPA, the partners generally have the contractual freedom to contract around these default provisions and to provide for the rights and obligations of the partners in the partnership agreement.¹⁵⁵ Since the default provisions of TRLPA 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.

TRLPA assumes the existence of a partnership agreement, but allows the agreement to be either written or oral. The name of the limited partnership must contain the words "Limited Partnership," "Limited," or the abbreviation "L.P." or "Ltd." as the last words or letters of its name.¹⁵⁶

Unless the partnership agreement says otherwise, unanimity is required to amend the partnership agreement. Since it may be difficult to get unanimity so it may be appropriate to provide that amendments may be made with the approval a simple majority or supermajority of

¹⁵² TRLPA § 8.04.

¹⁵³ TRLPA § 8.01; 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.

¹⁵⁴ TRLPA § 2.01.

¹⁵⁵ *See* TRPA § 1.03.

¹⁵⁶ TRLPA § 1.03.

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), a different approval (e.g., the approval of the affected partner or group of partners (or some percentage of that group of partners)) should be required. If the amendment provisions are purposefully drafted in order to give less than all of the partners the right to make amendments that disproportionately affect a particular partner or group of partners, it may be wise to expressly specify in the partnership agreement, to the extent permitted by TRLPA, the ability of the general partners to act inconsistently with the fiduciary duty 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.¹⁵⁷

L. Business Combinations. TRLPA §§ 2.11 and 2.15, like Texas' other business entity statutes, now authorize a limited partnership to merge with a corporation, LLC or another partnership and to convert from one form of entity into another without going through a merger or transfer of assets.¹⁵⁸ TRLPA has 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.

V. LIMITED LIABILITY COMPANY (LLC).

A. General. The Texas Limited Liability Company Act, as amended, is found at Article 1528n of Vernon's Texas Civil Statutes (the "LLC Act"). The operational provisions of the LLC Act are modeled¹⁵⁹ after the TBCA, the Texas Miscellaneous Corporation Laws Act ("TMCLA"),¹⁶⁰ and TRLPA.¹⁶¹ Texas was the fourth state to adopt an LLC statute and now every state has adopted an LLC Act.¹⁶²

"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

¹⁵⁷ See TRLPA Article 9.

¹⁵⁸ In order for a limited partnership to participate in a conversion, consolidation, or merger, as permitted by TRLPA §§ 2.11 and 2.15, the partnership agreement *must* authorize such action and the process for its approval. See TRLPA §§ 2.11(a)(1), 2.11(a)(2), 2.11(d)(1)(F), and 2.15(a)(1). 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.

¹⁵⁹ 1991 Bill Analysis Summary at 41.

¹⁶⁰ TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon Supp. 1999).

¹⁶¹ TEX. REV. CIV. STAT. ANN. art. 6132a-1, et. seq. (Vernon Supp. 1999).

¹⁶² See 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 (Feb. 2001).

both a corporate-styled liability shield and the pass-through tax benefits of a partnership.”¹⁶³ 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 LLC Act contemplates that LLC’s 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.¹⁶⁴ An LLC is subject to Texas corporate franchise tax.¹⁶⁵

An underlying premise of the LLC Act is that the LLC is based in large part upon a contract between its members, similar to a partnership agreement. As a result, fundamental principles of freedom of contract imply that the owners of an LLC have maximum freedom to determine the internal structure and operation of the LLC. Thus the LLC Act would be classified as a “flexible” LLC statute.¹⁶⁶ 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.¹⁶⁷

The LLC Act in many cases provides “default” provisions¹⁶⁸ designed to reflect the common expectations of persons engaged in business under the Former Classification Regulations, and to permit these expectations to be met in the event that the organizational documents for an LLC do not include a provision specifically dealing with an issue. Those 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.¹⁶⁹ Examples of provisions which were often included in an LLC structure because of the Former Classification Regulations and which are required by neither the LLC Act nor the Check-the-Box Regulations:

- (i) limited duration (the LLC Act 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.

¹⁶³ *PB Real Estate, Inc. v. DEM Properties*, 719 A.2d 73, 74 (Conn. App. Ct. 1998).

¹⁶⁴ See “I. General - C. Considerations In Selecting Entity - (b) Federal Check-the-Box Regulations” above.

¹⁶⁵ TEX. TAX CODE ANN. § 171.001. The LLC is also subject to a franchise tax in Florida, but not in Delaware and most other states.

¹⁶⁶ See Keatinge, *New Gang in Town - Limited Liability Companies: An Introduction*, 4 BUS. L. TODAY 5 (No. 4 March/April 1995); Paul, *Choosing A State of Organization for a Limited Liability Company*, Prentice Hall Law & Business -- Corporation Bulletin (Nov. 26, 1991).

¹⁶⁷ See Gray, *et. al.*, *Corporations*, 45 Sw.L.J. 1525, 1537 (1992).

¹⁶⁸ See Bar Committee Bill Analysis for H.B. 1239 (the “1993 LLC Bill Analysis”) at 1.

¹⁶⁹ See Bagley, *The IRS Steps Back - Entity Classification Rules are Relaxed*, 6 BUS. LAW TODAY No. 3 41 (Jan./Feb. 1997).

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. A single member LLC will be disregarded as an entity separate from its owner under the Check-the-Box Regulations, unless an election is made for it to be taxed as a corporation.

2. Other Tax Issues Relating to LLCs.

(a) Franchise Taxes. An LLC with gross receipts of \$150,000 or more is subject to the Texas franchise tax.¹⁷⁰ As a result, an LLC is 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.” The “net taxable earned surplus” of an LLC is based on the entity’s reportable federal taxable income with the compensation of officers and Managers being added back (unless the LLC has more than one Member but does not have more than 35 Members) and certain other adjustments and with that amount being apportionable to Texas based on the percentage of the LLC’s gross receipts from Texas sources.¹⁷¹ An LLC with fewer than 35 Members can eliminate its Texas franchise tax based on “net taxable earned surplus” with Member compensation, subject to limits on unreasonable compensation. Texas administrative regulations provide that a single Member LLC may not deduct officer and director compensation paid to the Member in computing “net taxable earned surplus.”¹⁷² Such an LLC may, however, deduct compensation paid to officers or managers other than a Member-Manager.

In each other state in which an LLC does business it will be necessary to ascertain the franchise and income tax treatment of foreign LLC’s doing business therein. Since most state income tax regimes are based on the federal adjusted gross income, an LLC treated as a partnership for federal income tax purposes should be treated as such for state income tax purposes in the absence of a specific state statute.¹⁷³

(b) Flexible Statute. In Rev. Rul. 88-76, I. R. B. 1988-38, 22, 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. 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. By contrast, the Texas LLC Act is considered a “flexible statute” because it allows the Members to vary the Regulations to allow greater organizational flexibility (thus, creating the possibility that an LLC organized thereunder would be taxable as an “association” rather than a partnership under the Former Classification Regulations).

¹⁷⁰ TEX. TAX CODE ANN. § 171.001.

¹⁷¹ See Janes and Moore, *The New Texas Franchise Tax*, TEX. B.J., Nov. 1991, at 1108.

¹⁷² 34 TEX. ADMIN. CODE § 3.562(g) (1998).

¹⁷³ Dietze, *The Limited Liability Company: Latest Strategy and Developments*, 6 INSIGHTS NO. 1, Jan. 1992, at 3, 7.

(c) One Member LLC. The LLC Act permits a one-Member LLC, the status of which is now certain under the Check-the-Box Regulations. 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.¹⁷⁴ Many state LLC statutes do not authorize single member LLCs.

(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 gain or loss being recognized by the transferor, the LLC or any of the other Members of the LLC.¹⁷⁵ 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.¹⁷⁶ Under certain circumstances, a Member's contribution of property may result in a net reduction in liability 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.

(e) Self-Employment Tax. Individuals are subject to a self-employment tax on self-employment income.¹⁷⁷ 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 2002 contribution base of \$84,900 (adjusted annually for inflation), plus (ii) a 2.9% medicare tax on all self-employment income (there is no ceiling). An individual's wage income is applied against the contribution base. Self-employment income generally means an individual's net earnings from the individual's trade or business. 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.¹⁷⁸

¹⁷⁴ In Priv. Ltr. Rul. 2001-18023 (January 31, 2001) the issue was the application of Section 1031 of the Code (which deals 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).

¹⁷⁵ IRC § 721(a); *but see* Treas. Reg. § 1.707-3 (disguised sales).

¹⁷⁶ IRC § 722, 723.

¹⁷⁷ *See* IRC § 1401.

¹⁷⁸ IRC § 1402.

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 and the Member could have qualified as a limited partner. See Treas. Reg. § 1.1402(a)-18 (Proposed). If the LLC does not have designated Managers with continuing and exclusive authority to manage the LLC, then all Members will be treated as Managers for this purpose.

On January 10, 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) that are classified as partnerships under the Check-the-Box Regulations. 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. Under the proposed regulations:

"Generally, an individual will be treated as a limited partner under the proposed regulations unless the individual (1) has personal liability (as defined in section 301.7701-3(b)(2)(ii) of the Procedure and Administration Regulations) for the debts of or claims against the partnership by reason of being a partner; (2) has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or, (3) participates in the partnership's trade or business for more than 500 hours during the taxable year. If, however, substantially all of the activities of a partnership involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides services as part of that trade or business will not be considered a limited partner."

Until the proposed regulations are effective for an LLC Member, there is a risk that the IRS will treat any individual Member's 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 9432018, 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. 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. 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.¹⁷⁹

C. Members; Managers. The owners of an LLC are called “Members,”¹⁸⁰ and are analogous to shareholders in a corporation or limited partners of a limited partnership.¹⁸¹ 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.¹⁸² Under the LLC Act, however, an LLC may be structured so that management shall be by the Members as in the case of a close corporation or a general partnership,¹⁸³ and in that case the Members would be analogous to general partners in a general or limited partnership but without personal liability.¹⁸⁴ For an LLC to be taxed as a partnership it must have at least two Members, although the LLC Act 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).¹⁸⁵

Under the LLC Act, any “person” may become a Member or Manager.¹⁸⁶ Because of the broad definition of “person” in the LLC Act, any individual, corporation, partnership, LLC or other person may become a Member or Manager.¹⁸⁷ 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 the LLC Act, an LLC may generally be formed to conduct any lawful business, subject to limitations of other statutes which regulate particular businesses.¹⁸⁸ It has all of the powers of a Texas corporation or limited partnership, subject to

¹⁷⁹ S. 949, Sec. 734, offered as Senate Floor Amendment No. 584.

¹⁸⁰ LLC Act § 4.01.

¹⁸¹ 1991 Bill Analysis Summary at 41.

¹⁸² LLC Act § 2.13; 1991 Bill Analysis Summary at 41.

¹⁸³ LLC Act § 2.12.

¹⁸⁴ 1991 Bill Analysis Summary at 41.

¹⁸⁵ In 1993 § 4.01A of the LLC Act was amended to expressly provide that an LLC “may have one or more members.” See “V. Limited Liability Company (LLC) - B. Taxation - 4. Other Tax Issues Relating to L.C.’s - (c) One Member LLC” above.

¹⁸⁶ LLC Act §§ 2.13 and 4.01C.

¹⁸⁷ “Person” is defined in LLC Act § 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.

¹⁸⁸ LLC Act § 2.01 provides as follows:

Art. 2.01. PURPOSES. A. A limited liability company formed under this Act may engage in any lawful business unless a more limited purpose is stated in its articles of organization or regulations.

B. A limited liability company engaging in a business that is subject to regulation by another Texas statute may be formed under this Act only if it is not prohibited by the other statute. The limited liability company is subject to all limitations of the other statute.

any restrictions imposed by statute or its Articles of Organization (“Articles”) or regulations (“Regulations”).¹⁸⁹

E. Formation; Articles of Organization. An LLC is formed when one or more persons file Articles, similar to a certificate of limited partnership under TRLPA and articles of incorporation under the TBCA, with the Texas Secretary of State (\$200 filing fee).¹⁹⁰ The initial Articles must contain (1) the name of the LLC, (2) the period of its duration, which may be perpetual, (3) its purpose, which may be the transaction of all lawful business for which LLC’s may be organized, (4) the address of its initial registered office and the name of its initial registered agent at that address, (5) 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, (6) the name and address of each organizer, (7) specified information if the LLC is to be a professional LLC, and (8) any other provisions not inconsistent with law.¹⁹¹ An LLC’s existence as such begins upon issuance of a certificate of organization by the Secretary of State.¹⁹² An LLC may also be formed pursuant to a plan of conversion or merger, in which case the Articles may be part of the plan, do not need to be filed separately with the Secretary of State and become effective upon the effectiveness of the plan.¹⁹³

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,” or “Limited Company” (Limited may be abbreviated “Ltd.” and Company may be abbreviated “Co.”), or the acronyms LLC or LC (with or without periods).¹⁹⁴ The name must not be the same as or deceptively similar to that of any domestic or foreign LLC, limited partnership or corporation authorized to transact business in Texas.¹⁹⁵ Prior to accepting Articles for filing, the

LLC Act Art. 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 probably cannot be used for a nonprofit purpose.

¹⁸⁹ LLC Act § 2.02.

¹⁹⁰ LLC Act §§ 3.01 and 9.01. The Secretary of State has not adopted rules solely applicable to LLC’s, but did modify the name availability rules to include LLC’s within the parameter of the rules.

¹⁹¹ LLC Act § 3.02.

¹⁹² LLC Act § 3.04 provides as follows:

Art. 3.04. EFFECT OF THE ISSUANCE OF CERTIFICATE OF ORGANIZATION. A. Except as provided by Section B of this Article, on the issuance of the certificate of organization, the limited liability company’s existence shall begin.

B. In the case of a new domestic limited liability company being organized pursuant to a plan of conversion or a plan of merger pursuant to Part Ten of this Act, the existence of the limited liability company as such shall begin on the effectiveness of the conversion or the merger, as the case may be.

C. On the issuance of the certificate of organization or the effectiveness of the merger or conversion, the certificate of organization shall be conclusive evidence that all conditions precedent required to be performed for the valid organization of the limited liability company have been complied with and that the limited liability company has been duly organized under this Act, except as against the state in a proceeding for involuntary dissolution.

¹⁹³ LLC Act §§ 3.02, 3.03 and Part Ten.

¹⁹⁴ LLC Act § 2.03A(1).

¹⁹⁵ LLC Act § 2.03A(3).

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 LLC, limited partnership or corporation.¹⁹⁶

LLC Act §2.23H provides that, except as otherwise provided in the Articles or Regulations, once capital has been paid to the LLC, the affirmative vote, approval or consent of all Members of the LLC is required to amend its Articles. This Section H makes it critical to provide in the Articles or Regulations the vote required for amendment of the Articles. If the Articles or Regulations permit amendment of the Articles by a less than unanimous vote, the Secretary of State will require that any amendment to the Articles adopted by less than unanimous vote specify both (i) the votes cast for and against the amendment and (ii) the authority in the Articles or Regulations for the less than unanimous vote.

LLC Act §2.23G provides that if no capital has been paid to an LLC, the majority of the Managers named in the Articles or a majority of the Members named in the Articles may amend the Articles or dissolve the LLC. Article 6.07A contemplates that articles of dissolution adopted under such circumstances be signed by the persons adopting the amendment or authorizing the dissolution. Therefore, the Secretary of State is currently requiring that the organizer authorize such a dissolution and sign the articles of dissolution.

F. Regulations. 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 Regulations, which would contain provisions similar to those in limited partnership agreements and corporate bylaws.¹⁹⁷ The Members of an LLC have the power to adopt, alter, amend or repeal the Regulations, although the Articles or Regulations may provide that the Managers also have the power to adopt, alter, amend or repeal the Regulations. Unless otherwise provided in the Articles or Regulations, the adoption, alteration, amendment or repeal of Regulations requires the unanimous vote of the Members or, if the power to adopt, amend, alter or repeal is vested in Managers, the unanimous vote of the Managers.¹⁹⁸

¹⁹⁶ TEX. ADMIN. CODE , § 79.30 (2001) provides as follows:

§ 79.30. Applicability

Pursuant to the Texas Business Corporation Act, Article 2.05, the Texas Revised Limited Partnership Act, Section 1.03, and the Texas Limited Liability Company Act, Article 2.03, a proposed entity name may not be the same as, or deceptively similar to, the name of a Texas or qualified foreign corporation, limited partnership, or limited liability company. In accordance therewith, these sections shall apply to all name availability determinations made for either a corporation, limited partnership or limited liability company name. Such names may be set forth in an entity's organizational document, reserved or registered name or application for a foreign entity to transact business in Texas. Wherever the terms entity or entities appears in this entity name availability section [§§ 79.30-79.54], they may be replaced with the following terms: domestic or foreign corporation; domestic or foreign limited partnership; or domestic or foreign limited liability company or the plural of such terms.

¹⁹⁷ LLC Act § 2.09A.

¹⁹⁸ LLC Act § 2.09B. The fall-back 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 accomplish the items listed therein; thus, when drafting the Regulations, it is important to override this provision if it does not properly reflect the desires of the parties. Also, Paragraph F. of LLC Act Art. 2.23 provides, as the fall-back rule, that a majority is defined to be determined on a per-capita basis and not, for instance, by capital contributions or sharing

Although the Regulations will ordinarily contain the capital account and other financial and tax provisions found in a typical limited partnership agreement,¹⁹⁹ the LLC Act does not require that the Regulations 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 Regulations and agree to be contractually bound thereby.²⁰⁰ The Members' express agreement to be contractually bound by the Regulations should facilitate enforcement thereof and their being treated as a "partnership agreement" for federal income tax purposes.²⁰¹

In some other states, the agreement which is referred to in Texas as Regulations is referred to as "operating agreement" or the "LLC agreement."

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.²⁰² A Manager may be a corporation or other entity, and it is possible to have an LLC which has a single Manager that is a corporation or other entity. The Articles or the Regulations, however, may provide that the management of the business and affairs of the LLC may be reserved, in whole or in part, to its Members.²⁰³ Thus an LLC could be organized to be run without Managers, as in the case of a close corporation under the TBCA, 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 Regulations should specify who has the authority to obligate the LLC contractually or to empower others to do so. LLC Act § 2.21B provides that all officers, agents, Managers and Members of an LLC, as among themselves and the LLC, have such authority in the management of the LLC as may be provided in its Regulations or as may be determined by resolution of the Managers or, to the extent to which management is reserved to them, the Members. LLC Act § 2.21C provides that the following are agents of an LLC: (1) any officer or other agent who is vested with actual or apparent authority; (2) each Manager (to the extent that management of the LLC is vested in that Manager); and (3) each Member (to the extent that management of the LLC has been reserved to that Member). LLC Act § 2.21D provides that an act (including the execution of an instrument in the name of the LLC) for the purpose of apparently carrying on in

ratios; since this may or may not be appropriate, it is critical that the regulations properly set forth the appropriate standard for what constitutes a majority.

¹⁹⁹ It is critical that the regulations accurately reflect the business deal of the parties. Absent a different provision in the regulations, (i) profits and losses of a limited liability company are to be allocated in accordance with the then-current percentage or other interest in the company reflected in the records that the company is required to maintain under LLC Act § 2.22, and (ii) 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 company is required to maintain under LLC Act § 2.22.

²⁰⁰ The agreement to be contractually bound could be through signing the Regulations directly or indirectly through a subscription agreement or power of attorney.

²⁰¹ Kinkaid, "Drafting Limited Liability Company Regulations and Articles: Sample Documents," University of Texas School of Law sponsored conference on Current Issues in Partnerships, Limited Liability Companies, and Registered Limited Liability Partnerships (Houston, Jan. 23-24, 1992).

²⁰² LLC Act §§ 2.12 and 2.21.

²⁰³ LLC Act §§ 2.12.

the usual way the business of the LLC by any of the persons named in LLC Act § 2.21C binds the LLC unless (1) the person so acting lacks authority to act for the LLC and (2) the third party with whom the LLC is dealing is aware of the actor's lack of authority. Lenders and others dealing with an LLC can determine with certainty who has authority to bind the LLC by reference to its Articles, Regulations 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.²⁰⁴

The LLC Act contains no requirements as to the terms of Managers, but allows Regulations to provide for specified terms of Managers and annual or other regularly scheduled meetings of Members; if the Regulations are silent as to the term, the default provision is retention of the Managers. LLC Act § 2.14 allows 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.

H. Fiduciary Duties. The LLC Act does not address specifically whether Manager or Member fiduciary duties exist or attempt to define them,²⁰⁵ but implicitly recognizes that they may exist in LLC Act § 2.20B (discussed below) which permits them to be expanded or restricted by provisions in the Regulations.²⁰⁶ The duty of Managers in a Manager-managed LLC and Members in a Member-managed LLC to the LLC is generally assumed to be fiduciary in nature, measured by reference to the fiduciary duties of corporate directors. 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 Articles or Regulations.²⁰⁷

²⁰⁴ See *Water, Waste & Land, Inc. v. Lanham*, 1998 WL 112869 (Colo. 1998).

²⁰⁵ See McGeever, *Hazardous Duty? The Role of the Fiduciary in Noncorporate Structures*, 4 BUS. L. TODAY 51, 53 (No. 4 March/April 1995); Keatinge, *et. al.*, *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 401 (Feb. 1992).

²⁰⁶ LLC Act § 2.20B provides that the Regulations may expand or reduce fiduciary duties as follows:

To the extent that at law or in equity, a member, manager, officer, or other person has duties (including fiduciary duties) and liabilities relating thereto to a limited liability company or to another member or manager, such duties and liabilities may be expanded or restricted by provisions in the regulations.

²⁰⁷ In *Suntech Processing Systems, L.L.C. v. Sun Communications, Inc.*, No. 05-99-00213-CV, 2000 WL 1780236 (Tex.App.-Dallas Dec. 5, 2000) (not designated for publication), a minority Member of a Texas LLC claimed that the controlling Member owed it a fiduciary duty as a matter of law in connection with the winding up of its operations and distribution of its assets; but the court (pointing out that the Regulations expressly provided for a duty of loyalty to the LLC rather than between the Members, noting the absence of

LLC Act § 2.20B allows LLC Regulations 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.²⁰⁸ This provision of the LLC Act was designed, in the same vein as the Delaware Limited Liability Company Act (the “*DGLLCA*”) from which it drew inspiration, to allow LLC’s the flexibility to address fiduciary duties through contract principles.²⁰⁹ Though the LLC Act, unlike its Delaware counterpart, does not include provisions that expressly emphasize the principles of freedom of contract and enforceability of LLC Regulations limiting liability fiduciary duties, the legislative history and scope of LLC Act § 2.20B indicate that there may be more latitude to exculpate Managers and Members for conduct that would otherwise breach a fiduciary duty under the LLC Act than under the TBCA. Provisions in Regulations purporting to limit fiduciary duties need to be explicit and conspicuous; coyness can lead to unenforceability. 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

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 and remanded the issue for determination by the factfinder.

²⁰⁸ Prior to the effectiveness of SB 555 on September 1, 1997, LLC Act § 8.12 had incorporated by reference the limitation of liability afforded to corporate directors under TMCLA 1302-7.06 and thereby allowed the limitation of Manager liability by a provision in Articles to the extent permitted for a director under TMCLA 1302-7.06. SB 555 deleted such incorporation by reference of TMCLA 1302-7.06 in favor of the broader authorization now in LLC Act § 2.20B.

²⁰⁹ The Delaware Limited Liability Company Act aggressively adopts a “contractarian approach” (i.e., the bargains of the parties manifested in LLC agreements are to be respected and rarely trumped by statute or common law), does not have any provision which itself creates or negates Member or Manager fiduciary duties, but 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) and liabilities relating thereto to a limited liability company or to another member or manager or to an other person that is a party to or is otherwise bound by a limited liability agreement:

(1) Any such member or manager or other person acting under the limited liability company agreement shall not be liable to the limited liability company or to any such other member or manager or to any such other person for the member’s or manager’s or other person’s good faith reliance on the provisions of the limited liability company agreement; and

(2) The member’s or manager’s or other person’s duties and liabilities may be expanded or restricted by provisions in the limited liability company agreement.

DLLCA Sections 18-1101(a), (b) and (c) are counterparts of, and virtually identical to, Sections 17-1101(b), (c) and (d) of the Delaware Revised Limited Partnership Act. Thus Delaware cases regarding partner fiduciary duties should be helpful in the LLC context.

date of these Regulations, as such Regulations 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 LLC’s to contractually limit fiduciary duties. In *McConnell v. Hunt Sports Enterprises*, 725 N.E.2d 1193 (Ohio App. 1999), 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 operating agreement of the Ohio LLC (operating agreements are to Ohio LLC’s what Regulations are to Texas LLC’s) that provided as follows:

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.

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

Persons who control Members can be held responsible for fiduciary duty breaches of the Members.²¹⁰ A legal claim exists for aiding and abetting a breach of fiduciary duty, whether arising under statute, contract, common law or otherwise.²¹¹

The LLC Act § 2.17, which is based on TBCA § 2.35-1, provides that, unless the Articles or Regulations otherwise provide, 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 Managers, and the Managers in good faith authorize the transaction by the affirmative vote of a majority of the disinterested Managers even though the disinterested Managers are less than a quorum; or

²¹⁰ See *In re USA Cafes, Inc.*, 600 A.2d 43 (Del. Ch. 1991); *Carson v. Lynch Multimedia Corp.*, 123 F. Supp. 1254 (D. Kansas 2000).

²¹¹ 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.” *Fitzgerald v. Cantor* 1999 WL 182573 (Del. Ch. 1999)

(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.

In a joint venture, the duty of a Manager to all Members could be an issue since the Managers would often have been selected to represent the interests of particular Members; the issue could be addressed by structuring the LLC to be managed by Members who would then appoint representatives to act for them on an operating committee which would run the business in the name of the Members. In such a situation, the Members would likely have fiduciary duties analogous to partners in a general partnership.²¹²

I. Indemnification. Under LLC Act §2.20A, 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 Articles or Regulations. The TBCA restrictions on indemnification are not applicable. This approach is similar to the approach taken under Delaware law, but could be subject to public policy limitations. 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 you do not want, 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.²¹³ The Regulations 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 Regulations.²¹⁴ If the Regulations do not otherwise provide, distributions are made on the basis of the agreed value of the contributions made by each Member.²¹⁵ A Member is entitled to receive distributions from an LLC prior to its winding up to the extent and at the times specified in the Regulations.²¹⁶ An LLC may not make a distribution

²¹² *Id.*; .see TRPA § 4.04.

²¹³ LLC Act § 5.01; LLC Act § 5.02 provides that written obligations to make contributions are enforceable, except to the extent otherwise provided in the Articles or Regulations, and LLC Act § 4.07 provides that an obligation to make a contribution will survive the assignment of the membership interest. LLC Act §5.02 provides 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, may not be enforced unless the conditions of the obligation have been satisfied or waived.

²¹⁴ LLC Act §§ 5.02-1 and 5.03.

²¹⁵ LLC Act § 5.03.

²¹⁶ LLC Act § 5.04.

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 nonrecourse liabilities, exceed the fair value of the LLC assets.²¹⁷ 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.²¹⁸

L. Owner Limited Liability Issues. The LLC Act provides that, except as provided in the Regulations, 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 to make.²¹⁹ Members may participate in the management of the LLC without forfeiting this liability shield.²²⁰ Since 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 LLC’s in Texas, although this issue will no doubt be litigated.²²¹ Some state LLC statutes

²¹⁷ LLC Act § 5.09A.

²¹⁸ LLC Act § 5.09B.

²¹⁹ LLC Act § 4.03 provides as follows:

Art. 4.03. **LIABILITY TO THIRD PARTIES.** A. Except as and to the extent the regulations specifically provide otherwise, a member or manager is not liable for the debts, obligations or liabilities of a limited liability company including under a judgment decree, or order of a court.

B. Transaction of business outside state. It is the intention of the legislature by the enactment of this Act that the legal existence of limited liability companies formed under this Act be recognized beyond the limits of this state and that, subject to any reasonable registration requirements, any such limited liability company transacting business outside this state be granted the protection of full faith and credit under Section 1 of Article IV of the Constitution of the United States.

C. Parties to actions. A member of a limited liability company is not a proper party to proceedings by or against a limited liability company, except where the object is to enforce a member’s right against or liability to the limited liability company.

See “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.

²²⁰ The LLC Act does not contain any provision comparable to TRLPA § 3.03, which makes a limited partner liable for partnership obligations under certain circumstances if “the limited partner participates in the control of the business.”

²²¹ While the author is aware of no reported case to date in Texas dealing with the applicability of veil piercing in the LLC context, there have been a number of cases in other jurisdictions in which courts have applied corporate veil piercing theories. In *Ditty v. Checkrite, Ltd., Inc.*, 973 F. Supp. 1320, 1335 (D. Utah 1997), a recent Utah case dealing with a Utah limitation of member liability provision similar to LLC Act § 4.03, the court wrote: “While there is little case law discussing veil piercing theories outside the corporate context, most commentators assume that the doctrine applies to limited liability companies.” The court then proceeded to uphold the limited liability of the sole member, office 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.* at 1336. In 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.* See also *Northern Tankers (Cyprus) Ltd. v. Backstrom*, 967 F.Supp. 1391 (D. Conn. 1997); *Hollowell v. Orleans Regional Hosp.*, 1998 WL 283298 (E.D. La.); *In re Multimedia Communications Group Wireless Assoc.*; *Mills v. Webster*, 212 B.R. 1006 (Bankr. M.D. Fla. 1997); and *Marina, LLC v. Burton*, 1998 WL 240364 (Ark. Ct. App. 1998). Texas has its own body of precedent in the corporate context with respect to piercing the corporate veil and, if a Texas court were to determine to look to corporate precedent in determining whether to respect the limitation of liability provided by the LLC Act, would not necessarily

expressly deal with the veil piercing issue by providing that the LLC veil will be pierced to the same extent as the corporate veil²²² or that the Members will have the same liabilities as corporate shareholders.²²³

M. Nature and Classes of Membership Interests. A membership interest in an LLC is personal property.²²⁴ It does not confer upon the Member any interest in specific LLC property.²²⁵ A membership interest may be evidenced by a certificate if the Regulations so provide.²²⁶

The Regulations 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 Articles and Regulations.²²⁷ The Regulations could provide for different classes of Members each authorized to elect a specified number or percentage of the Managers.²²⁸ The LLC Act generally allows even more flexibility in structuring classes of Members than is available in structuring classes of corporate stock under the TBCA or classes of limited partnership interests under TRLPA.²²⁹

An LLC membership interest would ordinarily be considered a “security” for the purposes of the Securities Act of 1933, as amended, and state securities or blue sky laws.²³⁰ The

consider the same factors as the courts in these reported cases. *See generally* Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 8-9 (Nov. 1995).

²²² See COLO. REV. STAT. 7-80-107, 7-60-103 (Supp. 1998); ME. REV. STAT. ANN. tit. 13, § 645 (West Supp. 1998); MINN. STAT. ANN. 322B.303.2 (1995 & Supp. 1998); N.D. CENT. CODE 10-32-29.3, 44-22-09 (Supp. 1998); WASH. REV. CODE. ANN. § 25.15.060 (West Supp. 1998).

²²³ See W. VA. CODE § 31-1A-33 (Supp. 1998).

²²⁴ LLC Act § 4.04.

²²⁵ *Id.*

²²⁶ LLC Act §4.05B.

²²⁷ LLC Act § 4.02.

²²⁸ LLC Act § 2.13.

²²⁹ See 1993 LLC Bill Analysis at 2.

²³⁰ 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, 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. 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

offer and sale of an interest must either be registered under applicable federal and state securities laws²³¹ or effected in a private²³² or other transaction structured to be exempt from those requirements.²³³

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 Schneider, *The Elusive Definitions of a “Security,”* 14 Rev. Sec. Reg. 981 (January 23, 1981); Schneider, *Developments in Defining a “Security,”* 16 Rev. Sec. Reg. 985 (January 5, 1983). The federal definition of security has served as a model for most modern state statutes. J. Long, 1985 Blue Sky Law Handbook 2-2 (1984).

By analogy to corporate stock and investment contracts, a membership interest in an LLC which is governed by Managers would ordinarily 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.

Schneider, “*The Elusive Definition of a ‘Security’ -- 1990 Update,*” 24 REV. SEC. & COM. REG. 13, 22 (January 23, 1991).

See Steinberg and Conway, *The Limited Liability Company As A Security*, 19 PEPP. L. REV. 1105, 1122 (1992), wherein the authors conclude:

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.”

See also *SEC v. Parkersburg Wireless*, 991 F.Supp. 6 (D.D.C. 1997) (interests in LLC with 700 Members held to be investment contracts); *SEC v. Vision Communications, Inc.*, DC DC Civ. Action No. 94-0615 (May 11, 1994), 26 BNA Sec. Reg. & L. Rep. 766 (1994) (holding LLC interests are securities); Sargent, *Will Limited Liability Companies Punch a Hole in the Blue Sky?*, 21 SEC. REG. L.J. 429 (1994).

²³¹ 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*, L. Loss, *Fundamentals of Securities Regulation 93-94* (1983). Unlike the federal statute that seeks full disclosure, many of the state “blue sky” acts are based on a concept known as “merit regulation.” 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).

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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 need the protection of the Act.” *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124-25 (1953). Subsequent court opinions have enumerated a number of more specific factors to be considered in determining whether a transaction involves a “public offering,” including the following:

- (a) the number of offerees (there is no number of offerees that always makes an offering either private or public; 25 to 35 is generally considered consistent with a private offering, but the sophistication of the offerees is more important; an offer to a single unqualified investor can defeat the exemption and an offering to a few hundred institutional investors can be exempt; note that the judicial focus is upon the number of persons to whom the securities are offered, not the number of actual purchasers);
- (b) offeree qualification (each offeree should be sophisticated and able to bear the economic risk of the investment; a close personal, family or employment relationship should also qualify an offeree);
- (c) manner of offering (the offer should be communicated directly to the prospective investors without the use of public advertising or solicitation);
- (d) availability of information (each investor should be provided or otherwise have access to information comparable to that contained in a registration statement filed under the 1933 Act; commonly investors are furnished a “private offering memorandum” describing the issuer and the proposed transaction in at least as much detail as would be found in a registration statement filed with the SEC for a public offering registered under the 1933 Act); and
- (e) absence of redistribution (the securities must come to rest in the hands of qualified purchasers and not be redistributed to the public; securities sold in a private placement generally may be replaced privately, freely sold by a person who is not an affiliate of the issuer in limited quantities to the public pursuant to SEC Rule 144, 17 C.F.R. 230.144 (1999), 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 one-year 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 Schneider, The Statutory Law of Private Placements, 14 REV. SEC. REG. 869 (August 26, 1981); ABA Committee on Federal Regulation of Securities, “*Integration of Securities Offerings: Report of the Task Force on Integration*,” 41 BUS. LAW. 595 (1986); Fletcher, “*Sophisticated Investors Under the Federal Securities Laws*,” 1988 DUKE L. J. 1081 (1988).

SEC Regulation D (“Reg D”), 17 C.F.R. 230.501-506 (1999), 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

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”).²³⁴ Such an interest would ordinarily have been considered a “certificated security” under Pre 9/1/95 B&CC § 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.²³⁵ Security interests in membership interests which were not evidenced by an instrument would have been perfected by a financing statement filing under Pre 9/1/95 B&CC § 9.²³⁶

Under H.B. 3200 which became effective September 1, 1995, LLC membership interests are not “securities” governed by Chapter 8 of the Texas Business & Commerce Code, as amended by H.B. 3200 (“Post 9/1/95 B&CC”), unless the interests are dealt in or traded on securities exchanges or markets or unless the parties expressly agree to treat them as such.²³⁷ 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.²³⁸

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.

²³³ 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).

²³⁴ TEX. BUS. & COMM. CODE ANN. §§ 8.101ff (1994).

²³⁵ Pre 9/1/95 B&CC § 8.321.

²³⁶ A membership interest not represented by an instrument would be a “general intangible” under Pre 9/1/95 B&CC § 9.106. A security interest therein would attach as provided in Pre 9/1/95 B&CC § 9.203 when the debtor has signed a proper security agreement, value has been given and the debtor has rights therein, and would be perfected by a financing statement filing under Pre 9/1/95 B&CC § 9.302.

²³⁷ Post 9/1/95 B&CC §§ 8.102 and 8.103(c).

²³⁸ Post 9/1/95 B&CC §§ 9.106 and 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

Under the LLC Act, like under TRLPA, 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.²³⁹ 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 Regulations, (1) a Member’s interest in an LLC is assignable in whole or in part, (2) 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, (3) 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, and (4) until the assignee becomes a Member, the assignor continues to be a Member and to have the power to exercise any rights or powers of a Member, except to the extent those rights or powers are assigned.²⁴⁰ An assignee of a membership interest may become a Member if and to the extent that the Regulations so provide or all Members consent.²⁴¹ Until an assignee is admitted as a Member, the assignee does not have liability as a Member solely as a result of the assignment.²⁴²

Regulations would typically contain restrictions on the assignment of interests to facilitate compliance with applicable securities and tax laws. Membership interest transfer restrictions contained in Regulations are enforceable.²⁴³

§§ 8.102(a)(17), 8.103(c) and 8.501(b)(1), and a security interest therein could be perfected by “control” or by filing under Post 9/1/95 B&CC §§ 9.106 and 9.115.

²³⁹ LLC Act § 4.06 provides:

On application to a court of competent jurisdiction by a judgment creditor of a member or any other owner of a membership interest, the court may charge the membership interest of the member or other owner with payment of the unsatisfied amount of the judgment. Except as otherwise provided in the regulations to the extent that the membership interest is charged in this manner, the judgment creditor has only the rights of an assignee of the interest. This Section does not deprive any member of the benefit of any exemption law applicable to that member’s membership interest.

See TRLPA § 7.03.

²⁴⁰ LLC Act § 4.05A.

²⁴¹ LLC Act § 4.07A. Under LLC Act § 4.07B, 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 Regulations and the LLC Act, 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 Regulations, although the assignment does not release the assignor from his liabilities to the LLC.

²⁴² LLC Act § 4.05C.

²⁴³ LLC Act § 4.05A provides that a membership interest is assignable “unless otherwise provided by the regulations.” There is no LLC Act requirement of “reasonableness” with respect to such transfer restrictions as is found in TBCA § 2.22.

O. Dissolution. LLC Act § 6.01A provides that an LLC is dissolved upon the occurrence of any of the following events:

- (1) the expiration of the period (if any) fixed for its duration, which may be perpetual (prior to its amendment in 1993, the LLC Act provided a maximum duration of 30 years);²⁴⁴
- (2) any event specified in the Articles or Regulations to cause dissolution;²⁴⁵
- (3) the action of the Members to dissolve the LLC (in the absence of a specific provision in the Articles or Regulations, the vote will be by a majority of the Members);²⁴⁶
- (4) if no capital has been paid in, the act of a majority of the Managers or Members named in the Articles to dissolve the LLC;²⁴⁷
- (5) except as otherwise provided in the Regulations, upon the death, expulsion, withdrawal pursuant to or as provided in the Articles or Regulations, bankruptcy or dissolution of a Member or the occurrence of any other event which terminates the continued membership of a Member in the LLC²⁴⁸; or
- (6) entry of decree of judicial dissolution under the LLC Act because it is not reasonably practicable to carry on the business of the LLC in conformity with its Articles and Regulations.²⁴⁹

LLC Act § 6.01B provides, however, that an LLC is not dissolved if (a) one of the events specified in (1) (expiration of fixed duration), (2) (events specified in Articles or Regulations to cause dissolution) or (5) (death, withdrawal, bankruptcy, etc.) above occurs, (b) there is at least one remaining Member and (c) the business of the LLC is continued as provided in the Articles or Regulations or, if not so provided, by all remaining Members. Unless otherwise provided in the Articles or Regulations, an election to continue the business of the LLC must be made within 90 days after the date of the occurrence of the event of dissolution. If an election to continue the business of the LLC is made following the termination of the period fixed for the duration of the LLC or the occurrence of events specified in the Articles to cause dissolution, the election is not effective unless an appropriate amendment is made by the LLC to its Articles during the three-year period following the date of the event of dissolution, extending the period fixed for the duration of the LLC or deleting the event specified in the Articles that caused the dissolution, as applicable.

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 LLC Act in defining the circumstances in which an LLC is dissolved, the Articles and Regulations should henceforth focus on dissolution from a

²⁴⁴ LLC Act §§ 3.02A(2) and 6.01A(1); see 1993 LLC Bill Analysis at 4.

²⁴⁵ LLC Act § 6.01A(2).

²⁴⁶ LLC Act § 6.01A(3); see 1993 LLC Bill Analysis at 5.

²⁴⁷ LLC Act § 6.01A(4).

²⁴⁸ LLC Act § 6.01A(5).

²⁴⁹ LLC Act § 6.01A(6) and 6.02A.

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.

On 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 Articles or Regulations or by resolution of the Managers or Members.²⁵⁰ Before filing articles of dissolution with the Secretary of State, the LLC shall (i) cease to carry on its business, except as may be necessary for the winding up thereof, (ii) mail written notice of its intention to dissolve to each of its known creditors and claimants, and (iii) collect its assets, discharge its obligations or make provision therefor, and distribute the remaining assets to its Members.²⁵¹ 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.²⁵² At any time prior to the issuance of a certificate of dissolution by the Secretary of State, an LLC may revoke voluntary dissolution proceedings by the written consent of all of its Members.²⁵³ Upon the issuance of the certificate of dissolution by 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.²⁵⁴

P. Merger; Conversion. Part Ten of LLC Act contains merger provisions for LLC's allowing an LLC to merge with one or more LLC's 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, whether organized for profit or not, to the extent that the laws or constituent documents of the other entity permit the merger). The merger must be pursuant to a written plan of merger containing the provisions required by LLC Act § 10.02 and the entities involved must approve the merger by the vote required by their respective governing laws and organizational documents. Under LLC Act § 10.03 a merger is effective when the entities file appropriate articles of merger with the Secretary of State.

The merger provisions in Part Ten of the LLC Act were modeled on the provisions of Section 2.11 of TRLPA and (with respect to LLC Act § 10.05) TBCA § 5.16.²⁵⁵ Important changes from TRLPA include (i) a requirement of unanimous approval by the Members of the LLC of mergers and share exchanges unless the Regulations provide otherwise and (ii) a broad description in LLC Act § 10.03.A of the persons who may execute the articles of merger. The provisions of LLC Act § 10.05 are drafted broadly to allow application of the provision 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.

LLC Act § 10.08, like Texas' other business entity statutes, now authorizes an LLC to convert into another form of entity, or convert from another into an LLC, without going through a merger or transfer of assets, and has provisions relating to the mechanics of the adoption of a

²⁵⁰ LLC Act § 2.09, 2.13, 6.02A and 6.03A.

²⁵¹ LLC Act § 6.05.

²⁵² LLC Act § 6.05(A)(3).

²⁵³ LLC Act § 6.06.

²⁵⁴ LLC Act § 6.08(B).

²⁵⁵ 1993 LLC Bill Analysis at 6.

plan of conversion, owner approval, filings with the Secretary of State, and the protection of creditors.

Q. Relationship to TBCA and TMCLA. The 1991 LLC Act § 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.²⁵⁶ In particular, TBCA § 2.02-1 and Part 5 with respect to indemnification and mergers, respectively, and TMCLA § 7.06 with respect to the limitation of director liability (made applicable to Managers) were incorporated.²⁵⁷

The 1991 LLC Act was left relatively short to give maximum flexibility of parties to tailor organizational structures to transactional needs, and the references to the TBCA and TMCLA were inserted to allow established bodies of law under those statutes to be used to fill the gaps not filled by the LLC Act, the Articles or the Regulations. Concepts of “piercing the corporate veil” which have developed under the TBCA are inconsistent with the concepts of limited liability of Members in the LLC Act and were not intended to be carried over.²⁵⁸ Concepts of cumulative voting and preemptive rights from TBCA §§ 2.29D and 2.22-1 may have been incorporated into the 1991 LLC Act by LLC Act § 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 § 8.12 was overbroad and presented interpretive difficulties and revised LLC Act § 8.12 to designate the sections of the TBCA and the TMCLA incorporated by reference. As amended in 1993 and 1997, LLC Act § 8.12A provides that only the following TBCA provisions apply to an LLC and its Members, Managers and officers:

- 2.07 (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 § 8.12B provides that the following TMCLA provisions apply to an LLC, its Members, Managers and officers:

- 2.03 (obligations to ostensible LLC)
- 2.04 (exclusive right of trustee to sue under indentures and security documents)
- 2.05 (facsimile signatures on debt instruments)
- 2.06 (consideration for indebtedness and guarantees)
- 2.09 (interest rate on borrowings)
- 2.09A (alternative interest rate on borrowings)
- 3.01 (veteran entities)
- 7.01-7.05 (correction of defective filings with Secretary of State)

²⁵⁶ 1991 LLC Act § 8.12.

²⁵⁷ *Id.*

²⁵⁸ *See* LLC Act § 4.03.

TBCA concepts of cumulative voting and preemptive rights are clearly not incorporated by reference into the LLC Act. Organizers desiring to provide those rights must expressly provide them in the Articles or Regulations, although an express denial thereof in the Articles or Regulations still seems useful so that all parties will be aware of the result.

R. Foreign LLC's. The LLC Act provides a mechanism by which a limited liability company formed under the laws of other jurisdictions 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 LLC Act to a domestic LLC.²⁵⁹ The LLC Act defines Foreign LLC so broadly that business trusts and other entities afforded limited liability under the laws under which they were organized can qualify to do business and achieve limited liability in Texas.²⁶⁰ When a foreign entity with "trust" in its name (such as a real estate investment trust) seeks to qualify to do business in Texas as a Foreign LLC, the Secretary of State will not qualify the Foreign LLC to do business until it obtains a letter of no objection from the Banking Department because the trust business in Texas is subject to regulation by the Banking Department.

The Foreign LLC qualification mechanism is derived from, and mirrors, TBCA Part Eight.²⁶¹ Any Foreign LLC "doing business" in Texas, like a foreign corporation, is required to qualify to do business in Texas by filing an application to do so with the Secretary of State.²⁶² The analysis of whether a Foreign LLC is "doing business" in Texas so as to have to qualify is the same as for a foreign corporation.²⁶³

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.²⁶⁴ Under LLC Act §7.13B the failure of a foreign LLC to qualify to do business in Texas will not impair the

²⁵⁹ LLC Act Part Seven.

²⁶⁰ "Foreign limited liability company" is broadly defined in LLC Act § 1.02(9) as follows:

(9) "Foreign Limited Liability Company" means an entity formed under the laws of a jurisdiction other than this state (a) that is characterized as a limited liability company by such laws or (b) although not so characterized by such laws, that elects to procure a certificate of authority pursuant to Article 7.01 of this act, that is formed under laws which 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.

²⁶¹ 1991 Bill Analysis Summary at 45.

²⁶² LLC Act §§ 7.01A and 7.05.

²⁶³ LLC Act § 7.01B; TBCA § 8.01B.

²⁶⁴ LLC Act § 7.02 provides in relevant part as follows with respect to a Foreign LLC that has procured a certificate of authority from the Secretary of State to transact business in Texas pursuant to LLC Act Part Seven:

. . . only the laws of the jurisdiction of organization of a foreign limited liability company shall govern (1) the internal affairs of the foreign limited liability company, including but not limited to the rights, powers, and duties of its manager and members and matters relating to its ownership, and (2) the liability, if any, of members of the foreign limited liability company for the debts, liabilities and obligations of the foreign limited liability company for which they are not otherwise liable by statute or agreement.

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.

S. Professional LLC's. Part Eleven of the LLC Act expressly provides for the formation of professional LLC's and specifies the statutory requirements for such entities.²⁶⁵ The provisions of Part Eleven, including the definition of "professional service," are based upon the Texas Professional Corporation Act ("TPCA").²⁶⁶ Unlike the TPCA, however, physicians, surgeons and other doctors of medicine are not excluded from forming professional LLC's.²⁶⁷

A professional limited liability company (a "PLLC") is required by LLC Act § 11.02 to contain in its name "the words 'Professional Limited Liability Company' or the abbreviation 'P.L.L.C.' or 'PLLC'." LLC Act § 11.03 provides that a person who is not either a "professional individual" (defined as an individual who is licensed or otherwise authorized to render the professional service of the PLLC, either within Texas or in any other jurisdiction)²⁶⁸ or a "professional entity" (defined as a person other than an individual that renders the same professional service as the PLLC only through partners, members, shareholders, Managers, directors, associates, officers, employees or agents who are professional individuals or professional entities)²⁶⁹ may not be a Member, Manager or officer of the PLLC. The PLLC, but not the 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 under LLC Act § 11.05.

T. Limited Banking Associations. A new Subchapter C of Chapter 3 to the Texas Banking Code (Tex. Rev. Civ. Stat. Ann. art. 342-301) was added in 1993, introducing yet another tax-flow-through entity: the "limited banking association" (an "L.B.A."). The L.B.A. is in essence a state bank with the characteristics of an LLC but tailored to the requirements of the bank regulators. The IRS has taken the position that an L.B.A. will be classified as a corporation rather than a partnership in a private letter ruling dated September 27, 1995 (PLR 9551032), and the Check-the-Box Regulations confirm the IRS' previous conclusion.²⁷⁰

U. 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

²⁶⁵ The Texas Disciplinary Rules of Professional Conduct permit Texas lawyers to form a Texas LLC for the practice of law. Texas Ethics Opinion 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. Rogers, *Questions of Law and Ethics Face Firms Becoming LLPs, LLCs*, 12 ABA/BNA Lawyer's Manual on Professional Conduct 411 (No. 23 Dec. 11, 1996); see ABA Formal Ethics Opinion 96-401 (1996).

²⁶⁶ TEX. REV. CIV. STAT. ANN. art. 1528e, §3(a) (Vernon 1997).

²⁶⁷ 1993 LLC Bill Analysis at 6; see Section IB(2) for information regarding changes in the 1999 Legislative Session relative to professional LLCs.

²⁶⁸ LLC Act § 11.01B(3).

²⁶⁹ LLC Act § 11.01B(4).

²⁷⁰ See Treas. Reg. § 301.7701-2(d)(5).

LLC is deemed a citizen of each state in which it has a Member.²⁷¹ Where corporate precedent is applied, an LLC is a citizen of its state of incorporation and the state where its principal place of business is located.²⁷²

VI. REGISTERED LIMITED LIABILITY PARTNERSHIP.²⁷³

A. **General.** An LLP is a general partnership in which the individual liability of partners for partnership obligations is substantially limited. This new species of general partnership represents a dramatic innovation and was first authorized by provisions (the “LLP Provisions”) added to the Texas Uniform Partnership Act²⁷⁴ (“TUPA”) by Sections 83-85 of House Bill 278. The LLP Provisions were refined and carried forward as § 3.08 of the Texas Revised Partnership Act²⁷⁵ (“TRPA”) passed in 1993, and then were substantially expanded by SB 555 effective September 1, 1997.²⁷⁶

B. **Background.** The LLP Provisions of TUPA originated in a separate bill, 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 Corporation Act.²⁷⁷ 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.²⁷⁸ 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

²⁷¹ *International Flavors & Textures, LLC v. Gardner*, 966 F.Supp. 552 (W.D. Mich. 1997).

²⁷² *SMS Fin. II, L.L.C. v. Stewart*, 1996 WL 722080 (N.D. Tex. 1996); *Carlos v. Adamany*, 1996 WL 210019 (N.D. Ill. 1996).

²⁷³ The discussion of LLP’s herein, insofar as it relates to LLP’s under H.B. 278, is drawn in part from Anderson, Bromberg, Egan, Griffin, Schoenbrun and Szalkowski, *Registered Limited Liability Partnerships*, Vol. 28, No. 3 BULL. OF SEC. OF BUS. L. 1 (Jan. 1992); reprinted 55 TEX. B. J. 728 (July 1992).

²⁷⁴ TEX. REV. CIV. STAT. ANN. art. 6132b (Vernon 1970).

²⁷⁵ TEX. REV. CIV. STAT. ANN. art. 6132b, §1.01 et seq. (Vernon Supp. 1999).

²⁷⁶ Under TRPA § 11.03(b), **TRPA § 3.08 governs all LLP’s on and after January 1, 1994** (regardless of when formed) except that an LLP formed before January 1, 1994 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 LLP’s deal only with the LLP Provisions in TRPA § 3.08. The other aspects of a partnership entity which is an LLP are governed by the remaining provisions of TRPA which have a different statutory phase-in. TRPA § 11.03 provides that, except for § 3.08, TRPA applies on and after January 1, 1994 to (i) new partnerships formed on and after that date and (ii) existing partnerships which elect to be governed by TRPA; and all partnerships will be governed by TRPA after January 1, 1999.

²⁷⁷ TEX. REV. CIV. STAT. ANN. art. 1528e (Vernon Supp. 1999).

²⁷⁸ See Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065 (1995).

misconduct.²⁷⁹ 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 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 art. 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 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.²⁸⁰ 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 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.²⁸¹

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, SB 555 amended TRPA §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 contract obligations. TRPA §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

²⁷⁹ See TEX. LAW., May 13, 1991 at 7; TEX. LAW., October 21, 1991 at 1.

²⁸⁰ N.Y. PARTNERSHIP LAW § 26(b); MINN. STAT. § 323.14 Subd. 2. The Minnesota statute also provides that the case law applicable to piercing the corporate veil also applies to LLCs, *Id.* Subd. 3, and this creates significant uncertainty in view of the vague concepts associated with veil piercing and the absence of precedent as to how those concepts would apply in the LLP context. Hamilton, *Registered Limited Liability Partnerships: Present at Birth (Nearly)*, 66 U. COL. L. REV. 1065, 1097 (1995).

²⁸¹ N.Y. Partnership Law § 26(c), (d).

debts and obligations of the partnership incurred while the partnership is a registered limited liability partnership. 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 §3.08(a) 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 §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 SB 555.²⁸² 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 §3.08, although they would be shielded against contractual obligations created thereafter.

TRPA §8.06 was amended by SB 555 to clarify that the obligations of a partner to make contributions to a partnership for the partner's negative balance in the partner's capital account and to satisfy obligations are subject to the limitations contained in TRPA §§3.07 and 3.08 relating to limited liability partnerships and the liability of incoming partners.

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 TRPA § 3.05(d) a creditor generally must first seek to satisfy the obligations out of partnership property.²⁸³ Although an LLP is a general partnership, the general partnership joint and several liability scheme is dramatically altered by the LLP Provisions when LLP status is attained.

1. TRPA § 3.08. The essence of the LLP Provisions, as amended by SB 555, 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, and is set forth in TRPA § 3.08(a), with changes effected by SB 555 marked, as follows:

(a) Liability of Partner. (1) Except as provided in Subsection (a)(2), a partner in a registered limited liability partnership is not individually liable, directly or indirectly, by contribution, indemnity, or otherwise, for debts and obligations of the partnership incurred while the partnership is a registered limited liability partnership.

²⁸² SB 555 § 125(d) provides as follows:

“(d) The change to Article 3.08, Texas Revised Partnership Act (Article 6132b-3.08, Vernon's Texas Civil Statutes), made by this Act shall not impair the obligations of a contract existing before the effective date of this Act.”

²⁸³ TRPA § 3.05(a), (d) and (e). See A. Bromberg and L. Ribstein on Partnership, § 1.01 and ch. 5 for a general discussion of the liabilities of general partners.

~~[(a) Liability of Partner.—(1)]~~ (2) A partner in a registered limited liability partnership is not individually liable, directly or indirectly, by contribution, indemnity, or otherwise, for debts and obligations of the partnership arising from errors, omissions, negligence, incompetence, or malfeasance committed while the partnership is a registered limited liability partnership and in the course of the partnership business by another partner or a representative of the partnership not working under the supervision or direction of the first partner unless the first partner:

(A) was directly involved in the specific activity in which the errors, omissions, negligence, incompetence, or malfeasance were committed by the other partner or representative; or

(B) had notice or knowledge of the errors, omissions, negligence, incompetence, or malfeasance by the other partner or representative at the time of occurrence and then failed to take reasonable steps to prevent or cure the errors, omissions, negligence, incompetence, or malfeasance.

~~[(2) Subsection]~~ (3) Subsections (a)(1) [does] and (a)(2) do not affect:

~~[(A) the joint and several liability of a partner for debts and obligations of the partnership arising from a cause other than the causes specified by Subsection (a)(1);]~~

~~[(B)]~~ (A) the liability of a partnership to pay its debts and obligations out of partnership property; ~~[or]~~

(B) the liability of a partner, if any, imposed by law or contract independently of the partner's status as a partner; or

(C) the manner in which service of citation or other civil process may be served in an action against a partnership.

(4) In this subsection, “representative” includes an agent, servant, or employee of a registered limited liability partnership.

(5) In the case of a registered limited liability partnership, this Subsection (a) prevails over the other parts of this Act regarding the liability of partners, their chargeability for the debts and obligations of the partnership, and their obligations regarding contributions and indemnity.

2. Limits to LLP Shield. The LLP Provisions, as amended by SB 555, 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.²⁸⁴ In addition, there are three situations under TRPA, as amended by SB 555, in which the LLP Provisions do not shield a partner from liability for a partnership obligation arising from the specified misconduct of a copartner or representative of the partnership:

²⁸⁴ TRPA § 3.08(a)(3)(B).

- (1) The miscreant copartner or representative is working under the supervision or direction of the partner.²⁸⁵
- (2) The partner is directly involved in the specific activity in which the copartner or representative commits the misconduct.²⁸⁶
- (3) The partner has “notice” or “knowledge” of the misconduct at the time of occurrence and, as added by TRPA, then fails to take reasonable steps to prevent the misconduct.²⁸⁷

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.²⁸⁸ For example, an environmental lawyer who negligently rendered legal advice with respect to the environmental law aspects of a real property acquisition would not ordinarily be viewed as “working under the supervision or direction” of a real estate lawyer having overall responsibility for the acquisition (which means that exception (1) would not be applicable), and the real estate lawyer would not ordinarily be viewed as “involved in the specific activity” (i.e., advising with respect to environmental law) in which the misconduct occurred (which means that exception (2) would not apply).

²⁸⁵ TRPA § 3.08(a)(2).

²⁸⁶ TRPA § 3.08(a)(2)(A).

²⁸⁷ TRPA § 3.08(a)(2)(B). TRPA § 1.02 provides 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.

²⁸⁸ *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).

3. Burden of Proof. The liability shield of the LLP Provisions 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 plaintiff would then have the burden of proving that one or more of the three exceptions applies to remove the liability shield from particular partners.

4. LLP Status Does Not Affect Liability of Partnership. LLP status does not relieve a partnership itself from liability for misconduct of its partners or representatives or prevent its assets from being reached to satisfy partnership obligations.²⁸⁹ A partnership may still be sued as an entity in its common name under TEX. R. CIV. P. 28, with or without the partners. Citation or other process against a partnership may still be served on a partner under TEX. CIV. PRAC. & REM. CODE § 17.022, regardless of whether the partner is shielded from liability by the partnership's LLP status.

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. 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 LLP Provisions 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 § 3.08 making Texas a full shield state does not apply to contractual obligations incurred prior to the September 1, 1997 effective date of SB 555 by virtue of SB 555 § 125(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.”

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 § 3.08, although the same obligation incurred thereafter would be shielded unless the partners had agreed to be liable therefor.

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,²⁹⁰ perhaps in recognition that some malpractice claims could be pled in

²⁸⁹ TRPA § 3.08(a)(3)(A) provides that TRPA §§ 3.08(a)(1) and (a)(2) “do not affect . . . the liability of a partnership to pay its debts and obligations out of partnership property.”

²⁹⁰ 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).

contract as well as in tort.²⁹¹ Under most LLP statutes, including that of Delaware,²⁹² 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.²⁹³ 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.²⁹⁴

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. 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 LLP Provisions require that an LLP must include in its name the words “registered limited liability partnership” or the abbreviation “L.L.P.” as the last words or letters of its name.²⁹⁵ Neither “R.L.L.P.” nor “L.P.” is acceptable.

2. **Filing with the Secretary of State of Texas.** To achieve domestic LLP status, a partnership must file with the Secretary of State of Texas²⁹⁶ an application accompanied by a fee for each partner of \$200.²⁹⁷ 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

²⁹¹ Miller, *Procedural and Conflict Laws Issues Arising In Connection With Multi-State Partnerships* (ABA BUS. L. SEC. 1996 Spring Meeting).

²⁹² 6 DEL. CODE § 1515.

²⁹³ MD. CORP. & ASS’N. CODE ANN. § 9-307(c)(1).

²⁹⁴ KY. REV. STAT. ANN. § 362.220; UTAH CODE ANN. § 48-1-12(2).

²⁹⁵ TRPA § 3.08(c); TEX. ADMIN. CODE tit. 1, § 80.1(b) (1998). 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 TRPA § 3.08(c) name requirement by a law firm should not conflict with the misleading name prohibition in Rule 7.04 of Texas Disciplinary Rules of Professional Conduct, which provides in relevant part as follows:

- (a) A lawyer in private practice shall not practice under a trade name, a name that is misleading as to the identity of the lawyer or lawyers practicing under such name, or a firm name containing names other than those of one or more of the lawyers in the firm, except that the names of a professional corporation or professional association may contain “P.C.” or “P.A.” or similar symbols indicating the nature of the organization . . . [Emphasis added].

The underscored language was in Rule 7.04 before LLP’s were authorized and was intended to clarify that it is permissible to include in a firm name words, initials or symbols indicating the nature of the limited liability form of organization. The references to “professional corporation,” “professional association,” “P.C.” and “P.A.” are by way of example and not limitation, and they do not limit the use of the words or letters “registered limited liability partnership” or “L.L.P.” in a firm name. The legislative history of the LLP Provisions clearly shows that the legislature intended the LLP form of business organization to be available to firms of lawyers and other professionals.

²⁹⁶ The rules of the Secretary of State dealing with LLP filings may be found at TEX. ADMIN. CODE tit. 1, §§ 80.1-80.7 (2001).

²⁹⁷ The \$200 per partner fee for LLPs organizing under TRPA is based on the total partners in the firm, and not the number of partners in Texas, under TRPA § 3.08(b)(3). For a foreign LLP, the fee is \$200 per partner in Texas, not to exceed \$750, under TRPA § 10.02(c).

partnership engages, plus the federal tax identification number of the partnership,²⁹⁸ and (b) be executed by a majority in interest²⁹⁹ of the partners or by one or more partners authorized by a majority in interest of the partners. The LLP Provisions do not require than 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 TRPA § 3.08(c) would ordinarily require that the partnership agreement contemplate LLP status.³⁰⁰

If the required information is supplied in the application and the fee is paid, the LLP registration becomes effective on filing.³⁰¹ 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 LLP Provisions now permit electronic filings of LLP documents as soon as the Secretary of State's procedures will permit.³⁰²

Registration remains effective for a year,³⁰³ regardless of changes in the partnership, unless the registration is earlier withdrawn or revoked or unless renewed.³⁰⁴ Because the registration is a notice filing and no listing of partners is required in the application, partnership changes due to withdrawals or to admissions of new partners do not require any refiling with the Secretary of State until the next renewal filing.³⁰⁵ Caution suggests an amendment to the application if the partnership changes its name. Registration expires after one year unless earlier withdrawn, revoked or renewed, and registration can be renewed.³⁰⁶ 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 TRPA is that the partnership must:

“(A) carry at least \$100,000 of insurance of a kind that is designed to cover the kinds of errors, omissions, negligence, incompetence, or malfeasance for which liability is limited by Subsection (a)(2); or

²⁹⁸ The Secretary of State's form of application and the LLP Provisions require the tax identification number of the partnership as part of the application to give more positive identification than the partnership name, which may change or may be similar to other names.

²⁹⁹ “Majority in interest” is defined in TRPA § 1.01(10) and TRLPA § 1.02(7) 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 LLP Provisions, 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.

³⁰⁰ In some states electing LLP status requires unanimous partner approval or an amendment to the partnership agreement in accordance with the applicable partnership agreement provisions. *See* Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 BUS. LAW. 101, 114-115 (Nov. 1997).

³⁰¹ 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, §§ 80.1(e) and (g) and 80.3 (2001).

³⁰² TRPA § 3.08(b)(16).

³⁰³ TRPA § 3.08(b)(5).

³⁰⁴ TRPA § 3.08(b)(6) and (7).

³⁰⁵ *See* TRLPA § 3.08(b)(4); TEX. ADMIN. CODE tit. 1, § 80.1 (1998).

³⁰⁶ TRPA § 3.08(b)(5).

(B) provide \$100,000 of funds specifically designated and segregated for the satisfaction of judgments against the partnership based on the kinds of errors, omissions, negligence, incompetence, or malfeasance for which liability is limited by Subsection (a)(2) by:

- (i) deposit in trust or in bank escrow of cash, bank certificates of deposit, or United States Treasury obligations; or
- (ii) a bank letter of credit or insurance company bond.”³⁰⁷

The insurance requirement (and the option under TRPA 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 LLP Provisions. The \$100,000 figure is arbitrary and may or may not be greater than the partners’ individual assets otherwise available to partnership creditors. The \$100,000 figure 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 § 3.08(d).

The insurance must be “designed to cover the kinds of” acts for which partner liability is shielded by TRPA § 3.08(a)(1).³⁰⁸ 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 § 3.08(d) allows an LLP the option of providing \$100,000 in funds in lieu of obtaining insurance, but requires one or the other. The burden of proving that insurance is not reasonably available under TUPA is on the partner claiming the liability shield of TUPA § 15(2).

The LLP Provisions 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.”³⁰⁹ These LLP Provisions are intended

³⁰⁷ TRPA § 3.08(d)(1). 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.

³⁰⁸ TRPA § 3.08(d)(1)(A).

³⁰⁹ TRPA § 3.08(d)(2).

to keep the existence of insurance from influencing a jury decision on liability or damages. TRPA § 3.08(d)(3) specifically states that if compliance with the insurance or fund provisions of § 3.08(d)(1) is disputed, “compliance must be determined separately from the trial or proceeding” to determine liability or damages.

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.

2. Texas Franchise Tax. As a species of general partnership, an LLP is not subject to the Texas franchise tax.³¹⁰

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.

F. Other Issues.

1. Advertisement of LLP Status. Although not required by the LLP Provisions, 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.³¹¹ Further, there is no requirement that a partnership publish notice of its becoming an LLP comparable to the notice required of certain incorporations.³¹²

³¹⁰ TEX. TAX CODE ANN. § 171.001.

³¹¹ The New York LLP statute requires publication once per week for six weeks of notice of creation of an LLP. N.Y. Partnership Law § 121-1500(a).

³¹² TEX. REV. CIV. STAT. art. 1302-2.02 provides:

A. Whenever any banking, mercantile or other business firm desires to become incorporated without a change of firm name, such firm shall, in addition to the notice of dissolution required at Common Law, give notice of such intention to become incorporated for at least four (4) consecutive weeks in some newspaper published in the county in which such firm has its principal business office, if there be a newspaper in such county; and, if not, then in some newspaper published in some adjoining county; provided, however, that such notice shall only be published one (1) day in each week during the said four (4) weeks. Until such notice has been so published for the full period above-named, no change shall take place in the liability of such firm or the members thereof to those dealing with the firm

2. Assumed Name Certificate. Since an LLP is a species of general partnership, prior to 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”)³¹³ like any other general partnership. H.B. 1239 §§ 1.29-1.31 amended the Assumed Name Statute so that LLP’s, LLC’s 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, although 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.³¹⁴ 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.³¹⁵ 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.³¹⁶ 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. The LLP Provisions as originally enacted were not explicit regarding the time at which a partnership must be in compliance with their requirements in order to raise the liability shield with respect to a particular obligation, but probably required that the partnership have been in compliance with these requirements at the time of the misconduct giving rise to the obligation. This conclusion is based on TUPA § 17, which provides that an incoming partner is liable only out of partnership property for obligations of the partnership arising before his admission. The limited liability available to equity holders under corporation and limited partnership law also turn on when the obligation arises.³¹⁷ 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.³¹⁸ 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.³¹⁹ 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.

or its members. It shall be a defense that a claimant had actual notice or knowledge of such incorporation.

³¹³ TEX. BUS. & COM. CODE §§ 36.01ff.

³¹⁴ TEX. BUS. & COM. CODE § 36.02(7) as amended by H.B. 1239.

³¹⁵ TEX. BUS. & COM. CODE § 36.10 as amended by H.B. 1239.

³¹⁶ TEX. BUS. & COM. CODE §§ 36.25 and 36.26.

³¹⁷ See Fletcher Cyc.Corp. § 4019 (Perm. Ed.).

³¹⁸ *Id.*; see also *Baca v. Weldon*, 230 S.W.2d 552 (Tex. Civ. App.--San Antonio, 1950, writ ref’d n.r.e.).

³¹⁹ 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).

Any temporal uncertainty originally existent under TUPA was removed by TRPA § 3.08(a)(1) which provides that the shielded partners are not liable for misconduct incurred “while the partnership is a registered limited liability partnership.” This result is buttressed by the Bar Committee Bill Analysis of H.B. 273 which at 14 states that TRPA § 3.08(a)(1) “clarifies that the partnership must be a registered limited liability partnership at the time of the errors and omissions for which partner liability is limited.”

4. Effect on Pre-LLP Liabilities. An LLP is the same partnership that existed before it became an LLP.³²⁰ Since the shield of TRPA § 3.08(a)(1) protects partners only against liabilities incurred “while the partnership is a registered limited liability partnership,” attainment of LLP status has no effect on pre-existing partnership liabilities. In *Medical Designs, Inc. v. Shannon, Gracey, Ratliff & Miller, L.L.P.*, 922 S.W.2d 626 (Tex. App.--Fort Worth 1996, writ denied), 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.” There is nothing in the court’s opinion suggesting that registration as an LLP is enough to make the partnership a different partnership.³²¹

5. Limited Partnership as LLP. TRPA § 3.08(e) states that a limited partnership can become an LLP simply by complying with the applicable LLP provisions of TRPA, in which case it would be a “LLL.P.” In addition, TRLPA § 2.14 provides that a limited partnership is an LLP as well as a limited partnership if it (i) registers as an LLP under TRPA § 3.08(b), 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 TRPA § 3.08(d), and (iii) has as the last words or letters of its name “Limited Partnership” or “Ltd.” followed by “registered limited liability partnership” or “L.L.P.”

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.³²² Under TRLPA § 2.14(c) a limited partner in an LLLP whose conduct would otherwise render it liable as a general partner has the benefit of the LLP shield.

6. Indemnification and Contribution. As amended by SB 555, the LLP Provisions eliminate the usual right of a partner who is held personally liable for a partnership

³²⁰ See *Middlemist v. BDO Seidman, LLP*, 1997 WL 603886 (Colo. Ct. App. 1997); *Sasaki v. McKinnon*, 1997 WL 781769 (Ohio Ct. App. 1997); and *Howard v. Klynveld Peat Marwick Goerdeler*, 977 F. Supp. 654 (S.D. N.Y. 1997).

³²¹ For an analysis of the *Shannon Gracey* case, see Miller, *The Advent of LLCs and LLPs in the Case Law: A Survey of Cases Dealing With Registered Limited Liability Partnerships and Limited Liability Companies* presented at symposium on Partnerships and LLCs - Important Case Law Developments 1998 at ABA Annual Meeting in Toronto, Ontario, Canada on August 4, 1998.

³²² TRPA § 3.03.

obligation to obtain indemnification from the partnership under TUPA § 18(1)(b) or contribution from copartners under TUPA §§ 40(a)(II) and 40(b) or TRPA § 8.06(c). It seems inconsistent with the LLP Provisions to allow a partner to recover, directly or indirectly, from copartners who are shielded from liability by the LLP Provisions, absent a specific agreement of indemnification, and TRPA § 3.08(a) expressly provides that a partner is not individually liable “by contribution, indemnity, or otherwise” for partnership obligations except as otherwise provided. Quite apart from the LLP Provisions, there is authority that a partner who commits malpractice cannot recover from his or her non-negligent copartners.³²³ It would certainly be inconsistent with the LLP Provisions to let a plaintiff reach those copartners 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,³²⁴ a creditor could argue that the partnership agreement supercedes the shield afforded by the LLP Provisions.³²⁵ Thus, if a miscreant partner is entitled to indemnification from the innocent partners in excess of the firm’s assets, then a creditor could claim the indemnification right has become an asset of the miscreant partner’s bankruptcy estate and the indemnification agreement could lead to a series of payments from the innocent partners, with each payment ultimately being for the benefit of creditors entitled to recover for the actions of the miscreant partner.³²⁶ The partnership could counter that compliance with the LLP

³²³ *E.g., Flynn v. Reaves*, 218 S.E.2d 661 (Ga. App. 1975).

³²⁴ Any LLP that intends by contract to require partners whose liabilities are shielded by the LLP Provisions to indemnify or contribute to partners whose liability is not shielded (due to their own misconduct) should be particularly sensitive to the “express negligence doctrine.” Under the “express negligence doctrine” as articulated by the Supreme Court of Texas, an indemnification agreement is not enforceable to indemnify a party from the consequences of its own negligence unless such intent is specifically stated in the agreement. *See Ethyl Corp. v. Daniel Constr. Co.*, 725 S.W.2d 705, 708 (Tex. 1987) wherein the Supreme Court held:

“The express negligence doctrine provides that parties seeking to indemnify the indemnitee from the consequences of its own negligence must express that intent in specific terms. Under the doctrine of express negligence, the intent of the parties must be specifically stated within the four corners of the contract. We now reject the clear and unequivocal test in favor of the express negligence doctrine. In so doing, we overrule [prior decisions] stating it is unnecessary for the parties to say, ‘in so many words,’ they intend to indemnify the indemnitee from liability for its own negligence.

* * *

“The contract between Daniel and Ethyl speaks to ‘any loss . . . as a result of operations growing out of the performance of this contract and caused by the negligence or carelessness of [Daniel]. . . .’ Ethyl emphasizes the ‘any loss’ and ‘as a result of operations’ language to argue an intent to cover its own negligence. We do not find such meaning in those words. The indemnity provision in question fails to meet the express negligence test.”

See also, Dresser Industries, Inc. v. Page Petroleum, Inc., 853 S.W.2d 505 (Tex 1993); *Atlantic Richfield Co. v. Petroleum Personnel, Inc.*, 768 S.W.2d 724 (Tex. 1989).

³²⁵ Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 Bus. Law. 101, 118-120 (Nov. 1997).

³²⁶ *See Banoff, “Alphabet Soup: A Navigator’s Guide,”* 4 BUS. L. TODAY 10, 12 (No. 4 March/April 1995).

Provisions 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 under TRPA §1.01(12) a partnership agreement may be written or oral, 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.³²⁷

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*, 1997 WL 20881, 6 (Tex. App.-Amarillo 1997), 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. Prior to SB 555, there was no statutory provision or Secretary of State procedure for the qualification of a foreign LLP to do business in Texas, as there is for foreign corporations, limited partnerships and LLC’s. This is because TRPA § 1.05 provides that a partnership’s internal affairs are governed by the law of the state chosen by the partners in the partnership agreement, if that state bears a reasonable relation to the partners or the partnership business and affairs, and that the law governing a partnership’s internal affairs also governs its liability to third parties. Although a filing in Texas was not necessary to avail a foreign LLP of the benefits of TRPA § 1.05, the Secretary of State’s office would accept filings (and filing fees) from foreign LLP’s (the filing fee and the form were the same as if the foreign LLP were in effect organizing in Texas).

SB 555 added a new Article X of TRPA providing for a foreign LLP doing business in Texas³²⁸ to qualify to do business in Texas like a Foreign LLC (the filing fee would

³²⁷ Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 BUS. LAW. 101, 120 (Nov. 1997).

³²⁸ TRPA does not define what constitutes “transacting business in Texas” for the purposes of the requirement of TRPA § 10.02(a) that “[b]efore transacting business in Texas, a foreign limited liability partnership must file with the secretary of state a statement of foreign qualification.” TRPA § 10.04, however, does contain the following non-exclusive list of activities not constituting transacting business in Texas:

Sec. 10.04. Activities Not Constituting Transacting Business.

Without excluding other activities that do not constitute transacting business in Texas, a foreign limited liability partnership is not considered to be transacting business in Texas for purposes of this Act because it carries on in Texas any one or more of the following activities:

be the lesser of \$200 per resident partner³²⁹ or \$750) and that the failure of the foreign LLP to qualify would not affect its LLP shield in Texas. Under new TRPA § 10.01³³⁰ the laws of the

- (1) maintaining or defending any action, suit, or administrative or arbitration proceeding, effecting settlement of the action, suit, or proceeding, or settling claims or disputes to which it is a party;
- (2) holding meetings of its partners or carrying on other activities concerning its internal affairs;
- (3) maintaining bank accounts;
- (4) maintaining offices or agencies for the transfer, exchange, and registration of partnership interests issued by it or appointing or maintaining trustees or depositories with relation to ownership interests in it;
- (5) effecting sales through independent contractors;
- (6) creating as borrower or lender or acquiring indebtedness or mortgages or other security interests in real or personal property;
- (7) securing or collecting debts due to it or enforcing rights in property securing such debts;
- (8) transacting business in interstate commerce;
- (9) conducting an isolated transaction completed within 30 days of the date of initiation of the transaction and not in the course of a number of repeated similar transactions;
- (10) exercising the powers of executor or administrator of the estate of a nonresident decedent under ancillary letters issued by a Texas court, or exercising the powers of trustee under the will of a nonresident decedent, or under a trust created by one or more nonresidents of Texas or by one or more foreign corporations or limited partnerships, if the exercise of those powers in any of these cases will not involve activities that would be considered to constitute the transacting of business in Texas in the case of a foreign corporation or foreign limited partnership acting in its own right;
- (11) acquiring, in transactions outside Texas or in interstate commerce, debts secured by mortgages or liens on real or personal property in Texas, collecting or adjusting principal and interest payments on those debts, enforcing or adjusting rights in property securing those debts, taking any actions necessary to preserve and protect the interest of the mortgagee in that security, or a combination of these transactions; or
- (12) investing in or acquiring, in transactions outside Texas, royalties and other nonoperating mineral interests, and the execution of division orders, contracts of sale, and other instruments incidental to the ownership of nonoperating mineral interests.

³²⁹ The Secretary of State has adopted a regulation for determining whether a partner is in Texas for purposes of annual fee calculations. TEX. ADMIN. CODE tit. 1, § 80.2(f) provides as follows:

- (f) *Partners in Texas.* For purposes of this section, a partner is considered to be in Texas if:
- (1) the *partner* is a resident of the state;
 - (2) the partner is domiciled or located in the state;
 - (3) the partner is licensed or otherwise legally authorized to perform the services of the partnership in this state; or

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.

Thus, under TRPA § 10.01, partners may choose the state law, and hence the liability shield, that they wish to apply to their relationship. That choice should not be subject to the general limitation in TRPA § 1.05(a)(1) 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.”

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,³³¹ 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 LLP’s to qualify to do business in the state.³³²

10. Bankruptcy. Section 723 of the Bankruptcy Code³³³ 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 LLP’s 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.³³⁴

(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.

³³⁰ TRPA § 10.01 provides as follows:

Sec. 10.01. Law Governing Foreign Limited Liability Partnership.

(a) The laws of the state under which a foreign limited liability partnership is formed govern its organization and internal affairs and the liability of partners for obligations of the partnership.

(b) A foreign limited liability partnership may not be denied a statement of foreign qualification by reason of any difference between the laws of the state under which it is formed and the laws of Texas.

(c) With respect to its activities in Texas, a foreign limited liability partnership is subject to Section 3.01 as if it were a domestic registered limited liability partnership.

³³¹ 6 DEL. CODE § 1515 (1998); 6 DEL. CODE § 1547 (1999).

³³² N.Y. PARTNERSHIP LAW § 121-1502 (1998); MD. CORP. & ASS’N. CODE § 9-902 (1999).

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

³³⁴ Congressional Record—House H 10767 (Oct. 4, 1994). This amendment to the Bankruptcy Code is attributable in large part to efforts of representatives of the Texas Business Law Foundation.

11. Federal Diversity Jurisdiction. An LLP is a citizen of every state in which one of its partners resides for the purposes of Federal court diversity jurisdiction.³³⁵ As a result, large accounting firms with offices in most states are likely beyond the reach of the diversity jurisdiction of the Federal courts.³³⁶

VII. EXTRATERRITORIAL RECOGNITION OF LLC AND LLP LIMITED LIABILITY.

A. General. Courts of other states should recognize the Texas statutory liability shield of LLC's and LLP's 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.³³⁷ 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.³³⁸

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."³³⁹

There is no comparable statement of legislative intention in the LLP Provisions. TRPA § 1.05, however, provides 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. Texas has thus codified the internal affairs doctrine recognized by the courts of other states, as discussed below.

C. Texas Cases. Texas appears to be the only state with a reported decision denying limited liability to owners of an unincorporated entity formed under another state's law (such as

³³⁵ *Reisman v. KPMG Peat Marwick LLP*, 965 F. Supp. 165 (D. Mass. 1997), relying on *Carden v. Arkoma Assoc.*, 494 U.S. 185 (1990).

³³⁶ The court in *Reisman, supra*, 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."

³³⁷ 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 Anderson and Dockery, "Formalities of Corporate Operations," Texas Corporations - Law and Practice § 31.05 (1986).

³³⁸ See 88 A.L.R. 3d 704 § 7 (1978): "In some jurisdictions a Massachusetts or business trust has been treated as a partnership for some purposes."

³³⁹ LLC Act § 4.03B.

the LLC Act) because the forum state did not have such a statute.³⁴⁰ In *Means v. Limpia Royalties*,³⁴¹ 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. § 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*, Tex. Civ. App., 252 S.W. 287, 290, “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.”³⁴²

³⁴⁰ 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, for example, 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).

³⁴¹ 115 S.W.2d 468, 475 (Tex. Civ. App.--Ft. Worth 1938, writ dism’d).

³⁴² 115 S.W.2d at 475. The *Limpia Royalties* case was cited and its rationale followed in *Cherokee Village v. Henderson*, 538 S.W.2d 169, 173 (Tex. Civ. App.--Houston 1976, writ dism’d), a personal injury case in which the property on which the injury occurred was held pursuant to a trust agreement. The trust agreement, which apparently was governed by Texas law, recited that no partnership was intended and that no party had any right to incur any liability on account of any other party. The defendants in the case were holders of beneficial interests in the trust, which was a successor to a general partnership in which the holders had been partners. Two years after the creation of the trust, but two years prior to the injury, three individuals withdrew from the arrangement by a document which purported to be an amendment to the venture’s “agreement of general partnership” and an assumed name certificate was filed in which the defendants were listed as general partners. The court was not persuaded by the defendants’ testimony that these actions were erroneous. In holding that the defendants were liable and that the trust was a partnership under Texas law, the court wrote:

Article 6132b, the Texas Uniform Partnership Act, Section 6, defines a partnership as “an association of two or more persons to carry on as coowners 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 existence, 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

The sections of the LLC Act providing for qualification of Foreign LLC's 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.³⁴³ The Bill Analysis³⁴⁴ 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. 1938), 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.³⁴⁵

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 coowners 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.

³⁴³ 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, art. 6132a-1 § 9.01(a): "The laws of the state under which a foreign limited partnership is formed govern its organization and internal affairs and the liability of its partners" (whether or not the foreign limited partnership is registered to do business in Texas). The 1989 amendment to Texas Business Corporation Act art. 8.02 prescribes that "only the laws of the jurisdiction of incorporation of a foreign corporation shall govern (1) the internal affairs of the foreign corporation . . . and (2) the liability, if any, of shareholders . . ."

³⁴⁴ Bill Analysis of H.B. 278 by Wolens at 10 (1991). See 1991 Bill Analysis Summary at 41.

³⁴⁵ "Foreign Limited Liability Company" is broadly defined in LLC Act § 1.02(9) as follows:

(9) "Foreign Limited Liability Company" means an entity formed under the laws of a jurisdiction other than this state (a) that is characterized as a limited liability company by such laws or (b) although not so characterized by such laws, that elects to procure a certificate of authority pursuant to Article 7.01 of this act, that is formed under laws which provides [sic] that some or all of the persons entitled to receive a distribution of 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.

H.B. 278 § 46 art. 7.02 provides in relevant part as follows with respect to a foreign limited liability company that has procured a certificate of authority from the Secretary of State to transact business in Texas pursuant to H.B. 278 § 46 Part Seven:

. . . only the laws of the jurisdiction of organization of a foreign limited liability company shall govern (1) the internal affairs of the foreign limited liability company, including but

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 LLC's and LLP's. 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.³⁴⁶ 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 Spain³⁴⁷ and that the liability of Sarria and the extent of the authority of his partners to bind him³⁴⁸ were to 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

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.

³⁴⁶ 69 N.Y. 24 (Ct. of App. 1877).

³⁴⁷ 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, 53 S. Ct. 295, 297, 89 L.Ed. 720 (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).

³⁴⁸ The court in *King v. Sarria* noted that, since the contract in question was made by persons other than Sarria, the plaintiff had to show that the other partners had authority to bind Sarria and that the plaintiff was relying upon the mutual general agency which results from the relation of partnership to show that authority. The court noted that, if the Spanish statute were not applicable, the plaintiff would prevail "for by virtue of the relationship of partnership, one partner becomes the general agent for the other, as to all matters within the scope of the partnership dealings, and has thereby given to him all authority needful for carrying on the partnership, and which is usually exercised by partners in that business" and "that any restriction which by agreement amongst the partners is attempted to be imposed upon the authority, which one partner possesses as the general agent of the other, is operative only between the partners themselves, and does not limit the authority as to third persons . . . unless they know that such restriction has been made." 69 N.Y. at 28-29. The court noted that the foregoing common law principles, which are comparable to TUPA §§ 9, 13, 14 and 15(1) (without the LLP exception), were qualified by the provisions of any applicable statute providing for the formation of partnerships with limited liability.

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.³⁴⁹

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.³⁵⁰ However, in reaching this conclusion, the court noted that the Spanish statute resembled New York's own statute for the formation of limited partnerships.³⁵¹

The 1982 New York case of *Downey v. Swan*³⁵² 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.³⁵³ 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.³⁵⁴

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.*,³⁵⁵ 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 status³⁵⁶

³⁴⁹ *Sarria*, 69 N.Y. at 34.

³⁵⁰ 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).

³⁵¹ The court indicated that the same reasoning would apply to contract and tort claims.

³⁵² 454 N.Y.S. 2d 895 (A.D. 2d Dept 1982).

³⁵³ 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).

³⁵⁴ 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.

³⁵⁵ 1994 WL 707133, Civ. A. No. 94-10609-MLW (D. Mass. Dec. 6 1994).

³⁵⁶ *Liberty Mutual Insurance Co. v. Gardere & Wynne, L.L.P.* involved claims of breach of fiduciary duty and conflict of interest asserted by Liberty Mutual Insurance Company ("Liberty") against the Dallas based law firm of Gardere & Wynne, L.L.P. ("Gardere"), which had represented Liberty for many years. Gardere was a Texas partnership that had taken the steps to become a registered LLP under the TRPA. Two Gardere lawyers, Nabors and Woods, also were defendants in the suit; Nabors clearly was a partner in Gardere, but the facts were uncertain about whether Woods's election to "income partner" status had been given effect before he left Gardere to join another firm. Liberty filed its suit in the federal district court in Massachusetts, where its principal office was located. Gardere, Nabors, and Woods moved for dismissal or, alternatively, to have the case transferred to Texas.

Gardere's motion to dismiss was based upon Massachusetts law providing that a general partnership could not be sued in its common name but that, instead, suit must be brought against each of the partners individually. The individual defendants' motions to dismiss were based upon a claimed lack of personal jurisdiction over Nabors and Woods by a court located in Massachusetts. Both of these asserted grounds for dismissal would be moot if the case were transferred to Texas, because Texas law permits a partnership to be sued in its

on a case pending in Massachusetts which did not have an LLP statute, the limited liability of partners under the LLP Provisions was recognized under the internal affairs doctrine as follows:

The court assumes that, if this case were tried in a state or federal court in Massachusetts, the court would look to Texas substantive law to determine the liability of partners in a Texas RLLP for debts arising out of claims for breach of fiduciary duty by other partners. *See* Mass.Gen.L. ch. 109, § 48 (liability of limited partners of a foreign limited partnership “shall be governed by the laws of the state under which it is organized”); *Klaxon v. Stentor Elec. Mfs. Co.*, 313 U.S. 487, 496, 61 S.Ct. 1020, 1021-22 (1941) (federal court in diversity case applies choice of law principles of state in which federal court is located). Thus, Texas law will apply to this question whether or not the case is transferred . . .³⁵⁷

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.

³⁵⁷ 1994 WL 707133 at note 7.

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.³⁵⁸ 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 LLC's, 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.³⁵⁹ Likewise, since at least 48 states (including Texas) plus the District of Columbia have LLP statutes and other states have them under consideration, foreign qualification needs to be considered as a means of reducing extraterritorial risk. The various statutes are not consistent as to the availability or necessity of foreign qualification as a means of obtaining local limited liability recognition, with Delaware relying on the internal affairs doctrine and not providing for foreign qualification³⁶⁰ and with New York and Maryland providing for foreign qualification.³⁶¹

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.³⁶²

³⁵⁸ Miller, "Procedural and Conflict of Laws Issues Arising In Connection With Multi-State Partnerships" (ABA Bus. L. Sec. 1996 Spring Meeting).

³⁵⁹ LLC Act §§ 7.01, 7.02; N.Y. LLC Law §§ 801, 802 (1998); 6 DEL. CODE §§ 18-901, 18-902 (1998).

³⁶⁰ 6 DEL. CODE § 1547 (1998).

³⁶¹ N.Y. PARTNERSHIP LAW § 121-1502 (1998); MD. CORP. & ASS'N. CODE § 9-902 (1998).

³⁶² See Rogers, *Questions of Law and Ethics Face Firms Becoming LLPs, LLCs*, 12 ABA/BNA Lawyers' Manual of Professional Conduct 411 (No. 23 Dec. 11, 1996); *Meyer v. Oklahoma Alcoholic Laws Enforcement Comm.*, 890 P.2d 1361 (Okla. Ct. App. 1995) (LLC not permitted to hold liquor license).

VIII. WHEN TO USE AN LLC OR AN LLP.

A. LLC. Generally an LLC should be considered as a possible entity of choice in any situation where limited liability and a flow-through for tax purposes for all owners are desired but otherwise unavailable. For example, because an LLC, unlike an S-corporation, (i) may have more than 75 equity holders and (ii) may have corporations, nonresident aliens, general or limited partnerships and trusts as equity holders, an LLC may be advantageous where an S-corporation or limited partnership with an S-corporation general partner is not available. The LLC may also be a viable alternative to use instead of a limited partnership in some situations where it is undesirable to have a general partner which is generally liable for all of the entity's obligations or where investors who would otherwise be limited partners desire to be involved in the management of the entity. The Texas franchise tax is an impediment to use of an LLC. Self-employment tax concerns also limit the situations where the LLC is the entity of choice.

B. LLP. An LLP is a possible entity of choice where limited contract and vicarious tort liability and tax flow through are important. The LLP is becoming the entity of choice for Texas law firms because it affords limitations on malpractice liability similar to a professional corporation or PLLC but without the franchise tax cost. The LLP is similarly desirable for other professional firms, although its applicability is not limited to professional firms, and its low cost and ease of use make it desirable for any business (including any joint venture) for which a general partnership would otherwise be the entity of choice. Because an LLP is a partnership, the LLP is not available where there is only one owner involved.

IX. 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 and 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, 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, 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:

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 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 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. the threat that the next legislature will cause limited partnerships to be taxed as corporations subject to the franchise tax

D. The LLC can be structured to have tax flow through and limited liability of S-corporation or limited partnership without any of the drawbacks for them, but:

- (i) subject to Texas franchise tax as a corporation
- (ii) self-employment tax issues
- (iii) as result of newness, 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 S-corporation will give limitation of owner liability and federal income tax flow through (even when there is only one owner), but an S-corporation is subject to the Texas franchise tax and there are limitations on its availability under the Code: S-corporation status is not available where the entity:

1. has more than 75 equity holders;
2. has more than one class of stock;
3. has among its shareholders any:
 - general or limited partnership
 - trust (certain exceptions)

- non resident alien
- corporation (exception for “qualified subchapter S subsidiary”).

The following chart compares the taxes that are paid by different entities and their owners. In each case, the entity earns \$100 of net income that is of a type subject to self-employment taxes (i.e., is income from a trade or business) and distributes the entire amount (after taxes) to its owners. It is also assumed that the owner 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 \$84,900).

Item	C Corporation	S Corp or Limited Liability Company*	General Partner in General or Limited Partnership*	Limited Partner in Limited Partnership*
<u>Entity Level</u>				
Income		100	100	100
Franchise Tax	4.50	4.50	0	0
Taxable Income Of Entity				
Fed. Income Tax (at 35%)	95.50	95.50	100	100
Income After Taxes	33.43	0	0	0
	62.07	95.50	100	100
<u>Owner Level</u>				
Distribution & Share of Income				
Self-Employment Tax	62.07	95.50	100	100
Taxable Income of Owner	0	2.77#	2.90	0
Fed. Income Tax (at 39.6%)	62.07	94.11†	98.55†	100
Amount Received After Taxes	24.58	37.27	39.03	39.60
	37.49	55.46	58.07	60.40

* Assumes the entity is treated as a partnership for federal income tax purposes.

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.

† One-half of the self-employment tax is deductible against the individual’s income.

X. CONCLUSION.

There are five entities 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.

ENTITY COMPARISON CHART

Item	Sole Proprietorship	General Partnership	Registered Limited Liability Partnership (General or Limited)	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	General Partnership L.L.P. must end with “Registered Limited Liability Partnership” or “LLP”. Limited Liability Limited Partnership Must Include “Limited Partnership” or “Ltd.” Followed by “Registered Limited Liability Partnership” or “LLP”).	Must contain “Limited Partnership”, “Ltd.”, “L.P.” or “Limited”.	Must contain “Limited Liability Company”, “Limited Company” or Abbreviations Thereof.	Must contain “Corporation”, “Company”, “Incorporated” or Abbreviations Thereof.	Must contain “Corporation”, “Company”, “Incorporated” or Abbreviations Thereof.
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 General Partner; Must Maintain Liability Insurance or Meet Alternative Financial	Certificate of Limited Partnership and Filing Fee of \$750	Articles of Organization and \$200 Filing Fee	Articles of Incorporation and \$300 Filing Fee	Articles of Incorporation and \$300 Filing Fee

Item	Sole Proprietorship	General Partnership	Registered Limited Liability Partnership (General or Limited)	Limited Partnership	Limited Liability Company	“C” Corp.	“S” Corp.
			Responsibility Test				
Ownership Types	Individuals	Any	Any	Any	Any	Any	Limited
No. of Owners	One	Minimum of 2	Minimum of 2	Minimum of 2	Single Member LLCs Permitted in Texas	No Restrictions	No More than 75
Professionals	Yes	Yes	Yes	Yes	Yes	Generally Governed By Texas Professional Corporation Act or Texas Professional Association Act	Generally Governed By Texas Professional Corporation Act or Texas Professional Association Act
Ownership Classes	One	Multiple Classes Allowed	Multiple Classes Allowed	Multiple Classes Allowed but Must Have at Least 1 General Partner and 1 Limited Partner.	Multiple Classes Allowed	Multiple Classes Allowed	Limitation as to 1 Class of Stock
Transferability of Interests	Freely Transferable	Economic Interest is Transferable Unless Restricted by Partnership Agreement; However, the Status of Partner is not Transferable Without Consent of All Partners	Economic Interest is Transferable Unless Restricted by Partnership Agreement; However, the Status of Partner is not Transferable Without Consent of All Partners	Economic Interest is Transferable Unless Restricted by Partnership Agreement; However, the Status of Partner is not Transferable Without Consent of All Partners	Economic Membership Interest Freely Transferable Unless Restricted by Articles of Organization or Regulations; However, Unless Otherwise Provided in Articles of Organization or Regulations, the Status of Member is Not Transferable Without Consent of All Members	Freely Transferable Unless Restricted by Articles of Incorporation, Bylaws or Shareholder Agreement	Freely Transferable Unless Restricted by Articles of Incorporation, Bylaws or Shareholder Agreement