

# **HOW REAL ESTATE DEALS ARE AFFECTED BY THE TEXAS BUSINESS ORGANIZATION CODE WHICH BECAME EFFECTIVE JANUARY 1, 2006**

By

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**Real Estate Documents, Workouts and Closings**

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BYRON F. EGAN AND JOHN R. WILLIFORD\*

## I. GENERAL.

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

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

The form of business entity most advantageous in a particular situation depends on the objectives of the business for which the entity is being organized. In most situations, the focus will be on how the entity and its owners will be taxed and the extent to which the entity will shield the owners of the business from liabilities arising out of its activities.

Until the 1990s, the spectrum of business entity forms available in Texas was not so broad. In 1991, the Texas Legislature passed legislation allowing for the creation of the LLP and the LLC, which 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 by the partnership filing with the Secretary of State of Texas (the “Secretary of State”) and complying with certain other statutory requirements.<sup>1</sup> The Texas LLP statute was later amended to extend

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<sup>1</sup> Act of May 9, 1961, 57th Leg., R.S., ch. 158, 1961 Tex. Gen. Laws 289; Act of May 17, 1979, 66th Leg., R.S., ch. 723, § 5, 1979 Tex. Gen. Laws 1782; Act of May 9, 1985, 69th Leg., R.S., ch. 159, § 76, 1985 Tex. Gen. Laws 692; Act of May 9, 1991, 72d Leg., R.S., ch. 901, §§ 83–85, 1991 Tex. Gen. Laws 3161; Act of May 31, 1993, 3d Leg., R.S., ch. 917, § 2, 1993 Tex. Gen. Laws 102, § 3.08(b) (expired Jan. 1, 1999); *see*

its LLP shield to contracts made after September 1, 1997. Also in 1991, Texas became the fourth state to adopt a statute providing for the creation of an LLC, which limits the personal liability of LLC interest owners for LLC obligations at least as much as the liability of corporate shareholders is limited for corporate obligations. Now all 50 states and the District of Columbia have adopted LLP and LLC statutes.<sup>2</sup> Both the LLP and the LLC can be treated as partnerships for federal income tax purposes.

The Texas Business Organizations Code (the “TBOC”) was enacted by the Texas Legislature in 2003 to codify the Texas statutes relating to business entities referenced above, together with the Texas statutes governing the formation and operation of other for-profit and non-profit private sector entities. The TBOC became effective for entities formed under Texas law after January 1, 2006. Entities in existence on January 1, 2006 may continue to be governed by the Texas source statutes in effect prior to January 1, 2006 or elect to be governed by the TBOC.

## **B. Statutory Updating.**

Texas’ entity statutes are continually being updated and improved through the efforts of the Texas Business Law Foundation and the Business Law Section of the State Bar of Texas.<sup>3</sup> This updating process commenced in 1950 with the organization of the State Bar’s Corporation Law Committee, which was succeeded in 1953 by what is now the Business Law Section and was later enhanced by the organization of the Texas Business Law Foundation.<sup>4</sup> Continuing this tradition, the 75<sup>th</sup> Session of the Texas Legislature (the “1997 Legislative Session”), which adjourned *sine die* on June 2, 1997, brought Senate Bill 555 (“SB 555”), which became effective September 1, 1997 and made numerous changes in Texas’ business entity statutes, some of which are quite innovative.<sup>5</sup> The changes effected in 1999 and 2001 were relatively limited. In the 78<sup>th</sup> Session of the Texas Legislature (the “2003 Legislative Session”), which convened January 14, 2003 and adjourned *sine die* on June 2, 2003, the TBOC was passed,<sup>6</sup> and significant

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

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

<sup>3</sup> Alan R. Bromberg, Byron F. Egan, Dan L. Nicewander, and Robert S. Trotti, *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 41 TEX. J. OF BUS. L. 41 (Spring 2005); Alan R. Bromberg, Byron F. Egan, Dan L. Nicewander, and Robert S. Trotti, *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 31 BULL. OF BUS. L. SEC. OF THE ST. B. OF TX. 1 (June 1994); see Alan R. Bromberg, *Texas Business Organization and Commercial Law—Two Centuries of Development*, 55 SMU L. REV. 83, 113-14 (2002).

<sup>4</sup> *Id.*

<sup>5</sup> Tex. SB 555, 75th Leg., R.S. (1997); Curtis W. Huff, *The New Business Organization Laws: Changes Made in the 75th Legislature to Address Modern Business Practices*, 34 TEX. J. BUS. L. 1 (1997).

<sup>6</sup> Tex. HB 1156, available at <http://www.capitol.state.tx.us/tlo/78r/billtext/HB01156F.HTM> by Rep. Helen Giddings. The Revisor’s Report for the TBOC is available at both [www.texasbusinesslaw.org](http://www.texasbusinesslaw.org) and on the Texas Legislative Council website at [http://www.tlc.state.tx.us/legal/bocode/bo\\_revisors\\_report.html](http://www.tlc.state.tx.us/legal/bocode/bo_revisors_report.html). The interim report from the House Sub-Committee studying the TBOC, which contains a side-by-side comparison of current and proposed law, is available at [www.house.state.tx.us](http://www.house.state.tx.us).



changes were made to Texas' other entity statutes.<sup>7</sup> Most recently, in the 79<sup>th</sup> Session of the Texas Legislature (the "2005 Legislative Session"), which convened January 11, 2005 and adjourned *sine die* on May 30, 2005, changes were again made to the Texas entity statutes,<sup>8</sup> including the TBOC.<sup>9</sup>

### C. Texas Business Organizations Code.

1. Background. In the 2003 Legislative Session, the Texas Business Organizations Code (the "TBOC"), which was previously introduced and not passed in the 1999<sup>10</sup> and 2001 Legislative Sessions, was again introduced and this time it passed.<sup>11</sup> The TBOC in its current form<sup>12</sup> also includes amendments made during the 2005 Legislative Session.<sup>13</sup> The TBOC is still a work in progress, and additional amendments will likely be made in the future as gaps and ambiguities therein are discovered through putting it into practice. The new TBOC provides considerable flexibility to organizations in establishing their capital structures, effecting business combination transactions and governing their internal affairs. It should become a model for future statutes and solidify Texas' position as a leader in corporate law.

2. Source Law Codified. The TBOC is principally a codification of the existing Texas statutes governing non-profit and for-profit private-sector entities, rather than substantive modifications thereto.<sup>14</sup> These statutes consist of the following: the Texas Business

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<sup>7</sup> See Tex. HB 1165, available at <http://www.capitol.state.tx.us/tlo/78r/billtext/HB01165F.HTM> by Rep. Burt R. Solomons; see also Tex. HB 1637, available at <http://www.capitol.state.tx.us/tlo/78r/billtext/HB01637F.HTM> by Rep. Rene Oliveira.

<sup>8</sup> Tex. HB 1507 by Rep. Burt Solomons, 79<sup>th</sup> Leg., R.S. (2005), available at <http://www.capitol.state.tx.us/tlo/79r/billtext/HB01507F.HTM>; Tex. HB 1154 by Rep. Gary Elkins, 79<sup>th</sup> Leg., R.S. (2005), available at <http://www.capitol.state.tx.us/tlo/79r/billtext/HB01154F.HTM>; Tex. HB 1319 by Rep. Helen Giddings, 79<sup>th</sup> Leg., R.S. (2005), available at <http://www.capitol.state.tx.us/tlo/79r/billtext/HB01319F.HTM>.

<sup>9</sup> Tex. HB 1319 by Rep. Helen Giddings, 79<sup>th</sup> Leg., R.S. (2005), available at <http://www.capitol.state.tx.us/tlo/79r/billtext/HB01319F.HTM>.

<sup>10</sup> Thomas F. Blackwell, *The Revolution is Here: The Promise of a Unified Business Entity Code*, 24 J. CORP. L. 333, 359 (1999).

<sup>11</sup> Tex. HB 1156, available at <http://www.capitol.state.tx.us/tlo/78r/billtext/HB01156F.HTM> by Rep. Helen Giddings. The Revisor's Report for the TBOC is available at both [www.texasbusinesslaw.org](http://www.texasbusinesslaw.org) and on the Texas Legislative Council website at [http://www.tlc.state.tx.us/legal/bocode/bo\\_revisors\\_report.html](http://www.tlc.state.tx.us/legal/bocode/bo_revisors_report.html). The interim report from the House Sub-Committee studying the TBOC, which contains a side-by-side comparison of current and proposed law, is available at [www.house.state.tx.us](http://www.house.state.tx.us).

<sup>12</sup> Available at [www.texasbusinesslaw.org](http://www.texasbusinesslaw.org). The final TBOC, as amended in 2005, will also be available on the Texas legislature's website at <http://www.capitol.state.tx.us/statutes/index.htm> beginning in March 2006.

<sup>13</sup> Tex. HB 1319 by Rep. Helen Giddings, 79<sup>th</sup> Leg., R.S. (2005), available at <http://www.capitol.state.tx.us/tlo/79r/billtext/HB01319F.HTM>.

<sup>14</sup> *Report of the Codification Committee of the Section of Business Law of the State Bar of Texas on the Proposed Business Organizations Code*, REPORT OF THE CODIFICATION COMM., Apr. 16, 2002, at 55, available at [http://www.texasbusinesslaw.org/608127\\_6\\_date\\_12262000.pdf](http://www.texasbusinesslaw.org/608127_6_date_12262000.pdf) [hereinafter *Codification Comm. Report*].

Corporation Act (the “TBCA”),<sup>15</sup> the Texas Non-Profit Corporation Act (the “TNPCA”),<sup>16</sup> the Texas Miscellaneous Corporation Laws Act (the “TMCLA”),<sup>17</sup> the Texas Limited Liability Company Act (the “LLC Act”),<sup>18</sup> the Texas Revised Partnership Act (the “TRPA”),<sup>19</sup> the Texas Revised Limited Partnership Act (the “TRLPA”),<sup>20</sup> the Texas Real Estate Investment Trust Act (the “TREITA”),<sup>21</sup> the Texas Uniform Unincorporated Nonprofit Associations Act (the “TUUNA”),<sup>22</sup> the Texas Professional Corporation Act (the “TPCA”),<sup>23</sup> the Texas Professional Associations Act (the “TPAA”),<sup>24</sup> the Texas Cooperative Associations Act (the “TCAA”),<sup>25</sup> and other existing provisions of Texas statutes governing private entities. Banks, trust companies, savings associations, insurance companies, railroad companies, cemetery organizations and certain abstract or title companies organized under other special Texas statutes are not “domestic entities”<sup>26</sup> governed by the TBOC, except to the extent that the special Texas statutes governing them incorporate by reference the TBOC or its source laws or are not inconsistent therewith.<sup>27</sup> Generally entities organized under Texas special statutes prior to January 1, 2006 would be subject to the transition rules applicable to other Texas entities and would continue to generally reference the source law rather than the TBOC until January 1, 2010.<sup>28</sup>

3. Hub and Spoke Organization of Code. The TBOC adopts a “hub and spoke” organizational approach under which provisions common to all entities are included in a central “hub” of the TBOC found in Title 1. These common provisions include, for example, the primary sections governing purposes and powers of entities, filings, meetings and voting, liability, indemnification of directors and partners, and mergers among entities. Outside Title 1, separate “spokes” contain provisions governing different types of entities which are not common or similar among the different entities. A detailed Table of Contents for the TBOC showing this organization appears in Appendix C of this article. To determine applicable law for a given business entity, one should look first to the general provisions in Title 1, and then to the entity-specific provisions containing additions and modifications to the general rules. However, where a direct conflict exists between a provision of Title 1 and a provision of any other Title, the other Title will govern the matter.<sup>29</sup>

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<sup>15</sup> TEX. BUS. CORP. ACT arts. 1.01 *et. seq.* (Vernon Supp. 2006).

<sup>16</sup> TEX. REV. CIV. STAT. ANN. art. 1396-1 (Vernon Supp. 2006).

<sup>17</sup> TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon Supp. 2006).

<sup>18</sup> TEX. REV. CIV. STAT. ANN. art. 1528n (Vernon Supp. 2006).

<sup>19</sup> TEX. REV. CIV. STAT. ANN. art. 6132b (Vernon Supp. 2006).

<sup>20</sup> TEX. REV. CIV. STAT. ANN. art. 6132a-1 (Vernon Supp. 2006).

<sup>21</sup> TEX. REV. CIV. STAT. ANN. art. 6138A (Vernon Supp. 2006).

<sup>22</sup> TEX. REV. CIV. STAT. ANN. art. 1396-1B (Vernon Supp. 2006).

<sup>23</sup> TEX. REV. CIV. STAT. ANN. art. 1528e (Vernon Supp. 2006).

<sup>24</sup> TEX. REV. CIV. STAT. ANN. art. 1528f (Vernon Supp. 2006).

<sup>25</sup> TEX. REV. CIV. STAT. ANN. art. 1396-1A (Vernon Supp. 2006).

<sup>26</sup> TBOC § 2.003.

<sup>27</sup> TBOC § 23.001.

<sup>28</sup> TBOC § 402.005.

<sup>29</sup> TBOC § 1.106(c).

4. Effective Date. The TBOC became effective on January 1, 2006 and applies to all domestic entities organized in Texas on or after that date.<sup>30</sup> Domestic entities already in existence on January 1, 2006 will continue to be governed by then existing entity statutes until January 1, 2010,<sup>31</sup> at which time the old laws will be repealed. However, such entities may elect to be governed by the TBOC prior to that date by making a filing with the Secretary of State of Texas and amending their governing documents as necessary.<sup>32</sup>

5. Changes Made By the TBOC. The TBOC, which had been under development since 1995, was a joint project of the Business Law Section of the State Bar of Texas, the office of the Texas Secretary of State and the Texas Legislative Council,<sup>33</sup> and was passed with the endorsement and strong support of the Texas Business Law Foundation. In the codification process, the objective generally was not to make substantive revisions to the Texas statutes. However, the TBOC did change the form and procedures of many of the existing provisions, and some substantive changes did occur. Some of the more general changes, as well as basic transition and construction provisions, are summarized below. Other changes that are more entity-specific are addressed in the appropriate sections of this article.

(a) Vocabulary. In an effort to streamline laws that govern business entities, the TBOC uses new terms to denote concepts and filings that previously were common to many different entity types but under different names. For example, each entity typically has a particular person or set of persons which govern that type of entity. For limited partnerships, that person is the general partner; for corporations, it is the board of directors; for LLCs, it is either the managers or members, as specified in the LLC's formation documents. The TBOC replaces all those different terms and simply refers to the persons or entities that control the main entity as that entity's "governing authority."<sup>34</sup> Similarly, the name of the document an entity must file to be duly organized under Texas law is now simply called a "certificate of formation," whereas previously each entity had its own name for such document.<sup>35</sup> One other significant vocabulary change is that the Regulations of a limited liability company are now referred to as its "Company Agreement."<sup>36</sup> Other changes include the shift in the titles of filings from "Application for Certificate of Authority to Transact Business,"<sup>37</sup> to "Application for Registration,"<sup>38</sup> from "Articles of Amendment"<sup>39</sup> to "Certificate of Amendment,"<sup>40</sup> and from

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<sup>30</sup> TBOC § 402.001(a).

<sup>31</sup> TBOC § 402.005.

<sup>32</sup> TBOC § 402.003.

<sup>33</sup> 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 TBOC in collaboration with the Secretary of State and the Texas Legislative Council.

<sup>34</sup> TBOC § 1.002(35).

<sup>35</sup> TBOC § 1.002(6). Comparable documents under pre-TBOC law include a corporation's Articles of Incorporation, an LLC's Articles of Organization, and a limited partnership's Certificate of Limited Partnership.

<sup>36</sup> See TBOC § 101.052.

<sup>37</sup> See TBCA art. 8.01.

<sup>38</sup> See TBOC § 9.004.

<sup>39</sup> See TBCA art. 4.04.

“Articles of Dissolution”<sup>41</sup> to “Certificate of Termination.”<sup>42</sup> Under the TBOC, a “domestic entity” is a corporation, partnership, LLC or other entity formed under the TBOC or whose internal affairs are governed by the TBOC,<sup>43</sup> and a “foreign entity” is an organization formed under, and the internal affairs of which are governed by, the laws of a jurisdiction other than Texas.<sup>44</sup>

(b) Certificate of Formation. In addition to changing the name of the formation document required of entities organizing in Texas, the TBOC has made small alterations to its required contents as well. For example, previously such a document had to state the entity’s period of duration. The TBOC eliminates this requirement, except for entities that will not exist perpetually.<sup>45</sup> However, it adds the requirement that the document state what type of entity shall be formed upon its filing.<sup>46</sup> Other requirements differ slightly for each entity.<sup>47</sup>

(c) Filing procedures. In addition to changing the form of the document required to organize a Texas business entity, the TBOC streamlines the filing fees for a number of documents.<sup>48</sup> For example, all domestic entities not subject to the Texas franchise tax are now generally subject to the same filing fee for a certificate of formation.<sup>49</sup> Additionally, the TBOC now authorizes a filing fee of \$50 for the pre-clearance of any document, whereas before, the Secretary of State was only authorized to charge such fee for pre-clearance of limited partnership documents.<sup>50</sup> Another procedural change is that previously, when certain entities sent in their formation document (i.e., articles of incorporation for a regular corporation), the Secretary of State would send back an official document in response (i.e., a certificate of incorporation).<sup>51</sup> Now, however, upon receipt of a certificate of formation, the Secretary of State may simply return a written acknowledgement of the filing, and is not required to issue any additional certificates or documents.<sup>52</sup> Filings are generally effective when filed, not when the Secretary of State acknowledges them.<sup>53</sup> Additionally, documents with delayed effective dates may now be abandoned at any time prior to effectiveness.<sup>54</sup>

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<sup>40</sup> See TBOC § 3.053.

<sup>41</sup> See TBCA art. 6.06.

<sup>42</sup> See TBOC § 11.101.

<sup>43</sup> TBOC § 1.002(18).

<sup>44</sup> TBOC § 1.002(28).

<sup>45</sup> TBOC §§ 3.003, 3.005, and Revisor’s Notes thereto.

<sup>46</sup> TBOC § 3.005 and Revisor’s Note thereto.

<sup>47</sup> TBOC § 3.005 provides the minimum requirements for all Certificates of Formation, and the sections immediately thereafter specify the additional information required for each type of entity.

<sup>48</sup> See TBOC Chapter 4, Subchapter D.

<sup>49</sup> See Revisor’s Note to TBOC § 4.151.

<sup>50</sup> TBOC § 4.151 and Revisor’s Note thereto.

<sup>51</sup> See TBCA art. 3.03.

<sup>52</sup> See TBOC § 4.002 and Revisor’s Note thereto.

<sup>53</sup> TBOC § 4.051.

<sup>54</sup> TBOC § 4.057.

(d) Entity Names. The TBOC relaxes the requirements for indicating the business entity form in the entity's official name further than even the most recent revisions to pre-TBOC law. A business's name must still indicate the business's entity form, but with greater flexibility regarding placement and abbreviation thereof than was previously permitted.<sup>55</sup> For example, previously, a limited partnership had to include in its name "limited," "limited partnership," "L.P.," or "Ltd.," and the name could not contain the name of a limited partner except under limited circumstances.<sup>56</sup> Now, however, limited partnerships need only contain "limited," "limited partnership," or "an abbreviation of that word or phrase" in their names, without any restrictions on the inclusion of a limited partner's name.<sup>57</sup>

(e) Governance. Subject to contrary provisions in an entity's governing documents, the TBOC now permits the removal of officers with or without cause, doing away with the requirement in much of the source law that such removal must be in the entity's best interests.<sup>58</sup> Also, the TBOC extends to all types of domestic entities the right for officers and directors to rely on opinions, reports, and statements given by certain people in the execution of their duties.<sup>59</sup> Further, it clarifies as a default rule that governing persons of domestic entities other than limited partnerships have the right to inspect the entity's books and records in connection with their duties.<sup>60</sup>

Additionally, the TBOC expands the permissible methods of holding required meetings to encompass the broad spectrum of technology now available by which such meetings may be conducted.<sup>61</sup> Related, it adds safeguards that must be followed when using such technology to assure that only authorized persons are able to vote at such meetings.<sup>62</sup>

(f) Construction. The TBOC incorporates the provisions of the Code Construction Act<sup>63</sup> to assist in its interpretation.<sup>64</sup> The Code Construction Act includes such useful aids as definitions of commonly used terms, basic rules of construction, the order of authority for conflicting statutes, and statutory savings provisions. The rules of the Code Construction Act are general in nature, and are intended to fill in any gaps left by the more specific rules of construction provided within the TBOC applicable to particular entity types.

(g) Transition Rules.<sup>65</sup> As previously stated, during the transition period between January 1, 2006 and January 1, 2010, entities which were formed in Texas prior

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<sup>55</sup> See TBOC §§ 5.054-5.063.

<sup>56</sup> TRLPA § 1.03.

<sup>57</sup> TBOC §§ 5.055, 153.102, Revisor's Notes thereto.

<sup>58</sup> TBOC § 3.104; TBCA art. 2.43; TNPCA art. 1396-2.21.

<sup>59</sup> TBOC § 3.102. This default right previously existed for certain entities (see, e.g., TBCA 2.41D and TNPCA art. 1396-2.28(B)), but not for partnerships or LLCs. See Revisor's Note to TBOC § 3.102.

<sup>60</sup> TBOC § 3.152 and Revisor's Note thereto.

<sup>61</sup> See TBOC § 6.002.

<sup>62</sup> *Id.*

<sup>63</sup> Chapter 311, Texas Government Code (2005).

<sup>64</sup> TBOC § 1.051.

<sup>65</sup> For more detailed rules governing the transition period, see TBOC Title 8.

to the TBOC's effective date but not opting in to TBOC governance will continue to be governed by the old Texas statutes. During that period, they may continue to make filings with the Texas Secretary of State in the same manner as before the TBOC effective date, without any need to conform to the new filing requirements of the TBOC or adjust the nomenclature used.<sup>66</sup> However, limited liability partnerships are only entitled to continue following the registration requirements of the TRPA and TRLPA until their current registrations expire,<sup>67</sup> at which point they must renew under the TBOC (although until January 1, 2010 they will continue to be substantively governed by the TRPA and TRLPA).

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

1. Classification. Under the Internal Revenue Code of 1986, as amended (the "IRC"), and the Treasury regulations promulgated thereunder, an unincorporated business entity may be classified as an "association" taxable as a corporation and subject to income taxes at the corporate level ranging from 15% to 35% of taxable net income (absent a valid S-corporation status election) in addition to any taxation which may be imposed on the owner as a result of distributions from the business entity. Alternatively, the entity may be classified as a partnership, a non-taxable "flow-through" entity in which taxation is imposed only at the ownership level. Finally, if it is a single-owner 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 "the Check-the-Box" Regulations discussed below, which effectively allow a partnership or LLC to elect whether to be taxed as a corporation.

2. Check-the-Box Regulations. On December 18, 1996 the IRS issued Treasury Regulations § 301.7701-1, -2 and -3 (the "Check-the-Box Regulations"), which became effective January 1, 1997 and completely replaced the former classification regulations (discussed hereinafter).<sup>68</sup> 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.<sup>69</sup> Although the four factor technical analysis of the IRS' former classification regulations ("Former Classification Regulations") has been completely replaced, the IRS still requires certain prerequisites to be fulfilled prior to qualifying under the default rules or making a valid election:<sup>70</sup>

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<sup>66</sup> To illustrate, a corporation incorporated in Texas prior to January 1, 2006 that wishes to amend its Articles of Incorporation may still do so by filing Articles of Amendment to its Articles of Incorporation, rather than a Certificate of Amendment. The Articles of Amendment would only need to conform to the current version of the Texas Business Corporation Act.

<sup>67</sup> TBOC § 402.001(b).

<sup>68</sup> T.D. 8697, 1997-1 C.B. 215.

<sup>69</sup> Treas. Reg. § 301.7701-3(a).

<sup>70</sup> *Id.*

(a) Eligible Entities. Initially, the entity must be a “business entity” that is separate from its owners for federal income tax purposes. A business entity is defined, in part, as any entity recognized for tax purposes that is not classified as a trust under Treas. Reg. § 301.7701-4 or otherwise subject to special treatment under the IRC, e.g., real estate mortgage investment conduits (“REMICs”).<sup>71</sup> 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.<sup>72</sup> 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).<sup>73</sup> Among the entities that the Check-the-Box Regulations automatically classify as corporations are over 85 specific types of foreign business entities.<sup>74</sup> 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.<sup>75</sup>

(b) The Default Rules. The default rules under Treas. Reg. § 301.7701-3(b)(1) provide that a domestic eligible entity (that is not classified as a corporation) is a partnership if it has two or more members and is disregarded as a separate entity if it has a single owner (i.e., treated as a sole proprietorship or division of the owner). Under Treas. Reg. § 301.7701-3(b)(2), a foreign eligible entity is (i) a partnership if it has two or more members and at least one member has unlimited liability (as determined solely by reference to the law under which the entity is organized), (ii) an association taxable as a corporation if no member has unlimited liability, or (iii) disregarded as a separate entity if it has a single owner with unlimited liability.

(c) The Election Rules. An eligible entity that desires to obtain a classification other than under the default classification rules, or desires to change its classification, may file an election with the IRS on Form 8832 (Entity Classification Election).<sup>76</sup> 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 each member of an entity, or any officer, manager or member of the entity who is authorized to make the election and who so represents under penalty of perjury, sign Form 8832.<sup>77</sup>

(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

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<sup>71</sup> *Id.* §§ 301.7701-2(a), 301.7701-4.

<sup>72</sup> *Id.* § 301.7701-1(a)(2).

<sup>73</sup> *Id.* § 301.7701-2.

<sup>74</sup> Treas. Reg. § 301.7701-2(b)(8) (1996).

<sup>75</sup> *Id.* § 301.7701-3(a).

<sup>76</sup> *Id.* § 301.7701-3(c).

<sup>77</sup> *Id.* § 301.7701-3(g)(2).

respected by the IRS if (i) the entity had a reasonable basis<sup>78</sup> 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.<sup>79</sup> Therefore, unless an existing eligible entity elected to change the classification claimed prior to January 1, 1997, the entity will be "grandfathered" and will not be required to make an election to protect its classification. However, the one exception to this rule is when a single owner entity previously claimed to be classified as a partnership.<sup>80</sup> 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.<sup>81</sup> 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. § 301.7701-2<sup>82</sup> (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 today, for they will be embodied in existing partnership and LLC agreements and likely will be encountered in drafts of new documents for years to come. The following sections discuss the four corporate characteristics:

(a) Continuity of Life. An organization does not have continuity of life if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member would cause a dissolution of the organization (hereinafter, "Dissolution Event").<sup>83</sup> 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.<sup>84</sup> Some states (including Texas) allow the partners of a partnership or

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<sup>78</sup> The term "reasonable basis" has the same meaning as under IRC §6662, which addresses the accuracy-related penalties. See I.R.C. § 6662. The "reasonable basis" standard is far from clear; however, it is significantly stronger than "not frivolous" and may be at least as high a standard as "more likely than not." See *Standards of Tax Practice Statement*, COMM. ON STANDARDS OF TAX PRACTICE OF THE SECTION OF TAXATION OF THE A.B.A., 54 TAX LAW. 185, 189 (2000).

<sup>79</sup> Treas. Reg. § 301.7701-3(h)(2) (1996).

<sup>80</sup> *Id.* § 301.7701-3(b)(3).

<sup>81</sup> *Id.* § 301.7701-3(f)(2).

<sup>82</sup> Former Treas. Reg. § 301.7701-2 (1967) (codifying *Morrissey v. Commissioner*, 296 U.S. 344, 357–58 (1935)); see BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 2.02 (5th ed. 1987) (discussing the classification of associations as corporations for federal income tax purposes).

<sup>83</sup> 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).

<sup>84</sup> Former Treas. Reg. § 301.7701-2(b). Until 1993, the Former Classification Regulations indicated that such a partnership would avoid continuity of life only if a Dissolution Event resulted in either automatic dissolution



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.<sup>85</sup> 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.<sup>86</sup> 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 authority to act on behalf of the organization independently of its members.<sup>87</sup> The key to this characteristic is the group’s ability to bind the entity in its role as a representative of the organization, as opposed to its role as an owner.

(c) Limited Liability. An organization has the corporate characteristic of limited liability if under local law no member is personally liable for the debts or obligations of the organization when the organization’s assets are insufficient to satisfy such debts or obligations.<sup>88</sup> In the case of a limited partnership, the IRS deems the entity to have limited

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or dissolution unless *all* of the remaining partners agreed to continue the business. Thus, it was assumed that a partnership *would* have the corporate characteristic of continuity of life if an agreement of a *majority* of the remaining partners were sufficient to save the partnership from dissolution upon the occurrence of a Dissolution Event. This belief was reinforced by Private Letter Ruling 90-100-27, in which the IRS, considering an LLC’s tax status, ruled that “[b]ecause dissolution under the Act may be avoided by a majority vote of members, rather than unanimous agreement, L possesses the corporate characteristic of continuity of life.” Priv. Ltr. Rul. 90-1090-27 (Dec. 7, 1989). (Even if a majority vote to continue the business was 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. *See* Rev. Rul. 93-91, 1983-2 C.B. 316; Rev. Proc. 95-10, 1995-1 C.B. 501 (confirming the applicability of this standard to LLCs).

<sup>85</sup> *See, e.g.*, LLC Act §§ 3.02(9), 6.01(B); TBOC § 101.052.

<sup>86</sup> *See* Priv. Ltr. Rul. 90-30-013 (Apr. 25, 1990) (“[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 members. Therefore, if a member of X ceases to be a member of X for any reason, the continuity of X is not assured, because all remaining members must agree to continue the business. Consequently, X lacks the corporate characteristic of continuity of life.”); *see also* Priv. Ltr. Rul. 90-29-019 (Apr. 19, 1990); Priv. Ltr. Rul. 89-37-010 (June 16, 1989); Former Treas. Reg. § 301.7701(b)(1) (1967) (“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.

<sup>87</sup> Rev. Proc. 95-10, 1995-1 C.B. 501; Rev. Rul. 93-6, 1993-1 C.B. 229; *see also* BITTKER & EUSTICE, *supra* ¶ 2.02.

<sup>88</sup> Former Treas. Reg. § 301.7701-2(d)(1).

liability where the general partner has no substantial assets (other than his interest in the partnership) that could be reached by creditors of the entity and the general partner is merely a “dummy” acting as agent of the limited partners.<sup>89</sup> To negate the characteristic of limited liability under the Former Classification Regulations, tax lawyers advised that the general partner should have substantial assets. The capitalization of the general partner is of reduced importance from a tax standpoint under the Check-the-Box Regulations.<sup>90</sup>

(d) Free Transferability of Interest. The characteristic of free transferability of interest does not exist in a case where a member can, without the consent of other members, assign only his right to a share in the profits but cannot assign his rights to participate in the management of the organization.<sup>91</sup> 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.<sup>92</sup> 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.<sup>93</sup> These provisions are no longer appropriate except to the extent necessary to achieve the party’s business objectives or to facilitate compliance with securities laws.

## **E. Texas Franchise Tax.**

1. Corporations and LLCs, but not Partnerships, now Subject to Franchise Tax. Corporations and LLCs are subject to the Texas franchise tax,<sup>94</sup> 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. The add-back is not required if (x) the corporation has not more than 35 shareholders or is an S-corporation for federal tax purposes with no more than 75 shareholders,<sup>95</sup> or (y) the LLC has not more than 35 members.<sup>96</sup> The result is apportioned to Texas based on the percentage of its gross receipts from Texas sources. Although labeled a “franchise tax,” the tax on “net taxable earned surplus” is really a 4.5% income tax levied at the entity level.

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<sup>89</sup> Former Treas. Reg. § 301.7701-2(d)(2).

<sup>90</sup> In contrast to the Former Classification Regulations and Revenue Procedure 89-12, the Check-the-Box Regulations do not focus on the capitalization of the general partner.

<sup>91</sup> Former Treas. Reg. § 301.7701-2(e)(1) (1967); *see also* Act of May 9, 1961, 57th Leg., R.S., ch. 158, 1961 Tex. Gen. Laws 289; Act of May 17, 1979, 66th Leg., R.S., ch. 723, § 5, 1979 Tex. Gen. Laws 1782; Act of May 9, 1985, 69th Leg., R.S., ch. 159, § 76, 1985 Tex. Gen. Laws 692; Act of May 9, 1991, 72d Leg., R.S., ch. 901, §§ 83–85, 1991 Tex. Gen. Laws 3161; Act of May 31, 1993, 73d Leg., R.S., ch. 917, § 2, 1993 Tex. Gen. Laws 102, § 27 (expired Jan. 1, 1999).

<sup>92</sup> Former Treas. Reg. § 301.7701-2(d)(2).

<sup>93</sup> In contrast to the Former Classification Regulations and Revenue Procedure 89-12, the Check-the-Box Regulations do not focus on the capitalization of the general partner.

<sup>94</sup> TEX. TAX CODE § 171.001 (West 2004).

<sup>95</sup> TEX. TAX CODE § 171.110(b) (West 2004).

<sup>96</sup> 34 TEX. ADMIN. CODE § 3.558(b)(10) (West 2004).

Limited and general partnerships (including the LLP) are not presently subject to the franchise tax, but there have been, and likely will be again, proposals to subject them to either the franchise tax or some other measure of tax on their income. The Texas Comptroller of Public Accounts (“Comptroller”) has issued private 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.<sup>97</sup>

Effective January 1, 2000, the Texas Tax Code was amended to provide that a corporation or LLC 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).<sup>98</sup> 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. Franchise Tax Change Proposals. Efforts to reduce Texas’ dependence on property taxes to fund the schools have led the 1997 through 2005 Texas Legislatures to consider, but not adopt, proposed changes in the Texas tax system which would subject partnerships to the franchise tax.<sup>99</sup> The 2005 Texas Legislature also proposed: (i) a payroll based tax; and (ii) an extension of the Texas franchise tax to foreign corporations earning Texas source income from Texas based partnerships. In 2006, property tax reform efforts are being primarily motivated by the Texas Supreme Court’s recent decision in *Neeley vs. West Orange-Cove*

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<sup>97</sup> See e.g., Comptroller Taxpayer Response Letter Accession No. 9811328L (Nov. 30, 1998).

<sup>98</sup> TEX. TAX CODE § 171.102(d) (West 2004).

<sup>99</sup> See Tex. HB 3146, 78th Leg., R.S. (2003), *available at* <http://www.capitol.state.tx.us/tlo/78r/billtext/HB03146L.HTM>. House Bill 3146 in the 2003 Legislative Session, by Representative Ron Wilson, attempted to amend the Texas Tax Code to define “corporation” for franchise purposes as “every corporation, limited liability company, limited partnership, business trust, real estate investment trust, savings and loan association, banking corporation, and any other entity for which any of the owners have limited liability” and exclude, in the case of a partnership, the distributive share of the partnership’s income or loss attributable to natural persons. See also Tex. HB 3, 79<sup>th</sup> Leg. R.S. (2005), *available at* <http://www.capitol.state.tx.us/tlo/79r/billtext/HB00003E.HTM>. House Bill 3, as passed by the House on March 14, 2005, would enact a Reformed Franchise Tax which would apply to most business entities, including most corporations, LLCs and partnerships, and allow them to elect either (i) 1.15% tax on Texas employee wages with no ceiling or (ii) the existing franchise tax at the rate of 4.5% of net taxable earned surplus. In the event an unincorporated entity owned wholly or partially by natural persons elects to be subject to the franchise tax, HB 3 requires that the business and those natural persons agree pursuant to an election form that the taxable earned surplus of the business shall be calculated without regard to any exclusion, exemption or prohibition set forth in Article 8, Section 24(a), of the Texas Constitution (the “*Bullock Amendment*”), which effectively recognizes the applicability of the Bullock Amendment to any form of income tax imposed on an unincorporated entity in which an interest is owned by a natural person. On May 11, 2005, the Senate passed CSHB 3, which, like HB 3, would include most corporations, LLCs and partnerships as “taxable entities” and would allow the entities to elect to be subject to either (1) a 1.75% tax on Texas employee wages up to a cap of \$1,500 per employee or (2) a 2.5% business activity tax which is similar to the current franchise tax plus all compensation exceeding \$30,000 per employee; in each case subject to a minimum tax of 0.25% of Texas gross receipts. Both the House and Senate bills included additional sales and other consumption taxes, although there were significant differences in the two bills. This tax legislation died in a Conference Committee at the end of the 2005 Legislative Session.

*Consol. ISD*, 176 S.W.3rd 746 (Tex. 2005). The Court in *West Orange-Cove* held that the current property tax rate cap of \$1.50 per \$1,000 of valuation violates Article VIII Section 1-e of the Texas Constitution, which prohibits the imposition of a statewide property tax. The Court directed the Texas Legislature to cure the defect by June 1, 2006. In anticipation of a Supreme Court decision in *West Orange-Cove*, on November 4, 2005 Governor Rick Perry appointed a 24-member Texas Tax Reform Commission and former Comptroller John Sharp as its Chairman (the “Sharp Commission”) to study and make recommendations on how to reform Texas’ business tax structure and provide significant property tax relief and also to later address court-mandated changes in how Texas funds its schools. On November 21, 2005 (the day before the Supreme Court decision in *West Orange-Cove*), the Sharp Commission held the first of a series of public hearings at which various affected parties testified as to what should be changed. On March 29, 2006, the Sharp Commission released its report (the “Sharp Commission Report”) which recommended that (1) the Legislature should cut school district property taxes for maintenance and operations substantially (with many districts setting rates at or near \$1.50 per \$100 of valuation, the Sharp Commission recommended that the property tax rate should be lowered to \$1 per \$100 and permanently re-capped at no more than \$1.30 per \$100 by the 2007 tax year and reductions for the 2006 tax year sufficient to comply with the Supreme Court’s mandate to be provided immediately) and (2) the Legislature should reform the state’s franchise tax by (a) broadening the base of businesses that pay into the system to include most entities whose owners are generally protected from the entities’ liabilities, (b) cutting the franchise tax rate from 4.5% to 1%, (c) basing the franchise tax on a business’ margin by allowing each business to choose between deducting either the cost of goods sold or employee or partner compensation (including health insurance, pensions and other benefits) from its total revenue, and (d) increasing the small-business exemption from \$150,000 to \$300,000 in total revenue and exempting sole proprietors and “non-corporate general partnerships.” The Sharp Commission Report also recommended raising the tax on cigarettes by \$1 per pack.

The Special Session of the Legislature to consider tax reform and addressing the requirements of the *West Cove-Orange* is to convene on April 17, 2006. Although no bill based on the Sharp Commission Report had been introduced as of the April 13, 2006 submission of this paper,<sup>100</sup> a draft bill to implement the 1%<sup>101</sup> margin tax (the “Margin Tax”) proposed by the Sharp Commission would amend Texas Tax Code § 171 to replace the current franchise tax on corporations and LLCs with a “margin” tax on all businesses except sole proprietorships and certain “passive” entities.<sup>102</sup> The Margin Tax calculation would begin with total revenues as

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<sup>100</sup> A recent draft of the legislation proposed by the Sharp Commission can be found at [http://www.ttrc.state.tx.us/files/tax\\_reform\\_bill.pdf](http://www.ttrc.state.tx.us/files/tax_reform_bill.pdf).

<sup>101</sup> Taxable entities primarily engaged in retail or wholesale trade would pay a reduced rate of 0.5%, in recognition of the low profit margins basic to the industry. “Retail and wholesale trade” is defined as activities described in the 1987 Standard Industrial Classification Manual published by the federal Office of Management and Budget. Under this definition, retail trade includes restaurants. A taxable entity is primarily engaged in retail or wholesale trade if the total revenue from these activities is greater than the total revenue from other activities. As a second test, a taxable entity that predominantly sells or resells products it or a member of the affiliated group produces does not qualify for the reduced rate. Retail or wholesale utilities, including telecommunications services, electricity or gas also do not qualify for the reduced rate.

<sup>102</sup> The bill would define “taxable entity” to include most businesses with state law liability protection, including the corporations and LLCs currently subject to the franchise tax plus general partnerships, limited

determined from the entity's federal income tax return.<sup>103</sup> From revenues, a business could deduct either (x) its cost of goods sold<sup>104</sup> or (y) its compensation costs (generally limited to \$300,000 per employee);<sup>105</sup> provided that the maximum margin would be 70% of total revenue. The result would be apportioned to Texas based on gross receipts (as is done in the current franchise tax) and taxed at a rate of 1.0 percent (or 0.5 percent for wholesalers and retailers).

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partnerships, LLPs, professional and business associations, joint ventures, joint stock companies and holding companies, but excluding (i) sole proprietorships, (ii) general partnerships owned entirely by natural persons (and excluding general partnerships for which an LLP election has been made), (iii) certain unincorporated passive entities, (iv) non-profit and other organizations currently exempt from the franchise tax, (v) grantor trusts, estates of natural persons, escrows, passive investment partnerships, family limited partnerships where at least 80% of the interests are held by members of the same family and that are passive investment partnerships, (vi) certain non-business passive entity trusts, real estate investment trusts (REITs) but only if the REIT does not own real estate directly (other than real estate occupied for business purposes), and (vii) real estate mortgage investment conduits (REMICs.)

A "passive entity" is defined as a general or limited partnership or trust, other than a business trust, where at least 90% of federal gross income is from investments such as dividends, interest, distributive shares of partnership income, capital gains, and royalties. A passive entity also cannot receive more than 10% of its income from conducting an active trade or business. There is also an active business test to determine whether a family limited partnership and a passive entity is a taxable entity. Rent income would not be considered passive income.

<sup>103</sup> For a corporation, total revenue equals line 1c plus lines 4-10 on IRS Form 1120. For partnerships, total revenue equals line 1c plus lines 4-7 on IRS Form 1065, plus lines 2-11 on IRS Form 1065, Schedule K.

Certain exclusions from total revenue would be allowed such as for bad debt, foreign royalties and dividends, and net distributive income from certain entities treated as partnerships for federal income tax purposes. Additionally, certain types of "flow-through" funds that are mandated to be distributed to other entities may be excluded.

Lending institutions would exclude from total revenue the proceeds from the principal repayment of loans. Staff leasing services companies must exclude from total revenue payments received from a client company for wages, payroll taxes on those wages, employee benefits, and workers' compensation benefits for the employees assigned to the client company.

<sup>104</sup> While "cost of goods sold" would generally follow the federal income tax definition, there are some modifications to reflect the unique circumstances (i.e., lobbying or political influence) of particular industries. Cost of goods sold is generally computed for Margin Tax purposes in a manner similar to that used for federal income tax purposes. The term "goods" is defined as real or tangible personal property sold in the ordinary course of business and does not include services sold. In addition, the taxable entity would be required to own the goods.

Cost of goods sold includes all direct costs of acquiring or producing goods, including the cost of labor and materials. It also includes indirect overhead costs related to the goods, but not to exceed 4% of the taxable entity's total indirect overhead costs. Cost of goods sold does not include selling, distribution, outbound transportation and advertising costs, nor does it include interest, income taxes and officers' compensation. If the taxable entity is a lending institution, the cost of goods sold is equal to interest expense.

<sup>105</sup> The deduction for wages and cash compensation (excluding benefits) would be capped at \$300,000 per employee (including officers, directors, owners and partners) and includes wages, salaries, stock options and net distributive income from entities treated as partnerships for federal income tax purposes, but only if the person receiving the distribution is a natural person. The \$300,000 cap would be indexed to inflation every two years in the same manner used for the small business exemption. The compensation deduction also includes the actual cost of health, retirement, and workers' compensation benefits, which is not capped.

A staff leasing services company may only deduct compensation (cost of goods sold is not allowed) for their own employees not assigned to client companies. Compensation for employees assigned to client companies would be included in the client company's compensation or cost of goods sold amount.

Entities would pay the Margin Tax on a “unitary combined basis” (i.e., affiliated groups of entities would in effect be required to pay taxes on a consolidated basis, and the internal partnership structure described below under the heading “3. Internal Partnerships Still Work” would no longer work as described).<sup>106</sup>

The Margin Tax would be phased in commencing in 2007. The current Texas franchise tax would remain in place for 2006, with the May 2006 tax payment based on business in 2005. The Margin Tax is effective January 1, 2007 and applies to business done after that date; however, the May 2007 tax payment will be based on the old franchise tax for (business in 2006). In May 2008, businesses will pay Margin Tax based on business in calendar year 2007.

Proponents of the Margin Tax claim that it is not an income tax because its name and deduction scheme differ from the income tax imposed by the IRC, although revenue, cost of goods sold and other computations would be based on amounts from specified lines in a federal income tax return, and it is imposed at the entity rather than the individual level. However, others disagree in the case of a partnership providing professional services (e.g. accounting, engineering, law or medical), and refer to Texas Constitution article 8, section 24(a) (often referred to as the “Bullock Amendment”), which provides:

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

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To minimize double taxation and potential tax planning opportunities, taxable entities that are part of an affiliated group of businesses with 80% common ownership and engaged in a unitary business must file a water's edge combined group report. An “affiliated group” is a group of companies where a controlling interest is owned by a common owner. A “combined group” is a group of companies engaged in a unitary business and required to file a combined group report. A “controlling interest” is 80 percent or more common ownership. “Unitary business” is a single economic enterprise made up of separate parts of a single business entity or of a commonly controlled group of entities whose activities are sufficiently interdependent, integrated, and interrelated. Guidelines for determining whether a unitary business exists include whether the activities of group members are in the same general line of business or steps in a vertically-integrated business process, and if the members have strong centralized management. “Water's edge” refers primarily to entities with U.S. operations, as entities with 80% or more of property and payroll assigned to locations outside the U.S. would not be included in the combined report. The combined group would be considered a single taxable entity and must elect the same deduction from total revenue.

A combined group would determine its total revenue by determining the total revenue of each of the members of the combined group as if the member were an individual taxable entity, summing the total revenue of the members and subtracting items of total revenue received from a member of the combined group. A combined group electing to deduct cost of goods sold would determine its cost of goods sold for each of its members as if the member were an individual taxable entity, summing the cost of goods sold of the members and subtracting any cost of goods sold amounts that relate to a corresponding item of total revenue that was subtracted in determining total revenue. Similarly, a combined group electing compensation as a deduction would determine its compensation for each of its members as if the member were an individual taxable entity, sum the compensation of the members and subtract any compensation amounts relating to a corresponding item of total revenue that was subtracted in determining total revenue.

A coalition of law firms has filed a brief with the Attorney General of Texas contending that the Bullock Amendment's voter approval requirement applies to the proposed Margin Tax. This coalition contends that the Bullock Amendment's language makes clear that its coverage includes an income tax on a partnership interest attributable to a natural person, whether imposed at the partnership or individual level. Moreover, the Bullock Amendment specifically refers to "a person's share of partnership and unincorporated association income." This plain language makes no distinction between general partnerships, limited partnerships and limited liability partnerships, and applies even if the partnership is viewed as a separate legal entity. This coalition argues that, when viewed in light of the plain language of the Bullock Amendment and relevant authorities,<sup>107</sup> the imposition of the Margin Tax would bring the constitutional provision into play, thereby requiring a public referendum to validate imposition of the Margin Tax.

Affected parties are communicating to the Legislature regarding a variety of inequities and technical flaws associated with the Margin Tax as proposed. Thus, there can be no assurance that Margin Tax legislation as described above will be sponsored in, or passed by, the Legislature.

Since the franchise tax exclusion for partnerships is a factor to be considered in deciding whether to form a corporation, LLC, or partnership, the uncertainty regarding future tax legislation is a material 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.<sup>108</sup> 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

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<sup>107</sup> See *Bishop v. District of Columbia*, 401 A.2d 955 (D.C. 1979), in which the imposition of the District of Columbia tax on unincorporated businesses at the partnership level was challenged by partners in District of Columbia law firms who were residents of surrounding states on the basis that it was actually a prohibited tax on the personal incomes of non-residents under the District of Columbia Home Rule Act, D.C. CODE ANN. § 1-206.02(a)(5), which prohibited a tax on the personal income of non-residents; the District of Columbia Court of Appeals held that "as to the characterization of the tax, it is fundamental that the nature and effect of the tax, not its label, determine if it is an income tax or not" and concluded that "since the tax is on unincorporated business, [it] is therefore in reality a tax on the associates or partners who run the business."

<sup>108</sup> TEX. TAX CODE ANN. § 171.1032(c) (Vernon 2002 & Supp. 2004); Tex. SB 1125, 77<sup>th</sup> Leg., R.S. (2001).

because either 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. There is also a risk that changes will be legislated in the Texas tax system or its administration that will make the use of internal partnerships less attractive as an alternative for reducing franchise taxes.

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 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, the TRLPA and the TRPA.<sup>109</sup> 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).

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

A Revenue Procedure 99-51,<sup>110</sup> 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 IRC’s requirement that an electing S-corporation may have only one class of stock. In at least one private letter ruling issued by the IRS prior to the publication of Revenue Procedure 99-51, the IRS 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 liquidating proceeds.<sup>111</sup> However, in Revenue Procedure 99-51 the IRS states that (i) the IRS will no longer rule on the

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<sup>109</sup> *Infra* Part “E. Business Combinations and Conversions - 2. Conversions.”

<sup>110</sup> Rev. Proc. 99-51, 1999-52 I.R.B. 761 (December 27, 1999).

<sup>111</sup> *See e.g.*, Priv. Ltr. Rul. 1999-42-009 (July 16, 1999).



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 in order to avoid Texas franchise taxes may want to consider the alternative of using a subsidiary LLP (i.e., Checking-the-Box to be taxed as a corporation) in lieu of a limited partnership, and specifically drafting equal, pro rata treatment of the partners in the partnership agreement to overcome the single class of stock concern.

5. Mergers. Senate Bill 1689 from the 2001 Legislative Session codifies Comptroller's policy that net operating losses ("NOLs") do not survive a merger for Texas franchise tax purposes unless they belong to the entity that survives the merger. Thus, the disappearing entity loses its NOLs.<sup>112</sup>

#### **F. Business Combinations and Conversions.**

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

(a) Merger. Texas law allows corporations, LLCs and partnerships to merge with each other (e.g., a limited partnership can merge into a corporation).<sup>113</sup> Detailed provisions appearing in the TBOC and its predecessor statutes provide the mechanics of adopting a plan of merger, obtaining owner approval, filing with the Secretary of State, and protecting creditors.

(b) Share Exchange. A business combination may be effected by a transfer of shares or other ownership interests in which either (i) all of the owners agree to the sale or exchange of their interests or (ii) there is a statutory share or interest exchange pursuant to 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.<sup>114</sup> The TBOC and its respective predecessor entity statutes – the TBCA, the LLC Act, the TRLPA and the TRPA – each have provisions providing the mechanics of adopting a plan of exchange, obtaining owner approval and filing with the Secretary of State.<sup>115</sup>

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<sup>112</sup> TEX. TAX CODE § 171.110(e) (West 2004); Tex. SB 1689, §2, 77<sup>th</sup> Leg. (2002).

<sup>113</sup> TEX. BUS. CORP. ACT. ANN. ("TBCA") art. 5.01, § A (Vernon Supp. 2006); TEX. REV. CIV. STAT. ANN. art. 1528n ("LLC Act"), art. 10.01, § A (Vernon 2002); TEX. REV. CIV. STAT. ANN. art. 6132a-1 ("TRLPA"), § 2.11 (Vernon Supp. 2006); TEX. REV. CIV. STAT. ANN. art. 6132b ("TRPA"), § 9.02 (Vernon Supp. 2006); TBOC § 10.001.

<sup>114</sup> TBCA art. 5.02 § A; LLC Act § 10.06; TRLPA § 2.11; TRPA § 9.03; TBOC § 10.051.

<sup>115</sup> *Id.*; TBOC §§ 10.052, 10.151-10.153.

(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.<sup>116</sup> In most states, shareholder approval of an asset sale has historically been required if the corporation is selling all or substantially all of its assets. The Delaware courts have used both "qualitative" and "quantitative" tests in interpreting the phrase "substantially all," as it is used in Section 271 of the Delaware General Corporation Law ("DGCL") which requires stockholder approval for a corporation to "sell, lease or exchange all or substantially all of its property and assets."<sup>117</sup>

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<sup>116</sup> See TBCA arts. 5.09 and 5.10; TBOC § 10.251. See also 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).

<sup>117</sup> See *Gimbel v. The Signal Companies, Inc.*, 316 A.2d 599 (Del. Ch. 1974) (assets representing 41% of net worth but only 15% of gross revenues held not to be "substantially all"); *Katz v. Bregman*, 431 A.2d 1274 (Del. Ch. 1981) (51% of total assets, generating approximately 45% of net sales, held to be "substantially all"); and *Thorpe v. CERBCO, Inc.*, 676 A.2d 436 (Del. 1996) (sale of subsidiary with 68% of assets, which was primary income generator, held to be "substantially all"; court noted that seller would be left with only one operating subsidiary, which was marginally profitable). See *Hollinger Inc. v. Hollinger International, Inc.*, 858 A.2d 342 (Del. Ch. 2004), *appeal refused*, 871 A.2d 1128 (Del. 2004), in which (A) the sale of assets by a subsidiary with approval of its parent corporation (its stockholder), but not the stockholders of the parent, was alleged by the largest stockholder of the parent to contravene DGCL § 271; (B) without reaching a conclusion, the Chancery Court commented in dicta that "[w]hen an asset sale by the wholly owned subsidiary is to be consummated by a contract in which the parent entirely guarantees the performance of the selling subsidiary that is disposing of all of its assets and in which the parent is liable for any breach of warranty by the subsidiary, the direct act of the parent's board can, without any appreciable stretch, be viewed as selling assets of the parent itself"; and (C) examining the consolidated economics of the subsidiary level sale, the Chancery Court held (1) that "substantially all" of the assets should be literally read, commenting that "[a] fair and succinct equivalent to the term 'substantially all' would be 'essentially everything', notwithstanding past decisions that have looked at sales of assets around the 50% level, (2) that the principal inquiry was whether the assets sold were 'quantitatively vital to the operations of' seller (the business sold represented 57.4% of parent's consolidated EBITDA, 49% of its revenues, 35.7% of the book value of its assets, and 57% of its asset values based on bids for the two principal units of the parent), (3) that the parent had a remaining substantial profitable business after the sale (the Chancery Court wrote: "if the portion of the business not sold constitutes a substantial, viable, ongoing component of the corporation, the sale is not subject to Section 271," and (4) that the "qualitative" test of *Gimbel* focuses on "factors such as the cash-flow generating value of assets" rather than subjective factors such as whether ownership of the business would enable its managers to have dinner with the Queen. See Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 Bus. Law. 843, 855-58 (2005); BALOTTI AND FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS*, §10.2 (3<sup>rd</sup> ed. Supp. 2004). To address the uncertainties raised by dicta in Vice Chancellor Strine's opinion in *Hollinger*, DGCL § 271 was amended effective August 1, 2005 to add a new subsection (c) which provides as follows:

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

Difficulties in determining when a shareholder vote is required in Delaware led Texas to adopt a bright line test. TBCA arts. 5.09 and 5.10 provide, in essence, that shareholder approval is required under Texas law only if it is contemplated that the corporation will cease to conduct any business following the sale of assets.<sup>118</sup> Under TBCA art. 5.10, a sale of all or substantially all of a corporation's property and assets must be approved by the shareholders (and shareholders who vote against the sale can perfect appraisal rights). TBCA art. 5.09(A) provides an exception to the shareholder approval requirement if the sale is "in the usual and regular course of the business of the corporation. . . .", and a 1987 amendment added section B to art. 5.09 providing that a sale is

in the usual and regular course of business if, [after the sale,] the corporation shall, directly or indirectly, either continue to engage in one or more businesses or apply a portion of the consideration received in connection with the transaction to the conduct of a business in which it engages following the transaction.<sup>119</sup>

TBOC §§ 21.451 and 21.455 carry forward TBCA arts. 5.09 and 5.10.

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shall be required for a sale, lease or exchange of property and assets of the corporation to a subsidiary.

This amendment answered certain questions raised by *Hollinger*, but raised or left unanswered other questions (e.g., (i) whether subsection (c) applies in the case of a merger of a subsidiary with a third party even though literally read DGCL § 271 does not apply to mergers, (ii) what happens if the subsidiary is less than 100% owned, and (iii) what additional is meant by the requirement that the subsidiary be wholly "controlled" as well as "wholly owned").

<sup>118</sup> 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, 287-290 (Winter 2001).

<sup>119</sup> In *Rudisill v. Arnold White & Durkee, P.C.*, 148 S.W.3d 556 (Tex. App. 2004), the 1987 amendment to art. 5.09 was applied literally. The *Rudisill* case arose out of the combination of Arnold White & Durke, P.C. ("AWD") with another law firm, Howrey & Simon ("HS"). The combination agreement provided that all of AWD's assets other than those specifically excluded (three vacation condominiums, two insurance policies and several auto leases) were to be transferred to HS in exchange for a partnership interest in HS, which subsequently changed its name to Howrey Simon Arnold & White, LLP ("HSAW"). In addition, AWD shareholders were eligible individually to become partners in HSAW by signing its partnership agreement, which most of them did.

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

An important reason for structuring an acquisition as an asset transaction is the desire on the part of a buyer to limit its responsibility for liabilities of the seller, particularly unknown or contingent liabilities. Unlike a stock purchase or statutory combination, where the acquired corporation retains all of its liabilities and obligations, known and unknown, the buyer in an asset purchase has an opportunity to determine which liabilities of the seller it will contractually assume. In certain other jurisdictions, the purchase of an entire business where the shareholders of the seller become shareholders of the buyer can cause a sale of assets to be treated as a common law “*de facto merger*,” which would result in the buyer becoming responsible as a matter of law for seller liabilities which buyer did not contractually assume.<sup>120</sup>

Texas has legislatively repealed the *de facto* merger doctrine in TBCA art. 5.10B, which provides that in relevant part that “[a] disposition of any, all, or substantially all, of the property and assets of a corporation . . . (1) is not considered to be a merger or conversion pursuant to this Act or otherwise; and (2) except as otherwise expressly provided by another statute, does not make the acquiring corporation, foreign corporation, or other entity responsible or liable for any liability or obligation of the selling corporation that the acquiring corporation, foreign corporation, or other entity did not expressly assume.”<sup>121</sup> TBOC § 10.254 carries forward TBCA art. 5.10B and makes it applicable to all domestic entities.

## 2. Conversions.

(a) General. Texas law allows corporations, LLCs and partnerships to convert from one form of entity into another without going through a transfer of assets or merger.<sup>122</sup> A conversion is not a combination of entities; rather it is only a change in the statutory form and nature of an existing entity. Additionally, a conversion involves only one entity and does not involve any change in the ownership of that entity, although it may change the rights of the owners. The TBOC and the older Texas entity statutes each have provisions relating to the mechanics of adopting a plan of conversion, obtaining owner approval, filing with the Secretary of State, and protecting creditors. Those Texas statutes and the federal income tax consequences of conversions are summarized below.

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<sup>120</sup> See *Knapp v. North American Rockwell Corp.*, 506 F.2d 361 (3<sup>rd</sup> Cir. 1974); *Philadelphia Electric Co. v. Hercules, Inc.*, 762 F.2d 303 (3<sup>rd</sup> Cir. 1985); *SmithKline Beecham Corp. v. Rohm and Haas Corp.*, 89 F.3d 154 (3<sup>rd</sup> Cir. 1996); *Cargo Partner AG v. Albatrans Inc.*, 352 F.3d 41 (2d Cir. 2003).

<sup>121</sup> In *C.M. Asfahl Agency v. Tensor, Inc.*, 135 S.W.3d 768, 780-81 (Tex.App.—Houston [1<sup>st</sup> Dist.] 2004), a Texas Court of Civil Appeals, quoting Tex. Bus. Corp. Act Ann. art. 5.10(B)(2) and citing two other Texas cases, wrote: “This transaction was an asset transfer, as opposed to a stock transfer, and thus governed by Texas law authorizing a successor to acquire the assets of a corporation without incurring any of the grantor corporation’s liabilities unless the successor expressly assumes those liabilities. [citations omitted] Even if the Agency’s sales and marketing agreements with the Tensor parties purported to bind their ‘successors and assigns,’ therefore, the agreements could not contravene the protections that article 5.10(B)(2) afforded Allied Signal in acquiring the assets of the Tensor parties unless Allied Signal expressly agreed to be bound by Tensor parties’ agreements with the Agency.” See Egan and Huff, *Choice of State of Incorporation -- Texas versus Delaware: Is it Now Time to Rethink Traditional Notions*, 54 SMU Law Review 249, 287-290 (Winter 2001).

<sup>122</sup> TBCA Part Five; TBOC Chapter 10, Subchapter C; cf. ABA Committee on Corporate Laws, *Changes in the Model Business Corporation Act Relating to Domestication and Conversion – Final Adoption*, 58 Bus. Law 219 (Nov. 2002).

(b) Texas Statutes. Under the conversion provisions of Texas law,<sup>123</sup> a Texas corporation may convert into another corporation or other entity if (i) the conversion is approved by its shareholders in the same manner as a merger in which the corporation is not the surviving entity would be approved; (ii) the conversion is consistent with the laws under which the resulting entity is to be governed; (iii) shareholders will have a comparable interest in the resulting entity unless a shareholder exercises his statutory dissenter's rights or otherwise agrees; (iv) no shareholder will become personally liable for the obligations of the resulting entity without his consent; and (v) the resulting entity is a new entity formed as a result of the conversion rather than an existing entity (which would be a merger).<sup>124</sup> Partnerships, limited partnerships, and LLCs are afforded comparable rights.<sup>125</sup>

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<sup>123</sup> TBCA arts. 5.17, 5.18, 5.19 and 5.20; TBOC §§ 10.101-10.151, 10.154-10.203.

<sup>124</sup> TBOC § 10.101. Under TBOC § 10.106, when a conversion takes effect upon the filing of a certificate of conversion with the Secretary of State after following the above procedures:

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

(c) Federal Income Tax Consequences. As in the case of organizational choice of entity determinations and business combinations, a conversion transaction should not be undertaken without a thorough analysis of the federal and state income tax consequences of the conversion. The following sections provide a brief summary of some of the federal income tax consequences of certain conversion transactions.<sup>126</sup>

(1) Conversions of Entities Classified as Partnerships. There generally should be no federal income tax consequences arising from the conversion of an entity classified as a domestic partnership for federal income tax purposes (e.g., general partnerships, LLPs, limited partnerships and LLCs) into another entity classified as a domestic partnership for federal income tax purposes, provided that the owners' capital and profit interests and shares of entity liabilities do not change as a result of the conversion and the entity's business and assets remain substantially unchanged.<sup>127</sup> These transactions are viewed as tax-free contributions under Section 721 of the IRC that do not cause the existing entity to terminate under Section 708, and do not cause the taxable year of the existing entity to close with respect to any or all of the partners or members. A new taxpayer identification number is not required. Careful attention should be paid to determining the partners' or members' correct share of the entity's liabilities before and after the conversion because a decrease in a partner's or member's share of those liabilities that exceeds the partner's or member's adjusted basis in its interest will result in recognition of gain.

The conversion of an entity classified as a partnership to an entity that is ignored for federal income tax purposes will occur if such entity only has a single member. For example, if one member of a two member LLC purchases the other member's interest, the partnership is deemed to make a liquidating distribution of all of its assets to the members, with the purchasing member treated as acquiring the assets distributed to the selling member. The selling member, however, is treated as selling a partnership interest.<sup>128</sup> Partnership liquidations generally do not result in recognition of gain by the partners except to the extent that the amount of cash (marketable securities are in certain cases treated as cash) actually or constructively received by a partner exceeds the partner's adjusted basis in his partnership interest.<sup>129</sup> Note that distributions of property contributed to the partnership within seven years of the date of the deemed distribution may result in gain recognition pursuant to IRC Sections 704(c)(1)(B) and 737.<sup>130</sup>

Conversion of an entity classified as a partnership into a corporation will generally be analyzed as a liquidating transaction with respect to the partnership

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*See also* TBCA art. 5.20.

<sup>125</sup> *See* TBOC § 10.101. The comparable provisions for such entities governed by pre-TBOC law are found for LLCs at LLC Act §§ 10.08-10.11, for limited partnerships at TRLPA § 2.15, and for general partnerships at TRPA §§ 9.01, 9.05 and 9.06.

<sup>126</sup> *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).

<sup>127</sup> *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.

<sup>128</sup> Rev. Rul. 99-6, 1999-1 C.B. 432.

<sup>129</sup> *See* I.R.C. §§ 731, 736, 751(b); Prop. Treas. Reg. § 301.7701-3(g), 66 Fed. Reg. 3959 (Jan. 17, 2001).

<sup>130</sup> *See* I.R.C. §§ 704(c)(1)(B), 737.

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.<sup>131</sup> Nevertheless, with careful planning, most conversions of this type can be accomplished without recognition of gain.<sup>132</sup>

(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.<sup>133</sup> A corporation cannot be converted into an entity classified as a partnership or sole proprietorship in a tax free transaction. In the case of a C-corporation (other than one that is owned 80% or more by another corporation) the liquidation potentially may be subject to tax at both the corporate and shareholder levels. The corporation will recognize gain or loss equal to the difference between the fair market value of each tangible and intangible asset of the corporation and the corporation's adjusted basis in each respective asset.<sup>134</sup> 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.<sup>135</sup> 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.<sup>136</sup> In order to comply with the single-class-of-stock requirement, careful tax analysis should be undertaken when converting a corporation with an otherwise valid pre-conversion S-corporation election into partnership form electing post-conversion Check-the-Box treatment as a corporation.

(d) Effect on State Licenses. The Texas Attorney General has issued an opinion to the effect that "[w]hen a corporation converts to another type of business entity in accordance with the TBCA, as a general rule a state license held by the converting corporation continues to be held by the new business entity . . . . subject to the particular statutory requirements or regulations of the specific state entity that issued the license."<sup>137</sup>

**G. Use of Equity Interests to Compensate Service Providers.** A corporation may compensate service providers using employee stock ownership plans ("ESOPs"), restricted stock, non-qualified stock options and incentive stock options; however, incentive stock options and ESOPs are not available in other forms of organization. The grant of equity interests or options

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<sup>131</sup> See, e.g., I.R.C. §§ 751(b), 351.

<sup>132</sup> See Rev. Rul. 84-111, 1984-2 C.B. 88; Prop. Treas. Reg. § 301.7701-3(g), 66 Fed. Reg. 3959 (Jan. 17, 2001).

<sup>133</sup> Treas. Reg. §§ 301.7701-3(g)(1)(ii), (iii).

<sup>134</sup> I.R.C. § 336.

<sup>135</sup> I.R.C. § 331(a).

<sup>136</sup> I.R.C. § 1371(a); see also I.R.C. § 1363(a); cf. I.R.C. § 1374 (imposing a tax on built-in gains).

<sup>137</sup> Op. Tex. Att'y Gen. No. JC-0126 (1999).

to acquire equity interests to service providers in an entity taxed as a partnership creates a number of tax uncertainties.<sup>138</sup>

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

## **II. CORPORATIONS.**

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

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

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

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

Prior to January 1, 2006, Texas business corporations were organized under, and many are still governed by, the Texas Business Corporation Act, as amended (the “TBCA”),<sup>139</sup> which was amended in 1997 by SB 555,<sup>140</sup> in 2003 by HB 1165 and in 2005 by HB 1507. However, corporations formed after January 1, 2006 are organized under and governed by the new Texas Business Organization Code (“TBOC”). For entities formed before that date, only the ones voluntarily opting into the TBOC will be governed by it, until January 1, 2010, at which time all Texas corporations will be governed by the TBOC. The TBOC provides that the TBOC provisions applicable to corporations<sup>141</sup> may be officially and collectively known as “Texas Corporation Law.”<sup>142</sup> However, because until 2010 some Texas for-profit corporations will be governed by the TBCA and others by the TBOC and because the substantive principles under both statutes are generally the same, the term “Tex. Corp. Stats.” is used herein to refer to the TBOC and the TBCA (as supplemented by the TMCLA) collectively, and the particular differences between the TBCA and the TBOC are referenced as appropriate.

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<sup>138</sup> See William H. Hornberger & James R. Griffin, Stock Options and Equity Compensation, Address at 47<sup>th</sup> Annual Texas CPA Tax Institute (Nov. 14-16, 2000), available at <http://www.jw.com/site/jsp/publicationinfo.jsp?id=56>.

<sup>139</sup> TEX. BUS. CORP. ANN. arts. 1.01 *et. seq.* (Vernon Supp. 2006).

<sup>140</sup> Tex. SB 555, 75<sup>th</sup> Leg., R.S. (1997).

<sup>141</sup> TBOC Titles 1 and 2.

<sup>142</sup> TBOC § 1.008(b).



**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 of dividends. Like the personal income tax, corporate tax rates vary depending on the level of income generated. The marginal corporate tax rates, based on taxable income for 2006 are generally as follows:

<u>Taxable Income</u>	<u>Marginal Tax Rate</u>
\$0 - 50,000	15%
\$50,001 - 75,000	25%
\$75,000 - 100,000	34%
\$100,000 - 335,000	39%
\$335,000 - 10,000,000	34%
\$10,000,000 - 15,000,000	35%
\$15,000,000 – 18,333,333	38%
> \$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; however, unreasonable compensation may be recharacterized by the IRS as a constructive dividend, which is not deductible by the corporation and is also taxed as income to the officer, director or employee.<sup>143</sup> There can also be corporate level taxes on excessive accumulations of earnings.

Because a C-corporation is a separately taxable entity, there is no flow-through of income, deductions (including intangible drilling costs and depletion allowances), NOLs or capital losses to a C-corporation’s shareholders, although a C-corporation’s shareholders are not subject to self-employment tax on distributions they receive. Additionally, a C-corporation can carry forward any unused losses and credits. If a C-corporation distributes appreciated assets to its shareholders, it will recognize a taxable gain. Furthermore, a C-corporation will generally recognize gain or loss on its liquidation (except for certain liquidations into a parent corporation),<sup>144</sup> and a shareholder will recognize taxable gain or loss on his or her interest in the corporation upon the corporation’s liquidation or the shareholder’s disposition thereof. However, both S- and C-corporations may be parties to a tax-free reorganization in which neither the corporation nor its shareholders are subject to taxation.

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<sup>143</sup> 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.

<sup>144</sup> See I.R.C. §§ 336, 337.

## 2. Taxation of S-Corporations.

(a) Effect of S-Corporation Status. S-corporation status is achieved by an eligible C-corporation making an election to be so treated. All shareholders, including their spouses if their stock is community property, must consent to such election. The result of electing S-corporation status is that no corporate level tax is imposed on the corporation's income. Instead, corporate level income is treated as having been received by the shareholders, whether or not such income was actually distributed, and is taxed at the shareholder level. An S-corporation that was previously a C-corporation is subject to a corporate level tax (i) if it realizes a gain on the disposition of assets that were appreciated (i.e., the fair market value exceeded the tax basis) on the date the S election became effective and the disposition occurs within 10 years of that date<sup>145</sup> and (ii) on its excess net passive income (subject to certain limits and adjustments) if it has subchapter C earnings and profits and more than 25% of its gross receipts for the year is passive investment income.<sup>146</sup>

A shareholder's deduction for S-corporation losses is limited to the sum of the amount of the shareholder's adjusted basis in his stock and in the corporation's indebtedness to him.<sup>147</sup> To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year.<sup>148</sup>

(b) Eligibility for S-Corporation Status. To be eligible for S-corporation status, a corporation must (i) be a domestic corporation (i.e., organized under the laws of a state of the United States),<sup>149</sup> (ii) have no more than 100 shareholders (for this purpose, stock owned by a husband and wife is treated as owned by one shareholder and all family members can elect to be treated as one shareholder),<sup>150</sup> (iii) have no more than one class of stock<sup>151</sup> and (iv) have no shareholders other than individuals who are residents or citizens of the United States and certain trusts, estates or exempt organizations (e.g., qualified employee benefit plans and IRC § 501(c)(3) organizations).<sup>152</sup> S-corporations may have a C-corporation as a subsidiary (even if the S-corporation owns 80% or more of the C-corporation). Additionally, an S-corporation may now own a qualified subchapter S subsidiary ("QSSS"). A QSSS includes any domestic corporation that qualifies as an S-corporation and is owned 100% by an S-corporation that elects to treat its subsidiary as a QSSS.<sup>153</sup> A QSSS is not treated as a corporation separate from the parent S-corporation; and all of the assets, liabilities, and items of income, deduction and credit are treated as though they belong to the parent S-corporation. For

<sup>145</sup> I.R.C. § 1374; Treas. Reg. § 1.1374-1 (2005).

<sup>146</sup> I.R.C. § 1374.

<sup>147</sup> I.R.C. §§ 1366(d)(1) and 1367(b)(2)(A).

<sup>148</sup> I.R.C. § 1366(d)(2)(A).

<sup>149</sup> I.R.C. §§ 1361(b)(1); 1361(c).

<sup>150</sup> I.R.C. § 1361(b)(1)(A) (as amended by The American Jobs Creation Act of 2004).

<sup>151</sup> I.R.C. § 1361(b)(1)(D); *see supra* Part "I. General: D. Texas Franchise Tax – 4. Conversions" (discussing the single class of stock requirement as applied to limited partnerships electing corporation status under Check-the-Box Regulations).

<sup>152</sup> I.R.C. §§ 1361(b)(1)(B) and (C) and 1361(c)(6).

<sup>153</sup> Paul G. King, *Small Business Job Protection Act of 1996 Increases the Attractiveness of S Corporations*, 53 J. Mo. B. 219, 221 (1997).

purposes of the requirement that an S-corporation have only one class of stock, indebtedness may be treated as a second class of stock unless it meets the requirements of the safe harbor rule for “straight debt”, the definition of which was expanded under the Small Business Job Protection Act of 1996. Certain options may also constitute a prohibited second class of stock. In order for the election of S-corporation status to be effective, the election must be made by all shareholders of the corporation.

(c) Termination of S-Corporation Status. Once an S-corporation election has been made, the election continues in effect until (i) it is voluntarily terminated by holders of more than one-half of the outstanding shares, (ii) the corporation ceases to meet the eligibility requirements specified above, or (iii) the corporation has subchapter C earnings and profits at the close of three consecutive taxable years and has gross receipts for each of such taxable years more than 25% of which are passive investment income.<sup>154</sup>

(d) Liquidation or Transfer of Interest. An S-corporation and its shareholders are treated in a manner similar to the way a C-corporation and its individual shareholders are treated when a shareholder disposes of its interest or the S-corporation is liquidated (except no double tax in most cases) or is a party to a nontaxable reorganization.<sup>155</sup>

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.<sup>156</sup>

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.<sup>157</sup> Both (i) S-corporations (up to 75 shareholders) and (ii) 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.

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<sup>154</sup> I.R.C. §§ 1362(d)(1)-(3).

<sup>155</sup> See BITTKER & EUSTICE, *supra*, at § 6.04.

<sup>156</sup> IRC § 351(a), 358(a), 362(a), 368(c).

<sup>157</sup> 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).

5. Self-Employment Tax. Shareholders of an S-corporation are generally not subject to self-employment tax on their share of the net earnings of trade or business income of the S-corporation if reasonable compensation is paid to the shareholders active in the business.<sup>158</sup>

**C. Owner Liability Issues.** Limited liability is one of the most important advantages of doing business as a corporation. In corporate law, it is fundamental that shareholders, officers, and directors are ordinarily protected from personal liability arising from the activities of the corporation.<sup>159</sup> 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.<sup>160</sup> 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*,<sup>161</sup> 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, as well as the parallel provision in TBOC Section 21.223, no shareholder, or affiliate of the shareholder or the corporation, may be held liable for (i) any contractual obligation of the corporation on the basis that the shareholder or affiliate is or was the alter ego of the corporation or on the basis of actual or constructive fraud, a sham to perpetuate a fraud or a similar theory, unless it is shown that the shareholder used the corporation for the purpose of perpetrating, and did perpetrate, an actual fraud, primarily for the personal benefit of the shareholder or affiliate or (ii) any obligation (whether contractual, tort or other) on the basis that the corporation failed to observe any corporate formality (e.g., maintaining separate offices and employees, keeping separate books, holding

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<sup>158</sup> Rev. Rul. 59-221, 1959-1 C.B. 225; see also Priv. Ltr. Rul. 87-16-060 (Jan. 21, 1987) (S corporation shareholders do not conduct the corporation’s business); Burgess J. W. Raby & William L. Raby, *Attempting to Avoid FICA and Self-Employment Tax*, 93 TAX NOTES 803, 213–22 (Nov. 5, 2001).

<sup>159</sup> *Delaney v. Fid. Lease Ltd.*, 517 S.W.2d 420, 423 (Tex. Civ. App.—El Paso 1974, writ ref’d n.r.e.), *aff’d in part and rev’d in part on other grounds*, 526 S.W.2d 543 (Tex. 1975).

<sup>160</sup> *Id.* at 423; *Sutton v. Reagan & Gee*, 405 S.W.2d 828 (Tex. Civ. App.—San Antonio 1966, writ ref’d n.r.e.).

<sup>161</sup> 721 S.W.2d 270, 272 (Tex. 1986).

regular meetings of shareholders and board of directors, keeping written minutes of such meetings, etc.).<sup>162</sup>

**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.<sup>163</sup> Shareholders elect directors, who are given the power to manage the affairs of the corporation generally and to formulate policies and objectives therefor.<sup>164</sup> Shareholders retain the power to vote on certain major matters.<sup>165</sup> Directors appoint officers, who are delegated the

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<sup>162</sup> TBCA art. 2.21 (emphasis added); TBOC § 21.223; *S. Union Co. v. City of Edinburg*, 2003 WL 22495756 (Tex. 2003) (repudiating the single business enterprise doctrine, and holding that “[s]ince 1993 . . . [S]ection A of [A]rticle 2.21 is the exclusive means for imposing liability on a corporation for the obligations of another corporation in which it holds shares” and that actual fraud is required to be plead and proved in a veil piercing case based on a contract claim); See Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation – Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 301-302 (Winter 2001); see also Alan R. Bromberg, Byron F. Egan, Dan L. Nicewander and Robert S. Trotti, *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 41 Tex. J. of Bus. L. 41, 64, 67 and 72 (Spring 2005); Alan R. Bromberg, Byron F. Egan, Dan L. Nicewander and Robert S. Trotti, *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 31 BULL. OF BUS. L. SEC. OF THE ST. B. OF TEX. 1, 2, 19, 22 (June 1994); James G. Gaspard, III, *A Texas Guide to Piercing and Preserving the Corporate Veil*, 31 BULL. OF BUS. L. SEC. OF THE ST. B. OF TEX. 24 (Sept. 1994). The later two articles were written prior to, and thus do not reflect, the changes to TBCA Article 2.21 effected in 1997. Some courts, however, continue to ignore TBCA Article 2.21, perhaps because the litigants fail to bring it to the attention of the court, and cite *Castleberry* as authority. See, e.g., *Cementos de Chihuahua, S.A. de C.V. v. Intermodal Sales Corporation*, 162 S.W.3d 581, 586-87 (Tx. Ct. App.—El Paso 2005).

<sup>163</sup> Douglas K. Moll, *Shareholder Oppression & Reasonable Expectations: Of Change, Gifts, and Inheritances in Close Corporation Disputes*, 86 MINN. L. REV. 717, 724 (2002).

<sup>164</sup> *Capital Bank v. Am. Eyeware, Inc.*, 597 S.W.2d 17, 20 (Tex. Civ. App.—Dallas 1980, no writ) (“The authority to manage a corporation’s affairs is vested in its board of directors.”).

<sup>165</sup> TBCA art. 2.28 and TBOC § 21.358 provide that the general requirement for a quorum of shareholders at a meeting of shareholders will be the holders of a majority of the outstanding shares entitled to vote at the meeting. This requirement may be increased or decreased to as few as one-third of the holders of the outstanding shares if so provided in the articles of incorporation or certificate of formation. Once there is a quorum of shareholders at a meeting of shareholders, there is a quorum for all matters to be acted upon at that meeting. Electronic meetings of shareholders are permitted by TBCA art. 2.24 if authorized in the articles of incorporation or bylaws. TBOC § 6.002 permits electronic meetings, subject to an entity’s governing documents.

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

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

In corporations formed prior to September 1, 2003, unless expressly prohibited by the articles of incorporation, shareholders have the right to cumulate their votes in the election of directors if they notify the

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

Most corporate statutes, including the TBCA, the TBOC, and the Delaware General Corporation Law (the “DGCL”), also provide for “close corporations” which may be managed by the shareholders directly.<sup>166</sup> A Texas corporation elects “close corporation” status by including a provision to such effect in its articles of incorporation or certificate of formation, and may provide in such document or in a shareholder agreement, which can be similar to a partnership agreement, that management will be by a board of directors or by the shareholders.<sup>167</sup> Under the Tex. Corp. Stats., any Texas corporation (except a corporation whose shares are publicly traded) may modify how the corporation is to be managed and operated, in much the same way as a close corporation, by an agreement set forth in the articles of incorporation, the certificate of formation, or the bylaws approved by all of the shareholders, or in a written agreement signed by all of the shareholders.<sup>168</sup> Thus, the management structure of corporations

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corporation at least one day before the meeting of their intent to do so; for corporations formed on or after September 1, 2003, shareholders do not have the right to cumulative voting unless the articles of incorporation or certificate of formation expressly grants that right. TBCA art. 2.29D; TBOC §§ 21.360, 21.362.

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

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

<sup>166</sup> See J. Leon Lebowitz, *Texas Close Corporation Law*, 44 TEX. B.J. 51 (1981); Robert W. Hamilton, *Corporations and Partnerships*, 36 SW. L.J. 227, 228–34 (1982).

<sup>167</sup> TBCA arts. 12.11, 12.13, 12.31; TBOC §§ 3.008, 21.703, 21.713.

<sup>168</sup> TBCA Art. 2.30-1 and TBOC § 21.101 in effect extend close corporation flexibility to all corporations that are not publicly traded by authorizing shareholders' agreements that modify and override the mandatory provisions of the TBCA or the TBOC relating to operations and corporate governance. The agreement must be set forth in either (i) the articles of incorporation or bylaws and approved by all shareholders or (ii) in an agreement signed by all shareholders and made known to the corporation. TBCA art. 2.30-1(B)(1); TBOC § 21.101(b). The agreement is not required to be filed with the Secretary of State unless it is part of the articles of incorporation. TBCA arts. 2.30-1(B), 3.03; TBOC §§ 21.101(b), 4.002. An agreement so adopted may:

- (1) restrict the discretion or powers of the board of directors;
- (2) eliminate the board of directors and permit management of the business and affairs of the corporation by its shareholders, or in whole or in part by one or more of its shareholders, or by one or more persons not shareholders;
- (3) establish the natural persons who shall be the directors or officers of the corporation, their term of office or manner of selection or removal, or terms or conditions of employment of any director, officer, or other employee of the corporation, regardless of the length of employment;
- (4) govern the authorization or making of distributions, whether in proportion to ownership of shares, subject to the limitations in TBCA Article 2.38 (or TBOC § 21.303, as the case may be), or determine the manner in which profits and losses shall be apportioned;

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

### **E. Fiduciary Duties.**

1. General. Directors of a corporation owe fiduciary duties of care, loyalty and obedience to the corporation.<sup>169</sup> The duty of care requires directors to exercise the degree of

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- (5) govern, in general or in regard to specific matters, the exercise or division of voting power by and between the shareholders, directors (if any), or other persons or by or among any of them, including use of disproportionate voting rights or director proxies;
  - (6) establish the terms and conditions of any agreement for the transfer or use of property or the provision of services between the corporation and any shareholder, director, officer or employee of the corporation, or other person or among any of them;
  - (7) authorize arbitration or grant authority to any shareholder or other person as to any issue about which there is a deadlock among the directors, shareholders or other person or persons empowered to manage the corporation to resolve that issue;
  - (8) require dissolution of the corporation at the request of one or more of the shareholders or upon the occurrence of a specified event or contingency in which case the dissolution of the corporation shall proceed as if all the shareholders had consented in writing to dissolution of the corporation as provided in TBCA Article 6.02 or TBOC §§ 21.501-21.504; or
  - (9) otherwise govern the exercise of corporate powers or the management of the business and affairs of the corporation or the relationship among the shareholders, the directors and the corporation, or among any of them, as if the corporation were a partnership or in a manner that would otherwise be appropriate only among partners, and is not contrary to public policy.

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

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

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

<sup>169</sup> *Gearhart Industries, Inc. v. Smith Intern. Inc.*, 741 F.2d 707 (5th Cir. 1984); see Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation - Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 259-270 (Winter 2001).

care that an ordinarily prudent person would exercise under similar circumstances.<sup>170</sup> 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.<sup>171</sup> In general, a director will not be permitted to derive a personal profit or advantage at the expense of the corporation and must act solely with an eye to the best interest of the corporation, unhampered by any pecuniary interest of his own.<sup>172</sup> Generally the duty of loyalty prohibits a director from usurping business opportunities that otherwise might be pursued by the corporation,<sup>173</sup> but Texas law permits a corporation to renounce in its certificate of formation or by action of its board of directors any interest in business opportunities presented to the corporation or one or more of its officers, directors or shareholders.<sup>174</sup> The duty of obedience requires directors to obey the law and the articles of incorporation.<sup>175</sup> Controlling shareholders owe a fiduciary duty to the minority shareholders to deal fairly with them.<sup>176</sup>

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.<sup>177</sup> 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

<sup>170</sup> *Gearhart Indus.*, 741 F.2d at 720.

<sup>171</sup> *Id.* at 719. The good faith of a director will be determined by whether the director acted with an intent to confer a benefit to the corporation. *See Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963). Whether there exists a personal interest by the director will be a question of fact. *See id.* at 578; *cf. Lyman Johnson, After Enron: Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27 (2003).

<sup>172</sup> *See A. Copeland Enters., Inc. v. Guste*, 706 F. Supp. 1283, 1291; *Milam v. Cooper Co.*, 258 S.W.2d 953, 956 (Tex. Civ. App.—Waco 1953, writ ref'd n.r.e.); *see also* TBCA art. 2.35-1(A) and TBOC § 21.418 (validating director transactions if (1) disinterested directors, after disclosure, approve the transaction; (2) shareholders of the corporation, after disclosure, approve the transaction; or (3) the transaction is otherwise fair); *cf. In re Mi-Lor Corp.*, 348 F.3d 294, 303 (1st Cir. 2003) (holding that a duty of full disclosure is imposed on directors in cases of self dealing). *See generally* John T. Kendrick, Jr., *The Interested Director in Texas*, 21 Sw. L.J. 794 (1967).

<sup>173</sup> The basic framework of the corporate opportunity doctrine was laid down by the Delaware Supreme Court in *Guth v. Loft, Inc.*, as follows:

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

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

<sup>174</sup> TBCA art. 2.02(20), TBOC § 2.101(21).

<sup>175</sup> *Gearhart Indus.*, 741 F.2d at 719.

<sup>176</sup> *See In re Pure Res., Inc.*, 808 A.2d 421, 433 (Del. Ch. 2002).

<sup>177</sup> *See AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986).



believe that the decision will reasonably benefit the corporation.<sup>178</sup> 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.<sup>179</sup>

3. Overcoming Business Judgment Rule. The business judgment rule is only a presumption that protects directors from liability arising out of business decisions made for the corporation. If the presumption created by the business judgment rule is overcome or shown not to apply, then the burden shifts to the director to justify the fairness of the transaction to the corporation.<sup>180</sup>

4. Limitation of Director Liability. Texas Miscellaneous Corporation Laws Act (the "TMCLA") Article 1302-7.06 provides that a Texas corporate entity governed in whole or in part by the TBCA, the Texas Non-Profit Corporation Act, the Finance Code or the TMCLA may provide in its articles of incorporation, as initially filed or by amendment, that a director shall not be liable to the corporation or its shareholders for an act in the director's capacity as a director, *except* to the extent that the director is found liable for (i) a breach of the duty of loyalty to the corporation or its shareholders, (ii) an act or omission not in good faith that constitutes a breach of duty to the corporation or that involves intentional misconduct or a knowing violation of law, (iii) a transaction from which the director received an improper personal benefit, or (iv) an act or omission for which the liability of the director is expressly provided by statute.<sup>181</sup> Sections 7.001(b) and (c) of the TBOC allow for similar such limitation of director liability for corporate entities governed by the TBOC. Neither the TMCLA nor the TBOC authorizes the limitation of liability of an officer or a director acting in the capacity of an officer.<sup>182</sup>

**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

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<sup>178</sup> *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985). See Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation - Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 263-270 (Winter 2001).

<sup>179</sup> See *Gearhart Indus.*, 741 F.2d at 719-21; Byron F. Egan and Curtis W. Huff, *supra*, 54 SMU L. Rev. at 260-263.

<sup>180</sup> *Gearhart Indus.*, 741 F.2d at 720.

<sup>181</sup> See Egan and Huff, *supra*, 54 SMU L. Rev. at 272-273; Byron F. Egan and Amanda M. 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).

<sup>182</sup> See TBOC § 7.001(b) ("The certificate of formation . . . may provide that a governing person of the organization is not liable, or is liable only to the extent provided by the certificate of formation or similar instrument, to the organization or its owners or members for monetary damages for an act or omission by the person *in the person's capacity as a governing person.*" (emphasis added)). See also TMCLA § 1302-7.06B. A corporate officer is an agent of the corporation. *Joseph Greenspon's Sons Iron & Steel Co. v. Pecos Valley Gas Co.*, 156 A. 350 (Del. Ch. 1931); *Hollaway v. Skinner*, 898 S.W.2d 793, 795 (Tex. 1995). If an officer commits a tort while acting for the corporation, under the law of agency, the officer is liable personally for his actions. See Dana M. Muir and Cindy A. Schipani, *The Intersection of State Corporation Law and Employee Compensation Programs: Is it Curtains for Veil Piercing?* 1996 U. Ill. L. Rev. 1059, 1078-1079 (1996); cf. *Centurion Planning Corporation, Inc. v. Seabrook Venture II*, 176 S.W.3d 498, 509 (Tex. App.—Houston 2004). The corporation may also be liable under *respondeat superior*.

governing documents to use any number of various devices to raise capital.<sup>183</sup> Different classes and series of common stock and preferred stock may be utilized to accommodate the desires of various types of investors.<sup>184</sup> Equity can be raised at the base level by common stock and at levels ranking above the common stock by preferred stocks.<sup>185</sup> Equity can be leveraged through many types of borrowings and financing devices, including stock options, warrants, and other forms of securities. In addition, convertible debt interests may be utilized. The different levels of a capital structure may include a differentiation in the voting rights assigned to equity holders, which may even be distributed differently among classes of common stock or even denied as to specified classes of common stock.

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

1. **Restrictions on Transfer of Shares.** Shareholders of a closely-held corporation often desire to prohibit the transfer of shares to persons who are not family members or are not employees of the corporation. To be enforceable, these restrictions on transfer must be reasonable under state law. In any event, an absolute restriction on transfer would be unreasonable and therefore void.<sup>186</sup> The Tex. Corp. Stats. provide that, among other restrictions, rights of first refusal and limitations on transfer necessary to maintain S-corporation status or other tax advantages are reasonable restrictions on transfer.<sup>187</sup> They also specify certain procedures that must be followed to assure the enforceability of the share transfer restrictions, such as the placement of a restrictive legend on stock certificates and the maintenance of a copy of the document containing the transfer restrictions at the corporation's principal place of business or registered office.<sup>188</sup> Since shares in a closely-held business typically lack an established trading market, those shares may be nontransferable as a practical matter. If the owners of the business enterprise desire to conduct an initial public offering for its shares, the corporate form of entity is the best option except in certain limited circumstances.

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

**H. Continuity of Life.** Corporations frequently have perpetual existence, either by default under the TBOC or by a provision in a corporation's articles of incorporation under older Texas law.<sup>189</sup> Since a corporation is treated as a separate entity with continuity of life, events such as death or bankruptcy of an owner have no effect on the legal structure of a corporation—

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<sup>183</sup> ROBERT W. HAMILTON, CORPORATIONS 356 (7th ed. 2001).

<sup>184</sup> *See id.* at 357–59.

<sup>185</sup> *See id.*

<sup>186</sup> *See* TBCA art. 2.22(C); *see also* TBOC § 21.213.

<sup>187</sup> TBCA arts. 2.22(D), (H); TBOC § 21.211.

<sup>188</sup> TBCA arts. 2.22(B), (C); TBOC §§ 21.210, 21.213.

<sup>189</sup> TBOC § 3.003; TBCA art. 3.02(A) provides that the articles of incorporation shall set forth: "(2) The period of duration, which may be perpetual."

at least absent a specific shareholder agreement attaching consequences and procedures for certain events. Even in bankruptcy, a shareholder continues to be a shareholder of the bankrupt entity. Shares can be passed down to heirs. In contrast, under some existing non-Texas partnership laws, particularly less modern ones, a partnership is not an entity separate from its partners and a deceased partner's estate may have to be probated in each state where the partnership owns property. Expenses and the hassle of multiple probate proceedings are avoided in a corporation because corporate shares are personal property subject to probate only in the deceased shareholder's state of domicile.

Under the pre-TBOC business entity rules, with respect to other types of entities, the problems associated with a finite lifetime or unanticipated dissolution could be solved in many cases in the drafting of the entity's constituent documents. However, under the TBOC, *all* domestic entities exist perpetually unless otherwise provided in its governing documents.<sup>190</sup> Thus, the perpetual existence of a corporation is not an advantage to be given much weight in determining the type of business entity to utilize, particularly since the TBOC governs all newly-formed entities.

**I. Formation.** The formation of a corporation requires certain legal formalities and the preparation of certain documents. Under the TBCA, articles of incorporation had to be prepared and filed with the Secretary of State, along with the payment of a \$300 filing fee.<sup>191</sup> Under the TBOC, a certificate of formation is the proper filing document.<sup>192</sup> The articles of incorporation or certificate of formation (either, hereinafter the "corporation's governing document") establishes the initial board of directors and capital structure of the corporation. After the Secretary of State officially acknowledges the filing of the corporation's governing document,<sup>193</sup> there should be an organizational meeting of the initial board of directors named in the corporation's governing document (at the call of a majority of the directors) for the purposes of adopting bylaws, electing officers and transacting such other business as may come before the meeting.<sup>194</sup> The bylaws may contain any provisions for the regulation and management of the affairs of the corporation not inconsistent with law or the corporation's governing document.<sup>195</sup> Although the initial bylaws of a corporation are ordinarily in writing and adopted by the directors at the organization meeting of the board, the shareholders may amend, repeal or adopt the bylaws, unless the corporation's governing document or a bylaw adopted by the shareholders provides otherwise.<sup>196</sup> In the absence of a contrary provision in the corporation's governing document, the TBCA or the TBOC, bylaws may be adopted or amended orally or by acts evidenced by a uniform course of proceeding or usage and acquiescence.<sup>197</sup>

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<sup>190</sup> TBOC § 3.003.

<sup>191</sup> TBCA arts. 3.02 and 3.03.

<sup>192</sup> TBOC §§ 3.001, 4.001. The filing fee for a for-profit corporation remains \$300 under the Code. TBOC § 4.152(1).

<sup>193</sup> TBOC § 4.002. Under pre-TBOC law, the Secretary of State would issue a Certificate of Incorporation once a corporation properly filed its Articles of Incorporation.

<sup>194</sup> TBCA art. 3.06; TBOC § 21.059.

<sup>195</sup> TBCA art. 2.33A; TBOC § 21.057.

<sup>196</sup> TBCA art. 2.23; TBOC § 21.058.

<sup>197</sup> *Keating v. K-C-K Corporation*, 383 S.W.2d 369 (Tex. Civ. App. – Houston 1964, no writ).

**J. Operations in Other Jurisdictions.** When a corporation does business outside of its state of incorporation, it may be required to qualify to do business as a foreign corporation in the other states in which it does business under statutory provisions comparable to TBCA Part Eight and TBOC Chapter 9 and subject to taxation by those states. Over the years there has evolved a substantial body of law for analyzing these questions.<sup>198</sup>

**K. Business Combinations; Conversions.** The Tex. Corp. Stats. now allow corporations, LLCs and partnerships to merge with each other (e.g., a limited partnership can merge into a corporation) and to convert from one form of entity to another without going through a merger or transfer of assets.<sup>199</sup> Both the TBOC and the older entity statutes each have provisions relating to the mechanics of the adoption of a plan of merger or conversion, owner approval, filings with the Secretary of State, and the protection of creditors.

Under the conversion provisions of the Tex. Corp. Stats.,<sup>200</sup> a Texas corporation may convert into another corporation or other entity if (a) the conversion is approved by its shareholders in the same manner as a merger where the corporation is not the surviving entity, (b) the conversion is consistent with the laws under which the resulting entity is to be governed, (c) shareholders will have a comparable interest in the resulting entity, unless the shareholder exercises his dissenters' rights under the Tex. Corp. Stats. or he otherwise agrees, (d) no shareholder will become personally liable for the obligations of the resulting entity without his consent, and (e) the resulting entity is a new entity formed as a result of the conversion rather than an existing entity (which would be a merger).

**L. Anti-Takeover.** TBCA Part Thirteen and TBOC Chapter 21, Subchapter M deal 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.<sup>201</sup> These anti-takeover provisions (i) apply only to an "issuing public corporation"<sup>202</sup> and (ii) prohibit a

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<sup>198</sup> See CT Corporation, *What Constitutes Doing Business* (2003), at 3-7, 67-168.

<sup>199</sup> See TBCA Part Five; TBOC Chapter 10.

<sup>200</sup> TBCA arts. 5.17, 5.18, 5.19 and 5.20. Comparable provisions are found for LLCs at LLC Act §§ 10.08-10.11, for limited partnerships at TRLPA § 2.15, and for general partnerships at TRPA §§ 9.01, 9.05 and 9.06. The TBOC contains substantially similar provisions, all consolidated in Chapter 10, Subchapter C.

<sup>201</sup> TBCA arts. 13.01-13.08; TBOC §§ 21.601-21.610. State corporation statutes intended to restrain some of the abuses associated with hostile takeovers were validated by the United States Supreme Court in *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 95 L. Ed. 2d 67, 107 S. Ct. 1637 (1987). See *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 505-09 (7<sup>th</sup> Cir. 1989), *cert. denied*, 493 U.S. 955 (1989) (upholding Wisconsin's 3-year moratorium statute); Byron F. Egan and Bradley L. Whitlock, *State Shareholder Protection Statutes*, Address at the University of Texas 11<sup>th</sup> Annual Conference on Securities Regulation and Business Law Problems (Mar. 10, 1989).

<sup>202</sup> "Issuing public corporation" is defined as a Texas corporation that has 100 or more shareholders of record, has a class of voting shares registered under the Securities Exchange Act of 1934, or has a class of voting shares qualified for trading on a national market system. TBCA arts. 13.02(A)(6), 13.03; TBOC §§ 21.601(1), 21.606. These TBCA and TBOC provisions do not apply to corporations that are organized under the laws of another state, but that have a substantial nexus to Texas, because such a "foreign application" provision might jeopardize the constitutionality thereof. See, e.g., *Tyson Foods, Inc. v. McReynolds*, 700 F. Supp. 906, 910-14 (M.D. Tenn. 1988); *TLX Acquisition Corp. v. Telex Corp.*, 679 F. Supp. 1022, 1029-30 (W.D. Okla. 1987).

“business combination” (which includes a merger, share exchange, sale of assets, reclassification, conversion or other transaction between the issuing public corporation and any “affiliated shareholder”<sup>203</sup>)<sup>204</sup> for three years after the affiliated shareholder became such unless (iii) the “business combination” is approved by the holders of not less than two-thirds of the voting shares not beneficially owned by the affiliated shareholder at a meeting of shareholders held not less than six months after the affiliated shareholder became such or, prior to the affiliated shareholder becoming such, the board of directors approved either the business combination or the affiliated shareholder’s acquisition of the shares that made him an affiliated shareholder.<sup>205</sup> Tex. Corp. Stats. also confirm that a director, in discharging his duties, may consider the long-term, as well as the short-term, interests of the corporation and its shareholders.<sup>206</sup>

### III. GENERAL PARTNERSHIP.

A. **General.** Texas law will only recognize an association or organization as being a “partnership” if it was created under (1) the TBOC, (2) the TRPA, (3) the older Texas Uniform Partnership Act (“TUPA”),<sup>207</sup> (4) the Texas Revised Limited Partnership Act (“TRLPA”) <sup>208</sup> or (5) under a statute of another jurisdiction which is comparable to any of the Texas statutes referred to in (1), (2), (3), or (4) above.<sup>209</sup> If an association is created under a law other than those listed, then it is not a partnership. A “partnership” is defined as an association of two or more persons to carry on a business for profit, whether they intend to create a partnership and whether they call their association a partnership, a joint venture or other name.<sup>210</sup> The definition of a partnership is crucial in litigation in which a person is arguing that he is not a partner and that the partnership disadvantages (e.g., individual, and joint and several liability of the obligations of the partnership) should not be imposed upon him.

The TBOC governs all Texas general partnerships formed on or after January 1, 2006,<sup>211</sup> as well as those formed before that date which voluntarily opt in to TBOC governance.<sup>212</sup> Within the TBOC, Chapter 152 is specifically applicable to general partnerships, though many of the general provisions in Title 1 and Title 4, Chapters 151 and 154, will also apply. The TBOC provides that such provisions may be collectively known as “Texas General Partnership Law.”<sup>213</sup>

<sup>203</sup> “Affiliated shareholder” is defined as a shareholder beneficially owning 20% or more of the corporation’s voting shares and certain of its related persons. TBCA Art. 13.02(A)(2); TBOC § 21.602.

<sup>204</sup> TBCA Art. 13.02(A)(4); TBOC § 21.604.

<sup>205</sup> TBCA Art. 13.03 is based on DGCL § 203. *See also* TBOC § 21.606.

<sup>206</sup> TBCA Art. 13.06; TBOC § 21.401(b).

<sup>207</sup> Act of May 9, 1961, 57th Leg., R.S., ch. 158, 1961 Tex. Gen. Laws 289; Act of May 17, 1979, 66th Leg., R.S., ch. 723, § 5, 1979 Tex. Gen. Laws 1782; Act of May 9, 1985, 69th Leg., R.S., ch. 159, § 76, 1985 Tex. Gen. Laws 692; Act of May 9, 1991, 72d Leg., R.S., ch. 901, §§ 83–85, 1991 Tex. Gen. Laws 3161; Act of May 31, 1993, 73d Leg., R.S., ch. 917, § 2, 1993 Tex. Gen. Laws 102 (expired Jan. 1, 1999).

<sup>208</sup> TEX. REV. CIV. STAT. ANN. art. 6132a-1 (Vernon Supp. 2006).

<sup>209</sup> TRPA § 2.02; TBOC § 152.051(c).

<sup>210</sup> TEX. REV. CIV. STAT. ANN. art. 6132a § 6(a)(1) (Vernon 1970); TRPA § 2.02(a); TBOC § 152.051(b).

<sup>211</sup> TBOC § 402.001.

<sup>212</sup> TBOC § 402.003.

<sup>213</sup> TBOC § 1.008(f).

Until January 1, 2010 (at which time *all* partnerships will be governed by the TBOC),<sup>214</sup> all other Texas general partnerships will be governed by the TRPA.<sup>215</sup> Because until 2010 some general partnerships will be governed by the TRPA and others by the TBOC and because the substantive principles under both statutes are generally the same, the term “Tex. GP Stats.” is used herein to refer to the TBOC and the TRPA collectively, and the particular differences between the TRPA and the TBOC are referenced as appropriate.

1. Definition of “Person”. Any person may be a partner unless the person lacks capacity apart from the Tex. GP Stats. Under TRPA, a “person” is defined to include “individual[s], corporation[s], business trust[s], estate[s], trust[s], custodian[s], trustee[s], executor[s], administrator[s], nominee[s], partnership[s of any sort], association[s], limited liability compan[ies], government[s], governmental subdivision[s], governmental agenc[ies], etc.] . . . and any other legal or commercial entity.”<sup>216</sup> The definition of “person” under the new TBOC comes from the Government Code,<sup>217</sup> which provides that “[p]erson” includes corporation, organization, government or governmental subdivision or agency, business trust, estate, trust, partnership, association, and any other legal entity.”<sup>218</sup>

2. Factors Indicating Partnership. Under the Tex. GP Stats., the following factors indicate that persons have created a partnership<sup>219</sup>:

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

3. Factors Not Indicative of Partnership. Conversely, under Tex. GP Stats., the following circumstances do not individually indicate that a person is a partner in a business<sup>220</sup>:

- 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

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<sup>214</sup> TBOC § 402.005.

<sup>215</sup> TRPA § 11.03(c). Prior to January 1, 1999, some entities were still governed by the Texas Uniform Partnership Act. *See* TRPA § 11.03(a); Steven M. Cooper, *The Texas Revised Partnership Act and the Texas Uniform Partnership Act: Some Significant Differences*, 57 Tex. B. J. 828 (Sept. 1994).

<sup>216</sup> TRPA § 1.01(14).

<sup>217</sup> *See* Texas Government Code § 311.002 regarding application of the Government Code to construction of other Texas laws.

<sup>218</sup> Texas Government Code § 311.005.

<sup>219</sup> TRPA § 2.03(a); TBOC § 152.052(a).

<sup>220</sup> TRPA § 2.03(b); TBOC § 152.052(b).

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

- Co-ownership of property whether in the form of joint tenancy, tenancy in common, tenancy by the 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.<sup>221</sup>

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

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

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

\* \* \*

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

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

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

4. Joint Venture. The definition of a partnership under Tex. GP Stats. includes a “joint venture” or any other named association that satisfies the definition of “partnership.”<sup>222</sup> 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.<sup>223</sup> Because a joint venture is a type of partnership and loss sharing is not necessary to form a partnership, Tex. GP Stats. effectively overrule cases in the line represented by *Coastal Plains Development Corp. v. Micrea, Inc.*<sup>224</sup> They also resolve old questions about whether an agreement to share losses was necessary to create a partnership by providing that it is unnecessary.<sup>225</sup>

## **B. Taxation.**

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

2. Joint Venture/Tax Implications. A joint venture is commonly thought of as a limited duration partnership formed for a specific business activity.<sup>226</sup> 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.<sup>227</sup>

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.<sup>228</sup> 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.<sup>229</sup> Under certain circumstances, a partner’s contribution of property may result in a net reduction in liability to that partner in excess of the partner’s tax basis in the contributed property. In such a situation, the partner will recognize a gain to the extent of such excess. In addition, certain contributions can be treated as “disguised sales” of all or a portion of the contributed property by the partner to the partnership if the partner receives cash or other property (in addition to a partnership interest) in connection with the transfer.

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

<sup>222</sup> TRPA § 2.02; TBOC § 152.051(b).

<sup>223</sup> See 2 Alan R. Bromberg & Larry E. Ribstein, *Bromberg & Ribstein on Partnership*, § 2.06 (2003).

<sup>224</sup> See *Coastal Plains Dev. Corp. v. Micrea, Inc.*, 572 S.W.2d 285, 287–88 (Tex. 1978).

<sup>225</sup> TRPA § 2.03(c); TBOC § 152.052(c).

<sup>226</sup> See, e.g., *Tompkins v. Comm’r*, 97 F.2d 396 (4th Cir. 1938); *United States v. United States Nat’l Bank of Portland, Or.*, 239 F.2d 475, 475-80 (9th Cir. 1956).

<sup>227</sup> I.R.C. § 7701(a)(2).

<sup>228</sup> I.R.C. § 721(a). But see Treas. Reg. § 1.707-3 (2003) (discussing disguised sales).

<sup>229</sup> I.R.C. § 722, 723.



4. Texas Franchise Tax. As of the date of this publication, a general partnership is not obligated to pay any Texas franchise taxes.<sup>230</sup>

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.<sup>231</sup>

C. **Owner Liability Issues.** Under Tex. GP Stats.,<sup>232</sup> and typically under common law, a general partnership as an entity is liable for loss or injury to a person, as well as for a penalty caused by or incurred as a result of a wrongful act or omission of any of its partners acting either in the ordinary course of the business of the partnership or with authority of the partnership. Generally, except as provided for an LLP (which is hereinafter discussed), all partners of a general partnership are jointly and severally liable for all debts and obligations of the partnership unless otherwise agreed by a claimant or otherwise provided by law.<sup>233</sup> Provisions in a partnership agreement that serve to allocate liability among the partners are generally ineffective against third-party creditors.<sup>234</sup> A partner who is, however, forced to pay more than his allocable share of a particular liability should have a right of contribution under Tex. GP Stats. from the partnership or the other partners who did not pay their allocable share.<sup>235</sup>

A person admitted as a new partner into an existing general partnership in Texas does not have personal liability for an obligation of the partnership that arose before his admission if the obligation relates to an action taken or omission occurring prior to his admission or if the obligation arises before or after his admission under a contract or commitment entered into before his admission.<sup>236</sup>

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.<sup>237</sup> A withdrawn general partner may also be liable for actions committed by the partnership while he was a partner, including malpractice, even though the action was not adjudicated to be wrongful until after the partner withdrew from the firm.<sup>238</sup>

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<sup>230</sup> TEX. TAX CODE ANN. § 17.001(a)(1) (Vernon 2002 & Supp. 2004) (but see discussion at Section I(D)(2) above).

<sup>231</sup> I.R.C. § 1402(a).

<sup>232</sup> TRPA § 3.03; TBOC § 152.303.

<sup>233</sup> TRPA; TBOC § 152.304.

<sup>234</sup> J. CARY BARTON, TEXAS PRACTICE GUIDE: BUSINESS ENTITIES § 20.205 (2003); see *Fincher v. B & D Air Conditioning & Heating Co.*, 816 S.W.2d 509, 512 (Tex. App.—Houston [1st Dist.] 1991, writ denied).

<sup>235</sup> TRPA §§ 4.01(c), 8.06(c); TBOC §§ 152.203(d), 152.708.

<sup>236</sup> TRPA § 3.07; TBOC § 152.304(b).

<sup>237</sup> TRPA § 6.02(c).

<sup>238</sup> *In re Keck, Mahin & Cate*, 274 B.R. 740, 745–47 (Bankr. N.D. Ill. 2002). In *Keck*, the court explained:

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

In a change from old Texas law, a creditor under current Tex. GP Stats. must exhaust partnership assets before collecting a partnership debt from an individual partner on his joint and several liability, except in limited circumstances.<sup>239</sup> Previously, a creditor could obtain a judgment enforceable against an individual partner's assets without suing the partnership.<sup>240</sup> Generally, Tex. GP Stats. require that there be a judgment against the partnership and that the individual partner has been served in that action; however, a judgment against a partnership is not automatically a judgment against its partners.<sup>241</sup>

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

**D. Management.** Partners have wide latitude to provide in the partnership agreement how the partnership is to be managed. Unless the partnership agreement provides otherwise, each partner has an equal right to participate in the management of the business.<sup>242</sup> 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.<sup>243</sup> 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.<sup>244</sup>

## **E. Fiduciary Duties.**

1. **General.** Under Tex. GP Stats., a partner owes duties of loyalty and care to the partnership, the other partners, and the heirs, legatees or personal representatives of a

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liability of any partners . . . partners cannot release one another from liability to [non-consenting] third parties.”

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

<sup>239</sup> TRPA § 3.05; TBOC § 152.306.

<sup>240</sup> Act of May 9, 1961, 57th Leg., R.S., ch. 158, 1961 Tex. Gen. Laws 289; Act of May 17, 1979, 66th Leg., R.S., ch. 723, § 5, 1979 Tex. Gen. Laws 1782; Act of May 9, 1985, 69th Leg., R.S., ch. 159, § 76, 1985 Tex. Gen. Laws 692; Act of May 9, 1991, 72d Leg., R.S., ch. 901, §§ 83–85, 1991 Tex. Gen. Laws 3161; Act of May 31, 1993, 73d Leg., R.S., ch. 917, § 2, 1993 Tex. Gen. Laws 102, § 15 (expired Jan. 1, 1999).

<sup>241</sup> TRPA § 3.05(c); TBOC § 152.306(a).

<sup>242</sup> TRPA § 4.01(d); TBOC § 152.203(a).

<sup>243</sup> TRPA § 3.02; TBOC §§ 152.301, 152.302.

<sup>244</sup> TRPA § 4.05; TBOC §§ 152.210, 152.302.

deceased partner to the extent of their respective partnership interests.<sup>245</sup> These duties are fiduciary in nature although not so labeled.<sup>246</sup>

2. Loyalty. The duty of loyalty requires a general partner to place the interests of the partnership ahead of his own interests.<sup>247</sup> It requires a partner to account to the partnership for any partnership asset received or used by the partner and prohibits a partner from competing with the partnership or dealing with the partnership in an adverse manner. The following fact patterns may evidence a breach of the fiduciary duty of loyalty in the general partnership context on the part of general partners, creating liability to the partnership or the other partners:

- Self-dealing or profiting from dealing with the partnership in ways not contemplated by the partnership agreement;
- Appropriation of partnership opportunities;
- Refusal to distribute profits to other members of the partnership;
- Diversion of an asset of the partnership for a non-intended use;
- Failure to disclose plans and conflicts to partners; and
- A general lack of candor with partners.<sup>248</sup>

3. Care. The duty of care requires a partner to act as an ordinarily prudent person would act under similar circumstances.<sup>249</sup> 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.<sup>250</sup>

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<sup>245</sup> TRPA § 4.04; TBOC § 152.204.

<sup>246</sup> See *Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193, 199–200 (Tex. 2002) (asserting that since the court historically has held that partners owe certain fiduciary duties to other partners, it did not have to consider the impact of the TRPA on such duties).

<sup>247</sup> *Meinhard v. Salmon*, 249 NY 458, 164 N.E. 545 (1928), in which Justice Cardozo wrote:

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

<sup>248</sup> See TRPA § 4.04(b); TBOC § 152.205; *Bromberg & Ribstein on Partnership* § 6.07 (2003).

<sup>249</sup> TRPA § 4.04(c); TBOC § 152.206(a).

<sup>250</sup> TRPA §§ 4.04(c), (d); TBOC §§ 152.204(b), 152.206(c).

4. Candor. In addition to the duties of loyalty and care, a partner owes his co-partners a fiduciary duty of candor, sometimes referred to as a duty of disclosure.<sup>251</sup>

5. Liability. A partner is liable to the partnership and the other partners for violation of a statutory duty that results in harm to the partnership or the other partners and for a breach of the partnership agreement.<sup>252</sup> Tex. GP Stats. provide that a partner, in that capacity, is not a trustee and is not held to the same standards as a trustee,<sup>253</sup> which represents a change from cases under TUPA.<sup>254</sup> A managing partner stands in a higher fiduciary relationship to other partners than partners typically occupy.<sup>255</sup>

6. Effect of Partnership Agreement. A partnership agreement governs the relations of the partners, but may not (i) unreasonably restrict a partner's statutory rights of access to books and records, (ii) eliminate the duty of loyalty, although the agreement may within reason identify specific types or categories of activities that do not violate the duty of loyalty, (iii) eliminate the duty of care, although the agreement may within reason determine the standards by which the performance of the obligation is to be measured, (iv) eliminate the obligation of good faith, although the agreement may within reason determine the standards by which the performance of the obligation is to be measured, (v) vary the power to withdraw as a partner, except to require the notice be in writing, or (vi) vary certain other requirements.<sup>256</sup>

**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.<sup>257</sup> Texas law differentiates between a transfer of a partner's partnership interest and the admission of a successor as a general partner. A transferee is neither

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<sup>251</sup> *Bromberg & Ribstein on Partnership* §§ 6.05(c) and 6.06 (2003).

<sup>252</sup> TRPA § 4.05; TBOC § 152.210.

<sup>253</sup> TRPA § 4.04(f); TBOC § 152.204(d).

<sup>254</sup> See *Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.) (holding that a managing partner owes his co-partners the highest fiduciary duty recognized in the law).

<sup>255</sup> See, e.g., *Hughes v. St. David's Support Corp.*, 944 S.W.2d 423 (Tex. App.—Austin 1997, writ denied); *Conrad v. Judson*, 465 S.W.2d 819, 828 (Tex. Civ. App.—Dallas 1971, writ ref'd n.r.e.); *Huffington*, 532 S.W.2d at 579; see also *Brazosport Bank of Tex. v. Oak Park Townhouses*, 837 S.W.2d 652, 659 (Tex. App.—Houston [14th Dist.] 1992), rev'd on other grounds, 851 S.W.2d 189 (Tex. 1993) (noting that a fiduciary relationship exists between general partners, as well as between general and limited partners); *Crenshaw*, 611 S.W.2d at 890.

<sup>256</sup> TRPA § 1.03(b); TBOC § 152.002.

<sup>257</sup> See TRPA § 5.03; TBOC §§ 152.401, 152.402(3).

able to participate in management nor liable as a partner solely because of a transfer unless and until he becomes a partner, but such transferee is entitled to receive, to the extent transferred, distributions to which the transferor would otherwise be entitled.<sup>258</sup> 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.<sup>259</sup> 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.<sup>260</sup> General partnership interests may be evidenced by transferable certificates, but ordinarily no such certificates are issued.<sup>261</sup>

2. Partnership Interests as Securities. Under the Securities Act of 1933, the Securities Exchange Act of 1934, and most state blue sky laws, the term “security” is defined to include an “investment contract.”<sup>262</sup> Neither federal securities act defines a partnership interest, whether general or limited, as a “security.” However, by overwhelming precedent, limited partnership interests are considered investment contracts for purposes of the securities laws.<sup>263</sup> The question of whether a general partnership interest is a security requires a case-by-case analysis. A general partner interest may be a security when the venture, 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*,<sup>264</sup> the court stated that a general partnership or joint venture interest may be categorized as a security if the investor can show that

(1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.<sup>265</sup>

While quoting from the *Williamson* case, the *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.* 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

<sup>258</sup> See TRPA §§ 5.02, 5.03 and 5.04; TBOC §§ 152.402(3), 152.404(a), (c).

<sup>259</sup> TRPA § 5.03(a); TBOC §§ 152.402(1), (2).

<sup>260</sup> TRPA § 4.01(g); TBOC § 152.201.

<sup>261</sup> TRPA § 5.02(b); TBOC § 3.201.

<sup>262</sup> Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2000); Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (2000).

<sup>263</sup> See *S.E.C. v. Murphy*, 626 F.2d 633, 640 (9th Cir. 1980) (concluding that shares in LPs fall within the definition of “securities,” as investors had no managerial role); *Stowell v. Ted S. Finkel Inv. Servs., Inc.*, 489 F. Supp. 1209, 1220 (S.D. Fla. 1980), *aff’d*, 64 F.2d 323 (5th Cir. 1981) (stating that the issue is whether the limited partnership interest meets the test of an investment contract).

<sup>264</sup> 645 F.2d 404, 424 (5th Cir. 1981) *cert. denied*, 454 U.S. 897 (1981).

<sup>265</sup> *But cf., Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236 (4th Cir. 1988).

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.”<sup>266</sup> The fact that some of the general partners may have remained passive should not affect the result.<sup>267</sup>

**H. Continuity of Life.** Under Tex. GP Stats., a partnership will continue after the withdrawal of a partner or an event requiring a winding up of the business of the partnership until the winding up of the partnership has been completed.<sup>268</sup> The statutes provide for “events of withdrawal” and “events of winding up.”<sup>269</sup> Upon the occurrence of an event of withdrawal, the business of the partnership is not required to be wound up.<sup>270</sup> An event of withdrawal occurs (i) upon the occurrence of events specified in the partnership agreement, (ii) when the partnership receives notice of a partner’s election to withdraw, (iii) upon the expulsion of a partner by partner vote or judicial decree in statutorily specified circumstances, or (iv) upon the death or bankruptcy of a partner, among other events.<sup>271</sup> Except for the partner’s right to withdraw, the statutory events of withdrawal may be modified by the partnership agreement,<sup>272</sup> and in view of the Check-the-Box Regulations, modification may become increasingly appropriate and common. Although a partner may withdraw from the partnership at any time, the withdrawal may subject the withdrawing partner to liability and various penalties if he or she violates the partnership agreement or the withdrawal is otherwise wrongful.<sup>273</sup> Unless the partnership agreement provides otherwise,<sup>274</sup> the interest of a withdrawing partner (except for a partner who wrongfully withdraws) must be redeemed by the partnership at fair market value.<sup>275</sup> 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.<sup>276</sup>

**I. Formation.** A general partnership can be one of the simplest, least expensive business entities to form because the existence of a partnership does not depend on the existence or filing of any particular document, but rather depends on the existence of an association of two or more persons carrying on, as co-owners, a business for profit.<sup>277</sup> The factors discussed in Part

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<sup>266</sup> *Rivanna*, 840 F.2d at 241.

<sup>267</sup> *Id.*

<sup>268</sup> TRPA §§ 2.06(a), 8.02; TBOC §§ 152.502, 152.701.

<sup>269</sup> TRPA §§ 1.01(6), (7); 6.01(b), 8.01; TBOC §§ 11.051, 11.057, 152.501(b).

<sup>270</sup> TRPA § 2.06(a), TBOC § 152.502.

<sup>271</sup> TRPA § 6.01; TBOC § 152.501(b).

<sup>272</sup> TRPA § 1.03; TBOC § 152.002.

<sup>273</sup> TRPA § 6.02; TBOC § 152.503.

<sup>274</sup> TRPA § 1.03; TBOC § 152.002.

<sup>275</sup> TRPA § 7.01; TBOC §§ 152.601-152.602. In the case of a partner who wrongfully withdraws, the redemption price is the lesser of fair market value or liquidation value. *Id.*

<sup>276</sup> TRPA § 8.01; TBOC § 11.057.

<sup>277</sup> TRPA § 2.02(a); TBOC § 152.051.

III.A. are used to determine whether or not a general partnership exists.<sup>278</sup> Thus, it is not necessary that any written partnership agreement exists or that any significant expenses be incurred in the formation of a partnership.<sup>279</sup> Most of the time, however, partners will wish to have their relationship governed by a partnership agreement rather than rely on the default statutory provisions, and partnership agreements can be very complex.

Under Tex. GP Stats., a partnership agreement, which does not have to be in writing, governs the relations of the partners and the relations between the partners and the partnership; to the extent the partnership agreement does not otherwise provide, Tex. GP Stats. governs those relationships.<sup>280</sup> 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.<sup>281</sup> 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.<sup>282</sup>

Because partners are granted wide contractual freedom to specify the terms of their partnership, "standard" partnership agreements are less likely to be useful. Additionally, the time and expense of preparing a partnership agreement can be significant. For these reasons, the cost of organizing a general partnership is usually higher than the cost of organizing a corporation.

**J. Operations in Other Jurisdictions.** A general partnership does not qualify to do business as a foreign general partnership under the laws of other states, although the partnership may have to file tax returns and the partners may be subject to taxation in the other states in which the partnership does business.<sup>283</sup>

**K. Business Combinations.** Texas law now authorizes a partnership to merge with a corporation, LLC or another partnership, as well as to convert from one form of entity into another without going through a merger or transfer of assets.<sup>284</sup> Article IX of the TRPA and

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<sup>278</sup> TRPA § 2.03(a); TBOC § 152.052(a).

<sup>279</sup> See *Pappas v. Gounaris*, 301 S.W.2d 249, 254 (Tex. Civ. App.—Galveston 1957, writ ref'd n.r.e.).

<sup>280</sup> TRPA § 1.03(a); TBOC § 152.002(a).

<sup>281</sup> TRPA § 1.03(b); TBOC § 152.002(b).

<sup>282</sup> See TRPA § 4.01(b); TBOC § 152.202(c).

<sup>283</sup> Cf. TRPA § 9.05(a) (acknowledging that the laws of other states apply to a partnership looking to be bound by that jurisdiction's law as a domestic partnership); see also TBOC § 10.101(d).

<sup>284</sup> TRPA §§ 9.01-9.06; TBOC Chapter 10.

Chapter 10 of the TBOC include provisions relating to the mechanics of adopting a plan of merger or conversion, obtaining owner approval, filing with the Secretary of State and protecting creditors.<sup>285</sup>

#### **IV. LIMITED PARTNERSHIP.**

**A. General.** A “limited partnership” is a partnership formed by two or more persons, with one or more general partners and one or more limited partners.<sup>286</sup> Limited partnerships are statutorily authorized entities. Most states have adopted some form of the Uniform Limited Partnership Act or the Revised Uniform Limited Partnership Act to govern the rights, duties and liabilities of limited partnerships organized under such statutes. In Texas, domestic limited partnerships are governed by either the Texas Revised Limited Partnership Act (“TRLPA”)<sup>287</sup> or the TBOC.<sup>288</sup> Because until 2010 some limited partnerships will be governed by the TRLPA and others by the TBOC and because the substantive principles under both statutes are generally the same, the term “Tex. LP Stats.” is used herein to refer to the TBOC and the TRPA collectively, and the particular differences between the TRLPA and the TBOC are referenced as appropriate.

Similarly to other entities under Texas law, limited partnerships formed prior to January 1, 2006 which do not voluntarily opt into the TBOC will continue to be governed by the TRLPA until January 1, 2010.<sup>289</sup> All other Texas limited partnerships are governed by the TBOC.<sup>290</sup>

#### **B. Taxation.**

1. Federal Income Taxation. A domestic limited partnership would ordinarily be treated as a partnership for federal income tax purposes under the Check-the-Box Regulations so long as it has two or more partners.<sup>291</sup>

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.<sup>292</sup> 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.<sup>293</sup> Under certain

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<sup>285</sup> *Id.*; TBOC §§ 10.001-10.009; 10.101-10.151; 10.154-10.201.

<sup>286</sup> TRLPA § 1.02(6); TBOC § 1.002(50).

<sup>287</sup> TEX. REV. CIV. STAT. ANN. art. 6132a-1 (Vernon Supp. 2006).

<sup>288</sup> The TBOC provisions relating to limited partnerships are Title 1 and Chapters 151, 153, and 154. Such provisions may officially and collectively be referred to as “Texas Limited Partnership Law.” TBOC § 1.008(g).

<sup>289</sup> TRLPA § 13.10.

<sup>290</sup> TBOC §§ 401.001, 402.003.

<sup>291</sup> *See* Treas. Reg. § 301.7701-2(c)(1) (as amended in 2003).

<sup>292</sup> I.R.C. § 721(a). *But see* Treas. Reg. § 1.707-3 (1992) (discussing disguised sales).

<sup>293</sup> I.R.C. §§ 722, 723.



circumstances, a partner's contribution of property may result in a net reduction in liability<sup>294</sup> 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.<sup>295</sup> In addition, certain contributions can be treated as "disguised sales" of all or a portion of the contributed property by the partner to the partnership if the partner receives cash or other property (in addition to a partnership interest) in connection with the transfer.

3. Texas Franchise Tax. A limited partnership is not subject to the Texas franchise tax, although there have been proposals to amend Texas' tax laws to make limited partnerships subject to the Texas franchise tax.<sup>296</sup>

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.<sup>297</sup> Guaranteed payments made to a limited partner by the partnership for services rendered and the general partner's share of the net earnings of trade or business income of a limited partnership generally will be subject to self-employment tax. On January 13, 1997, the IRS issued proposed regulations under IRC § 1402 that would define "limited partner" for employment tax purposes as follows, irrespective of the partner's status under state law, as follows:

"Generally, an individual will be treated as a limited partner under the proposed regulations unless the individual (1) has personal liability (as defined in 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."<sup>298</sup>

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.<sup>299</sup>

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<sup>294</sup> I.R.C. § 752.

<sup>295</sup> I.R.C. § 731.

<sup>296</sup> See TEX. TAX CODE ANN. § 171.001 (Vernon 2002 & Supp. 2004).

<sup>297</sup> I.R.C. § 1402(a)(13); see Robert G. Fishman, *Self-Employment Tax, Family Limited Partnerships and the Partnership Anti-Abuse Regulations*, 74 Taxes 689 (No. 11, Nov. 1996).

<sup>298</sup> Definition of Limited Partner for Self-Employment Tax Purposes, Prop. Reg. 1.1402(a)-2(h), 62 Fed. Reg. 1702-01 (Jan. 13, 1997).

<sup>299</sup> *Id.*

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.<sup>300</sup> 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.<sup>301</sup> 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.<sup>302</sup>

**C. Owner Liability Issues.** A general partner of a limited partnership has the same unlimited liability as does a partner of a general partnership.<sup>303</sup> 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).<sup>304</sup> A limited partner may lose this limited liability, however, if he or she participates in the management of partnership business.<sup>305</sup> The safe harbor provisions of Tex. LP Stats. specify activities that will not subject a limited partner to unlimited liability, such as consulting with and advising a general partner, acting as a contractor for or an agent or employee of the limited partnership or of a general partner, proposing, approving or disapproving certain specified matters related to the partnership business or the winding up of the partnership business or guaranteeing specific obligations of the limited partnership.<sup>306</sup> Even if the limited partner’s activities exceed the safe harbors, the limited partner will only have unlimited liability to those third parties dealing with the limited partnership who have actual knowledge of the limited partner’s participation and control and who reasonably believe that the limited partner is a general partner based on the limited partner’s conduct.<sup>307</sup> Under the TRLPA, though not under the TBOC, a limited partner who knowingly permits his name to be used in the name of the partnership will be liable to creditors who extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner.<sup>308</sup> A corporation can serve as the general partner of a limited partnership, although the ordinary grounds for piercing the corporate veil (e.g. if the corporate general partner is not sufficiently capitalized in light of known and contingent liabilities) may be applied to hold the shareholders of such a corporate general partner liable in certain factual contexts.<sup>309</sup>

Tex. LP Stats. authorize a limited partnership to register as an LLP by complying with the LLP provisions of TRPA or TBOC discussed below, whereupon the general partner would be

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<sup>300</sup> Taxpayer Relief Act of 1997, Pub. L. 105-34, 105th Cong. § 935 (1997) (enacted).

<sup>301</sup> Taxpayer Relief Act of 1997, H.R. 2014, 105th Cong. § 734 (1997) (enacted).

<sup>302</sup> S. 949, 105th Cong. § 734 (1997).

<sup>303</sup> See TRLPA §§ 4.01(d), 4.03(a); TBOC § 153.152.

<sup>304</sup> See TRLPA § 3.03; TBOC § 153.102.

<sup>305</sup> *Id.*

<sup>306</sup> TRLPA § 3.03(b); TBOC § 153.103.

<sup>307</sup> TRLPA § 3.03(a); TBOC § 153.102(b).

<sup>308</sup> TRLPA § 3.03(d); Revisor’s Note to TBOC § 153.102.

<sup>309</sup> See *Grierson v. Parker Energy Partners 1984-I*, 737 S.W.2d 375, 377–78 (Tex. App.—Houston [14th Dist.] 1987, no writ) (stating that in tortious activity, the corporate veil of a corporate general partner need not be pierced in order to impose liability, thus implying the veil may be pierced in other circumstances).

liable for the debts or obligations of the limited partnership only to the extent provided in TRPA § 3.08(a) or TBOC § 152.801.<sup>310</sup>

**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.<sup>311</sup> Therefore, management of a limited partnership tends to be centralized in the general partner or partners, although safe harbor provisions in most modern limited partnership statutes give limited partners greater latitude in certain matters of management of the limited partnership than was given previously.<sup>312</sup> Under Tex. LP Stats., the partnership agreement may provide for multiple classes or groups of limited partners having various rights or duties, including voting rights.<sup>313</sup>

**E. Fiduciary Duties.** Case law has adopted fiduciary standards for general partners of limited partnerships mirroring the unbending fiduciary standards espoused in general partnership cases.<sup>314</sup> Because of their control over partnership affairs, general partners may be subjected to an even higher fiduciary standard with respect to limited partners.<sup>315</sup> Those in control of the general partner have been held to the same high standards.<sup>316</sup>

Since a general partner in a limited partnership has the powers, duties and liabilities of a partner in a general partnership unless applicable law or the partnership agreement provides otherwise,<sup>317</sup> a general partner in a limited partnership has the duties of care and loyalty set forth in TRPA § 4.04 and TBOC § 152.204, which basically codify those duties without giving them the “fiduciary” appellation. Since Tex. LP Stats. provide that a general partner’s conduct is not to be measured by trustee standards,<sup>318</sup> it may no longer be appropriate to measure general

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<sup>310</sup> TRPA § 3.08(e); TRLPA § 2.14; TBOC §§ 152.805, 153.351, 153.353.

<sup>311</sup> TRLPA § 4.03(a); TBOC § 153.152.

<sup>312</sup> TRLPA § 3.03; TBOC §§ 153.102, 153.103.

<sup>313</sup> TRLPA § 3.02; TBOC § 154.101.

<sup>314</sup> See *Hughes v. St. David’s Support Corp.*, 944 S.W.2d 423, 425–26 (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 the beneficiaries of a trust.”); *McLendon v. McLendon*, 862 S.W.2d 662, 676 (Tex. App.—Dallas 1993, writ denied) (“In a limited partnership, the general partner acting in complete control stands in the same fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of a trust.”); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. Civ. App.—Austin 1980, writ ref’d n.r.e.) (same); *Watson v. Ltd. Partners of WCKT, Ltd.*, 570 S.W.2d 179, 182 (Tex. Civ. App.—Austin 1978, writ ref’d n.r.e.) (same); Robert W. Hamilton, *Corporate General Partners of Limited Partnerships*, 1 J. SMALL & EMERGING BUS. L. 73, 73 (1997) (“General partners are personally liable for all partnership obligations, including breaches of fiduciary duties owed to the limited partners.”); see also *Huffington v. Upchurch*, 532 S.W.2d 576 (Tex. 1976); *Johnson v. Peckham*, 120 S.W.2d 786 (Tex. 1938); *Kunz v. Huddleston*, 546 S.W.2d 685 (Tex. Civ. App.—El Paso 1977, writ ref’d n.r.e.).

<sup>315</sup> In *Palmer v. Fuqua*, 641 F.2d 1146, 1155 (5<sup>th</sup> 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].”

<sup>316</sup> See *In re Bennett*, 989 F.2d 779, 790 (5<sup>th</sup> Cir. 1993) (explaining that when a partner is in complete control of the partnership, the partner owes the highest level of fiduciary duty).

<sup>317</sup> TRLPA §§ 4.03(b), 13.03; TBOC §§ 153.003, 153.152.

<sup>318</sup> TRPA § 4.04(f); TBOC § 152.204(d).

partner conduct in terms of trustee fiduciary standards. Courts, however, continue to refer to the trustee standard.<sup>319</sup>

A partner owes the duties of care and loyalty to the partnership and the other partners.<sup>320</sup> Tex. LP Stats. define the duty of care as requiring a partner to act in the conduct and winding up of the partnership business with the care of an ordinarily prudent person under similar circumstances.<sup>321</sup> 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.<sup>322</sup> These provisions draw on the corporate business judgment rule in articulating the duty of care. Nevertheless, Texas law does not specify whether the standard of care is one of simple or gross negligence. The sparse case law in this area (pre-dating the TRPA) indicates that a partner will not be held liable for mere negligent mismanagement.<sup>323</sup>

In Texas, the duty of loyalty is defined as including<sup>324</sup>:

1. accounting to the partnership and holding for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or from use by the partner of partnership property;
2. refraining from dealing with the partnership on behalf of a party having an interest adverse to the partnership; and
3. refraining from competing with the partnership or dealing with the partnership in a manner adverse to the partnership.

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).<sup>325</sup> To temper some of the broader expressions of partner duties in older Texas case law and permit a balancing analysis as in the corporate cases, Texas law specifically states that a partner does not breach a duty merely because his conduct furthers his own interest and that the trustee standard should not be used to test general partner conduct.<sup>326</sup> It does, however, impose on a general partner in a limited partnership the obligation to discharge any duty, and exercise any rights or powers, in

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<sup>319</sup> See *Hughes v. St. David's Support Corp.*, 944 S.W.2d 423 (Tex. App.—Austin 1997, writ denied).

<sup>320</sup> TRPA § 4.04(a); TBOC § 152.204(a).

<sup>321</sup> TRPA § 4.04(c); TBOC § 152.206.

<sup>322</sup> TRPA § 4.04(c), (d); TBOC §§ 152.204(b), 152.206.

<sup>323</sup> See *Ferguson v. Williams*, 670 S.W.2d 327, 331 (Tex. App.—Austin 1984, writ ref'd n.r.e.).

<sup>324</sup> TRPA § 4.04(b); TBOC § 152.205.

<sup>325</sup> Under Texas law, persons engaged in a partnership owe to one another one of the highest duties recognized in law—the duty to deal with one another with the utmost good faith and most scrupulous honesty. *Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976); *Smith v. Bolin*, 271 S.W.2d 93, 96 (Tex. 1954); *Johnson v. J. Hiram Moore, Ltd.*, 763 S.W.2d 496 (Tex. App.—Austin 1988, writ denied); see also *Brazosport Bank of Tex. v. Oak Park Townhouses*, 837 S.W.2d 652, 659 (Tex. App.—Houston [14th Dist.] 1992), rev'd on other grounds, 851 S.W.2d 189 (Tex. 1993); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.).

<sup>326</sup> TRPA § 4.04(f); TBOC § 152.204(c), (d).

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.<sup>327</sup>

The TBOC makes it clear that *limited* partners, as limited partners, generally do not owe fiduciary duties to the partnership or to other partners.<sup>328</sup> Previously, a literal reading of the TRPA and TRLPA suggested that limited partners owed such duties by virtue of the linkage of TRPA to TRLPA under TRLPA § 13.03. That literal interpretation of the statutes, however, was contrary to the general concept that limited partners are merely passive investors and thus should not be subjected to liability for their actions as limited partners. Further, even before the TBOC was enacted there was some case law to the effect that limited partners do not have fiduciary duties.<sup>329</sup> An exception is made to this general rule in the case where a limited partner actually has or exercises control in management matters (e.g., because of control of the general partner, contractual veto powers over partnership actions or service as an agent of the partnership). In such situations, the limited partner's conduct may be judged by fiduciary principles.<sup>330</sup>

The Tex. LP Stats. state in part that except as provided in various statutory provisions or the partnership agreement, a general partner of a limited partnership “has the liabilities of a partner in a partnership without limited partners to the partnership and to the other partners.”<sup>331</sup> This language indicates that the partnership agreement may modify the internal liabilities of a general partner, but it is not clear whether it is an authorization without express limits or whether it would link to Texas general partnership statutes that prohibit elimination of duties and set a “manifestly unreasonable” floor for contractual variation.<sup>332</sup> Delaware also allows the limitation

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<sup>327</sup> TRPA § 4.04(d); TBOC § 152.204(b).

<sup>328</sup> TBOC § 153.003(b), (c).

<sup>329</sup> See, e.g., *In re Villa West Assocs.*, 146 F.3d 798, 806 (10<sup>th</sup> Cir. 1998); *In re Kids Creek Partners, L.P.*, 212 B.R. 898, 937 (Bankr. N.D. Ill. 1997).

<sup>330</sup> See *RJ Assocs., Inc. v. Health Payors' Org. Ltd. P'ship, HPA, Inc.*, No. 16873, 1999 WL 550350, at \*10 (Del. Ch. July 16, 1999) (unpublished mem. op.) (suggesting that, unless a partnership agreement provides to the contrary, any limited partner owes fiduciary duties to the partnership); *KE Prop. Mgmt. Inc. v. 275 Madison Mgmt. Inc.*, Civ. A. No. 12683, 1993 WL 285900, at \*4 (Del. Ch. July 27, 1993) (unpublished mem. op.). Limited partners who function as officers or managers of a limited partnership are typically considered agents of the limited partnership, and as agents to owe fiduciary duties, including the duty of loyalty, to the limited partnership and its other partners. See American Law Institute, *Restatement of the Law of Agency* 2<sup>nd</sup> (1958) §§ 13 (“An agent is a fiduciary with respect to matters within the scope of his agency”), 387 (“Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency”), 393 (“Unless otherwise agreed, an agent is subject to a duty not to compete with the principal concerning the subject matter of his agency”), 394 (“Unless otherwise agreed, an agent is subject to a duty not to act or to agree to act during the period of his agency for persons whose interests conflict with those of the principal in matters in which the agent is employed”), and 395 (“Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge”); see also *Daniel v. Falcon Interest Realty Corp.*, \_\_\_ S.W.3d \_\_\_ (Tex. App.—\_\_\_\_\_ 2006).

<sup>331</sup> TRLPA § 4.03(b); TBOC § 153.152(a). Note, this language should *not* be mistaken as an authorization for partnership agreements to alter partner liabilities to third parties.

<sup>332</sup> See TRPA § 1.03(b); TBOC § 152.002. One additional point applies to limited partnerships that continue to be governed by the TRLPA. When originally drafted, it was the intent of the Partnership Law

of partner fiduciary duties in the partnership agreement.<sup>333</sup> Although limitations on fiduciary duty in a partnership agreement may be respected by courts when they are expressly set forth in the four corners of the partnership agreement, “a topic as important as this should not be addressed coyly.”<sup>334</sup>

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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. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 4.03 bar committee’s cmt. (Vernon Supp. 2004). Given the subsequent adoption of the TRPA, with its more flexible approach to contractual modifications of the statutory provisions, and the linkage provision contained in Section 13.03 of the TRLPA, there is some question as to whether the more restrictive approach of the TRLPA to contractual modifications continues to have any application. Cf. TEX. REV. CIV. STAT. ANN. art. 6132b-1.03 bar committee’s cmt. (Vernon Supp. 2004). Thus, a prudent course for limited partnerships formed before January 1, 2006 was to draft the partnership agreement as if the flexibility afforded by the TRPA applied, but to be aware that any provisions of the partnership agreement that varied the requirements of the TRLPA without express statutory authority were subject to challenge.

“Partnership agreement” is defined to be either a written *or oral* agreement of the partners concerning the affairs of the partnership and the conduct of its business. See TRLPA § 1.02(11); TBOC § 151.001(5).

Some TRLPA provisions permit modification by either a written or oral partnership agreement, while others require the modification to be in the form of a written partnership agreement. Compare TRLPA § 4.03(a) and TBOC § 153.152 concerning restrictions on a general partner with TRLPA § 11.02 and TBOC § 8.103(c) concerning indemnification of a general partner.

<sup>333</sup> Section 17-1101(d) of the Delaware Revised Limited Partnership Act (“DRLPA”), DEL. CODE ANN. tit. 6, § 17-1101(d) (Supp. 2002), 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.

DEL. CODE ANN. tit. 6, § 17-1101(d) (Supp. 2002).

<sup>334</sup> *Miller v. Am. Real Estate Partners, L.P.*, No. CIV.A.16788, 2001 WL 1045643, at \*8 (Del. Ch. Sept. 6, 2001) (unpublished mem. op.). In *Miller*, the general partner contended that the partnership agreement eliminated any default fiduciary duty of loyalty owed by the general partner to the limited partners in § 6.13(d) of the partnership agreement, which read as follows:

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

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

This is yet another case in which a general partner of a limited partnership contends that the partnership agreement eliminates the applicability of default principles

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

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

This case presents a twist on *Gotham Partners* and *Gelfman*. Like the provisions in *Gotham Partners* and *Gelfman*, § 6.13(d) sets forth a sole discretion standard that appears to be quite different from the duty of a fiduciary to act with procedural and substantive fairness in a conflict situation. What is different about § 6.13(d), however, is that it does not expressly state that default provisions of law must give way if they hinder the General Partner's ability to act under the sole discretion standard. Rather, § 6.13(d) merely states that other standards in the Agreement or 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.

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

Under Tex. LP Stats., the duties of care and loyalty and the obligation of good faith may not be eliminated by the partnership agreement, but the statute leaves room for some modification by contract.<sup>335</sup> For example, the partnership agreement may not eliminate the duty of care but may determine the standards by which the performance of the obligation is to be measured, if the standards are not “manifestly unreasonable.”<sup>336</sup> In one case decided prior to the passage of the TRPA and the TBOC, the court stated that, when the parties bargain on equal terms, a fiduciary may contract for the limitation of liability, though public policy would preclude limitation of liability for self-dealing, bad faith, intentional adverse acts, and reckless indifference with respect to the interest of the beneficiary.<sup>337</sup>

With respect to a partner’s duty of loyalty, Tex. LP Stats. provide that the partnership agreement may not eliminate the duty of loyalty, but may identify specific types or categories of activities that do not violate the duty of loyalty, again if not “manifestly unreasonable.”<sup>338</sup> The level of specificity required of provisions in the partnership agreement limiting duties pursuant to Tex. LP Stats. is unknown. In fact, it may depend upon the circumstances, such as the sophistication and relative bargaining power of the parties, the scope of the activities of the partnership, etc.

Tex. LP Stats. provide that the obligation of good faith may not be eliminated by the partnership agreement, but the agreement may determine the standards by which the performance is to be measured if not “manifestly unreasonable.”<sup>339</sup> Again the parameters of this provision are not readily apparent and probably will depend, at least in part, on the circumstances of any particular case. Texas law requires a limited partnership to keep in its registered office, and make available to the partners for copying and inspection, certain minimum books and records of the partnership.<sup>340</sup> This mandate provides a statutory mechanism by which a partner may obtain the documents specified therein, but should not be viewed as in any way limiting a general partner’s broader fiduciary duty of candor regarding partnership affairs as developed in case law and as provided in Tex. LP Stats.<sup>341</sup>

**F. Indemnification.** A limited partnership is required to indemnify a general partner who is “wholly successful on the merits or otherwise” unless indemnification is limited or

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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.

<sup>335</sup> TRLPA §§ 4.03(b), 13.03(a); TRPA § 1.03(b); TBOC §§ 152.002(b); 153.003(a).

<sup>336</sup> TRLPA §§ 4.03(b), 13.03(a); TRPA § 1.03(a)(3); TBOC § 152.002(b)(3).

<sup>337</sup> *Grider v. Boston Co., Inc.*, 773 S.W.2d 338, 343 (Tex. App.-Dallas 1989, writ denied).

<sup>338</sup> TRLPA §§ 4.03(b), 13.03(a); TRPA § 1.03(b)(2); TBOC §§ 152.002(b)(2), 153.003(a).

<sup>339</sup> TRLPA §§ 4.03(b), 13.03(a); TRPA § 1.03(b)(4); TBOC §§ 152.002(b)(4), 153.003(a).

<sup>340</sup> TRLPA § 1.07; TBOC § 153.551.

<sup>341</sup> See TRPA § 4.03; TBOC §§ 153.551, 153.552.



prohibited by a written partnership agreement.<sup>342</sup> 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.<sup>343</sup> 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.<sup>344</sup> 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.<sup>345</sup> General partners may only be indemnified to the extent consistent with the statute.<sup>346</sup> 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.<sup>347</sup> Insurance providing coverage for unindemnifiable areas is expressly permitted.<sup>348</sup>

**G. Flexibility In Raising Capital.** Limitations on liability and more centralized management make the limited partnership a more suitable entity for raising capital than the general partnership. However, the limited partnership's usefulness with respect to raising capital is limited by restrictions on the ability of owners to deduct passive losses for federal income tax purposes.

Under Tex. LP Stats., contributions to a limited partnership by either a general or a limited partner may consist of any tangible or intangible benefit to the limited partnership or other property of any kind or nature, including cash, a promissory note, services performed, a contract for services to be performed, other interests in or securities of the limited partnership, or interests or securities of any other limited partnership, domestic or foreign, or other entity.<sup>349</sup> However, a conditional contribution obligation, including a contribution payable upon a discretionary call prior to the time the call occurs, may not be enforced until all conditions have been satisfied or waived.<sup>350</sup>

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<sup>342</sup> TRLPA §§ 11.08, 11.21; TBOC §§ 8.003, 8.051.

<sup>343</sup> TRLPA §§ 11.03, 11.05; TBOC § 8.102(b).

<sup>344</sup> TRLPA § 11.02; TBOC § 8.101(a).

<sup>345</sup> TRLPA § 11.03; TBOC § 8.102(b).

<sup>346</sup> TRLPA § 11.13; TBOC § 8.004.

<sup>347</sup> TRLPA §§ 11.15, 11.17; TBOC § 8.105.

<sup>348</sup> TRLPA § 11.18; TBOC § 8.151.

<sup>349</sup> TRLPA § 5.01; TBOC § 153.201.

<sup>350</sup> TRLPA § 5.02(d); TBOC § 153.202.

Although a general partner is personally liable for all of the debts and obligations of the limited partnership,<sup>351</sup> if provided in a written partnership agreement, (i) a person may be admitted as a general partner in a limited partnership, including as the sole general partner, and acquire a partnership interest in the limited partnership without (x) making a contribution to the limited partnership or (y) assuming an obligation to make a contribution to the limited partnership; and (ii) a person may be admitted as a general partner in a limited partnership, including as the sole general partner, without acquiring a partnership interest in the limited partnership.<sup>352</sup>

Absent a contrary provision in the written partnership agreement, profits and losses of a limited partnership are to be allocated in accordance with the partnership interests reflected in the records that the partnership is required to maintain under Tex. LP Stats., or in the absence of such records, in proportion to capital accounts.<sup>353</sup> Additionally, absent a different provision in the written partnership agreement, distributions representing a return of capital are to be made in accordance with the relative agreed value of capital contributions made by each partner, and other distributions are made in proportion to the allocation of profits.<sup>354</sup>

**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.<sup>355</sup> 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.<sup>356</sup> Instead, the assignment will entitle the assignee to an allocation of income, gain, loss, deductions, credits or similar items and to receive distributions to which the assignor was entitled.<sup>357</sup> 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.<sup>358</sup> Until an assignee of a partnership interest becomes a partner, the assignee has no liability as a partner solely by reason of the assignment.<sup>359</sup>

**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.<sup>360</sup> A limited partnership is dissolved under Tex. LP Stats. 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

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<sup>351</sup> TRLPA §§ 4.01(d) and 4.03(b); TBOC § 153.152.

<sup>352</sup> TRLPA § 4.01(c); TBOC § 153.151(c), (d).

<sup>353</sup> See TRLPA § 5.03; TBOC § 153.206.

<sup>354</sup> See TRLPA § 5.04; TBOC § 153.208.

<sup>355</sup> TRLPA § 7.02; TBOC § 153.251.

<sup>356</sup> TRLPA § 7.02(a)(2); TBOC § 153.251(b)(2).

<sup>357</sup> TRLPA § 7.02(a)(3); TBOC § 153.251(b)(3).

<sup>358</sup> TRLPA § 7.02(a)(4); TBOC § 153.252(b).

<sup>359</sup> TRLPA § 7.02(b); TBOC § 153.254(a).

<sup>360</sup> TRLPA §§ 8.01, 8.02; TBOC §§ 11.051, 11.058.

partnership agreeing in writing to dissolve the limited partnership, (iii) an event of withdrawal of a general partner under Tex. LP Stats. (i.e., death, removal, voluntary withdrawal and, unless otherwise provided in the partnership agreement, bankruptcy of a general partner)<sup>361</sup> absent certain circumstances<sup>362</sup> or (iv) a court of competent jurisdiction dissolving the partnership because (a) the economic purpose of the partnership is likely to be unreasonably frustrated, (b) a partner has engaged in conduct relating to the partnership that makes it not reasonably practicable to carry on the business in the partnership with that partner, or (c) it is not reasonably practicable to carry on the business of the limited partnership in conformity with the partnership agreement.<sup>363</sup>

If the limited partnership is terminated or dissolved, the limited partnership's affairs must be wound up as soon as reasonably practicable unless it is reconstituted or the partnership agreement provides otherwise.<sup>364</sup> However, upon the withdrawal of a general partner,<sup>365</sup> the limited partnership may continue its business without being wound up if (i) at least one general partner remains and the partnership agreement permits the business of the limited partnership to be carried on by the remaining general partner or partners or (ii) all (or a lesser percentage stated in the partnership agreement) remaining partners agree in writing to continue the business of the limited partnership within a specified period after the occurrence of the event dissolution event and agree to the appointment, if necessary, of one or more new general partners.<sup>366</sup>

Many existing limited partnership agreements contain provisions defining events of withdrawal in a manner intended to negate continuity of life for purposes of the Former Classification Regulations (e.g., certain events of bankruptcy of the general partner). Since these dissolution provisions are not required under the new Check-the-Box Regulations, consideration should be given to whether the provisions conform to the business purposes of the partners; if they do not, the provisions should be amended. The lenders to these limited partnerships, as well as the lenders' lawyers, may also have an interest in the wording of the limited partnership dissolution provisions.

**J. Formation.** The cost of forming a limited partnership is usually greater than that of forming a general partnership. A certificate of formation containing (1) the name of the entity, (2) a statement that it is a limited partnership, (3) the name and address of each general partner; (4) the address of the registered office and the name and address of the registered agent

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<sup>361</sup> TRLPA § 4.02; TBOC § 153.155.

<sup>362</sup> Under TRLPA § 6.02 and TBOC § 153.155(b) a general partner has a right to withdraw which cannot be eliminated by the partnership agreement, although the partnership may prohibit withdrawal and violation thereof can result in the general partner being liable for damages. TRLPA § 6.03 and TBOC § 153.110 provide that a limited partner may withdraw in accordance with the partnership agreement; previously a limited partner could withdraw on six months notice if the partnership agreement were silent on limited partner withdrawal.

<sup>363</sup> TRLPA § 8.02; TBOC §§ 11.051, 11.314.

<sup>364</sup> TRLPA § 8.04; TBOC § 11.052.

<sup>365</sup> TRLPA § 8.01(3); TBOC §§ 11.051(4), 11.058(2).

<sup>366</sup> TRLPA § 8.01; TBOC §§ 11.051(4), 11.058(2), 11.152(a), 153.501(b). Under the TRLPA, such agreement must be made within ninety days; under the TBOC, it must be made within a year. TBOC § 153.501 and Revisor's Note thereto. The partnership agreement may also provide for continuation of the partnership after dissolution for reasons in addition to an event of withdrawal in respect of a general partner.

for service of process; and (5) the address of the principal office where books and records are to be kept, must be filed with the Secretary of State.<sup>367</sup> Additionally, a filing fee of \$750 must be paid upon filing the certificate of formation.<sup>368</sup>

The Tex. LP Stats. contain a number of default provisions that govern the limited partnership in the absence of any relevant provisions in the partnership agreement. Except as provided in the Tex. LP Stats., the partners generally have the freedom to contract around these default provisions and to provide for the rights and obligations of the partners in the partnership agreement.<sup>369</sup> Since the default provisions of the Tex. LP Stats. to an extent reflect the requirements of the Former Classification Regulations, attorneys drafting limited partnership agreements should now consider whether the business expectations of the partners require negation of some of the default provisions, particularly in the context of dissolution.

The Tex. LP Stats. assume the existence of a partnership agreement, but allow the agreement to be either written or oral. The name of the limited partnership must contain the word “limited,” the phrase “limited partnership,” or an abbreviation of either.<sup>370</sup>

Unless the partnership agreement provides otherwise, unanimity is required to amend a limited partnership agreement.<sup>371</sup> Since it may be difficult to get unanimity, it may be appropriate to provide that amendments may be made with the approval of a simple majority or supermajority of the partners. If this type of provision is included, it is important to specify whether the requisite approval is based on sharing ratios, capital account balances, or some other factor or is merely per capita. Also, even if a majority vote is sufficient for most amendments, certain amendments (*e.g.*, those that disproportionately affect a particular partner or group of partners or increases the capital commitment of partners) require a different approval (*e.g.*, the approval of the affected partner or group of partners (or some percentage of that group of partners)). If the amendment provisions are purposefully drafted to give less than all of the partners the right to make amendments that disproportionately affect a particular partner or group of partners, it may be wise to expressly specify in the partnership agreement, to the extent permitted by the Tex. LP Stats., the ability of the general partners to act inconsistently with the fiduciary duties normally required of them.

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<sup>367</sup> TBOC §§ 3.001, 3.005, 3.011. Limited partnerships formed prior to January 1, 2006 were required to file a certificate of limited partnership instead, though with substantially similar requirements for the contents. *See* TRLPA § 2.01; *see also* *Arkoma Basin Exploration Co. v. FMF Assocs.1990-A, Ltd.*, 118 S.W.3d 445, 455 (Tex. App.—Dallas 2003, no pet.); *Garrett v. Koepke*, 569 S.W.2d 568,569 (Tex. Civ. App.—Dallas 1978, writ ref’d n.r.e.); *Brewer v. Tehuacana Venture, Ltd.*, 737 S.W.2d 349, 352 (Tex. App.—Houston [14th Dist.] 1987, no writ).

<sup>368</sup> TBOC § 4.155(1). The fee is the same as it was under the TRLPA. *See* TRLPA § 2.01(a).

<sup>369</sup> *See* TRPA § 1.03; TBOC §§ 152.002(a), 153.003.

<sup>370</sup> TBOC § 5.055(a). The TBOC has eliminated the TRLPA limitations on using a limited partner’s name in the name of the partnership, as well as the requirement that the necessary words or letters designating a limited partnership be at the end of the entity’s name. *See* Revisor’s Note to TBOC § 5.055. Under TRLPA § 1.03, an entity’s name had to contain the words “Limited Partnership,” “Limited,” or the abbreviation “L.P.,” “LP” (no periods) or “Ltd.” as the last words or letters of its name.

<sup>371</sup> TRPA § 4.01(i); TBOC §§ 152.208, 153.003.

**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.<sup>372</sup>

**L. Business Combinations.** Under Texas law, a limited partnership may merge with a corporation, LLC or another partnership and convert from a limited partnership into another form of entity without effecting a merger or transfer of assets.<sup>373</sup> The Tex. LP Stats. have provisions relating to the mechanics of adopting a plan of merger or conversion, obtaining owner approval, filing with the Secretary of State, and protecting creditors.

## **V. LIMITED LIABILITY COMPANY.**

**A. General.** Limited liability companies (“LLCs”) formed after January 1, 2006, those formed prior to that date but voluntarily opting in, and all limited liability companies after January 1, 2010 will be governed by Title 3 and pertinent provisions of Title 1 of the TBOC.<sup>374</sup> Older LLCs not opting in will continue to be governed by the Texas Limited Liability Company Act (the “LLC Act”) until January 1, 2010.<sup>375</sup> Because until 2010 some LLCs will be governed by the LLC Act and others by the TBOC and because the substantive principles under both statutes are generally the same, the term “Tex. LLC Stats.” is used herein to refer to the TBOC and the LLC Act collectively, and the particular differences between the LLC Act and the TBOC are referenced as appropriate. Texas was the fourth state to adopt an LLC statute and now every state has adopted an LLC Act.<sup>376</sup>

“The allure of the [LLC] is its unique ability to bring together in a single business organization the best features of all other business forms - properly structured, its owners obtain both a corporate-styled liability shield and the pass-through tax benefits of a partnership.”<sup>377</sup> All

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<sup>372</sup> See TRLPA Article 9; *see generally* TBOC Title 1, Chapter 9.

<sup>373</sup> TRLPA §§ 2.11, 2.15; TBOC §10.001. In order for a limited partnership to participate in a conversion, consolidation, or merger, the partnership agreement *must* authorize such action and the process for its approval. See TRLPA §§ 2.11(a)(1), 2.11(a)(2), 2.11(d)(1)(F), 2.15(a)(1); TBOC § 10.009(f). Therefore, it is important to include such a provision. Failure to include the provision will mean that, if such a transaction is desired, the partnership agreement will first need to be amended to permit it. To the extent the merger also results in amendments to the partnership agreement, the provisions relating to amendments will also need to be followed, so it would be prudent to coordinate the vote needed for conversions, consolidations, and mergers with the vote needed for amendments.

<sup>374</sup> TBOC §§ 401.001, 402.001, 402.003. The TBOC provisions applicable to LLCs may be officially and collectively referred to as “Texas Limited Liability Company Law.” TBOC § 1.008(e).

<sup>375</sup> The Texas Limited Liability Company Act, as amended, is found at Article 1528n of Vernon’s Texas Civil Statutes (the “LLC Act”). TEX. REV. CIV. STAT. ANN. art. 1528n (Vernon Supp. 2006). The operational provisions of the LLC Act are modeled after the TBCA, the Texas Miscellaneous Corporation Laws Act (“TMCLA”), and TRLPA. 1991 Bill Analysis Summary at 41; TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon Supp. 2006); *Summary of Business Organizations Bill (HB 278)*, 28 BULL. OF BUS. L. SEC. OF THE ST. B. OF TEX. 2, 31 (June 1991) [hereinafter “*1991 Bill Analysis Summary*”]; TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon 2003 & Supp. 2004); TEX. REV. CIV. STAT. ANN. art. 6132a-1, arts. 1-13 (Vernon Supp. 2006).

<sup>376</sup> See Charles W. Murdock, *Limited Liability Companies in the Decade of the 1990s: Legislative and Case Law Developments and Their Implications for the Future*, 56 Bus. Law 499, 502 (2001).

<sup>377</sup> *PB Real Estate, Inc. v. DEM Properties*, 719 A.2d 73, 74 (Conn. App. Ct. 1998).

equity holders of an LLC have the limited liability of corporate shareholders even if they participate in the business of the LLC. Thus the Tex. LLC Stats. contemplate that LLCs will be organized with features that resemble corresponding features of corporations.

Under the Check-the-Box Regulations, a domestic LLC with two or more Members typically would be treated for federal income tax purposes as a partnership.<sup>378</sup> An LLC is subject to Texas corporate franchise tax.<sup>379</sup>

An underlying premise of the Tex. LLC Stats. is that the LLC is based in large part upon a contract between its Members, similar to a partnership agreement. As a result, fundamental principles of freedom of contract imply that the owners of an LLC have maximum freedom to determine the internal structure and operation of the LLC. Thus the Tex. LLC Stats. would be classified as “flexible” LLC statutes.<sup>380</sup> 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.<sup>381</sup>

The Tex. LLC Stats. in many cases provide “default” provisions<sup>382</sup> designed to reflect the common expectations of persons engaged in business under the Former Classification Regulations, and to permit those expectations to be met in the event that the LLC’s organizational documents do not include a provision specifically dealing with an issue. These default provisions, however, may result in restrictions on the LLC that are not necessary under the Check-the-Box Regulations and may unnecessarily change the intended business deal.<sup>383</sup> Examples of provisions that were often included in an LLC structure because of the Former Classification Regulations and which are required by neither the Tex. LLC Stats. nor the Check-the-Box Regulations:

- (i) limited duration (Texas law now permits an LLC to have a perpetual duration like a corporation);
- (ii) management by Members rather than Managers;
- (iii) restrictions on assignments of interests beyond what is required by applicable securities laws and the desires of the parties; and
- (iv) dissolution of the LLC upon the death, expulsion, withdrawal, bankruptcy or dissolution of a Member.

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<sup>378</sup> See “I. General: C. Federal ‘Check-the-Box’ Regulations” *supra*.

<sup>379</sup> TEX. TAX CODE ANN. § 171.001 (Vernon 2002 & Supp. 2004). The LLC is not subject to a franchise tax in Delaware or most other states. See Bruce P. Ely & Christopher R. Grissom, *State Taxation of LLCs and LLPs: An Update*, 1 BUS. ENTITIES 24 (Mar./Apr. 1999).

<sup>380</sup> See Robert B. Keatinge, *New Gang in Town - Limited Liability Companies: An Introduction*, BUS. L. TODAY, Mar./Apr. 1995, at 5.

<sup>381</sup> See Robert F. Gray *et al.*, *Corporations*, 45 Sw.L.J. 1525, 1537 (1992).

<sup>382</sup> See CORPORATION LAW COMMITTEE, BUSINESS LAW SECTION, STATE BAR OF TEXAS, BILL ANALYSIS, Tex. HB 1239, 73d Leg., R.S. (1993) at 1 [hereinafter 1993 LLC Bill Analysis].

<sup>383</sup> See William D. Bagley, *The IRS Steps Back - Entity Classification Rules are Relaxed*, 6 BUS. L. TODAY 41 (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.<sup>384</sup> A single Member LLC will be disregarded as an entity separate from its owner under the Check-the-Box Regulations unless the LLC elects to be taxed as a corporation.<sup>385</sup>

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.<sup>386</sup> 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.”<sup>387</sup> 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.<sup>388</sup> 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.<sup>389</sup> Texas administrative regulations provide that a single Member LLC may not deduct compensation paid to the Member in computing “net taxable earned surplus.”<sup>390</sup> 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 LLCs doing business therein. Since most state income tax regimes are based on the federal adjusted gross income, an LLC treated as a partnership for federal income tax purposes should be treated as such for state income tax purposes in the absence of a specific state statute.<sup>391</sup>

(b) Flexible Statute. In Revenue Ruling 88-76, a Wyoming LLC was held to lack continuity of life and free transferability of interest, because the Wyoming LLC *statute* requires the unanimous vote of *all* remaining Members to continue the LLC upon a Dissolution Event, and the consent of *all* LLC Members for any transferee of an interest to participate in the management of the LLC or to become a Member.<sup>392</sup> The Wyoming LLC

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<sup>384</sup> Treas. Reg. § 301.7701-3(b)(i) (as amended in 2003).

<sup>385</sup> *Id.* § (b)(ii).

<sup>386</sup> TEX. TAX CODE ANN. § 171.001 (Vernon 2002 & Supp. 2004).

<sup>387</sup> TEX. TAX CODE ANN. § 171.002(a) (Vernon 2002 & Supp. 2004).

<sup>388</sup> See Brandon Janes & Steven D. Moore, *The New Texas Franchise Tax*, TEX. B.J., Nov. 1991, at 1108.

<sup>389</sup> TEX. TAX CODE ANN. § 171.110(a)(1) (Vernon 2002 & Supp. 2004).

<sup>390</sup> 34 TEX. ADMIN. CODE § 3.562(f)(2) (2003).

<sup>391</sup> David G. Dietze, *The Limited Liability Company: Latest Strategy and Developments*, 6 No. 1 INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR, Jan. 1992, at 7.

<sup>392</sup> Rev. Rul. 88-76, 1988-2 C.B. 360, *obsoleted by* Rev. Rul. 98-37, 1998-2 C.B. 133.

statute was considered a “bullet proof statute” because an LLC formed thereunder would always lack these two corporate characteristics important under the Former Classification Regulations.<sup>393</sup> By contrast, the Tex. LLC Stats. are considered “flexible” statutes because they allow 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).<sup>394</sup>

(c) One Member LLC. The Tex. LLC Stats. permit a one-Member LLC, the status of which is now certain under the Check-the-Box Regulations.<sup>395</sup> 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.<sup>396</sup> Many state LLC statutes do not authorize single Member LLCs.<sup>397</sup>

(d) Contributions of Appreciated Property. As a general rule, a transfer of appreciated property in exchange for an interest in an LLC classified as a partnership will not result in any recognizable gain or loss for the transferor, the LLC or any other Member of the LLC.<sup>398</sup> 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.<sup>399</sup> Under certain circumstances, a Member’s contribution of property may result in a net reduction in liability<sup>400</sup> 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.<sup>401</sup> In addition, certain contributions can be treated as “disguised sales” of all or a portion of the contributed property by the member to the LLC if the member receives cash or other property (in addition to an LLC interest) in connection with the transfer.

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<sup>393</sup> *Id.*; WYO. STAT. ANN. §§ 17-15-101–17-15-147 (Michie 2003).

<sup>394</sup> LLC Act § 3.02(A), 6.01(B); TBOC § 101.052.

<sup>395</sup> Treas. Reg. § 301.7701-2(a), (c)(2) (as amended in 2003).

<sup>396</sup> In Priv. Ltr. Rul. 2001-18023 (January 31, 2001) the issue was the application of Section 1031 of the IRC (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).

<sup>397</sup> See Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 7 (1995).

<sup>398</sup> I.R.C. § 721(a). *But see* Treas. Reg. § 1.707-3 (2003) (discussing disguised sales).

<sup>399</sup> I.R.C. §§ 722, 723.

<sup>400</sup> I.R.C. § 752.

<sup>401</sup> I.R.C. § 731.



(e) Self-Employment Tax. Individuals are subject to a self-employment tax on self-employment income.<sup>402</sup> 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 2006 contribution base of \$94,200 (adjusted annually for inflation), plus (ii) a 2.9% Medicare tax on all self-employment income (there is no ceiling).<sup>403</sup> An individual's wage income is applied against the contribution base.<sup>404</sup> Self-employment income generally means an individual's net earnings from the individual's trade or business.<sup>405</sup> 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.<sup>406</sup>

In 1994, the IRS issued proposed regulations providing that an individual Member's share of income from a trade or business of the LLC is subject to self-employment tax (assuming the LLC is treated as a partnership for federal income tax purposes) unless (i) the Member is not a managing Member and (ii) the entity could have been formed as a limited partnership rather than an LLC in the same jurisdiction with the Member qualifying as a limited partner.<sup>407</sup> Under such regulations, if the LLC did not have designated Managers with continuing and exclusive authority to manage the LLC, then all Members would be treated as Managers for this purpose.

On January 13, 1997 the IRS withdrew its 1994 proposed regulation dealing with employment taxes in the LLC context and proposed new regulations that would apply to all entities (including LLCs) classified as partnerships under the Check-the-Box Regulations.<sup>408</sup> 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.<sup>409</sup> 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

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<sup>402</sup> See I.R.C. § 1401.

<sup>403</sup> *Id.*

<sup>404</sup> *Id.*

<sup>405</sup> I.R.C. § 1402(a).

<sup>406</sup> I.R.C. § 1402.

<sup>407</sup> See Prop. Treas. Reg. § 1.1402(a)-18, 59 Fed. Reg. 67,253-01 (Dec. 29, 1994).

<sup>408</sup> Prop. Treas. Reg. § 1.1402(a)-2, 62 Fed. Reg. 1702 (Jan. 13, 1997).

<sup>409</sup> See *id.*

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.”<sup>410</sup>

Until the proposed regulations are effective for an LLC Member, there is a risk that the IRS will treat any individual Member’s distributive share of the trade or business income of the LLC as being subject to self-employment tax, even if the Member is not a Manager and would be treated as a limited partner under the 1997 proposed regulations, based on the IRS position set forth in Private Letter Ruling 94-32-018, which was issued prior to the proposed regulation. Under both current law and the 1997 proposed regulations, an LLC Member will be subject to self-employment tax on guaranteed payments for services, and Members will not be subject to self-employment tax on distributions if the LLC is treated as an association taxable as a corporation for Federal tax purposes.

The Taxpayer Relief Act of 1997 prohibited the IRS from issuing any temporary or final regulations relating to the definition of a limited partner for employment tax purposes that would be effective before July 1, 1998.<sup>411</sup> 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.<sup>412</sup> 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.<sup>413</sup> Congress may again consider ways to rationalize the self-employment tax treatment of LLCs, partnerships and S-corporations.<sup>414</sup>

**C. Members; Managers.** The owners of an LLC are called “Members,”<sup>415</sup> and are analogous to shareholders in a corporation or limited partners of a limited partnership.<sup>416</sup> 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.<sup>417</sup> Under the Tex. LLC Stats., however, an LLC may be structured so that management shall be by the Members as in the case of a close corporation or a general partnership,<sup>418</sup> and in that case the

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<sup>410</sup> *Id.*

<sup>411</sup> H.R. CONF. REP. NO. 105-220, at 765 (1997).

<sup>412</sup> *Id.*

<sup>413</sup> *Id.* In a letter dated July 6, 1999 to the Chairman of the House Ways and Means Committee, the American Bar Association Tax Section commented on the uncertainty of the law in this area, recommended that the IRC be amended to provide that the income of an entity taxable as a partnership (including an LLC) that is attributable to capital is not subject to self-employment tax, but suggested that if legislation is not forthcoming, the best immediately available approach is that contained in the 1997 proposed regulations. Paul A. Sax, *ABA Tax Section Suggests Legislative Fix for LLC Self-Help Employment Tax*, TAX NOTES TODAY, July 13, 1999, 1999 TNT 133-23, at <http://www.taxanalysts.com>.

<sup>414</sup> See “*Options to Improve Tax Compliance and Reform Tax Expenditures*” prepared by the Staff of the Joint Committee on Taxation (January 27, 2005).

<sup>415</sup> LLC Act § 4.01; TBOC §§ 1.002(53), 101.101, 101.102.

<sup>416</sup> 1991 Bill Analysis Summary at 41.

<sup>417</sup> See LLC Act § 2.13; TBOC § 101.302; 1991 Bill Analysis Summary at 41.

<sup>418</sup> LLC Act § 2.12; TBOC §§ 1.002(35), 101.251.

Members would be analogous to general partners in a general or limited partnership but without personal liability.<sup>419</sup> For an LLC to be taxed as a partnership it must have at least two Members, although Texas law would permit an LLC to have only one Member; a single Member LLC is not treated as a separate entity for federal tax purposes under the Check-the-Box Regulations unless it elects to be taxed as a corporation (i.e., a single Member LLC may be taxed as a sole proprietorship or corporation, but not as a partnership).<sup>420</sup>

Under the Tex. LLC Stats., any “person” may become a Member or Manager.<sup>421</sup> Because of the broad construction given to “person” by the Tex. LLC Stats., any individual, corporation, partnership, LLC or other person may become a Member or Manager.<sup>422</sup> Thus, it is possible to have an LLC with a corporation as the sole Manager just as it is possible to have a limited partnership with a sole corporate general partner.

**D. Purposes and Powers.** Under Texas law, an LLC may generally be formed to conduct any lawful business, subject to limitations of other statutes which regulate particular

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<sup>419</sup> 1991 Bill Analysis Summary at 41.

<sup>420</sup> See discussions *supra* Parts “I. General: C. Federal ‘Check-the-Box’ Tax Regulations – 2. Check-the-Box Regulations” and “V. Limited Liability Company: B. Taxation - 2. Other Tax Issues Relating to LLCs – (c) One Member LLC.” In 1993, Article 4.01(A) of the LLC Act was amended to expressly provide that an LLC “may have one or more members.” Tex. HB 1239, 73d Leg., R.S. (1993). See also TBOC § 101.101.

<sup>421</sup> LLC Act § 4.01C; TBOC § 101.102(a).

<sup>422</sup> “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.

The definition afforded to “person” in the TBOC comes from the Code Construction Act, which states that “‘Person’ includes corporation organization, government or governmental subdivision or agency, business trust, estate, trust, partnership, association, and any other legal entity.” Texas Government Code § 311.005(2).

businesses.<sup>423</sup> It has all of the powers of a Texas corporation or limited partnership, subject to any restrictions imposed by statute or its governing documents.<sup>424</sup>

**E. Formation.** An LLC is formed when one or more persons file a certificate of formation with the Texas Secretary of State (\$300 filing fee).<sup>425</sup> The initial certificate of formation must contain (1) the name of the LLC, (2) a statement that it is an LLC, (3) the period of its duration, unless such duration is perpetual, (4) its purpose, which may be any lawful purpose for which LLCs may be organized, (5) the address of its initial registered office and the name of its initial registered agent at that address, (6) if the LLC is to have a Manager or Managers, a statement to that effect and the names and addresses of the initial Manager or Managers, or if the LLC will not have Managers, a statement to that effect and the names and addresses of the initial Members, (7) the name and address of each organizer, (8) specified information if the LLC is to be a professional LLC, and (9) any other provisions not inconsistent with law.<sup>426</sup> An LLC's existence as such begins when the Secretary of State files the certificate of formation, unless it provides for delayed effectiveness as authorized by the TBOC.<sup>427</sup> An LLC may also be formed pursuant to a plan of conversion or merger, in which case the certificate of formation must be filed with the certificate of conversion or merger, but need not be filed separately. In such case the LLC's formation takes effect on the effectiveness of the plan.<sup>428</sup>

The name of an LLC must contain words or an abbreviation to designate the nature of the entity. The designation may be any of the following: the words "Limited Liability Company," "Limited Company," or an abbreviation of either phrase.<sup>429</sup> The name must not be the same as or deceptively similar to that of any domestic or foreign filing entity authorized to transact

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<sup>423</sup> LLC Act § 2.01 provides as follows:

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

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

LLC Act 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 governed by the LLC Act possibly could not be used for a nonprofit purpose. However, under the TBOC, an LLC's purpose "may be stated to be or include any lawful purpose for [an LLC]." TBOC § 3.005(3). Such broad language would seem to negate the prior profit versus nonprofit ambiguity. *See also* TBOC § 2.001, which provides as follows: "A domestic entity has any lawful purpose or purposes, unless otherwise provided by this code."

<sup>424</sup> Governing documents, as used here, includes a company's Articles of Organization, Certificate of Formation, Regulations, or Company Agreement. LLC Act § 2.02; *see* TBOC § 101.402.

<sup>425</sup> TBOC §§ 3.001, 4.152(1), 4.154. Prior to January 1, 2006, an LLC was formed by filing articles of organization with the Secretary of State, which were similar to a certificate of limited partnership under TRLPA and articles of incorporation under the TBCA. *See* LLC Act §§ 3.01, 9.01.

<sup>426</sup> TBOC §§ 3.005, 3.010, 3.014.

<sup>427</sup> TBOC §§ 4.051, 4.052.

<sup>428</sup> TBOC § 3.006(b).

<sup>429</sup> TBOC § 5.056. However, LLCs formed prior to September 1, 1993 in compliance with the laws then in existence need not change their names to comply with the current provisions. TBOC § 5.056(b).

business in Texas.<sup>430</sup> Prior to accepting a certificate of formation for filing, the Secretary of State reviews its LLC, limited partnership and corporation records to determine whether the LLC's proposed name is impermissibly close to that of an existing filing entity.<sup>431</sup>

The Tex. LLC Stats. provide that, except as otherwise provided in an LLC's certificate of formation or Company Agreement, the affirmative vote, approval, or consent of all Members is required to amend its certificate of formation.<sup>432</sup> Any such amendment must include a statement that it was approved in accordance with the proper provisions of governing laws,<sup>433</sup> or for entities governed by the LLC Act, alternately as provided in the articles of organization or Regulations, along with the date of approval.<sup>434</sup>

LLC Act § 2.23G provides that if the LLC has not received any capital and has not otherwise commenced business, the articles of organization may be amended by and the LLC may be dissolved by (a) a majority of the Managers, if there are no Members, or (b) a majority of the Members, if there are no Managers. The TBOC does not contain such an express provision, but simply grants broad leeway for an LLC's Company Agreement (equivalent to the "Regulations" under the LLC Act) to govern such matters.<sup>435</sup>

**F. Company Agreement.** Most of the provisions relating to the organization and management of an LLC and the terms governing its securities are to be contained in the LLC's Company Agreement, which will typically contain provisions similar to those in limited partnership agreements and corporate bylaws.<sup>436</sup> A Company Agreement is the same as the document referred to as the "Regulations" for LLCs still governed by the LLC Act. Under the TBOC, the Company Agreement controls the majority of LLC governance matters and generally trumps the default TBOC provisions relating to LLCs.<sup>437</sup> For example, the TBOC provides that the Company Agreement or certificate of formation may only be amended by unanimous member consent,<sup>438</sup> but if either document provides otherwise (such as for amendment by manager consent), then it may be amended pursuant to its own terms.<sup>439</sup> The only statutory provisions not subject to contrary agreement are enumerated in TBOC § 101.054. While the structure and wording of the TBOC relating to these matters differs from the source LLC Act, the rule has not substantively changed.<sup>440</sup>

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<sup>430</sup> TBOC § 5.053.

<sup>431</sup> *Id.*

<sup>432</sup> LLC Act § 2.23H; TBOC §§ 101.356(d), 101.051, 101.052. For LLCs that continue to be governed by the LLC Act, the pertinent documents are referred to as the Articles of Organization and the Regulations.

<sup>433</sup> LLC Act § 3.06(3); TBOC § 3.053(4).

<sup>434</sup> LLC Act § 3.06(3).

<sup>435</sup> *See* TBOC §§ 101.051, 101.052.

<sup>436</sup> LLC Act § 2.09A; TBOC § 101.052.

<sup>437</sup> *See* TBOC § 101.052 and Revisor's Note thereto.

<sup>438</sup> TBOC §§ 101.053, 101.356(d).

<sup>439</sup> *See* TBOC §§ 101.052, 101.054.

<sup>440</sup> *See* Revisor's Note to TBOC § 101.052; LLC Act §§ 2.09B, 2.23H. With respect to LLCs that continue to be governed by the LLC Act, the default provision in LLC Act § 2.23D provides that the affirmative vote, approval, or consent of a majority of all the Members is required to approve any merger or interest exchange,

Although the Company Agreement will ordinarily contain the capital account and other financial and tax provisions found in a typical limited partnership agreement,<sup>441</sup> the Tex. LLC Stats. do not require that the Company Agreement ever be approved by the Members or be filed with the Secretary of State or otherwise made a public record. Nevertheless it may be desirable for the Members to approve the Company Agreement and agree to be contractually bound thereby.<sup>442</sup> The Members' express agreement to be contractually bound by the Company Agreement should facilitate enforcement thereof and their treatment as a "partnership agreement" for federal income tax purposes.<sup>443</sup>

In some other states, the agreement which is referred to in Texas as the Company Agreement is referred to as "operating agreement" or the "LLC agreement."<sup>444</sup>

**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.<sup>445</sup> A Manager may be an individual, corporation, or other entity, and it is possible to have an LLC which has a single Manager that is a corporation or other entity.<sup>446</sup> The certification of formation or the Company Agreement, however, may provide that the management of the business and affairs of the LLC may be

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dissolution or any act which would make it impossible to carry on the ordinary business of the LLC. The LLC Act default provisions would require unanimous approval of the Members to amend the Articles (LLC Act § 2.23H), issue additional membership interests (LLC Act § 4.01B-1, as amended by HB 1637 effective September 1, 2003) or take action beyond the stated purposes of the LLC (LLC Act § 2.02B). The general default voting provision is in LLC Act § 2.23C-1, which provides that Members or Managers may take action at a meeting or without a meeting in any manner permitted by the Articles, the Regulations or the LLC Act and that, unless otherwise provided by the Articles or the Regulations, an action is effective if it is taken by (1) an affirmative vote of those persons having not fewer than the minimum number of votes that would be necessary to take the action at a meeting at which all Members or Managers, as the case may be, entitled to vote on the action were present and voted; or (2) consent of each Member of the LLC, which may be established by (a) the Member's failure to object to the action in a timely manner, if the Member has full knowledge of the action, (b) consent to the action in writing signed by the Member, or (c) any other means reasonably evidencing consent. Thus, when drafting the Regulations, it is important to override these provisions if they do not properly reflect the desires of the parties. Also, Paragraph F of LLC Act § 2.23 provides, as the default rule, that a majority is defined to be determined on a per-capita basis and not, for instance, by capital contributions or sharing ratios; since this may or may not be appropriate, it is critical that the Regulations properly set forth the appropriate standard for what constitutes a majority.

<sup>441</sup> It is critical that the Company Agreement accurately reflect the business deal of the parties. Absent a different provision therein, profits and losses of an LLC are to be allocated, and all distributions, whether a return of capital or otherwise, are to be made in accordance with the relative agreed value of capital contributions made by each member reflected in the records that the LLC is required to maintain under the Tex. LLC Stats. LLC Act §§ 2.22, 5.01-1, 5.03; TBOC §§ 3.151, 101.203, 101.501.

<sup>442</sup> The agreement to be contractually bound could be through signing the Company Agreement directly or indirectly through a subscription agreement or power of attorney.

<sup>443</sup> Philip M. Kinkaid, *Drafting Limited Liability Company Regulations and Articles: Sample Documents*, Address at The University of Texas School of Law Sponsored Conference on Current Issues in Partnerships, Limited Liability Companies, and Registered Limited Liability Partnerships (Jan. 23-24, 1992).

<sup>444</sup> See, e.g., OHIO REV. CODE ANN. § 1705.01(J) (West 2003) ("operating agreement"); DEL. CODE ANN. tit. 6, § 18-101(7) (1999 & Supp. 2005) ("LLC agreement").

<sup>445</sup> LLC Act §§ 2.12, 2.21; TBOC §§ 101.251-101.253.

<sup>446</sup> LLC Act §§ 2.12, 1.02(4); TBOC § 101.302; Texas Government Code § 311.005(2).

reserved to its Members.<sup>447</sup> Thus an LLC could be organized to be run without Managers, as in the case of a close corporation, or it could be structured so that the day to day operations are run by Managers but Member approval is required for significant actions as in the case of many joint ventures and closely held corporations.

The Company Agreement should specify who has the authority to obligate the LLC contractually or to empower others to do so. It should dictate the way in which the Managers or Members, whichever is authorized to manage the LLC, are to manage the LLC's business and affairs.<sup>448</sup> The Tex. LLC Stats. provide that the following are agents of an LLC: (1) any officer or other agent who is vested with actual or apparent authority; (2) each Manager (to the extent that management of the LLC is vested in that Manager); and (3) each Member (to the extent that management of the LLC has been reserved to that Member).<sup>449</sup> Texas law also provides that an act (including the execution of an instrument in the name of the LLC) for the purpose of apparently carrying on in the usual way the business of the LLC by any of the persons named in LLC Act § 2.21C or TBOC § 101.254(a) binds the LLC unless (1) the person so acting lacks authority to act for the LLC and (2) the third party with whom the LLC is dealing is aware of the actor's lack of authority.<sup>450</sup> Lenders and others dealing with an LLC can determine with certainty who has authority to bind the LLC by reference to its certificate of formation, Company Agreement, and resolutions, just as in the case of a corporation. In routine business transactions where verification of authority is not the norm in transactions involving corporations, the same principles of apparent authority should apply in the LLC context.

Members and Managers acting on behalf of an LLC should disclose that they are acting on behalf of the entity and that it is an LLC. Under common law agency principles, an agent can be personally liable on a contract made for an undisclosed or unnamed principal.<sup>451</sup>

The Tex. LLC Stats. contain no requirements as to the terms of Managers, but allow the Company Agreement to provide for specified terms of Managers and annual or other regularly scheduled meetings of Members<sup>452</sup>; if the Company Agreement is silent as to the term, the default provision is retention of the Managers. Tex. LLC Stats. allow any number of classes of Managers, and contains no requirement that such classes either be equal or nearly equal in number or be elected in strict rotation at successive annual meetings of Members.<sup>453</sup>

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<sup>447</sup> LLC Act § 2.12; *see* TBOC § 101.251.

<sup>448</sup> TBOC § 101.252. Along the same lines, LLC Act § 2.21B provides that all officers, agents, Managers and Members of an LLC, as among themselves and the LLC, have such authority in the management of the LLC as may be provided in its Regulations or as may be determined by resolution of the Managers or, to the extent to which management is reserved to them, the Members.

<sup>449</sup> LLC Act § 2.21C; TBOC §§ 1.002(35), (37), 101.254(a).

<sup>450</sup> LLC Act § 2.21D; TBOC § 101.254(b).

<sup>451</sup> *See Water, Waste & Land, Inc. v. Lanham*, 955 P.2d 997, 1001 (Colo. 1998).

<sup>452</sup> *See* TBOC § 101.303.

<sup>453</sup> *See* LLC Act § 2.14; TBOC § 101.307.

**H. Fiduciary Duties.** The Tex. LLC Stats. do not address specifically whether Manager or Member fiduciary duties exist or attempt to define them,<sup>454</sup> but implicitly recognize that they may exist in statutory provisions which permit them to be expanded or restricted in the Company Agreement.<sup>455</sup> 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 Certificate of Formation or Company Agreement.<sup>456</sup>

The Tex. LLC Stats. allow LLC Company Agreements to expand or restrict the duties (including fiduciary duties) and liabilities of Members, Managers, officers and other persons to the LLC or to Members or Managers of the LLC.<sup>457</sup> This provision of Texas law was designed, in the same vein as the Delaware Limited Liability Company Act (the “DGLLCA”) from which it drew inspiration, to allow LLCs the flexibility to address fiduciary duties through contract

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<sup>454</sup> See Elizabeth M. McGeever, *Hazardous Duty? The Role of the Fiduciary in Noncorporate Structures*, 4 BUS. L. TODAY 51, 53 (Mar.–Apr.1995); Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 401 (1992) (noting that LLC statutes usually do not specify fiduciary duties of Members or Managers).

<sup>455</sup> LLC Act § 2.20B provides that the Regulations may expand or reduce fiduciary duties as follows:

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

Similarly, TBOC § 101.401 provides:

The company agreement of a limited liability company may expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person has to the company or to a member or manager of the company.

<sup>456</sup> *Suntech Processing Sys., L.L.C. v. Sun Communications, Inc.*, No. 05-99-00213-CV, 2000 WL 1780236, at \*6 (Tex. App.—Dallas Dec. 5, 2000, pet. denied) (not designated for publication). In *Suntech Processing Systems*, a minority Member of a Texas LLC claimed that the controlling Member owed a fiduciary duty as a matter of law in connection with the winding up of operations and distribution of assets. *Id.* at \*5. The court pointed out that the Regulations expressly provided for a duty of loyalty to the LLC rather than between the Members, and, noting the absence of Texas case law on fiduciary duties of LLC Members and looking to case law regarding fiduciary duties of shareholders of a closely held corporation, held that there was no fiduciary relationship between the Members as a matter of law. *Id.* at \*1.

<sup>457</sup> See LLC Act § 2.20B; TBOC § 101.401. 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 the Articles (now, the Certificate of Formation) 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.



principles.<sup>458</sup> Although the Tex. LLC Stats., unlike their Delaware counterpart, do not include provisions that expressly emphasize the principles of freedom of contract and enforceability of LLC Company Agreements limiting liability for breach of fiduciary duties, the legislative history and scope of LLC Act § 2.20B, the precursor to TBOC § 101.401, indicate that there may be more latitude to exculpate Managers and Members for conduct that would otherwise breach a fiduciary duty under the Tex. LLC Stats. than under provisions of the TBOC and the TBCA relating specifically to regular corporations. Provisions in Company Agreements purporting to limit fiduciary duties need to be explicit and conspicuous; coyness can lead to unenforceability.<sup>459</sup> A provision which purports to limit fiduciary duties in the LLC context “to

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<sup>458</sup> DEL. CODE ANN. tit. 6, § 18-1101 (1999 & Supp. 2002). 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) and does not have any provision which itself creates or negates Member or Manager fiduciary duties, but instead allows modification of fiduciary duties by an LLC agreement as follows:

**18-1101 CONSTRUCTION AND APPLICATION OF CHAPTER AND LIMITED LIABILITY COMPANY AGREEMENT.** (a) The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.

(b) it is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.

(c) to the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) and liabilities relating thereto to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability 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. *See* DEL. CODE ANN. tit. 6, § 17-1101 (1999 & Supp. 2002). Thus, Delaware cases regarding partner fiduciary duties should be helpful in the LLC context.

<sup>459</sup> *Solar Cells, Inc. v. True N. Partners, LLC*, No. CIV.A.19477, 2002 WL 749163, at \*4 (Del. Ch. Apr. 25, 2002). In *Solar Cells*, Chancellor Chandler enjoined the merger of an LLC with an affiliate of the controlling owner on the basis of the Delaware “entire fairness” doctrine notwithstanding an operating agreement section providing in relevant part as follows:

Solar Cells and [First Solar] acknowledge that the True North Managers have fiduciary obligations to both [First Solar] and to True North, which fiduciary obligations may, because of the ability of the True North Managers to control [First Solar] and its business, create a conflict of interest or a potential conflict of interest for the True North Managers. Both [First Solar] and Solar Cells hereby waive any such conflict of interest or potential conflict of interest and agree that neither True North nor any True North Manager shall have any liability to [First Solar] or to Solar Cells with respect to any such conflict of

the maximum extent permitted by the laws in effect at the effective date of this Company Agreement, as such Agreement may be amended from time to time” probably is not adequate.

While courts may be tempted to find contractual limitations on fiduciary duties ambiguous in particular situations where it appears that the provision is allowing a fiduciary to get away with something egregious, they should generally recognize the ability of LLC’s to contractually limit fiduciary duties. In *McConnell v. Hunt Sports Enterprises*,<sup>460</sup> the court stated that Members (of what was apparently a Member-managed LLC) are generally in a fiduciary relationship and would ordinarily be prohibited from competing with the LLC. The court, however, recognized the validity of a provision in the Ohio LLC’s operating agreement (the equivalent of a Texas LLC’s Company Agreement) providing:

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

The Ohio court in *McConnell* found that this provision clearly and unambiguously permitted a Member to compete against the LLC to obtain a hockey franchise sought by the LLC.<sup>461</sup> The court noted the trial court’s finding that the competing Members had not engaged in willful misconduct, misrepresentation or concealment.<sup>462</sup>

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interest or potential conflict of interest, provided that the True North managers have acted in a manner which they believe in good faith to be in the best interest of [First Solar].

Chancellor Chandler noted that the above clause purports to limit liability stemming from any conflict of interest, but that Solar Cells had not requested that the Court impose liability on the individual defendants; rather it was only seeking to enjoin the proposed merger. Therefore, exculpation for personal liability would have no bearing on whether the proposed merger was inequitable and should be enjoined. Further, Chancellor Chandler wrote that “even if waiver of liability for engaging in conflicting interest transactions is contracted for, that does not mean that there is a waiver of all fiduciary duties [for the above quoted provision] expressly states that the True North Managers must act in ‘good faith.’”

Noting that the LLC was in financial distress and that the owners had been negotiating unsuccessfully to develop a mutually acceptable recapitalization, the Chancellor found that the managers appointed by the controlling owners appeared not to have acted in good faith when they had adopted the challenged plan of merger by written consent without notice to the minority managers. Chancellor Chandler commented:

The fact that the Operating Agreement permits action by written consent of a majority of the Managers and permits interested transactions free from personal liability does not give a fiduciary free reign to approve any transaction he sees fit regardless of the impact on those to whom he owes a fiduciary duty.

<sup>460</sup> 725 N.E.2d 1193 (Ohio App. 1999).

<sup>461</sup> *Id.* at 1215.

<sup>462</sup> *Id.* at 1214.

Persons who control Members can be held responsible for fiduciary duty breaches of the Members.<sup>463</sup> A legal claim exists for aiding and abetting a breach of fiduciary duty, whether arising under statute, contract, common law or otherwise.<sup>464</sup>

The Tex. LLC Stats., which are based on TBCA § 2.35-1, provide that, unless the articles, certificate of formation, Regulations, or Company Agreement provides otherwise, a transaction between an LLC and one or more of its Managers or officers, or between an LLC and any other LLC or other entity in which one or more of its Managers or officers are Managers, directors or officers or have a financial interest, shall be valid notwithstanding the fact that the Manager or officer is present or participates in the meeting of Managers which authorizes the transaction or the Manager's votes are counted for such purpose, if any of the following is satisfied:

(i) The material facts as to the transaction and interest are disclosed or known to the governing authority, and the governing authority in good faith authorizes the transaction by the affirmative vote of a majority of the disinterested Managers or Members (as appropriate) even though the disinterested Managers or Members are less than a quorum; or

(ii) The material facts as to the transaction and interest are disclosed or known to the Members entitled to vote thereon, and the transaction is approved in good faith by a vote of the Members; or

(iii) The transaction is fair to the LLC as of the time it is authorized, approved or ratified by the Managers or Members.<sup>465</sup>

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.<sup>466</sup>

**I. Indemnification.** Under the Tex. LLC Stats., an LLC may indemnify any of its Members, Managers, officers or other persons subject only to such standards and restrictions, if any, as may be set forth in the LLC's certificate of formation or Company Agreement.<sup>467</sup> The restrictions on indemnification applicable to regular corporations are not applicable to LLCs.<sup>468</sup>

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<sup>463</sup> See *In re USACafes, Inc.*, 600 A.2d 43, 48 (Del. Ch. 1991); *Carson v. Lynch Multimedia Corp.*, 123 F. Supp. 2d 1254, 1264 (D. Kan. 2000).

<sup>464</sup> *Fitzgerald v. Cantor*, No. CIV.A.16297-NC, 1999 WL 182573, at \*1 (Del. Ch. Mar. 25, 1999) (holding that the elements of a claim for aiding and abetting a breach of fiduciary duty are: (1) the existence of a fiduciary relationship; (2) the fiduciary breached its duty; (3) a defendant, who is not a fiduciary, knowingly participated in a breach; and (4) damaged to the plaintiff resulted from the concerted action of the fiduciary and the non-fiduciary).

<sup>465</sup> LLC Act § 2.17; TBOC § 101.255.

<sup>466</sup> *Id.*; see TRPA § 4.04; see also TBOC § 152.204.

<sup>467</sup> LLC Act § 2.20A; TBOC § 101.402.

<sup>468</sup> See generally Chapter 8 of the TBOC, specifically § 8.002(a).

This approach is similar to the approach taken under Delaware law, but could be subject to public policy limitations.<sup>469</sup> In any event, this change increases the importance of having long form indemnification because a “to maximum extent permitted by law” provision may encompass things neither the drafter nor the client foresaw, which could lead courts to read in public policy limits or find the provision void for vagueness. The indemnification provisions should specify who is entitled to be indemnified for what and under what circumstances, which requires both thought and careful drafting.

**J. Capital Contributions.** The contribution of a Member may consist of any tangible or intangible benefit to the LLC or other property of any kind or nature, including a promissory note, services performed, a contract for services to be performed or other interests in or securities or other obligations of any other LLC or other entity.<sup>470</sup> The Company Agreement ordinarily would contain provisions relative to capital accounts and the allocation of profits and losses comparable to those in a limited partnership agreement.

**K. Allocation of Profits and Losses; Distributions.** Allocations of profits and losses, and distributions of cash or other assets, of an LLC are made to the Members in the manner provided by the Company Agreement.<sup>471</sup> If the Company Agreement does not otherwise provide, allocations and distributions are made on the basis of the agreed value of the contributions made by each Member.<sup>472</sup> A Member is not entitled to receive distributions from an LLC prior to its winding up unless specified in the Company Agreement if the LLC is governed by the TBOC.<sup>473</sup> An LLC may not make a distribution to its Members to the extent that, immediately after giving effect to the distribution, all liabilities of the LLC, other than liabilities to Members with respect to their interests and non-recourse liabilities, exceed the fair value of the LLC assets.<sup>474</sup> 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.<sup>475</sup>

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<sup>469</sup> Cf. DEL. CODE ANN. tit. 6, § 18-108 (1999 & Supp. 2002) (providing that an LLC may, and shall have the power to, indemnify and hold harmless Members, Managers, and other persons from and against any and all claims).

<sup>470</sup> LLC Act § 5.01; TBOC § 1.002(9). LLC Act Section 5.02 and TBOC Sections 101.052 and 101.151 provide that written obligations to make contributions are enforceable, except to the extent otherwise provided in the Articles or Regulations (or Certificate of Formation or Company Agreement, as appropriate), and LLC Act Section 4.07 and TBOC Section 101.111(b) provide that an obligation to make a contribution will survive the assignment of the membership interest. LLC Act Section 5.02 and TBOC Section 101.156 provide that a conditional obligation to make a contribution to an LLC, which includes contributions payable upon a discretionary call prior to the time the call occurs, must be in writing and signed by the Member, and may not be enforced unless the conditions of the obligation have been satisfied or waived.

<sup>471</sup> LLC Act §§ 5.02-1, 5.03; TBOC §§ 101.052, 101.201.

<sup>472</sup> LLC Act §§ 5.02-1, 5.03; TBOC §§ 101.052, 101.201.

<sup>473</sup> TBOC Section 101.204 provides this as a new default rule, subject to contrary agreement under Section 101.052. The older LLC Act, however, simply provides that Members are entitled to pre-winding up distributions in accordance with the Articles of Incorporation. LLC Act § 5.04.

<sup>474</sup> LLC Act § 5.09A; TBOC § 101.206.

<sup>475</sup> LLC Act § 5.09B; TBOC § 101.206(d).

**L. Owner Limited Liability Issues.** The Tex. LLC Stats. provide that, except as provided in the Company Agreement, a Member or Manager is not liable to third parties for the debts, obligations or liabilities of an LLC, although Members are liable for the amount of any contributions they agreed in writing to make.<sup>476</sup> Members may participate in the management of the LLC without forfeiting this liability shield.<sup>477</sup> 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 LLCs in Texas, although this issue is not settled.<sup>478</sup> Some state LLC

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<sup>476</sup> LLC Act §§ 4.03, 5.02A; TBOC §§ 101.114; 101.151. LLC Act § 4.03 provides as follows:

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

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

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

TBOC Section 101.114 provides for substantially the same protection of Members and Managers as LLC Act Section 4.03A. See Part “VII. Extraterritorial Recognition of LLC and LLP Limited Liability” regarding uncertainties as to the extent to which this statutory limitation of liability will be recognized in other states.

The legislative history of the LLC Act mirrors the clear statutory statement that members and managers of an LLC are not to be personally liable for the obligations of the LLC (whether arising in tort or contract) by virtue of being a member or manager:

Article 4.03. Liability to Third Parties. This Article provides except as provided in the regulations, that a member or manager is not liable to third parties, expresses the legislative intent that limited liability be recognized in other jurisdictions and states a member is not a proper party to a proceeding by or against a Limited Liability Company.

The clear and unequivocal limitation of personal liability wording of LLC Act § 4.03A is to be contrasted with the more complicated and narrow wording of TBCA art. 2.21, which evolved as the Legislature attempted to drive a stake through the heart of *Castleberry v. Branscum*, 721 S.W.2d 270 (Tex. 1986) and its progeny. If the Bar Committee or the Legislature had conceived that the case law which had evolved in the corporate context would be applicable to LLCs, the wording of the LLC Act would have been different and might have mirrored that of the TBCA. Intending that corporate veil piercing principles not be applicable to LLCs, the Bar Committee and the Legislature opted for a simple, expansive and unequivocal statement that members and managers of LLCs do not have liability for any LLC obligations.

<sup>477</sup> The LLC Act does not contain any provision comparable to TRLPA § 3.03 or TBOC § 153.102, which make a limited partner liable for partnership obligations under certain circumstances if “the limited partner participates in the control of the business.”

<sup>478</sup> Only one Texas case has suggested that piercing the veil concepts from corporation law are applicable to LLCs. *Pinebrook Props., Ltd. v. Brookhaven Lake Prop. Owners Ass’n*, 77 S.W.3d 487, 500 (Tex. App.—Texarkana 2002, pet. denied). However, that opinion is neither well reasoned nor of precedential value. The Texarkana Court of Appeals assumed that corporate veil piercing rules must be applicable to an LLC because the LLC is a limited liability entity, but cited *Castleberry v. Branscum* as its only authority. See *Castleberry*, 721 S.W.2d at 272 (holding that alter ego is a basis for disregarding the corporate fiction). However, *Castleberry* was decided five years before the LLC Act, a precursor to the TBOC, was passed and made no reference to the LLC or any entity other than a business corporation. See *id.* The *Pinebrook* court then

statutes expressly deal with the veil piercing issue by providing that the LLC veil will be pierced to the same extent as the corporate veil<sup>479</sup> or that the Members will have the same liabilities as corporate shareholders.<sup>480</sup>

**M. Nature and Classes of Membership Interests.** A membership interest in an LLC is personal property.<sup>481</sup> It does not confer upon the Member any interest in specific LLC

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proceeded to analyze the facts before it under *Castleberry*—which has been repudiated by the legislature in amendments to TBCA art. 2.21A, and under TBCA art. 2.21A, which applies only to corporations and does not apply to LLCs. Ultimately the court held that veil piercing was not appropriate in the case *sub judice*.

The Tex. LLC Stats. do not generally incorporate general corporate law or principles for situations not addressed in the Tex. LLC Stats. See LLC Act § 8.12 (Applicability of Other Statutes) for reference to the few provisions of the TBCA and the TMCLA which apply to LLCs. None of those provisions relates to piercing the corporate veil. The provisions referenced in LLC Act § 8.12 were expressly incorporated into the TBOC, but still without reference to piercing the corporate veil.

While the Tex. LLC Stats. repudiate corporate veil piercing theories, parties dealing with an LLC are not without remedies against those responsible for the actions of the entity in appropriate situations. In contract situations, persons dealing with an LLC can condition their doing business with the LLC on (i) the LLC including in its Company Agreement provisions for the personal liability of members or managers in specified circumstances or (ii) members or managers personally guaranteeing obligations of the LLC. In the tort context, a member or manager individually may be a direct tortfeasor and liable under traditional tort law theories for his own conduct. See *Shapolsky v. Brewton*, 56 S.W.3d 120, 133 (Tex. App. Houston [14<sup>th</sup> Dist.] 2001, pet. denied). Thus, the LLC shield would be effective as to vicarious torts arising out of LLC activities, but not against a member's own miscreant conduct. For example, in a negligence action, the complaint would be against the member *qua* actor for his own negligent acts rather than *qua* member for the LLC's acts. See Murdock, *Limited Liability Companies in the Decade of the 1990s: Legislative and Case Law Developments and Their Implications for the Future*, 56 BUS. LAW. 499, 504 (Feb. 2001). A complaint could state a cause of action against a member for his individual negligence *qua* actor, but could not state a cause of action against a member for negligence attributed to the LLC due to the act of someone else.

There have been a number of cases in other jurisdictions in which courts have applied corporate veil piercing theories to LLCs. See, e.g., *N. Tankers (Cyprus) Ltd. v. Backstrom*, 967 F. Supp. 1391, 1402 (D. Conn. 1997); *Hollowell v. Orleans Reg'l Hosp.*, No. CIV.A.95-4029, 1998 WL 283298, at \*9 (E.D. La. May 29, 1998); *In re Multimedia Communications Group Wireless Assoc.*, 212 B.R. 1006 (Bankr. M.D. Fla. 1997); *Marina, LLC v. Burton*, No. CA 97-1013, 1998 WL 240364, at \*7 (Ark. App. May 6, 1998); *Ditty v. CheckRite, Ltd.*, 973 F. Supp. 1320, 1336 (D. Utah 1997). In *Ditty*, a case examining a Utah limitation of Member liability statute similar to LLC Act Article 4.03, the court wrote: "While there is little case law discussing veil piercing theories outside the corporate context, most commentators assume that the doctrine applies to limited liability companies." *Ditty*, 973 F. Supp. at 1336. The court then proceeded to uphold the limited liability of the sole Member, officer and director for the LLC, noting that the fact that defendant "played an active role in the firm's business is, at best, only marginally probative of the factors considered when determining whether to pierce the corporate veil." *Id.* In the court's view, the significant factors in determining whether to pierce the entity are "undercapitalization of a close corporation; failure to observe corporate formalities; siphoning of corporate funds by the dominant shareholder; nonfunctioning of other officers and directors; and the use of the corporation as a facade for operations of the dominant shareholder." *Id.* Texas has its own body of precedent in the corporate context with respect to piercing the corporate veil and, if a Texas court were to determine to look to corporate precedent in determining whether to respect the limitation of liability provided by the LLC Act, would not necessarily consider the same factors as the courts in the reported cases from other jurisdictions. See generally Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 8-9 (Nov. 1995).

<sup>479</sup> See COLO. REV. STAT. 7-80-107 (1998); MINN. STAT. ANN. 322B.303.2 (1995 & Supp. 1998); N.D. CENT. CODE §§ 10-32-29.3, 44-22-09 (2001); WASH. REV. CODE ANN. § 25.15.060 (West Supp. 2003).

<sup>480</sup> See W. VA. CODE § 31-B-3-303(b) (2003).

<sup>481</sup> LLC Act § 4.04; TBOC § 101.106.

property.<sup>482</sup> A membership interest may be evidenced by a certificate if the Company Agreement so provides.<sup>483</sup>

The Company Agreement may establish classes of Members having expressed relative rights, powers and duties, including voting rights, and may establish requirements regarding the voting procedures and requirements for any actions including the election of Managers and amendment of the Certificate of Formation and Company Agreement.<sup>484</sup> The Company Agreement could provide for different classes of Members, each authorized to elect a specified number or percentage of the Managers.<sup>485</sup> The Tex. LLC Stats. generally allow even more flexibility in structuring classes of Members than is available under Texas law in structuring classes of corporate stock.<sup>486</sup>

Whether an LLC membership interest is considered a “security” for the purposes of the Securities Act of 1933, as amended, and state securities or blue sky laws turns on the rights of the Members as set forth in the Company Agreement and other governing documents and the ability of the investor to exercise meaningful control over his investment.<sup>487</sup> The offer and sale

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<sup>482</sup> *Id.*

<sup>483</sup> LLC Act § 4.05B; TBOC § 3.201(e).

<sup>484</sup> LLC Act § 4.02; TBOC § 101.104.

<sup>485</sup> *See* LLC Act § 2.13; TBOC § 101.104.

<sup>486</sup> *See* 1993 LLC Bill Analysis at 2; *see also* TBOC §§ 21.152, 101.104.

<sup>487</sup> The Securities Act of 1933, 15 U.S.C.A. 77a, et seq. (1997) (the “1933 Act”), in § 77b(a)(1) defines the term “security” to include:

any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

As a result of judicial construction of the term “investment contract” this definition now encompasses most long-term means for raising funds. *See* Carl W. Schneider, *The Elusive Definitions of a “Security”*, 14 REV. SEC. REG. 981, 981 (1981); Carl W. Schneider, *Developments in Defining a “Security”*, 16 REV. SEC. REG. 985 (1983). The United States Supreme Court has held that the test for determining whether an “investment contract” exists is “whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.” *SEC v. W. J. Howey Co.*, 328 U.S. 293, 301 (1946); *see Robinson v. Glynn*, 349 F.3d 166 (4th Cir. 2003). In *Robinson*, the Fourth Circuit wrote:

Since *Howey*, however, the Supreme Court has endorsed relaxation of the requirement that an investor rely only on others’ efforts, by omitting the word “solely” from its restatements of the *Howey* test. And neither our court nor our sister circuits have required that an investor like *Robinson* expect profits “solely” from the efforts of others. Requiring investors to rely wholly on the efforts of others would exclude from the protection of the securities laws any agreement that involved even slight efforts from investors themselves. It would also exclude any agreement that offered investors control in theory, but denied it to

of an interest must either be registered under applicable federal and state securities laws<sup>488</sup> or effected in a private<sup>489</sup> or other transaction structured to be exempt from those requirements.<sup>490</sup>

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them in fact. Agreements do not annul the securities laws by retaining nominal powers for investors unable to exercise them.

What matters more than the form of an investment scheme is the “economic reality” that it represents. The question is whether an investor, as a result of the investment agreement itself or the factual circumstances that surround it, is left unable to exercise meaningful control over his investment. Elevating substance over form in this way ensures that the term “investment contract” embodies “a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”

*Id.* at 170. By analogy to corporate stock and investment contracts, a membership interest in an LLC which is governed by Managers is most likely to be considered to be a security. By analogy to interests in a general partnership, however, where the LLC is managed by its Members, the membership interest may not be deemed a security:

A general partnership interest normally is not a security, even if the investor elects to remain passive. But a general partnership interest may be a security if the rights of a partner are very limited in substance, or if the partner is an unsophisticated investor who must rely in fact on the business acumen of some other person.

A limited partnership interest normally is a security. On unusual facts, however, a limited partnership might not be a security -- e.g., where there is a single limited partner who negotiates directly with the general partner and retains significant influence over the venture, or where the limited partner otherwise has an active role in the venture.

Carl W. Schneider, *The Elusive Definition of a ‘Security’ -- 1990 Update*, 24 REV. SEC. & COM. REG. 13, 22 (Jan. 23, 1991); *see also* Marc I. Steinberg & Karen L. Conway, *The Limited Liability Company As A Security*, 19 PEPP. L. REV. 1105 (1992). Steinberg and Conway concluded that:

While each LLC interest must be analyzed by looking at the applicable statutes as well as the specific provisions contained in the member agreement and other operating documents, this article takes the position that LLC interests normally are securities. Three different methods of analysis lead to this result. First, one may look at the traditional “investment contract” test and find that LLC interests satisfy the *Howey* test, especially in light of the *Williamson* rationale. Second, LLC interests meet the attributes of stock test as set forth by the Supreme Court. Finally, one can classify an interest in a LLC as “any interest commonly known as a security.”

*Id.* at 1122. *See also SEC v. Parkersburg Wireless, LLC*, 991 F.Supp. 6, 8 (D.D.C. 1997) (holding that interests in an LLC with 700 Members were investment contracts); *S.E.C. v. Vision Communications, Inc.*, CIV. No. 94-0615, 1944 WL 855061, at \*1 (D.D.C. May 11, 1994) (holding LLC interests are securities); Mark A. Sargent, *Will Limited Liability Companies Punch a Hole in the Blue Sky?*, 21 SEC. REG. L.J. 429 (1994).

The federal definition of “security” has served as a model for most modern state statutes. JOSEPH C. LONG, 1985 BLUE SKY LAW HANDBOOK § 2.01 (1988 revision).

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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



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C and S-K thereunder contain the general registration requirements. The Securities and Exchange Commission (“SEC”) has set forth a number of registration forms to be used under varying circumstances. Form S-1 is the basic form to be used by an issuer unless another form is specifically prescribed. There are basically three stages in the registration process: the pre-filing stage, the waiting period, and the post-effective stage. During the pre-filing stage, § 5(c) of the 1933 Act prohibits the use of interstate facilities (including telephones) or the mails to “offer to sell.” Further, § 5(a) prohibits sales or deliveries at any time before the “effective” date of the registration statement, which includes the pre-filing stage. The term sale is defined to include “every contract of sale or disposition of a security or interest in a security, for value.” During the waiting period, written offers are still prohibited, but oral offers are permitted. Since the registration statement is still not “effective,” sales or deliveries are still forbidden. During the post-effective stage, sales may be made freely. A prospectus satisfying the requirements under the 1933 Act must accompany any interstate or mailed “delivery” of the security if the prospectus has not preceded the delivery. *See generally*, LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION ch. 2B (1988). Unlike the federal statute that seeks full disclosure, many of the state “blue sky” acts are based on a concept known as “merit regulation.” *Id.* at chs. 1B, 1C. Under these systems, the state securities administrator can prohibit a particular security from being offered in that state if the administrator determines that the terms of the offering are not “fair, just and equitable.” Most state acts do not define “fair, just and equitable.” In the Blue Sky Cases, the United States Supreme Court validated a number of state acts regulating securities on the basis that the acts neither violated the Fourteenth Amendment nor unduly burdened interstate commerce. *See Hall v. Geiger - Jones Co.*, 242 U.S. 539 (1917); *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559 (1917); *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917).

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

- (a) the number of offerees (there is no number of offerees that always makes an offering either private or public; 25 to 35 is generally considered consistent with a private offering, but the sophistication of the offerees is more important; an offer to a single unqualified investor can defeat the exemption and an offering to a few hundred institutional investors can be exempt; note that the judicial focus is upon the number of persons to whom the securities are offered, not the number of actual purchasers);
- (b) offeree qualification (each offeree should be sophisticated and able to bear the economic risk of the investment; a close personal, family or employment relationship should also qualify an offeree);
- (c) manner of offering (the offer should be communicated directly to the prospective investors without the use of public advertising or solicitation);
- (d) availability of information (each investor should be provided or otherwise have access to information comparable to that contained in a registration statement filed under the 1933 Act; commonly investors are furnished a “private offering memorandum” describing the issuer and the proposed transaction in at least as much detail as would be found in a registration statement filed with the SEC for a public offering registered under the 1933 Act); and
- (e) absence of redistribution (the securities must come to rest in the hands of qualified purchasers and not be redistributed to the public; securities sold in a private placement generally may be replaced privately, freely sold by a person who is not an affiliate of the issuer in limited quantities to the public pursuant to SEC Rule 144, 17 C.F.R. 230.144 (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

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”).<sup>491</sup> 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.<sup>492</sup> 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.<sup>493</sup>

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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 Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 900 (5th Cir. 1977); Carl W. Schneider, *The Statutory Law of Private Placements*, 14 REV. SEC. REG. 869, 870 (1981); ABA Comm. on Fed. Regulation of Sec., *Integration of Securities Offerings: Report of the Task Force on Integration*, 41 BUS. LAW. 595, 595 (1986); C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L. J. 1081, 1120-24 (1988).

SEC Regulation D (“Reg D”), 17 C.F.R. 230.501-506 (2005), became effective April 15, 1982 and is now the controlling SEC regulation for determining whether an offering of securities is exempt from registration under § 4(2) of the 1933 Act. Under Rule 506 of Reg D, there is no limitation on the dollar amount of securities that may be offered and sold, and the offering can be sold to an unlimited number of “accredited investors” (generally institutions, individuals with a net worth of over \$1 million and officers and directors and general partners of the issuer) and to a maximum of thirty-five nonaccredited investors (there is no limit on the number of offerees so long as there is no general advertising or solicitation). Each of the purchasers, if not an accredited investor, must (either alone or through a representative) have such knowledge and experience in financial matters as to be capable of evaluating the risks and merits of the proposed investment. Unless the offering is made solely to accredited investors, purchasers must generally be furnished with the same level of information that would be contained in a registration statement under the 1933 Act. Resales of the securities must be restricted and a Form D notice of sale must be filed with the SEC. An offering which strictly conforms to the Reg D requirements will be exempt even if it does not satisfy all of the judicial criteria discussed above; however, since Reg D does not purport to be the exclusive means of compliance with § 4(2), a placement which conforms to the foregoing judicial standards also will be exempt from registration under § 4(2) of the 1933 Act, even if it does not strictly conform to Reg D.

<sup>490</sup> 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).

<sup>491</sup> Act of June 17, 1983, 68th Leg., R.S., ch. 442, § 1, 1983 Tex. Gen. Laws 2511, *amended by* Act of June 16, 1995, 74th Leg., R.S., ch. 962, § 1, sec. 8.102, 1995 Tex. Gen. Laws 4760, 4761.

<sup>492</sup> Pre 9/1/95 B&CC § 8.321.

<sup>493</sup> 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

As of September 1, 1995, LLC membership interests are not “securities” governed by Chapter 8 of the Texas Business & Commerce Code, as amended by House Bill 3200 (“HB 3200” and “Post 9/1/95 B&CC”), unless the interests are dealt in or traded on securities exchanges or markets or unless the parties expressly agree to treat them as such.<sup>494</sup> 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.<sup>495</sup>

Under the Tex. LLC Stats., a judgment creditor of a Member may on application to a court of competent jurisdiction secure a “charging order” against the Member’s membership interest.<sup>496</sup> In a “charging order” a court “charges” the membership interest such that any distributions thereon are made as directed by the court, but does not order foreclosure of the interest or compel any distributions. A charging order should not permit a judgment creditor of a Member to receive distributions on an interest subject to a prior perfected security interest.

**N. Assignment of Membership Interests.** Unless otherwise provided in an LLC’s Company Agreement, a Member’s interest in an LLC is assignable in whole or in part.<sup>497</sup> 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.<sup>498</sup> 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.<sup>499</sup> 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.<sup>500</sup> An assignee of a membership interest may

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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.

<sup>494</sup> Post 9/1/95 B&CC §§ 8.102, 8.103(c).

<sup>495</sup> Post 9/1/95 B&CC §§ 9.106, 9.302(a). An LLC membership interest held in a securities account at a broker or dealer would be a “financial asset” and a “security entitlement” under Post 9/1/95 B&CC §§ 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.

<sup>496</sup> 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. TBOC § 101.112 provides substantially the same.

<sup>497</sup> LLC Act § 4.05A; TBOC § 101.108.

<sup>498</sup> *Id.*

<sup>499</sup> LLC Act § 4.05A; TBOC § 101.109.

<sup>500</sup> LLC Act § 4.05A; TBOC § 101.111.

become a Member if and to the extent that the Company Agreement so provides or all Members consent.<sup>501</sup> Until an assignee is admitted as a Member, the assignee does not have liability as a Member solely as a result of the assignment.<sup>502</sup>

The Company Agreement would typically contain restrictions on the assignment of interests to facilitate compliance with applicable securities and tax laws. Membership interest transfer restrictions contained in the Company Agreement are enforceable.<sup>503</sup>

**O. Dissolution.** Tex. LLC Stats. provide 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;<sup>504</sup>
- (2) any event specified in the Articles or Company Agreement to cause dissolution;<sup>505</sup>
- (3) the action of the Members to dissolve the LLC (in the absence of a specific provision in the Articles or Company Agreement, the vote will be by a majority of the Members);<sup>506</sup>
- (4) the occurrence of any event that terminates the continued membership of the last remaining Member of the LLC, absent certain circumstances;<sup>507</sup> or
- (5) entry of decree of judicial dissolution under the Tex. LLC Stats.<sup>508</sup>

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<sup>501</sup> LLC Act § 4.07A; TBOC §§ 101.109(b); 101.052. Under Tex. LLC Stats., an assignee who becomes a Member (i) has (to the extent assigned) the rights and powers, and is subject to the restrictions of, a Member under the Company Agreement and the Tex. LLC Stats., and (ii) becomes liable for the obligations of the assignor to make contributions known to him at the time he becomes a member or as provided in the Company Agreement, although the assignment does not release the assignor from his liabilities to the LLC. LLC Act § 4.07B; TBOC §§ 101.110; 101.111(b).

<sup>502</sup> LLC Act § 4.05C; TBOC § 101.109(c).

<sup>503</sup> Tex. LLC Stats. provide that a membership interest is assignable unless otherwise provided by the Company Agreement. LLC Act § 4.05A; TBOC § 101.108(a). There is no statutory requirement of “reasonableness” with respect to LLC transfer restrictions as is found in TBCA § 2.22 and TBOC §§ 21.211 and 21.213.

<sup>504</sup> LLC Act §§ 3.02A(2), 6.01A(1); TBOC § 11.051(1); *see* 1993 LLC Bill Analysis at 4.

<sup>505</sup> LLC Act § 6.01A(2); TBOC § 11.051(3).

<sup>506</sup> LLC Act §§ 2.23D(2), 6.01A(3); TBOC §§ 11.051(2), 101.552. *See* 1993 LLC Bill Analysis at 5. Additionally, the TBOC provides that if there are no members, dissolution may occur upon the majority vote of the LLC’s managers. *See* TBOC § 101.552. This provision was intended to parallel the LLC Act provision which provided for dissolution upon the act of a majority of the Managers or Members named in the Articles, if no capital has been paid into the LLC and the LLC has not otherwise commenced business. LLC Act § 6.01A(4); *see* Revisor’s Note to TBOC § 101.552.

<sup>507</sup> LLC Act § 6.01A(5), as amended by HB 1637 effective September 1, 2003; TBOC § 11.056. An LLC is not dissolved upon the termination of membership of the last remaining Member if the legal representative or successor of the last remaining Member agrees to continue the LLC and to become a Member as of the date of the termination of the last remaining Member’s membership in the LLC or designates another person who agrees to become a Member of the LLC as of the date of the termination. LLC Act § 6.01C as amended by HB 1637 effective September 1, 2003; TBOC § 11.056.

<sup>508</sup> LLC Act § 6.01A(6), 6.02A; TBOC § 11.051(5).

However, an LLC may in many cases cancel the event that would otherwise require dissolution or termination and carry on its business. The procedures for doing so differ both by whether the LLC is governed by the TBOC or the LLC Act and by the type of event requiring dissolution. The TBOC simply requires a majority vote of all the LLC's Members (or, if there are no Members, a majority vote of all its Managers) to either revoke a voluntary winding up or approve cancellation of an event that would otherwise require termination and winding up, other than a judicial decree.<sup>509</sup> Under the LLC Act, revocation of a voluntary dissolution simply requires the written consent of all its members,<sup>510</sup> while an election to continue following the expiration of a fixed period of duration for the LLC or the occurrence of events in the LLC's governing documents requiring dissolution can only happen if there is at least one remaining member and all members vote to continue (unless a lesser percentage is specified in the Articles of Organization Regulations).<sup>511</sup>

The time frames for permissible elections to continue in business also differ by governing law and type of event of dissolution, and are all subject to restrictions in an LLC's governing documents. Where the event of dissolution is the termination of the LLC's period of duration, the TBOC allows three years for cancellation, whereas the LLC Act requires an election to cancel within 90 days of the expiration, and subject to the amendment within three years of the LLC's formation document allowing for a longer duration.<sup>512</sup> For voluntary dissolutions, the LLC Act allows the LLC to cancel such dissolution within 120 days of the issuance of a certificate of dissolution, whereas the TBOC mandates that such election be made before the effective date of termination of the LLC's existence.<sup>513</sup> For the occurrence of an event determined in the LLC's governing documents to require automatic dissolution, the LLC Act requires any cancellation election to be made within 90 days of the event, subject to amendment of the LLC's governing documents within three years to eliminate dissolution upon such event, while the TBOC allows one year to revoke such dissolution.<sup>514</sup> For other circumstances requiring termination under the TBOC, LLCs are permitted one year to cancel the event of termination.<sup>515</sup>

Since (i) under the Check-the-Box Regulations continuity of life is not an issue in determining whether an LLC will be treated as a partnership for federal income tax purposes and (ii) there is considerable flexibility under the Tex. LLC Stats. in defining the circumstances in which an LLC is dissolved, the Certificate and Company Agreement should henceforth focus on dissolution from a business rather than a tax standpoint. The result in many cases will be that the LLC will not dissolve until the parties take affirmative action to cause dissolution.

Upon the dissolution of an LLC, its affairs must be wound up as soon as practicable by its Managers, or Members or other persons as provided in its Certificate or Company Agreement or

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<sup>509</sup> TBOC § 101.552.

<sup>510</sup> LLC Act § 6.06A.

<sup>511</sup> LLC Act § 6.01B.

<sup>512</sup> LLC Act § 6.01B; TBOC § 11.152(b).

<sup>513</sup> LLC Act § 6.06A; TBOC § 11.151.

<sup>514</sup> LLC Act § 6.01B; TBOC § 11.152(a).

<sup>515</sup> TBOC § 11.152(a).

by resolution of the Managers or Members.<sup>516</sup> Before filing a certificate of termination with the Secretary of State,<sup>517</sup> the LLC shall (i) cease to carry on its business, except as may be necessary for the winding up thereof, (ii) send written notice of its intention to dissolve to each of its known creditors and claimants,<sup>518</sup> and (iii) collect its assets, discharge its obligations or make provision therefor, and distribute the remaining assets to its Members.<sup>519</sup> 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.<sup>520</sup> Upon the filing of a certificate of termination with the Secretary of State, the existence of the LLC terminates except for the purpose of suits and other proceedings by Members, Managers and other LLC representatives.<sup>521</sup>

**P. Merger; Conversion.** Part Ten of LLC Act and Chapter 10 of the TBOC contain merger provisions that allow an LLC to merge with one or more LLCs or “other entities” (i.e. any corporation, limited partnership, general partnership, joint venture, joint stock company, cooperative, association, bank, insurance company or other legal entity) to the extent that the laws or constituent documents of the other entity permit the merger.<sup>522</sup> The merger must be pursuant to a written plan of merger containing certain provisions,<sup>523</sup> and the entities involved must approve the merger by the vote required by their respective governing laws and organizational documents. Under Tex. LLC Stats., a merger is effective when the entities file an appropriate certificate of merger with the Secretary of State, unless the plan of merger provides for delayed effectiveness.<sup>524</sup>

An LLC's merger with another entity must be approved by a majority of the LLC's members, unless its certificate of formation or Company Agreement specifies otherwise.<sup>525</sup> The Tx. LLC Stats. grant broad authority for who can execute merger documents on a company's behalf.<sup>526</sup> Their provisions on short form mergers are broadly drafted to allow their application

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<sup>516</sup> LLC Act § 6.03A; TBOC § 101.551.

<sup>517</sup> For entities still governed by the LLC Act, the proper filing document is articles of dissolution. *See* LLC Act § 6.07. For the required elements that must appear in a certificate of termination under the TBOC, see TBOC § 11.101.

<sup>518</sup> Under Article 6.05 of the LLC Act, notice must be sent by registered or certified mail. Under the new TBOC, notice must still be written, but can alternately be sent through a variety of technological means. *See* Revisor's Note to TBOC § 11.052.

<sup>519</sup> LLC Act § 6.05; TBOC § 11.052.

<sup>520</sup> LLC Act § 6.05(A)(3); TBOC § 11.053(b). The TBOC provides that such distribution may be delayed if continuing the business for a limited period will prevent unreasonable loss of the LLC property. *See* TBOC § 11.053(d).

<sup>521</sup> LLC Act § 6.08(B); TBOC §§ 11.055, 11.102. Under the LLC Act, such existence terminates upon the issuance of a certificate of dissolution by the Secretary of State. LLC Act § 6.08B.

<sup>522</sup> However, the TBOC does impose restrictions on mergers involving nonprofit corporations. *See* TBOC § 10.010.

<sup>523</sup> The LLC Act's requirements appear in its Article 10.02. The TBOC's requirements are in its Sections 10.002 and 10.003.

<sup>524</sup> LLC Act §§ 9.03, 10.03; TBOC § 10.007 and Revisor's Note thereto.

<sup>525</sup> LLC Act § 10.01A; TBOC §§ 10.001, 101.356, 101.052.

<sup>526</sup> LLC Act § 10.03A; TBOC §§ 10.001(b), 10.151(b).

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.<sup>527</sup>

The Tex. LLC Stats. also authorize 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 plan of conversion, owner approval, filings with the Secretary of State, and the protection of creditors.<sup>528</sup>

**Q. TLLCA Relationship to TBCA and TMCLA.** While LLCs governed by the TBOC need only look to the TBOC to ascertain applicable law, those LLCs still governed by the LLC Act are subject not only to that Act but also other pre-TBOC business entity statutes incorporated by reference thereto. The 1991 LLC Act § 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.<sup>529</sup> 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.<sup>530</sup>

The 1991 LLC Act was left relatively short to provide maximum flexibility to parties to tailor their organizational structures to transactional needs. The references to the TBCA and TMCLA were inserted to allow established bodies of law under those statutes to serve as gap fillers in areas where the LLC Act, the Articles and the Company Agreement are silent. The concept of “piercing the corporate veil,” which developed under the TBCA, is inconsistent with the concept of limited liability for Members in the LLC Act and was not intended to be carried over.<sup>531</sup> The concepts of cumulative voting and preemptive rights, from TBCA §§ 2.29D and 2.22-1 respectively, 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, 1997 and 2003, LLC Act § 8.12A provides that only the following TBCA Articles apply to an LLC and its Members, Managers and officers:

- 2.07 (registered name)
- 2.08 (renewal of registered name)
- 4.14 (amendments of Articles, merger and dissolution pursuant to Federal bankruptcy laws)
- 5.14 (derivative suits)
- Part Seven (involuntary dissolution and receivership).

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<sup>527</sup> See LLC Act § 10.05; TBOC § 10.006.

<sup>528</sup> LLC Act §§ 10.08-10.09; TBOC §§ 10.101-10.105. Note, the TBOC permits LLCs still governed by the LLC Act to convert into another entity form to be governed by the TBOC. TBOC § 10.102.

<sup>529</sup> 1991 LLC Act § 8.12.

<sup>530</sup> *Id.*

<sup>531</sup> See LLC Act § 4.03; *see also* Section V.L., *infra*.

LLC Act § 8.12B provides that the following TMCLA Articles apply to an LLC, its Members, Managers and officers:

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

TMCLA Articles 2.03, 2.04, 2.09 and 2.09A were repealed by HB 1165 effective September 1, 2003, but LLC Act § 8.12B was not correspondingly amended.

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

**R. Foreign LLCs.** The Tex. LLC Stats. provide a mechanism by which a limited liability company formed under the laws of 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 Tex. LLC Stats. to a domestic LLC.<sup>532</sup> The LLC Act defines Foreign LLC broadly so that business trusts and other entities afforded limited liability under the laws under which they were organized, but which would not qualify for LLC status if formed in Texas, can still qualify to do business and achieve limited liability in Texas.<sup>533</sup> However, under the TBOC, such specific provision was unnecessary, as such entities may register directly to transact business in Texas under TBOC Chapter 9 and be afforded the limited liability shield.<sup>534</sup> A foreign entity comparable to a Texas LLC and doing business in Texas registers and thereby qualifies to do business in Texas by filing an application to do so with the Secretary of State.<sup>535</sup>

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<sup>532</sup> LLC Act Part Seven; TBOC Chapter 101.

<sup>533</sup> “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.

<sup>534</sup> See TBOC §§ 9.001 and 101.001 and the Revisor’s Notes thereto.

<sup>535</sup> LLC Act §§ 7.01A, 7.05; TBOC §§ 9.001, 9.004.



The analysis of whether a Foreign LLC is doing business in Texas so as to require qualification is the same as for a foreign corporation.<sup>536</sup>

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.<sup>537</sup> However, for matters affecting intrastate business in Texas, a Foreign LLC is subject to the same duties, restrictions, and liabilities as a domestic LLC.<sup>538</sup> The failure of a Foreign LLC to qualify to do business in Texas will not impair the limitation on liability of its Members or Managers, which gives specific effect to the applicability of the internal affairs doctrine relating to foreign entities in the case of a non-qualified Foreign LLC.<sup>539</sup>

**S. Professional LLCs.** Tex. LLC Stats. expressly provide for the formation of professional LLCs and specify the statutory requirements for such entities.<sup>540</sup> The pertinent provisions of the LLC Act (a predecessor to the TBOC), including the definition of “professional service,” were based upon the Texas Professional Corporation Act (“TPCA”).<sup>541</sup> Unlike the TPCA, however, physicians, surgeons and other doctors of medicine are not excluded from forming professional LLCs.<sup>542</sup>

A professional limited liability company (a “PLLC”) is required to contain in its name the words ‘Professional Limited Liability Company’ or an abbreviation thereof.<sup>543</sup> Only a

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<sup>536</sup> LLC Act § 7.01B; TBCA § 8.01B; TBOC § 9.251.

<sup>537</sup> LLC Act § 7.02 provides in relevant part as follows with respect to a Foreign LLC that has procured a certificate of authority from the Secretary of State to transact business in Texas pursuant to LLC Act Part Seven:

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

The TBOC also provides for governance of a Foreign LLC’s internal affairs by the laws of its jurisdiction of organization. In fact, such governance is in the TBOC’s very definition of “foreign entity,” which states that the term “means an organization formed under, and the internal affairs of which are governed by, the laws of a jurisdiction other than this state.” TBOC § 1.002(28).

<sup>538</sup> LLC Act § 7.02A; TBOC § 9.203.

<sup>539</sup> LLC Act § 7.13B; TBOC § 9.051(c).

<sup>540</sup> See Part Eleven of the LLC Act; see also TBOC Chapters 301 and 304. The Texas Disciplinary Rules of Professional Conduct permit Texas lawyers to form a Texas LLC for the practice of law. Op. Tex. Ethics Comm’n No. 486 (1994). Most (but not all) states will also allow attorneys to practice in an LLC, at least so long as the client is on notice of dealing with a limited liability entity and each lawyer rendering services to a client remains fully accountable to the client. Lance Rogers, *Questions of Law and Ethics Face Firms Becoming LLPs, LLCs*, in 12 ABA/BNA Law. Manual on Prof. Conduct 411 (No. 23, Dec. 11, 1996); see ABA Comm. on Ethics and Prof’l Responsibility, Formal Op. 96-401 (1996).

<sup>541</sup> TEX. REV. CIV. STAT. ANN. art. 1528e, §3(a) (Vernon 2002).

<sup>542</sup> 1993 LLC Bill Analysis at 6; LLC Act § 11.01; TBOC §§ 301.003, 301.012.

<sup>543</sup> LLC Act § 11.02; TBOC § 5.059.

“professional individual”<sup>544</sup> or a “professional organization”<sup>545</sup> may be a governing person<sup>546</sup> of a PLLC.<sup>547</sup> The PLLC, but not the other individual Members, Managers or officers, is jointly and severally liable with a Member, Manager, officer, employee or agent rendering professional service for an error, omission, negligence, incompetence, or malfeasance on the part of the Member, Manager, officer, employee or agent when the Member, Manager, officer, employee or agent is rendering professional service in the course of employment for the PLLC.<sup>548</sup>

**T. Diversity Jurisdiction.** The cases are divided as to whether the citizenship of an LLC for federal diversity jurisdiction purposes should be determined by analogy to a partnership or a corporation. Where citizenship is determined in accordance with partnership precedent, an LLC is deemed a citizen of each state in which it has a Member.<sup>549</sup> 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.<sup>550</sup>

## **VI. LIMITED LIABILITY PARTNERSHIP.<sup>551</sup>**

**A. General.** An LLP is a general partnership in which the individual liability of partners for partnership obligations is substantially limited. This species of general partnership represents a dramatic innovation and was first authorized in 1991 by provisions (the “LLP Provisions”) added to the Texas Uniform Partnership Act (“TUPA”) by Sections 83-85 of House Bill 278.<sup>552</sup> The LLP Provisions were refined and carried forward as § 3.08 of the Texas Revised Partnership Act<sup>553</sup> (“TRPA”) passed in 1993, and then were substantially expanded by SB 555 effective September 1, 1997.<sup>554</sup>

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<sup>544</sup> Tex. LLC Stats. define “professional individual” to mean an individual who is licensed or otherwise authorized to render the same professional service as the PLLC, either within Texas or in any other jurisdiction. LLC Act § 11.01B(3); TBOC § 301.003(5).

<sup>545</sup> TBOC § 301.003(7). The LLC Act uses the alternate term “professional entity,” LLC Act § 11.01B(4), but either term indicates a person other than an individual that renders the same professional service as the PLLC, only through owners, members, employees, agents, and the like, each of whom is either a professional individual or professional organization or entity.

<sup>546</sup> “Governing person” is a new term of art in the TBOC, and refers to a person entitled to manage and direct an entity’s affairs under the TBOC and the entity’s governing documents. TBOC §§ 1.001(37), (35). In terms of the LLC Act, the governing person would be the same as the members, if member-managed, and the managers if manager-managed.

<sup>547</sup> LLC Act § 11.03A; TBOC §§ 301.007(a), 301.004(2).

<sup>548</sup> LLC Act § 11.05; TBOC § 301.010.

<sup>549</sup> *International Flavors & Textures, LLC v. Gardner*, 966 F.Supp. 552 (W.D. Mich. 1997).

<sup>550</sup> *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).

<sup>551</sup> The discussion of LLPs herein, insofar as it relates to LLP’s under HB 278, is drawn in part from R. Dennis Anderson, Alan R. Bromberg, Byron F. Egan, Campbell A. Griffin, Larry L. Schoenbrun and Charles Szalkowski, *Registered Limited Liability Partnerships*, Vol. 28, No. 3 BULL. OF SEC. OF BUS. L. 1 (Jan. 1992); reprinted 55 TEX. B. J. 728 (July 1992).

<sup>552</sup> Tex. HB 278, 72d Leg., R.S. (1991).

<sup>553</sup> TEX. REV. CIV. STAT. ANN. art. 6132b, §1.01 et seq. (Vernon Supp. 2006).

<sup>554</sup> Tex. SB 555, 75th Leg., R.S. (1997). Under TRPA § 11.03(b), TRPA § 3.08 governs all LLPs between January 1, 1994 and December 31, 2005 (regardless of when formed). Its coverage continues until December

The LLP provisions appearing in the new TBOC<sup>555</sup> took effect on January 1, 2006 and govern all LLPs formed on or after that date.<sup>556</sup> The source LLP Provisions will govern LLPs formed before that date which do not voluntarily opt in to TBOC governance until their registrations expire, unless they are revoked or withdrawn prior to expiration.<sup>557</sup> Registration renewal, however, will be governed by the TBOC.<sup>558</sup> The LLP Provisions or TBOC LLP provisions, as each may be applicable to a particular LLP, will be hereinafter collectively referred to as “Tex. LLP Stats.,” with differences between the two noted as appropriate.

**B. Background.** The LLP Provisions of TUPA originated in a separate bill, Senate Bill 302 (“SB 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.<sup>559</sup> 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 SB 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.<sup>560</sup> Thus, the proposed amendments to TUPA that were contained in SB 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. SB 302 passed the Senate but encountered criticism in hearings before the House Business and Commerce Committee on grounds, among others, that the Bill was discriminatory against non-professional partnerships, that the Bill did not tell persons dealing with a partnership whether the partnership had the liability shield, and that the Bill did not require any substitute source of recovery for a person injured by partnership misconduct.<sup>561</sup> 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 HB 278 in the Senate, and the House concurred in HB 278 as so amended. With the adoption of TRPA in House Bill 273 (“HB 273”), the LLP Provisions of TUPA were refined and carried over into TRPA.

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31, 2009 for those LLPs formed prior to January 1, 2006 but not opting into the TBOC. However, an LLP formed before January 1, 1994 and governed by the TRPA is subject to TUPA for the purposes of determining liability for acts occurring prior to January 1, 1994. The TRPA phase-in provisions relating to LLPs deal only with the LLP Provisions in TRPA § 3.08. The other aspects of a partnership entity which is an LLP are governed by the remaining provisions of TRPA which have a different statutory phase-in. TRPA § 11.03 provides that, except for § 3.08, TRPA applies on and after January 1, 1994 to (i) new partnerships formed on and after that date and (ii) existing partnerships which elect to be governed by TRPA; and all partnerships will be governed by TRPA after January 1, 1999 (though again, subject to the phase in of the TBOC).

<sup>555</sup> See TBOC Title 1 and §§ 152.801-152.805.

<sup>556</sup> TBOC §§ 401.001, 402.001, 402.003, 402.005.

<sup>557</sup> TBOC § 402.001(b).

<sup>558</sup> TBOC § 402.001(c).

<sup>559</sup> TEX. REV. CIV. STAT. ANN. art. 1528e (Vernon Supp. 2006).

<sup>560</sup> See Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065 (1995).

<sup>561</sup> See TEX. LAW., May 13, 1991 at 7; TEX. LAW., October 21, 1991 at 1.

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 HB 278, (iii) the passage of TRPA in HB 273, maintaining the LLP entity created by HB 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 TMCLA art. 1302-7.06 authorizing the limitation of liability of directors. These legislative changes were made during a period of increasing litigation against individuals for actions that they allegedly took, or failed to take, while serving as directors, officers or partners of a firm that failed or provided services to a firm that failed. This litigation often involved amounts that dwarfed the net worth of the individuals involved.

The LLP has spread beyond its Texas roots and now every state has adopted an LLP statute. As the adoption of LLP statutes became more widespread, the LLP statutes of an increasing number of states protected partners from liabilities arising other than from the negligence, malpractice, wrongful acts or misconduct of other partners and employees.<sup>562</sup> 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.<sup>563</sup>

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 contractual 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 debts and obligations of the partnership incurred while the partnership is a registered limited liability partnership. The new TBOC affords LLP partners the same protection.<sup>564</sup> 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.

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<sup>562</sup> See, e.g., N.Y. Partnership Law § 26(b) (McKinney 1988 & Supp.); Hamilton, *Registered Limited Liability Partnerships: Present at Birth (Nearly)*, 66 U. COL. L. REV. 1065, 1097 (1995).

<sup>563</sup> N.Y. Partnership Law § 26(c), (d) (McKinney 1988 & Supp.).

<sup>564</sup> TBOC § 152.801.

A new subsection (5) was added to TRPA § 3.08(a)<sup>565</sup> 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.<sup>566</sup> 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. Similarly, for organizations subject to the TBOC, the TBOC's provisions govern contracts the LLP enters on and after the first date the TBOC applies to the LLP, but prior law governs any contracts entered into under such old law.<sup>567</sup>

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 LLPs and the liability of incoming partners. TBOC § 152.707 provides substantially the same.

**C. Liability Shielded.** Partners in a general partnership that is not an LLP are individually liable, jointly and severally, for all partnership obligations, including partnership liabilities arising from the misconduct of other partners, although under Texas law a creditor generally must first seek to satisfy the obligations out of partnership property.<sup>568</sup> Although an LLP is a general partnership, the general partnership joint and several liability scheme is dramatically altered by the Tex. LLP Stats. when LLP status is attained.

1. **LLP Shield.** The essence of the Tex. LLP Stats. shield is to relieve a partner from individual liability for partnership obligations, except to the extent that they are attributable to the fault of the partner. The shield is set forth in TBOC § 152.801 as follows:

Sec. 152.801. Liability of Partner.

(a) Except as provided by Subsection (b), a partner in a limited liability partnership is not personally liable, directly or indirectly, by contribution, indemnity, or otherwise, for a debt or obligation of the partnership incurred while the partnership is a limited liability partnership.

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<sup>565</sup> The TBOC's parallel provision is in § 152.801(f).

<sup>566</sup> 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.”

<sup>567</sup> TBOC § 402.006.

<sup>568</sup> TRPA § 3.05(a), (d), (e); TBOC § 152.306(b). See A. Bromberg and L. Ribstein on Partnership, § 1.01 and ch. 5 for a general discussion of the liabilities of general partners.

(b) A partner in a limited liability partnership is not personally liable for a debt or obligation of the partnership arising from an error, omission, negligence, incompetence, or malfeasance committed by another partner or representative of the partnership while the partnership is a limited liability partnership and in the course of the partnership business unless the first partner:

- (1) was supervising or directing the other partner or representative when the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative;
- (2) was directly involved in the specific activity in which the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative; or
- (3) had notice or knowledge of the error, omission, negligence, incompetence, or malfeasance by the other partner or representative at the time of the occurrence and then failed to take reasonable action to prevent or cure the error, omission, negligence, incompetence, or malfeasance.

(c) Sections 2.101(1), 152.305, and 152.306 do not limit the effect of Subsection (a) in a limited liability partnership.

(d) In this section, "representative" includes an agent, servant, or employee of a limited liability partnership.

(e) Subsections (a) and (b) do not affect:

- (1) the liability of a partnership to pay its debts and obligations from partnership property;
- (2) the liability of a partner, if any, imposed by law or contract independently of the partner's status as a partner; or
- (3) the manner in which service of citation or other civil process may be served in an action against a partnership.

(f) This section controls over the other parts of this chapter and the other partnership provisions regarding the liability of partners of a limited liability partnership, the chargeability of the partners for the debts and obligations of the partnership, and the obligations of the partners regarding contributions and indemnity.

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

2. Limits to LLP Shield. The Tex. LLP Stats. expressly do not relieve a partner for any liability imposed by law or contract independently of his status as a partner, including torts committed by him while acting on behalf of the partnership.<sup>569</sup> In addition, there are three situations in which the statutes do not shield a partner from liability for a partnership obligation arising from the specified misconduct of a copartner or representative of the partnership:

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<sup>569</sup> TRPA § 3.08(a)(3)(B); TBOC § 152.801(e).

- (1) The miscreant copartner or representative is working under the supervision or direction of the partner.<sup>570</sup>
- (2) The partner is directly involved in the specific activity in which the copartner or representative commits the misconduct.<sup>571</sup>
- (3) The partner has “notice” or “knowledge” of the misconduct at the time of occurrence and fails to take reasonable steps to prevent the misconduct.<sup>572</sup>

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.<sup>573</sup> 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

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<sup>570</sup> TRPA § 3.08(a)(2); TBOC § 152.801(b)(1).

<sup>571</sup> TRPA § 3.08(a)(2)(A); TBOC § 152.801(b)(2).

<sup>572</sup> TRPA § 3.08(a)(2)(B); TBOC § 152.801(b)(3). Tex. LLP Stats. provide that a person has “notice” of a fact if such person (i) has actual knowledge of such fact, (ii) has received a communication of the fact, or (iii) reasonably should have concluded, from all facts known to such person at the time in question, that the fact exists. A person is treated as having received a communication of a fact if the fact is communicated to the person, the person’s place of business, or another place held out by the person as the place for receipt of communications. TRPA § 1.02; TBOC § 151.003.

<sup>573</sup> *But see* Fortney, *Am I My Partner’s Keeper? Peer Review in Law Firms*, 66 U. COL. L. REV. 329, 331-32 (1995) (notes that in six “actions brought in connection with failed savings and loan associations, the government has alleged that *each law firm partner is personally liable for failing to monitor* the conduct of *other firm partners*. \* \* \* In making such allegations the government has asserted that the failure to monitor claims are distinct from the vicarious liability claims,” for which the LLP shield was designed).

“involved in the specific activity” (i.e., advising with respect to environmental law) in which the misconduct occurred (which means that exception (2) would not apply).

3. Burden of Proof. The liability shield of the Tex. LLP Stats. is an affirmative defense, with the burden of proof on the partner claiming its benefit to show that the partnership is an LLP (i.e. that it complied at the relevant time(s) with the registration, name and insurance requirements). The burden would then shift to the plaintiff to prove that one or more of the three exceptions apply to remove the liability shield from particular partners.

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.<sup>574</sup> A partnership may still be sued as an entity in its common name under Rule 28 of the Texas Rules of Civil Procedure, with or without the partners.<sup>575</sup> Citation or other process against a partnership may still be served on a partner under Section 17.022 of the Texas Civil Practice and Remedies Code, regardless of whether the partner is shielded from liability by the partnership’s LLP status.<sup>576</sup>

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 Tex. LLP Stats. do not deal with the right of a partnership to pay unshielded obligations before paying shielded obligations or whether partner contributions may be earmarked to cover particular unshielded obligations. These matters are left to fiduciary principles and laws pertaining to creditors rights.

6. Contractual Obligations Incurred Prior to September 1, 1997. The amendment to TRPA § 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.”

Such obligations are similarly unshielded for partnerships governed by the TBOC.<sup>577</sup> 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.

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<sup>574</sup> TRPA § 3.08(a)(3)(A) and TBOC § 152.801(e)(1) provide that the other Texas LLP provisions “do not affect . . . the liability of a partnership to pay its debts and obligations [out of] partnership property.”

<sup>575</sup> TEX. R. CIV. P. 28.

<sup>576</sup> TEX. REV. CIV. STAT. ANN. art. 6132b-3.08(a)(3)(C) (Vernon Supp. 2006).

<sup>577</sup> TBOC § 402.006.



7. Other State LLP Statutes. In the other states that have LLP statutes, the scope of liability from which an innocent partner in an LLP is protected varies from state to state. Some LLP statutes only protect partners from vicarious liability for tort-type liabilities (“*partial shield*”), while others provide a “*full shield*” of protection from both tort and contract liabilities of the partnership,<sup>578</sup> perhaps in recognition that some malpractice claims could be pled in contract as well as in tort.<sup>579</sup> Under most LLP statutes, including that of Delaware,<sup>580</sup> 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.<sup>581</sup> 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.<sup>582</sup>

**D. Requirements for LLP Status.** Each of the three requirements described below must be satisfied in order for the LLP shield to be in place in Texas. Creditors seeking to break the shield can be expected to require proof of satisfaction of each of the conditions and to challenge any noncompliance.

1. Name. The Tex. LLP Stats. require that an LLP must include in its name the words “limited liability partnership” or an abbreviation thereof.<sup>583</sup>

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<sup>578</sup> 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).

<sup>579</sup> Miller, *Procedural and Conflict Laws Issues Arising In Connection With Multi-State Partnerships* (ABA BUS. L. SEC. 1996 Spring Meeting).

<sup>580</sup> DEL. CODE ANN. tit. 6, § 1515 (1999 & Supp. 2005).

<sup>581</sup> MD. CORP. & ASS’N. CODE ANN. § 9A-306(d)(1) (1999).

<sup>582</sup> KY. REV. STAT. ANN. § 362.220 (Michie 2002); UTAH CODE ANN. § 48-1-12(2) (2002).

<sup>583</sup> TRPA § 3.08(c); TBOC § 5.063; TEX. ADMIN. CODE tit. 1, § 80.1(b) (2003). Under the TRPA, LLPs were officially called registered limited liability partnerships. The TRPA also imposed additional restrictions regarding an LLP’s name which have been omitted from the TBOC. See Revisor’s Notes to TBOC §§ 1.002(48) and 5.063. A firm with a written partnership agreement should amend the agreement to include the required words or letters as part of its name.

Compliance with the Texas name requirements by a law firm should not conflict with the misleading name prohibition in Rule 7.01 of Texas Disciplinary Rules of Professional Conduct, which provides in relevant part as follows:

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

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

2. Filing with the Secretary of State of Texas. LLPs are considered to be non-filing entities under the TBOC.<sup>584</sup> Nonetheless, to achieve domestic LLP status, a partnership must file with the Secretary of State of Texas<sup>585</sup> an application accompanied by a fee for each partner of \$200.<sup>586</sup> The application must (a) state the name of the partnership, the address of its principal office, the number of partners and the business in which the partnership engages, plus the federal tax identification number of the partnership,<sup>587</sup> and (b) be executed by a majority in interest<sup>588</sup> of the partners or by one or more partners authorized by a majority in interest of the partners. The Tex. LLP Stats. do not require that an LLP filing with the Secretary of State have any express authorization in the partnership agreement, but changing the name to include the required words or abbreviation required by Tex. LLP Stats. would ordinarily require that the partnership agreement contemplate LLP status.<sup>589</sup>

If the required information is supplied in the application and the fee is paid, the LLP registration becomes effective upon filing.<sup>590</sup> There is no requirement for the Secretary of State to issue a certificate. As evidence of the filing, the Secretary of State will return a file-stamped duplicate of the application. The Tex. LLP Stats. now permit electronic filings of LLP documents as soon as the Secretary of State's procedures will permit.<sup>591</sup>

Registration remains effective for a year,<sup>592</sup> regardless of changes in the partnership, unless the registration is earlier withdrawn or revoked or unless renewed.<sup>593</sup> Because the registration is a notice filing and no listing of partners is required in the application, partnership changes due to withdrawals or to admissions of new partners do not require any

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Provisions clearly shows that the legislature intended the LLP form of business organization to be available to firms of lawyers and other professionals.

<sup>584</sup> See TBOC §§ 1.002(57), (34).

<sup>585</sup> The rules of the Secretary of State dealing with LLP filings may be found at TEX. ADMIN. CODE tit. 1, §§ 80.1-80.7 (2003) as well as TRPA § 3.08(b) and TBOC § 152.802.

<sup>586</sup> The \$200 per partner fee for LLPs organizing under Texas law is based on the total partners in the firm, and not the number of partners in Texas, under TRPA § 3.08(b)(3) and TBOC § 4.158(1). For a foreign LLP, the fee is \$200 per partner in Texas, not to exceed \$750, under TRPA § 10.02(c) and TBOC § 4.158(1).

<sup>587</sup> The Secretary of State's form of application and the Tex. LLP Stats. require the tax identification number of the partnership as part of the application to provide more positive identification than the partnership name, which may change or may be similar to other names.

<sup>588</sup> "Majority in interest" is defined in TRPA § 1.01(10), TRLPA § 1.02(7), and TBOC § 151.001(3) as more than 50% of the current interest in profits of the partnership. Although not required by the Secretary of State's form or the Tex. LLP Stats., it is prudent for an application to recite that it is signed by a majority in interest of the partners or by one or more partners authorized by a majority in interest of the partners.

<sup>589</sup> 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).

<sup>590</sup> TBOC § 4.051. The Secretary of State must register or renew as an LLP any partnership that submits a completed application with the required fee. See Tex. Admin. Code tit. 1, § 80.3 (2001); TBOC § 4.002.

<sup>591</sup> TRPA § 3.08(b)(16); TBOC § 4.001(a)(2).

<sup>592</sup> TRPA § 3.08(b)(5); TBOC § 152.802(e).

<sup>593</sup> TRPA §§ 3.08(b)(6), (7); TBOC § 152.802(e).

refiling with the Secretary of State until the next renewal filing.<sup>594</sup> Caution suggests an amendment to the application if the partnership changes its name. LLP's should arrange their own reminders, since the Secretary of State is not obliged to send renewal notices.

3. Insurance or Financial Responsibility. The third requirement for LLP status under Tex. LLP Stats. is that the partnership must:

“(1) carry at least \$100,000 of liability insurance of a kind that is designed to cover the kind of error, omission, negligence, incompetence, or malfeasance for which liability is limited by Section 152.801(b); or

(2) provide \$100,000 specifically designated and segregated for the satisfaction of judgments against the partnership for the kind of error, omission, negligence, incompetence, or malfeasance for which liability is limited by Section 152.801(b) by:

(A) deposit of cash, bank certificates of deposit, or United States Treasury obligations in trust or bank escrow;

(B) a bank letter of credit; or

(C) insurance company bond.”<sup>595</sup>

The insurance requirement (and the option to provide \$100,000 of funds instead) is intended to provide some source of recovery as a substitute for the assets of partners who are shielded from liability by the Tex. LLP Stats. The \$100,000 figure is arbitrary and may or may not be greater than the partners' individual assets otherwise available to partnership creditors. 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) and TBOC § 152.804.

The insurance must be “designed to cover the kinds of” acts for which partner liability is shielded by Tex. LLP Stats.<sup>596</sup> The quoted phrase contains some flexibility; actual coverage of the misconduct that occurs is not an absolute necessity. The partner claiming the

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<sup>594</sup> See TRLPA § 3.08(b)(4); TEX. ADMIN. CODE tit. 1, § 80.1 (1998); *see also* TBOC § 152.802(d).

<sup>595</sup> TBOC § 152.804(a). TRPA § 3.08(d)(1) provides substantially the same. The partnership should, of course, be a named insured. While a policy naming only the partners may suffice, caution suggests not relying on this approach.

<sup>596</sup> TRPA § 3.08(d)(1)(A); TBOC § 152.804(a)(1).

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) and TBOC § 152.804(a) allow an LLP the option of providing \$100,000 in funds in lieu of obtaining insurance, but require one or the other. Proof of compliance with the insurance or financial responsibility requirements is on the partner claiming the liability shield of TBOC § 152.801 or TRPA § 3.08(a).<sup>597</sup>

The Tex. LLP Stats. provide that the LLP insurance requirements “shall not be admissible nor in any way made known to the jury in determining the issue(s) of liability for or extent of the debt or obligation or damages in question.”<sup>598</sup> These provisions are intended to keep the existence of insurance from influencing a jury decision on liability or damages. Tex. LLP Stats. specifically state that if compliance with their insurance or fund provisions is disputed, “compliance must be determined separately from the trial or proceeding” to determine liability or damages.<sup>599</sup>

#### **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 of the date of this publication, as a species of general partnership, an LLP is not subject to the Texas franchise tax.<sup>600</sup>

3. Self-Employment Tax. Partners in an LLP generally will be subject to self-employment tax on their share of the trade or business income of the LLP since an LLP is a species of general partnership and under state law different from a limited partnership.<sup>601</sup>

#### **F. Other Issues.**

1. Advertisement of LLP Status. Although not required by the Tex. LLP Stats., an LLP should include the LLP words or initials wherever the partnership’s name is used, e.g., on directory listings, signs, letterheads, business cards and other documents that typically contain the name of the partnership. Although the LLP designation is part of the partnership’s name and should be used as such, it is common and should be permissible for some partnership communications to be shorthanded and omit the designation. A rule of reason should apply in deciding how far a partnership should go in using the LLP designation. Thus, a partnership

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<sup>597</sup> See TRPA § 3.08(d)(3); TBOC § 152.804(c).

<sup>598</sup> TRPA § 3.08(d)(2); *see also* TBOC § 152.804(b).

<sup>599</sup> TRPA § 3.08(d)(3); *see also* TBOC § 152.804(c).

<sup>600</sup> TEX. TAX CODE ANN. § 171.001 (Vernon 2002 and Supp. 2004) (But *see*, discussion at Section I(D)(2) above).

<sup>601</sup> Burgess J. W. Raby & William L. Raby, *Partners, LLC Members, and SE Tax*, 87 Tax Notes 665, 668 (April 26, 2000).

should in answering the telephone be able to use a shortened version of its name that does not refer to its LLP status and, when an existing partnership elects to become an LLP, it should have a reasonable period of time in which to implement the use of the LLP status words or symbols in printed matter and should be able to use up existing supplies of letterhead, etc.

There is no requirement, beyond the name change, that a partnership that becomes an LLP notify its customers, clients or patients of the partnership's new status. Further, there is no requirement that a partnership publish notice of its becoming an LLP comparable to the notice required of certain incorporations in other states.<sup>602</sup>

2. Assumed Name Certificate. Since an LLP is a species of general partnership, prior to House Bill ("HB 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")<sup>603</sup> like any other general partnership. HB 1239 §§ 1.29-1.31 amended the Assumed Name Statute so that LLPs, LLCs and limited partnerships are not deemed to be conducting business under an "assumed name," and do not have to make filings under the Assumed Name Statute if they conduct business in the same name as shown in their documents on file in the office of the Secretary of State. However, a general partnership which is not an LLP would have to file under the Assumed Name Statute if it conducted business under a name that does not include the surname or legal name of each general partner.<sup>604</sup> 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.<sup>605</sup> 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.<sup>606</sup> Although under the Assumed Name Statute it would be possible for an LLP to adopt an assumed name that did not include the LLP designation, failure to include the designation is inadvisable since it would frustrate the LLP Act requirement that the designation be in the firm name.

3. Time of Compliance. A partnership must be in compliance with the Tex. LLP Stats. requirements for an LLP at the time of misconduct giving rise to an obligation in order to raise the liability shield. Texas law explicitly states that the shielded partners are not liable for misconduct incurred while the partnership is a limited liability partnership.<sup>607</sup>

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<sup>602</sup> The New York LLP statute requires publication of a notice once per week for six weeks upon creation of an LLP. N.Y. Partnership Law § 121-1500(a)(9) (McKinney Supp. 2004).

<sup>603</sup> TEX. BUS. & COM. CODE § 36.01ff (Vernon 2002).

<sup>604</sup> TEX. BUS. & COM. CODE § 36.02(7) as amended by HB 1239.

<sup>605</sup> TEX. BUS. & COM. CODE § 36.10 as amended by HB 1239.

<sup>606</sup> TEX. BUS. & COM. CODE §§ 36.25 and 36.26.

<sup>607</sup> TBOC § 152.801(a); *see also* TRPA § 3.08(a)(1). This result is buttressed by the Bar Committee Bill Analysis of HB 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."

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.<sup>608</sup> 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.<sup>609</sup> 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.

4. Effect on Pre-LLP Liabilities. An LLP is the same partnership that existed before it became an LLP.<sup>610</sup> Since the Tex. LLP Stats. shield protects partners only against liabilities incurred while the partnership is an LLP, attainment of LLP status has no effect on pre-existing partnership liabilities. In *Medical Designs, Inc. v. Shannon, Gracey, Ratliff & Miller, L.L.P.*,<sup>611</sup> 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." However, there is nothing in the court's opinion suggesting that registration as an LLP is enough to make the partnership a different partnership.<sup>612</sup>

5. Limited Partnership as LLP. A limited partnership can become an LLP simply by complying with the applicable LLP provisions, in which case it would be a "LLLP."<sup>613</sup> In addition, Tex. LLP Stats. provide that a limited partnership is an LLP as well as a limited partnership if it (i) registers as an LLP under the proper provisions,<sup>614</sup> as permitted by its partnership agreement or with the consent of partners required to amend its partnership agreement to so permit, (ii) complies with the insurance or financial responsibility provisions of Tex. LLP Stats.,<sup>615</sup> and (iii) contains in its name "limited liability partnership," "limited liability limited partnership," or an abbreviation thereof.<sup>616 617</sup>

<sup>608</sup> *Id.*; see also *Baca v. Weldon*, 230 S.W.2d 552 (Tex. Civ. App.--San Antonio, 1950, writ ref'd n.r.e.).

<sup>609</sup> 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).

<sup>610</sup> 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).

<sup>611</sup> 922 S.W.2d 626 (Tex. App.—Fort Worth 1996, writ denied).

<sup>612</sup> 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.

<sup>613</sup> See TRPA § 3.08(e); TBOC §§ 152.805, 1.002(47).

<sup>614</sup> TRPA § 3.08(b); TBOC § 152.802.

<sup>615</sup> TRPA § 3.08(d); TBOC § 152.804.

<sup>616</sup> TBOC § 5.055(b). The name requirements differ slightly for entities still governed by the TRLPA. See TRLPA § 2.14(a)(3).

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.<sup>618</sup> Under Tex. LLP Stats., a limited partner in an LLLP whose conduct would otherwise render it liable as a general partner has the benefit of the LLP shield.<sup>619</sup>

6. Indemnification and Contribution. The Tex. LLP Stats. eliminate the usual right of a partner who is held personally liable for a partnership obligation to obtain indemnification from the partnership or contribution from co-partners.<sup>620</sup> It seems inconsistent with the Tex. LLP Stats. to allow a partner to recover, directly or indirectly, from copartners who are shielded from liability by the same statutes, absent a specific agreement of indemnification. Indeed, TRPA § 3.08(a) and TBOC § 152.801 expressly provide that a partner is not individually liable “by contribution, indemnity, or otherwise” for partnership obligations except as otherwise provided. Quite apart from the Tex. LLP Stats., there is authority that a partner who commits malpractice cannot recover from his or her non-negligent copartners.<sup>621</sup> It would certainly be inconsistent with the Tex. LLP Stats. to let a plaintiff reach those co-partners through some theory of subrogation based on an alleged indemnification or contribution right of the misfeasant partner.

7. Inconsistent Partnership Agreement Provisions. A written or oral partnership agreement can modify or defeat the LLP liability shield. In cases where a partnership agreement sets forth partner indemnification or contribution obligations inconsistent with those described above,<sup>622</sup> a creditor could argue that the partnership agreement supersedes

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<sup>617</sup> TRLPA § 2.14; TBOC § 153.351.

<sup>618</sup> TRLPA § 3.03; TBOC § 153.102.

<sup>619</sup> TRLPA § 2.14(c); TBOC § 153.353.

<sup>620</sup> TRPA § 3.08; TBOC § 152.801.

<sup>621</sup> See, e.g., *Flynn v. Reaves*, 218 S.E.2d 661 (Ga. App. 1975).

<sup>622</sup> Any LLP that intends by contract to require partners whose liabilities are shielded by the Tex. LLP Stats. to indemnify or contribute to partners whose liability is not shielded (due to their own misconduct) should be particularly sensitive to the “express negligence doctrine.” Under the “express negligence doctrine” as articulated by the Supreme Court of Texas, an indemnification agreement is not enforceable to indemnify a party from the consequences of its own negligence unless such intent is specifically stated in the agreement. See *Ethyl Corp. v. Daniel Constr. Co.*, 725 S.W.2d 705, 708 (Tex. 1987), wherein the Supreme Court held:

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

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“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

the shield afforded by the Tex. LLP Stats.<sup>623</sup> 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.<sup>624</sup> The partnership could counter that compliance with the Tex. LLP Stats. amends or otherwise trumps any inconsistent partnership agreement provisions. Attorneys should exercise care to assure that the partnership agreement of an LLP does not contain indemnification or contribution provisions that would inadvertently frustrate the LLP purpose.

Since a partnership agreement may be written or oral,<sup>625</sup> 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.<sup>626</sup>

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. A foreign LLP doing business in Texas<sup>627</sup> may qualify to do business in Texas like a foreign LLC<sup>628</sup> (the filing fee would be the lesser of

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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).

<sup>623</sup> Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 Bus. Law. 101, 118-120 (Nov. 1997).

<sup>624</sup> See Banoff, "Alphabet Soup: A Navigator's Guide," 4 BUS. L. TODAY 10, 12 (No. 4 March/April 1995).

<sup>625</sup> TRPA § 1.01(12); TBOC § 151.001(4).

<sup>626</sup> Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 BUS. LAW. 101, 120 (Nov. 1997).

<sup>627</sup> Texas law does not define what constitutes "transacting business in Texas" for the purposes of the requirement of TBOC § 152.905 (and the substantially similar TRPA § 10.02(a)) that "[b]efore transacting business in this state, a foreign limited liability partnership must file an application for registration in accordance with this section and Chapters 4 and 9." TBOC § 9.251, however, does contain the following non-exclusive list of activities not constituting transacting business in Texas:



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**Sec. 9.251. Activities Not Constituting Transacting Business In This State.**

For purposes of this chapter, activities that do not constitute transaction of business in this state include:

- (1) maintaining or defending an action or suit or an administrative or arbitration proceeding, or effecting the settlement of:
  - (A) such an action, suit, or proceeding; or
  - (B) a claim or dispute to which the entity is a party;
- (2) holding a meeting of the entity's managerial officials, owners, or members or carrying on another activity concerning the entity's internal affairs;
- (3) maintaining a bank account;
- (4) maintaining an office or agency for:
  - (A) transferring, exchanging, or registering securities the entity issues; or
  - (B) appointing or maintaining a trustee or depositary related to the entity's securities;
- (5) voting the interest of an entity the foreign entity has acquired;
- (6) effecting a sale through an independent contractor;
- (7) creating, as borrower or lender, or acquiring indebtedness or a mortgage or other security interest in real or personal property;
- (8) securing or collecting a debt due the entity or enforcing a right in property that secures a debt due the entity;
- (9) transacting business in interstate commerce;
- (10) conducting an isolated transaction that:
  - (A) is completed within a period of 30 days; and
  - (B) is not in the course of a number of repeated, similar transactions;
- (11) in a case that does not involve an activity that would constitute the transaction of business in this state if the activity were one of a foreign entity acting in its own right:
  - (A) exercising a power of executor or administrator of the estate of a nonresident decedent under ancillary letters issued by a court of this state; or
  - (B) exercising a power of a trustee under the will of a nonresident decedent, or under a trust created by one or more nonresidents of this state, or by one or more foreign entities;
- (12) regarding a debt secured by a mortgage or lien on real or personal property in this state:
  - (A) acquiring the debt in a transaction outside this state or in interstate commerce;

\$200 per resident partner<sup>629</sup> or \$750); however, the failure of the foreign LLP to qualify would not affect its LLP shield in Texas.<sup>630</sup> Under the Tex. LLP Stats., the laws of the state under which a foreign LLP is formed will govern its organization and internal affairs and the liability of partners for obligations of the partnership.<sup>631</sup>

Thus, under the Tex. LLP Stats., partners may choose the state law, and hence the liability shield, that they wish to apply to their relationship.<sup>632</sup> That choice should not be subject to the general limitation in the Tex. LLP Stats. that the law chosen by the partners to govern binds only “if that state bears a reasonable relation to the partners or to the partnership business and affairs under principles that apply to a contract among the partners other than the partnership agreement.”<sup>633</sup>

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(B) collecting or adjusting a principal or interest payment on the debt;

(C) enforcing or adjusting a right or property securing the debt;

(D) taking an action necessary to preserve and protect the interest of the mortgagee in the security; or

(E) engaging in any combination of transactions described by this subdivision;

(13) investing in or acquiring, in a transaction outside of this state, a royalty or other non-operating mineral interest; or

(14) the execution of a division order, contract of sale, or other instrument incidental to ownership of a non-operating mineral interest.

*See also* TBOC § 153.903. The TRPA provides substantially the same. TRPA § 10.04.

<sup>628</sup> *See* TRPA Article X; TBOC Chapter 9 and §§ 152.901-152.914 and 402.001(e).

<sup>629</sup> 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

(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.

<sup>630</sup> TRPA § 10.03(c); TBOC §§ 9.051, 152.910.

<sup>631</sup> The TBOC places governance by foreign law into the very definition of “foreign”: “‘Foreign’ means, with respect to an entity, that the entity is formed under, and the entity’s internal affairs are governed by, the laws of a jurisdiction other than this state.” TBOC § 1.002(27). *See also* TBOC § 1.103. TRPA § 10.01 similarly recognizes foreign governance of a foreign LLP’s internal affairs.

<sup>632</sup> TRPA § 10.01; TBOC §§ 1.101-1.105.

<sup>633</sup> TRPA § 1.05(a)(1). *See* TBOC § 1.002(43)(C), providing substantively the same. *See also* Texas Business and Commerce Code § 35.51.

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,<sup>634</sup> do not require such qualification, but recognize that the law governing the internal affairs of a partnership also governs its liability to third parties. By contrast, New York and Maryland require foreign LLPs to qualify to do business in the state.<sup>635</sup>

10. Bankruptcy. Section 723 of the Bankruptcy Code<sup>636</sup> addresses the personal liability of general partners for the debts of the partnership, granting the trustee a claim against “any general partner” for the full partnership deficiency owing to creditors to the extent that the partner would be personally liable for claims against the partnership. In recognition of uncertainty as to how this provision would be construed to apply with regard to LLPs which had been authorized by a number of states since the advent of the 1978 Bankruptcy Code, the 1994 amendments to the Bankruptcy Code clarified that a partner of an LLP would only be liable in bankruptcy to the extent that the partner would be personally liable for a deficiency according to the LLP statute under which the partnership was formed.<sup>637</sup>

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.<sup>638</sup> As a result, large accounting firms with offices in most states are likely beyond the reach of the diversity jurisdiction of the Federal courts.<sup>639</sup>

## **VII. EXTRATERRITORIAL RECOGNITION OF LLC AND LLP LIMITED LIABILITY.**

**A. General.** Courts of other states should recognize the Texas statutory liability shield of LLCs and LLPs under the “internal affairs” doctrine, which treats the laws of the state of organization as governing the liability of members of business organizations, such as corporations and limited partnerships.<sup>640</sup> The principal case that did not follow this doctrine was a Texas case, which has been effectively overturned by HB 278. The extent to which LLC or

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<sup>634</sup> DEL. CODE ANN., tit. 6, §§ 1515, 1547 (1999 & Supp. 2002).

<sup>635</sup> N.Y. PARTNERSHIP LAW § 121-1502 (McKinney Supp. 2004); MD. CODE ANN. CORPS. & ASS’NS § 9A-1101 (1999).

<sup>636</sup> 11 U.S.C. § 723, as amended by Pub.L. 103-394, Title II, § 212, Oct. 22, 1994, 108 Stat. 4125 (the “Bankruptcy Code”).

<sup>637</sup> 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.

<sup>638</sup> *Reisman v. KPMG Peat Marwick LLP*, 965 F. Supp. 165 (D. Mass. 1997), relying on *Carden v. Arkoma Assoc.*, 494 U.S. 185 (1990).

<sup>639</sup> 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.”

<sup>640</sup> TBOC § 1.101-1.105; cf. Revised Uniform Limited Partnership Act § 9.01 adopted in many states and in this state as TRLPA § 9.01(a); TBCA art. 8.02; 59A Am. Jur. 2d Partnership § 30 (1987); 29 A.L.R. 2d 295 (1953). For a discussion of the history of TBCA art. 8.02, see R. Dennis Anderson and Harva R. Dockery, “Formalities of Corporate Operations,” Texas Corporations - Law and Practice § 31.05 (1986).

LLP status will be recognized in other jurisdictions absent a specific statute, however, remains a question for which there is little case-law precedent.<sup>641</sup>

**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.”<sup>642</sup>

There is no comparable statement of legislative intention in the Tex. LLP Stats. However, they do provide that (1) a partnership’s internal affairs are governed by the law of the state chosen by the partners if the law chosen bears a reasonable relationship to the partnership’s business and affairs under applicable choice of law principles and (2) the law governing a partnership’s internal affairs also governs the liability of its partners to third parties.<sup>643</sup> 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 because the forum state did not have such a statute.<sup>644</sup> In *Means v. Limpia Royalties*,<sup>645</sup> 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

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<sup>641</sup> See Herbert B. Chermiside, Jr., Annotation, *Modern Status of the Massachusetts or Business Trust*, 88 A.L.R. 3d 704 (1978) (“In some jurisdictions a Massachusetts or business trust has been treated as a partnership for some purposes.”).

<sup>642</sup> LLC Act § 4.03B.

<sup>643</sup> TRPA § 1.05; TBOC §§ 1.101-1.105.

<sup>644</sup> 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).

<sup>645</sup> 115 S.W.2d 468, 475 (Tex. Civ. App.--Ft. Worth 1938, writ dism’d).

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.”<sup>646</sup>

The sections of the Tex. LLC Stats. providing for qualification of Foreign LLCs were intended to repudiate, and resolve the concern raised by, the *Limpia Royalties* case with respect to limited liability of non-corporate entities created under the laws of other states but not authorized to be created under Texas law.<sup>647</sup> The Bill Analysis<sup>648</sup> used by the Legislature in connection with the consideration of HB 278 states:

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<sup>646</sup> 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 dismissed), a personal injury case in which the property on which the injury occurred was held pursuant to a trust agreement. The trust agreement, which apparently was governed by Texas law, recited that no partnership was intended and that no party had any right to incur any liability on account of any other party. The defendants in the case were holders of beneficial interests in the trust, which was a successor to a general partnership in which the holders had been partners. Two years after the creation of the trust, but two years prior to the injury, three individuals withdrew from the arrangement by a document which purported to be an amendment to the venture’s “agreement of general partnership” and an assumed name certificate was filed in which the defendants were listed as general partners. The court was not persuaded by the defendants’ testimony that these actions were erroneous. In holding that the defendants were liable and that the trust was a partnership under Texas law, the court wrote:

Article 6132b, the Texas Uniform Partnership Act, Section 6, defines a partnership as “an association of two or more persons to carry on as co-owners a business for profit.” Section 7 of this Act sets forth certain criteria for determining the existence of a partnership under the Act. Under this section it is provided that with the exception of certain circumstances not here existent, the receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner of the business. TEX. REV. CIV. STAT. ANN. art. 6132a, the Texas Uniform Limited Partnership Act, sets forth the method by which limited partners, who do not wish to be bound by the obligations of the partnership, may carry on a business as a limited partnership. TEX. REV. CIV. STAT. ANN. art. 6138a sets forth the requirements for creation of a Real Estate Investment Trust. Section 8 of that Act provides for limited liability of the shareholders of such a trust. Appellants here do not contend that there was compliance with the requisites of either of these statutes.

Where two or more persons associate themselves as co-owners of a business for profit they become jointly and severally responsible for obligations incurred in the conduct of such business unless they have established, under some applicable statute, an association which the law recognizes as providing limited personal liability.

<sup>647</sup> HB 278 § 46 Part Seven. Prior to the enactment of HB 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

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.<sup>649</sup>

**D. Decisions in Other States.** There is precedent in other jurisdictions suggesting that their courts would apply the internal affairs doctrine to unincorporated entities not organized or qualified to do business as foreign entities under local law, thus preserving the liability shield of Texas law for LLCs and LLPs. Further, there apparently are no reported cases in other jurisdictions that follow the reasoning of, or reach the same result as, the *Limpia Royalties* case.

This issue of which jurisdiction’s law governs liabilities of partners to third parties arose in *King v. Sarria*, an 1877 New York case of first impression.<sup>650</sup> 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

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any, of shareholders . . .” The TBOC provides substantively the same. TBOC §§ 1.002(27), (28), 1.102-1.105.

<sup>648</sup> Bill Analysis of HB 278 by Wolens at 10 (1991). See 1991 Bill Analysis Summary at 41.

<sup>649</sup> “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.

See also *infra* Section V.R and TBOC §§ 9.001-9.003.

HB 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 HB 278 § 46 Part Seven:

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

See also TBOC §§ 1.104 and 1.105.

<sup>650</sup> 69 N.Y. 24 (Ct. of App. 1877).

of the partnership, but could not be made liable for its debts. The plaintiffs sought to recover from Sarria a sum of money due under a contract with the partnership.

The court held that the partnership agreement was governed by the laws of Spain<sup>651</sup> and that the liability of Sarria and the extent of the authority of his partners to bind him<sup>652</sup> 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 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.<sup>653</sup>

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.<sup>654</sup> However, in reaching this conclusion, the court noted that the Spanish statute resembled New York's own statute for the formation of limited partnerships.<sup>655</sup>

The 1982 New York case of *Downey v. Swan*<sup>656</sup> helps answer the question of what happens when the forum state has no corresponding statute. In *Downey*, the defendant Swan was

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<sup>651</sup> 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).

<sup>652</sup> 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.

<sup>653</sup> *Sarria*, 69 N.Y. at 34.

<sup>654</sup> 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).

<sup>655</sup> The court indicated that the same reasoning would apply to contract and tort claims.

<sup>656</sup> 454 N.Y.S. 2d 895 (A.D. 2d Dept 1982).

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.<sup>657</sup> 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.<sup>658</sup>

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.*,<sup>659</sup> 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 status<sup>660</sup>

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<sup>657</sup> 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).

<sup>658</sup> 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.

<sup>659</sup> 1994 WL 707133, Civ. A. No. 94-10609-MLW (D. Mass. Dec. 6 1994).

<sup>660</sup> *Liberty Mutual Insurance Co. v. Gardere & Wynne, L.L.P.* involved claims of breach of fiduciary duty and conflict of interest asserted by Liberty Mutual Insurance Company (“Liberty”) against the Dallas based law firm of Gardere & Wynne, L.L.P. (“Gardere”), which had represented Liberty for many years. Gardere was a Texas partnership that had taken the steps to become a registered LLP under the TRPA. Two Gardere lawyers, Nabors and Woods, also were defendants in the suit; Nabors clearly was a partner in Gardere, but the facts were uncertain about whether Woods’s election to “income partner” status had been given effect before he left Gardere to join another firm. Liberty filed its suit in the federal district court in Massachusetts, where its principal office was located. Gardere, Nabors, and Woods moved for dismissal or, alternatively, to have the case transferred to Texas.

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

Massachusetts had no counterpart to the Texas LLP statute. The court observed that, if it undertook to consider the motions to dismiss, its analysis would be complicated the fact that Gardere was not a general partnership “in the traditional sense familiar to Massachusetts judges and lawyers.” The court identified numerous procedural and substantive questions emanating from the uncertainty of Gardere’s organizational status under Massachusetts law, including the following issues:

- (1) Whether, for Massachusetts law purpose, Gardere was a limited partnership;
- (2) If Gardere was a limited partnership, whether suit could be brought against it by naming only its general partners as defendants;
- (3) If Gardere was a limited partnership and could be sued by naming only its general partners, whether the “general partners” were only those partners who, under TRPA, could be liable for the alleged breaches of duty claimed by Liberty;



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

The court assumes that, if this case were tried in a state or federal court in Massachusetts, the court would look to Texas substantive law to determine the liability of partners in a Texas RLLP for debts arising out of claims for breach of fiduciary duty by other partners. See Mass.Gen.L. ch. 109, § 48 (liability of limited partners of a foreign limited partnership “shall be governed by the laws of the state under which it is organized”); *Klaxon v. Stentor Elec. Mfgs. Co.*, 313 U.S. 487, 496, 61 S.Ct. 1020, 1021-22 (1941) (federal court in diversity case applies choice of law principles of state in which federal court is located). Thus, Texas law will apply to this question whether or not the case is transferred . . .<sup>661</sup>

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.<sup>662</sup> 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

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- (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.

<sup>661</sup> 1994 WL 707133 at note 7.

<sup>662</sup> Miller, “*Procedural and Conflict of Laws Issues Arising In Connection With Multi-State Partnerships*” (ABA Bus. L. Sec. 1996 Spring Meeting).

the better authority to date would apply the internal affairs principle and uphold the statutory liability shield.

**E. Qualification as Foreign Entity and Other Ways to Reduce Extraterritorial Risk.** Since all 50 states (including Texas) plus the District of Columbia now have LLC statutes, the LLC extraterritorial risk analysis requires analysis of the applicable LLC statute in each of the states in which the LLC contemplates doing business. Generally qualification as a foreign LLC in a jurisdiction will protect Members' limited liability, but failure to qualify may not result in the loss of limited liability, although it may result in the imposition of statutory penalties. The LLC statutes in Texas, New York and Delaware, which each contain provisions for the registration/qualification of foreign LLCs, expressly provide that the failure of a foreign LLC to so qualify shall not affect the limited liability of its members or managers, which shall be determined by the laws of the LLC's jurisdiction of organization.<sup>663</sup> Likewise, since all states plus the District of Columbia have LLP statutes, foreign qualification needs to be considered as a means of reducing extraterritorial risk for LLPs. Delaware, New York, and Maryland all provide for foreign qualification.<sup>664</sup>

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.<sup>665</sup>

## **VIII. DECISION MATRIX.**

Key elements in deciding among business entities are (1) how the entity will be taxed and (2) who will be liable for its obligations. The entity itself will always be liable to the extent of its assets, so the question is who will be liable, if anyone, if the entity's assets are not sufficient to satisfy all claims. These two considerations tend to receive the principal focus in the entity choice decision, although management, capital raising, interest transferability, continuity of life and formation issues such as cost and timing can be critical in many cases.

If the owners are content to pay federal income taxes at the entity level and then pay taxes on earnings distributed to them, the choice is easy — regular business corporation without an S-corporation election.

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

- General partnership
- LLP

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<sup>663</sup> LLC Act §§ 7.01, 7.02; N.Y. LLC Law §§ 801, 802 (1998); 6 DEL. CODE §§ 18-901, 18-902 (1998).

<sup>664</sup> DEL. CODE ANN. tit. 6 § 15-1101 et seq (2005); N.Y. PARTNERSHIP LAW § 121-1502 (McKinney 1998 & Supp. 2003); MD. CODE ANN., CORPS. & ASS'NS § 9A-1101 (1999).

<sup>665</sup> 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).

- 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 is not important and a limited partnership can elect to also be an LLP which has the effect of limiting the liability of the general partner
2. limited partners who participate in management of business 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 Texas 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 IRC. S-corporation status is not available where the entity:

1. has more than 100 equity holders;
2. has more than one class of stock;
3. has among its shareholders any:
  - general or limited partnership
  - trust (certain exceptions)
  - non resident alien
  - corporation (exception for “qualified subchapter S subsidiary”).

## TAX COSTS IN CHOICE OF ENTITY DECISION

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 \$94,200 in 2006) and that the respective entities are taxed as they were prior to January 1, 2006.

Item	C-Corporation	S-Corp or Limited Liability Company*	General Partner in General or Limited Partnership*	Limited Partner in Limited Partnership*
<b>Entity Level</b>				
Income	100.00	100.00	100.00	100.00
Franchise Tax	4.50	4.50	0	0
Taxable Income of Entity	95.50	95.50	100.00	100.00
Fed. Income Tax (at 35%)	33.43	0	0	0
Income After Taxes	62.07	95.50	100.00	100.00
<b>Owner Level</b>				
Distribution & Share of Income	62.07	95.50	100.00	100.00
Self-Employment Tax	0	2.90#	2.90	0
Taxable Income of Owner	62.07	94.05†	98.55†	100.00
Fed. Income Tax On Dividends (at 15%)	9.31			
Fed. Tax On Income Allocation (at 35%)		32.92	34.49	35.00
Amount Received After Taxes	<b>52.76</b>	<b>61.13</b>	<b>64.06</b>	<b>65.00</b>

\* 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.

## IX. CONCLUSION.

There are several entity forms to consider when organizing a business in Texas. The characteristics of each, which are discussed above and are tabulated on the Entity Comparison Chart attached as Appendix A, will influence the choice among the entities for a particular situation.

## ENTITY COMPARISON CHART

Note: Chart reflects requirements and allowances from the TBOC, not from older law which may apply to some entities until January 1, 2010.

<b>Item</b>	<b>Sole Proprietorship</b>	<b>General Partnership</b>	<b>Limited Liability Partnership (General or Limited)</b>	<b>Limited Partnership</b>	<b>Limited Liability Company</b>	<b>“C” Corp.</b>	<b>“S” Corp.</b>
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 contain “Limited Liability Partnership” or an abbreviation thereof. Limited Liability Limited Partnership must include “limited liability partnership,” “limited liability limited partnership,” or an abbreviation of either.	Must contain “Limited Partnership,” “Limited,” or an abbreviation of either.	Must contain “Limited Liability Company,” “Limited Company,” or an abbreviation of either (unless formed prior to September 1, 1993 in compliance with the laws then in effect).	Must contain “Corporation,” “Company,” “Incorporated,” “Limited,” or an abbreviation of any of these.	Must contain “Corporation,” “Company,” “Incorporated,” “Limited,” or an abbreviation of any of these.
Filing Requirements	Assumed Name Certificate Filing and Payment of Applicable Filing Fees	Assumed Name Certificate Filing and Payment of Applicable Filing Fees	Annual Registration and Filing Fee of \$200 per General Partner; Must Maintain Liability Insurance or Meet Alternative	Certificate of Formation and Filing Fee of \$750	Certificate of Formation and Filing Fee of \$300	Certificate of Formation and Filing Fee of \$300	Certificate of Formation and Filing Fee of \$300

<b>Item</b>	<b>Sole Proprietorship</b>	<b>General Partnership</b>	<b>Limited Liability Partnership (General or Limited)</b>	<b>Limited Partnership</b>	<b>Limited Liability Company</b>	<b>“C” Corp.</b>	<b>“S” Corp.</b>
			Financial 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 100
Professionals	Yes	Yes	Yes	Yes	Yes	Yes, But Generally Governed By TBOC Title 7 Professional Entities if There is Conflict With TBOC Title 2 Corporations. For Entities Existing Prior To January 1, 2006, Generally Governed By Texas Professional Corporation Act or Texas Professional Association Act	Yes, But Generally Governed By TBOC Title 7 Professional Entities if There is Conflict With TBOC Title 2 Corporations. For Entities Existing Prior To January 1, 2006, Generally Governed By Texas Professional Corporation Act or Texas Professional Association Act
Ownership Classes	One	Multiple Classes Allowed	Multiple Classes Allowed	Multiple Classes Allowed but Must Have at Least 1 General Partner and 1 Limited Partner.	Multiple Classes Allowed	Multiple Classes Allowed	Limitation as to 1 Class of Stock
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	Freely Transferable Unless Restricted by Articles of Incorporation, Bylaws or Shareholder Agreement	Freely Transferable Unless Restricted by Articles of Incorporation, Bylaws or Shareholder Agreement

Item	Sole Proprietorship	General Partnership	Limited Liability Partnership (General or Limited)	Limited Partnership	Limited Liability Company	“C” Corp.	“S” Corp.
					Provided in Articles of Organization or Regulations, the Status of Member is Not Transferable Without Consent of All Members		



**Basic Texas Business Entities  
and  
Federal/Franchise Taxation Alternatives Chart**

<i>Texas Law Entity</i>	<i>Check-the-Box</i>	<i>Federal Taxation</i>	<i>TX Franchise Tax</i>
<b>Proprietorship</b>	<b>Not Applicable</b>	<b>Form 1040, Schedule C or E</b>	<b>None</b>
<b>LLC / single individual member</b>	<b>Disregarded<sup>1</sup></b>	<b>Form 1040, Schedule C or E (Proprietorship)</b>	<b>Yes</b>
<b>LLC / single entity member</b>	<b>Disregarded<sup>1</sup></b>	<b>Division of Member Entity</b>	<b>Yes</b>
<b>General Partnership or LLP</b>	<b>Partnership<sup>2</sup></b>	<b>Partnership</b>	<b>None</b>
<b>General Partnership or LLP</b>	<b>Corporation</b>	<b>C or S-Corp<sup>3</sup></b>	<b>None</b>
<b>Limited Partnership</b>	<b>Partnership<sup>2</sup></b>	<b>Partnership</b>	<b>None</b>
<b>Limited Partnership</b>	<b>Corporation</b>	<b>C or S-Corp<sup>3</sup></b>	<b>None</b>
<b>LLC / multi-members</b>	<b>Partnership<sup>2</sup></b>	<b>Partnership</b>	<b>Yes</b>
<b>LLC / multi-members</b>	<b>Corporation</b>	<b>C or S-Corp<sup>3</sup></b>	<b>Yes</b>
<b>Corporation</b>	<b>Not Applicable</b>	<b>C or S-Corp<sup>3</sup></b>	<b>Yes</b>

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<sup>1</sup> Unless a single member LLC affirmatively makes an election on Form 8832 to be taxed as a corporation, it defaults to being disregarded for federal tax purposes. Treas. Reg. § 301.7701-3(b)(ii). Thus, where the single member of the LLC is an individual, the result is that the LLC is treated as a proprietorship for federal income tax purposes; where the single member of the LLC is an entity, the result is that the LLC is treated as if it were a division of the owning entity for federal income tax purposes.

<sup>2</sup> Unless a partnership or multi-member LLC affirmatively makes an election on Form 8832 to be taxed as a corporation, it defaults to being taxed as a partnership for federal tax purposes. Treas. Reg. § 301.7701-3(b)(i).

<sup>3</sup> To be taxed as an S Corp, the entity and all its equity owners must make a timely election on Form 2553 and meet several other requirements, generally having only citizen/resident individuals or estates as equity owners (with the exception of certain qualifying trusts and other holders), no more than 100 owners, and only one “class of stock.” IRC § 1361(b).

BUSINESS ORGANIZATIONS CODE  
(As Amended By H.B. 1319 in 2005 Texas Legislature)

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