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Distinctions Between Texas and Delaware LLC Law for the M&A Lawyer

Mergers and Acquisitions Committee
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Byron F. Egan – Bio Information

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

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

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

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

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

Publications

- Treatise by Byron F. Egan entitled EGAN ON ENTITIES: Corporations, Partnerships and Limited Liability Companies in Texas (First Edition 2016 and Second Edition 2018) (the Second Edition, "**EGAN ON ENTITIES**"). The Second Edition will be available from Corporation Service Company and LexisNexis in March 2018.
- *Acquisition Structure Decision Tree*, TexasBarCLE & Business Law Section of State Bar of Texas Choice, Governance & Acquisition of Entities Course, San Antonio, May 19, 2017 ("*Acquisition Structure paper*"): http://www.jw.com/wp-content/uploads/2017/04/Acquisition-Structure-Decision-Tree-Paper-5-19-2017.pdf
- *Joint Venture Governance and Business Opportunity Issues*, University of Texas School of Law 11th Annual Mergers and Acquisitions Institute, Dallas, October 15, 2015 ("*Joint Venture paper*"): www.jw.com/joint-venture-governance-and-business-opportunity-issues/

Five Business Entity Forms in Both Texas and Delaware

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

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

Texas Secretary of State – Statistical Information

Certificates of Formation Filed for Calendar Year 2017	
Domestic For-Profit Corporation	22,319
Domestic Limited Liability Company	167,957
Domestic Limited Partnership	4,603
Domestic Nonprofit Corporation	12,420
Domestic Professional Corporation	729
Domestic Professional Association	434
Domestic Limited Liability Partnership Statistics for Calendar Year 2017	
Registrations of Domestic Limited Liability Partnership	525
Renewals of Domestic LLP Registrations	3,581

Texas Secretary of State – Statistical Information

MASTER FILE STATISTICS AS OF JANUARY 1, 2018	
Entity Type	Active Entities
Domestic For-Profit Corporation	367,936
Domestic Limited Liability Company	933,972
Domestic Limited Partnership	131,216
Domestic Nonprofit Corporation	143,880
Domestic Professional Corporation	17,828
Domestic Professional Association	19,555

Delaware Secretary of State – Statistical Information

Certificates of Formation Filed for Calendar Year 2017	
Domestic For-Profit Corporation	41,553
Domestic Public Benefit Corporations	1,029
Domestic Limited Liability Company	143,996
Domestic Limited Partnership	11,444
Domestic Statutory Trusts	1,445
Master File Statistics for December 31, 2017 (Est.)	
Entity Type	Active Entities
Domestic For-Profit Corporation	306,074
Domestic Limited Liability Company	893,578
Domestic Limited Partnership	96,669

Texas Business Organizations Code

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

See EGAN ON ENTITIES §1.3 (7-18)

Texas Business Organizations Code

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

Texas Business Organizations Code

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

Delaware Limited Liability Company Act

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

Federal Income Taxes
Prior to Tax Cuts and Jobs Act of 2017
[EGAN ON ENTITIES Appendix A (621-643)]

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

Federal Income Taxes
After Tax Cuts and Jobs Act of 2017
(the "Tax Act")

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

Texas Margin Tax
[EGAN ON ENTITIES Appendix B (645-689)]

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

Texas Margin Tax – cont'd
[EGAN ON ENTITIES Appendix B (645-689)]

- Apportion to Texas: multiply the tax base by a fraction:

  $$\frac{\text{Texas gross receipts}}{\text{aggregate gross receipts}}$$

- Tax rate for 2017 applied to the Texas portion of the tax base is 0.75%.
  - Exception for retail and wholesale businesses which pay a 0.375% rate.
- Margin Tax changes the calculus for entity selections, but not necessarily the result.
  - LLC has become more attractive as it can elect to be taxed as a corporation or partnership for federal income tax purposes. [EGAN ON ENTITIES Appendix A (621-623; 635-638); Appendix C (671-681)]
  - Uncertainties as to an LLC's treatment for self employment purposes can restrict its desirability in some situations. [EGAN ON ENTITIES Appendix A (635-638)]

Delaware Corporate Income Tax

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

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

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

Delaware Taxation of LLCs

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

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

Delaware Taxation of LLC Members

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

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

Alternative Entities

LLCs and partnerships are called "*alternative entities*"

- Courts apply "contractarian" approach in considering their governing documents in measuring fiduciary duties of their governing persons.

- Texas LLC and partnership statutes allow modification (but not elimination) of common law fiduciary duties, but now allow limitation of governing person liability to the extent permitted for corporations (eliminate for breaches of duty of care but not duty of loyalty).

- Delaware allows partnership and LLC agreements to eliminate all fiduciary duties, but cannot be "coy" in wording and cannot eliminate the duty of good faith and fair dealing.

Alternative Entities – Governing Documents

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

Delaware Law — Partnership and LLC Agreements Respected

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

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

Delaware Law — Partnership and LLC Agreements Respected

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

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

Delaware Law – Partnership and LLC Agreements Respected

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

Delaware Law – Partnership and LLC Agreements Respected

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

Delaware Law — Partnership and LLC Agreements Respected

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

LLC Vocabulary - Texas

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

LLC Vocabulary - Delaware

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

LLC Formation and Governing Documents

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

LLC Formation and Governing Documents

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

LLC Formation and Governing Documents

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

LLC Formation and Governing Documents

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

LLC Formation and Governing Documents

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

LLC Formation and Governing Documents

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

LLC Formation and Governing Documents

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

LLC Formation and Governing Documents

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

LLC Formation and Governing Documents

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Management - Texas

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Management - Texas

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Management - Texas

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Management - Delaware

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Fiduciary Duties

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Fiduciary Duties

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

Fiduciary Duties in Texas Cases

- As the Fifth Circuit noted in *Gearhart Industries, Inc. v. Smith International*, 741 F.2d 707 (5th Cir. 1984), which involved a Texas corporation's Board of Directors adoption of a take-over defense comparable to a poison pill, Texas has its own body of precedent with respect to director, officer and controlling shareholder fiduciary duties, distinct from the law developed in Delaware and other jurisdictions.

See EGAN ON ENTITIES §2.6.3 (100-101)

Fiduciary Duties in Texas Cases

In *Gearhart*, the Fifth Circuit sharply criticized the parties' arguments based on Delaware cases and failure to cite Texas jurisprudence in their briefing on director fiduciary duties:

- "We are both surprised and inconvenienced by the circumstances that, despite their multitudinous and voluminous briefs and exhibits, neither plaintiffs nor defendants seriously attempt to analyze officers' and directors' fiduciary duties or the business judgment rule under Texas law. This is a particularly so in view of the authorities cited in their discussions of the business judgment rule: Smith and Gearhart argue back and forth over the applicability of the plethora of out-of-state cases they cite, yet they ignore the fact that we are obligated to decide these aspects of this case under Texas law."

See EGAN ON ENTITIES p 74

Formal and Informal Fiduciary Duties

- Controlling shareholders generally do not owe <u>formal</u> fiduciary duties to minority shareholders, but may owe <u>informal</u> fiduciary duties to the minority shareholders (whether an informal fiduciary duty exists is usually a question of fact for the jury).

See EGAN ON ENTITIES §2.6.3 (103)

Ritchie v. Rupe

On June 20, 2014, the Texas Supreme Court issued its opinion in *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014) holding that:

- For claims of "minority shareholder oppression" (which can be defined essentially as acts of a majority shareholder group that are harmful to a minority shareholder without necessarily harming the corporation itself) the sole remedy available under Texas law is a statutory receivership.

See EGAN ON ENTITIES §2.6.3 (101-116)

Ritchie v. Rupe

- Common law fiduciary duties, as articulated in *Gearhart* are still the appropriate lens through which to evaluate the conduct of directors of Texas corporations.

Ritchie v. Rupe

Gearhart held that under Texas law “[t]hree broad duties stem from the fiduciary status of corporate directors: namely the duties of obedience, loyalty, and due care.”

Ritchie v. Rupe

The Fifth Circuit commented in *Gearhart* that:

- (i) the duty of obedience requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the authority of the corporation as defined by its articles of incorporation or the laws of the state of incorporation
- (ii) the duty of loyalty dictates that a director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation
- (iii) the duty of due care requires that a director must handle his corporate duties with such care as an ordinarily prudent man would use under similar circumstances.

Ritchie v. Rupe

The *Gearhart* decision stated a strong business judgment rule:

- "The business judgment rule is a defense to the duty of care. As such, the Texas business judgment rule precludes judicial interference with the business judgment of directors absent a showing of fraud or an *ultra vires* act. If such a showing is not made, then the good or bad faith of the directors is irrelevant."

Ritchie v. Rupe: Informal Fiduciary Duty

- The Supreme Court remanded *Ritchie v. Rupe* to the Court of Appeals to consider the plaintiff's fiduciary duty claim against the directors of the corporation that was "not based on the formal fiduciary duties that officers and directors owe to the corporation by virtue of their management action," but on "an informal fiduciary relationship that 'existed between' plaintiff and defendant."
- The Supreme Court in a footnote explained that "an informal fiduciary duty may arise from 'a moral, social, domestic or purely personal relationship of trust and confidence,' and its existence is generally a question of fact for the jury."
- On remand, the Court of Appeals held that "there is no evidence of a relationship of trust and confidence to support a finding of an informal fiduciary duty" and thus did not address whether an informal fiduciary duty was breached; the Supreme Court denied the petition for review.

Sneed v. Webre

On May 29, 2015, the Texas Supreme Court in *Sneed v. Webre*, **465 S.W.3d 169, 178 (Tex. 2015), which involved the application of the business judgment rule to a shareholder derivative suit on behalf of a closely held Texas corporation with fewer than 35 shareholders, held:**

> "The business judgment rule in Texas generally protects corporate officers and directors, who owe fiduciary duties to the corporation, from liability for acts that are within the honest exercise of their business judgment and discretion."

See EGAN ON ENTITIES §2.6.3(b) (109-112)

Sneed v. Webre

Following *Ritchie v. Rupe* and *Gearhart*, the Texas Supreme Court in *Sneed v. Webre* cited and quoted from the 1889 Supreme Court opinion of *Cates v. Sparkman* as setting the standard for judicial intervention in cases involving duty of care issues noting:

- In Texas, the business judgment rule protects corporate officers and directors from being held liable to the corporation for alleged breach of duties based on actions that are negligent, unwise, inexpedient, or imprudent if the actions were "within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved." *Cates*, 11 S.W. at 849.
- "Directors, or those acting as directors, owe a fiduciary duty to the corporation in their directorial actions, and this duty 'includes the dedication of [their] uncorrupted business judgment for the sole benefit of the corporation.'" *Ritchie*, 443 S.W.3d at 868 (quoting *Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963)).
- The business judgment rule also applies to protect the board of directors' decision to pursue or forgo corporate causes of action.

Gross Negligence Claims after Sneed, Ritchie and Gearhart

- None of *Sneed v. Webre*, *Ritchie v. Rupe*, *Gearhart* nor the earlier Texas cases on which they relied referenced "gross negligence" as a standard for director liability.
- Earlier Federal District Court decisions in the context of lawsuits by the Federal Deposit Insurance Corporation and the Resolution Trust Company arising out of failed financial institutions held that the Texas business judgment rule does not protect "any breach of the duty of care that amounts to gross negligence" or "directors who abdicate their responsibilities and fail to exercise any judgment."
- These decisions, however, "appear to be the product of the special treatment banks may receive under Texas law" and likely will not be followed to hold directors "liable for gross negligence under Texas law as it exists now" in other businesses. *See Floyd v. Hefner*, C.A. No. H-03-5693, 2006 WL 2844245, at *28 (S.D. Tex. Sept. 29, 2006).

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Fiduciary Duties

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Fiduciary Duties

- Texas.

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Fiduciary Duties

- Texas.

Notwithstanding anything to the contrary contained in this Agreement,

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

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

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Fiduciary Duties

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Fiduciary Duties

- Texas.

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

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Fiduciary Duties

- Texas.
  - TBOC §101.255 provides that, unless the certificate of formation or Company Agreement provides otherwise, a transaction between an LLC and one or more of its Managers or officers, or between an LLC and any other LLC or other entity in which one or more of its Managers or officers are Managers, directors or officers or have a financial interest, shall be valid notwithstanding the fact that the Manager or officer is present or participates in the meeting of Managers, or signs a written consent, which authorizes the transaction or the Manager's votes are counted for such purpose, if any of the following is satisfied:

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Fiduciary Duties

- Texas.

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

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

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Fiduciary Duties

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Fiduciary Duties

- Delaware.

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Fiduciary Duties

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Fiduciary Duties

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Fiduciary Duties

- Delaware.

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

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

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Fiduciary Duties

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Business Combinations - Texas

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Business Combinations - Texas

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Business Combinations - Delaware

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Business Combinations - Delaware

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Indemnification - Texas

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Indemnification - Delaware

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Capital Contributions

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Allocation of Profits and Losses; Distributions

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

Owner Liability for Entity Obligations — "Piercing the Corporate Veil"

LLC

See EGAN ON ENTITIES §5.9 (560-566)

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

- Some cases suggest corporate veil piercing concepts apply to LLCs. TBOC §101.002 amended in 2011 to provide TBOC veil piercing limitations for corporations also apply to LLCs if veil piercing permitted.

Owner Liability for Entity Obligations — "Piercing the Corporate Veil"

LLC

See EGAN ON ENTITIES §5.9 (560-566)

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

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

Owner Liability for Entity Obligations – "Piercing the Corporate Veil"

LLC

See EGAN ON ENTITIES §5.9 (560-566)

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

Owner Liability for Entity Obligations — "Piercing the Corporate Veil"

LLC

See EGAN ON ENTITIES §5.9 (560-566)

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Nature and Classes of Membership Interests

See EGAN ON ENTITIES §5.9 (566-573)

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Assignment of Membership Interests

See EGAN ON ENTITIES §5.11 (573-578)

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Assignment of Membership Interests

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Winding Up and Termination

See EGAN ON ENTITIES §5.12 (574-578)

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

(1) the expiration of the period (if any) fixed for its duration, which may be perpetual;

(2) the action of the Members to dissolve the LLC (in the absence of a specific provision in its certificate of formation or Company Agreement, the vote will be by a majority of the Members);

(3) any event specified in its certificate of formation or Company Agreement to cause dissolution, or to require the winding up or termination, of the LLC;

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Winding Up and Termination

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

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

- Under the TBOC, the bankruptcy of a Member does not dissolve an LLC, or require its winding up or termination, unless its certificate of formation or Company Agreement so provides. In Delaware, however, the bankruptcy of a Member dissolves the LLC unless its LLC Agreement otherwise provides.

- The DLLCA dissolution provisions (DLLCA §§ 18.801 et seq.) are comparable to the TBOC provisions.

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Foreign LLCs

See EGAN ON ENTITIES §5.13 (578-579)

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Series LLC

See EGAN ON ENTITIES §5.12 (580-583)

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Series LLC

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Series LLC

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

LIMITED LIABILITY COMPANIES [EGAN ON ENTITIES Chapter 5]

Diversity Jurisdiction

See EGAN ON ENTITIES §5.16 (583)

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

Applicable LLC Law — Internal Affairs Doctrine

"The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs," [*Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982)] **and "under the commerce clause a state has no interest in regulating the internal affairs of foreign corporations."** [*McDermott, Inc. v. Lewis*, 531 A.2d 206, 217 (Del. 1987)] [EGAN ON ENTITIES §2.6.2 (94-98)]

Applicable LLC Law – Internal Affairs Doctrine

- **Internal corporate affairs are "those matters which are peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders."**
- **A corporation's internal affairs are to be distinguished from matters which are not unique to the relationships among a corporation and its governing persons.**

Applicable LLC Law — Internal Affairs Doctrine

Under the internal affairs doctrine followed by Texas, Delaware and most other states, the law of the state of organization of an entity governs its internal affairs, including the liability of an owner or governing person of the entity for actions taken in that capacity.

Applicable LLC Law — Internal Affairs Doctrine

The internal affairs doctrine is codified in TBOC §§1.101-1.105 (2015).

TBOC §1.105 provides:

- INTERNAL AFFAIRS. For purposes of this code, the internal affairs of an entity include:
  (1) the rights, powers, and duties of its governing authority, governing persons, officers, owners, and members; and
  (2) matters relating to its membership or ownership interests.

Applicable LLC Law – Internal Affairs Doctrine

The internal affairs doctrine in Texas mandates that courts apply the law of a corporation's state of formation in adjudications regarding director fiduciary duties. *Hollis v. Hill*, 232 F.3d 460, 465 (5th Cir. 2000); *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984); *A. Copeland Enters., Inc. v. Guste*, 706 F. Supp. 1283, 1288 (W.D. Tex. 1989).

Applicable LLC Law — Internal Affairs Doctrine

- Delaware also subscribes to the internal affairs doctrine.

See EGAN ON ENTITIES §2.6.2 (98-99)

Applicable Law — Contractual Freedom of Choice

Texas Business & Commerce Code §271.001 *et seq*. **allows contractual freedom of choice of law in "qualified transactions" involving at least $1 Million, but generally does not trump the internal affairs doctrine for fiduciary duties cases.**

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

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

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

Alternative Structures for Acquisitions of Businesses – cont'd

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

Alternative Structures for Acquisitions of Businesses – cont'd

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

Alternative Structures for Acquisitions of Businesses – cont'd

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

Alternative Structures for Acquisitions of Businesses – cont'd

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

Alternative Structures for Acquisitions of Businesses – cont'd

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

Alternative Structures for Acquisitions of Businesses – cont'd

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

Alternative Structures for Acquisitions of Businesses – cont'd

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

Alternative Structures for Acquisitions of Businesses – cont'd

– Many state and local jurisdictions impose sales, documentary or similar transfer taxes on the sale of certain categories of assets.

– A sale of assets may yield more employment or labor issues than a stock sale or statutory combination, because the seller will typically terminate its employees who may then be employed by the buyer (perhaps on different terms) or have to seek other employment.

Alternative Structures for Acquisitions of Businesses – cont'd

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

Joint Ventures

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

Joint Ventures

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

Joint Ventures

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

See EGAN ON ENTITIES §1.5 (28-36)

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FIDUCIARY DUTIES, EXCULPATION, AND INDEMNIFICATION IN TEXAS BUSINESS ORGANIZATIONS

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Table of Contents

FIDUCIARY DUTIES, EXCULPATION, AND INDEMNIFICATION IN TEXAS BUSINESS ORGANIZATIONS

I. Introduction

Statutory developments beginning in the 1990s have impacted the analysis of fiduciary duties in the Texas business organizations context. The duties of general partners are now defined by statutory provisions that delineate the duties without referring to them as "fiduciary" duties and specifically provide that partners shall not be held to the standard of a trustee. Whether limited partners in a limited partnership have fiduciary duties is not well-settled, but the Texas Business Organizations Code (BOC) clarifies that a limited partner does not owe the duties of a general partner solely by reason of being a limited partner. While the fiduciary duties of directors are still principally defined by common law, various provisions of the corporate statutes are relevant to the application of fiduciary-duty concepts in the corporate context. Because limited liability companies (LLCs) are a relatively recent phenomenon and the Texas LLC statutes do not specify duties of managers and members, there is some uncertainty with regard to the duties in this area, but the LLC statutes allude to or imply the existence of duties, and managers in a manager-managed LLC and members in a member-managed LLC should expect to be held to fiduciary duties similar to the duties of corporate directors or general partners. In each type of entity, the governing documents may vary (at least to some extent) the duties and liabilities of managerial or governing persons. The power to define duties, eliminate liability, and provide for indemnification is addressed somewhat differently in the statutes governing the various forms of business entities.

II. Corporations

A. Fiduciary Duties of Corporate Directors, Officers, and Shareholders

The provisions of the BOC governing for-profit corporations (like the predecessor Texas Business Corporation Act), do not explicitly set forth or define the fiduciary duties of corporate directors; however, case law generally recognizes that directors owe the corporation (but not individual shareholders) a duty of obedience, a duty of care, and a duty of loyalty. *See Ritchie v. Rupe,* 443 S.W.3d 856, 868 (Tex. 2014); *Gearhart Indus., Inc. v. Smith Int'l, Inc.,* 741 F.2d 707, 719-721 (5th Cir. 1984); *FDIC v. Harrington,* 844 F.Supp. 300, 306 (N.D. Tex. 1994); *Resolution Trust Corp. v. Norris*, 830 F.Supp. 351 (S.D. Tex. 1993).

1. Director's Duty of Obedience

The directors' duty of obedience forbids *ultra vires* acts but is rarely implicated given that modern corporation laws define corporate powers expansively and permit broad purpose clauses in the certificate of formation. *See* Tex. Bus. Orgs. Code §§ 2.001, 2.003, 2.007, 2.008, 2.101, 3.005(a)(3); *see also* Tex. Bus. Orgs. Code § 20.002 (defining scope of *ultra vires* doctrine). In general, courts appear reluctant to hold directors liable for *ultra vires* acts. As one court has summed up Texas law in this area, "Texas courts have refused to impose personal liability on corporate directors for illegal or *ultra vires* acts of corporate agents unless the directors either participated in the act or had actual knowledge of the act." *Resolution Trust Corp. v. Norris*, 830 F.Supp. 351, 357 (S.D. Tex. 1993).

2. Director's Duty of Care

Until the 1990s, Texas cases dealing with director liability for breach of the duty of care, as distinct from the duty of loyalty, had been few and far between. The Fifth Circuit analyzed a director's duty of care under Texas law in *Gearhart Industries, Inc. v. Smith International, Inc.*, 741 F.2d 707 (5th Cir. 1984) as follows:

> Under the law of most jurisdictions, the duty of care requires a director to be diligent and prudent in managing the corporation's affairs. Ubelaker at 784. The leading case in Texas defining a director's standard of care is *McCollum v. Dollar*, 213 S.W. 259 (Tex.Comm'n App.1919, holding approved). That case held that a director must handle his corporate duties with such care as "an ordinarily prudent man would use under similar circumstances." *Id*. at 261. The question of director negligence is a question of fact and must be decided on a case-by-case basis. *Id.* Texas courts hold directors liable for negligent mismanagement of their corporations, but the decisions do not specifically refer to such acts as violations of the duty of care, preferring to speak in general terms of directors as fiduciaries. *International Bankers Life Ins. Co. v. Holloway*, *supra*; *Tenison v. Patton*, *supra*; *Dowdle v. Texas Am. Oil Corp.*, 503 S.W.2d 647, 651 (Tex.Civ.App.—El Paso 1973, no writ); *Fagan v. La Gloria Oil & Gas Co.*, 494 S.W.2d 624, 628 (Tex.Civ.App.—Houston [14th Dist.] 1973, no writ); *Sutton v. Reagan & Gee*, 405 S.W.2d 828, 834 (Tex.Civ.App.—San Antonio 1966, writ ref'd n.r.e.). Unquestionably, under Texas law, a director as a fiduciary must exercise his unbiased or honest business judgment in pursuit of corporate interests. *In re Westec Corp.*, 434 F.2d 195, 202 (5th Cir.1970); *International Bankers Life Ins. Co. v. Holloway*, *supra* at 577. "The modern view definitely stresses the duty of loyalty and avoids specific discussion of the parameters of due care." Ubelaker at 789.[footnote omitted]
>
> In other jurisdictions, a corporate director who acts in good faith and without corrupt motive will not be held liable for mistakes of business judgment that damage corporate interests. Ubelaker at 775; *see, e.g., Lasker v. Burks*, 404 F. Supp. 1172 (S.D.N.Y.1975). This principle is known as the business judgment rule and it is a defense to accusations of breach of the duty of care. Ubelaker at 775, 790. Few Texas cases discuss the issues of a director's standard of care, negligent mismanagement, and business judgment. An early case, *Cates v. Sparkman*, 73 Tex. 619, 11 S.W. 846 (1889), set the standard for judicial intervention in cases involving these issues:
>
> > [I]f the acts or things are or may be that which the majority of the company have a right to do, or if they have been done irregularly, negligently, or imprudently, or are within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved, these would not constitute such a breach of duty, however unwise or inexpedient such acts might be, as would authorize interference by the courts at the suit of a shareholder.
>
> *Id.* at 622, 11 S.W. at 849. Even though *Cates* was decided in 1889, and despite the ordinary care standard announced in *McCollum v. Dollar*, *supra*, Texas courts to this day will not impose liability upon a noninterested corporate director unless the challenged action is ultra vires or is

> tainted by fraud. See *Robinson v. Bradley*, 141 S.W.2d 425 (Tex.Civ.App.—Dallas 1940, no writ); *Bounds v. Stephenson*, 187 S.W. 1031 (Tex.Civ.App.—Dallas 1916, writ ref.); *Caffall v. Bandera Tel. Co.*, 136 S.W. 105 (Tex.Civ.App. 1911); *Farwell v. Babcock*, 27 Tex.Civ.App. 162, 65 S.W. 509 (Tex.Civ.App. 1901); see also *Zauber v. Murray Sav. Ass'n*, 591 S.W.2d 932 (Tex.Civ.App.—Dallas 1979, writ ref'd n.r.e.). Such is the business judgment rule in Texas.

741 F.2d at 720-21.

Thus, despite the "ordinary care" standard announced in early Texas cases, the Fifth Circuit characterized the business judgment rule in Texas as protecting all but fraudulent or *ultra vires* conduct, which would literally protect even grossly negligent conduct and thus provide more protection than the Delaware business judgment rule. The tension between the standard of care and standard of liability in Texas received little attention in the reported cases until the 1990s when federal banking regulatory agencies began seeking recovery from the directors of failed financial institutions (and their liability insurers) for their alleged mismanagement of the failed institutions. Federal district courts were then faced squarely with the issue of what degree of negligence, if any, would subject the directors to liability under Texas corporate law. These federal district courts generally rejected the argument of the FDIC and RTC that directors are liable under Texas common law for acts of mismanagement that amount to simple negligence, but concluded that the business judgment rule does not protect a breach of the duty of care that amounts to gross negligence or an abdication of responsibilities resulting in a failure to exercise any judgment. *See FDIC v. Schreiner*, 892 F.Supp. 869 (S.D. Tex. 1995); *FDIC v. Daniel*, 158 F.R.D. 101 (E.D. Texas. 1994); *RTC v. Acton*, 822 F.Supp. 307 (N.D. Tex. 1994); *FDIC v. Benson*, 867 F.Supp. 512 (S.D. Tex. 1994); *FDIC v. Harrington*, 844 F.Supp. 300 (N.D. Tex. 1994); *Resolution Trust Corp. v. Norris*, 830 F.Supp. 351 (S.D. Tex. 1993); *FDIC v. Brown*, 812 F.Supp. 722 (S.D. Tex. 1992); *Resolution Trust Corp. v. Bonner*, 1993 WL 414679 (S.D. Tex. 1993). At least two courts in Texas have relied upon this line of cases outside the banking context. *See In re Life Partners Holdings, Inc. Shareholder Derivative Litigation*, 2015 WL 8523103 (W.D. Tex. 2015); *Weaver v. Kellog*, 216 B.R. 563, 584 (S.D. Tex. 1997).

In *Floyd v. Hefner*, 2006 WL 2844245 (S.D. Tex. 2006), Judge Harmon followed the *Gearhart* opinion and rejected the proposition that corporate directors can be held liable for gross negligence under current Texas law. The court concluded that the district court opinions that followed a gross negligence standard appear to be the product of the special treatment that banks receive under Texas law[1] whereas *Floyd v. Hefner* involved actions taken by directors of an oil and gas exploration company, which the court characterized as "a far more speculative business." In *TTT Hope, Inc. v. Hill*, 2008 WL 4155465 (S.D. Tex. 2008), the court discussed the division in case law as to whether the business judgment rule permits a gross negligence claim against a director under Texas law, but the court concluded that it need not resolve the issue because the record did not raise a fact issue as to the defendant's gross negligence. In *In re Life Partners Holdings, Inc. Shareholder Derivative Litigation*, 2015 WL 8523103 (W.D. Tex. 2015), Judge Moses acknowledged Judge Harmon's rejection of the proposition that directors can be held liable for gross negligence under Texas law but joined the

[1]In 2003, H.B. 1076 amended the Texas Banking Code to provide that bank officers and directors may be held liable only for acts of gross negligence. H.B. 1076 states that the statute was intended merely to clarify existing law regarding the proper standard of care for bank officers and directors.

majority of federal district courts in finding that Texas courts would hold a director liable for breach of the duty of care if the director causes the corporation harm through gross negligence. In that case, Judge Moses also addressed the standard of liability applicable to a claim for failure of oversight under Texas law. The court noted that courts in Texas have indicated that the business judgment rule does not protect a failure to exercise oversight or supervision, but looked to Delaware law for a framework for determining director liability in the absence of an exact standard of liability for failure of oversight under Texas law. The court concluded that director oversight liability in Texas, as in Delaware, is premised on conscious disregard of oversight responsibility, which entails bad faith and is thus a breach of the duty of loyalty.

The Texas Supreme Court alluded to the Texas business judgment rule in a recent opinion addressing the sufficiency of a shareholder's demand prior to filing a derivative suit. *In re Schmitz*, 285 S.W.3d 451 (Tex. 2009). In *Schmitz*, the Texas Supreme Court cited *Cates v. Sparkman*, 73 Tex. 619, 11 S.W. 846, 849 (1889) and *Pace v. Jordan*, 999 S.W.2d 615, 623 (Tex.App.–Houston [1st Dist.] 1999, pet. denied) when referring to the business judgment rule. Interestingly, the court did not cite the *Gearhart* case. *Cates v. Sparkman* and *Pace v. Jordan* state that acts of the board of directors that are merely unwise, inexpedient, negligent, or imprudent do not authorize the courts to interfere at the behest of a shareholder. According to these cases, judicial interference with a board decision is warranted only if the board's conduct or breach of duty is characterized by "*ultra vires*, fraudulent, and injurious practices, abuse of power and oppression...clearly subversive of the rights of...a shareholder." *Cates*, 11 S.W. at 849; *see also Pace*, 999 S.W.2d at 623. *Pace v. Jordan*, goes on, however, to state that a board may only invoke the protection of the business judgment rule if the directors are informed of all material information reasonably available to them before making a decision. *Pace*, 999 S.W.2d at 624.

In 2014, in *Ritchie v. Rupe*, the Texas Supreme Court cited *Gearhart* when describing the common law fiduciary duties of corporate directors as follows:

> Directors, or those acting as directors, owe a fiduciary duty to the corporation in their directorial actions, and this duty "includes the dedication of [their] uncorrupted business judgment for the sole benefit of the corporation." *Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963); *see also Gearhart Indus., Inc. v. Smith Intern., Inc.*, 741 F.2d 707, 723-24 (5th Cir. 1984)(describing corporate director's fiduciary duties of obedience, loyalty, and due care).

443 S.W.3d at 868.

In 2015, the Texas Supreme Court addressed the business judgment rule in the context of a double derivative suit brought by a shareholder of a closely held corporation against officers of the corporation's wholly owned subsidiary. *Sneed v. Webre*, 465 S.W.3d 169 (Tex. 2015). The court described the business judgment rule as "generally protect[ing] corporate officers and directors, who owe fiduciary duties to the corporation, from liability for acts that are within the honest exercise of their business judgment and discretion," citing *Cates v. Sparkman*. *Id.* at 173. The court explained that the special BOC provisions applicable to derivative suits on behalf of closely held corporations alter the role of the business judgment rule in the analysis of a shareholder's standing to assert a claim on behalf of the corporation such that the board's decision not to assert the claim cannot deprive a shareholder of standing to pursue the claim derivatively. However, the court confirmed that the business judgment rule still applies to the merits of a claim against the officers and directors of a closely held corporation such that the officers and directors do not have liability for acts within the honest exercise of their business judgment.

The court in *Sneed* reiterated its explanation in *Cates* that "courts will not interfere with the officers or directors in control of the corporation's affairs based on allegations of mere mismanagement, neglect, or abuse of discretion." *Id.* at 186. In order to merit relief, a claim for breach of duty against an officer or director must be "'characterized by ultra vires, fraudulent, and injurious practices, abuse of power, and oppression on the part of the company or its controlling agency clearly subversive of the rights of the minority, or of a shareholder, and which, without such interference, would leave the latter remediless.'" *Id.*

Though the BOC does not specify the standard of care applicable to directors of a for-profit corporation, it contains a number of provisions that are relevant to a director's potential liability for breach of the duty of care. In recognition that informed decision making by directors cannot feasibly involve personal research or expertise on the part of each director with respect to the myriad business decisions faced, the BOC provides that a director may, in good faith and with ordinary care, rely on information, opinions, reports, or statements prepared or presented by officers or employees of the corporation, by a committee of the board of which the director is not a member, or by legal counsel, accountants, investment bankers, or others with professional or other expertise. Tex. Bus. Orgs. Code § 3.102; *see also* Tex. Bus. Corp. Act art. 2.41D (expired Jan. 1, 2010). Additionally, as further discussed below, the corporate statutes contain broad indemnification provisions and even permit a corporation's certificate of formation to eliminate the liability of a director for breach of the duty of care.

3. <u>Director's Duty of Loyalty</u>

The director's duty of loyalty "demands that there shall be no conflict between duty and self-interest. The [methods] for the determination of honesty, good faith and loyal conduct are many and varied, and no hard and fast rule can be formulated. The standard of loyalty is measured by no fixed scale." *Imperial Grp. (Texas), Inc. v. Scholnick*, 709 S.W.2d 358, 365 (Tex.App.–Tyler 1986, writ ref'd n.r.e.), quoting *Guth v. Loft*, 23 Del. 255, 5 A.2d 503, 510 (1939). Common examples of transactions or conduct implicating the duty of loyalty are self-dealing and usurpation of a corporate opportunity. *See Int'l Bankers Life Ins. Co. v. Holloway,* 368 S.W.2d 567 (Tex. 1963); *Gearhart Indus., Inc. v. Smith Int'l, Inc.,* 741 F.2d 707 (5th Cir. 1984). In *In re Life Partners Holdings, Inc. Shareholder Derivative Litigation*, 2015 WL 8523103 (W.D. Tex. 2015), Judge Moses addressed the standard of liability under Texas law applicable to a claim against directors for a failure of oversight. The court noted that courts in Texas have indicated that the business judgment rule does not protect directors from liability for failure to exercise oversight or supervision, but the court looked to Delaware law for a framework for determining director liability in the absence of an exact standard of liability for failure of oversight under Texas law. The court concluded that director oversight liability in Texas, as in Delaware, is premised on conscious disregard of oversight responsibility, which entails bad faith and is thus a breach of the duty of loyalty.

The BOC contains provisions outlining procedures under which interested-director transactions will be deemed valid notwithstanding the director's interest in the transaction or participation in the meeting at which the transaction is approved. *See* Tex. Bus. Orgs. Code § 21.418; *see also* Tex. Bus. Corp. Act art. 2.35-1 (expired Jan. 1, 2010). Generally, these procedures require full disclosure by the interested director and approval by disinterested directors or the shareholders. If one of these procedures is not followed, the transaction will nevertheless withstand challenge if it passes scrutiny for "fairness" to the corporation. Likewise, before a director can safely embark on what would be considered a corporate opportunity, the opportunity must be fully disclosed to and declined by the corporation. *See Imperial Group (Texas), Inc. v. Scholnick*, 709 S.W.2d 358, 365 (Tex.App.–Tyler 1986, writ ref'd n.r.e.). In 2011, the interested-director provisions of the BOC were amended to make clear that if at least one of the three conditions provided by the statute is met, neither the corporation nor its shareholders have any cause of action against the conflicted director for breach of duty in respect of the contract or transaction because of the director's relationship or interest or as a result of the director's taking any of the actions described in Section 21.418(d), i.e., the execution of a consent or participation in a meeting of directors.

4. Officers

As agents of the corporation, officers have duties of obedience, care, and loyalty. *See generally* RESTATEMENT (THIRD) OF AGENCY §§ 8.01-8.12 (2006) (dealing with an agent's duties of loyalty and performance); RESTATEMENT (SECOND) OF AGENCY §§ 377-398 (1958) (dealing with an agent's duties of service, obedience, and loyalty). *See also Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193, 200 (Tex. 2002) (stating that agency is a special relationship giving rise to a fiduciary duty on the part of the agent to act solely for the benefit of the principal); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 cmt. a (1994) (stating that it is relatively well-settled that officers will be held to the same duty-of-care standards as directors and that sound public policy supports holding officers to the same duty of care and business judgment standards as directors); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS Part V, introductory note b (1994) (stating that courts have usually treated officers in the same category as directors when imposing and enforcing the duty of fair dealing). The application of these duties may vary somewhat from the application to directors, but often the courts speak of officers and directors in one breath when addressing duties. *See, e.g., Sneed v. Webre*, 465 S.W.3d 169, 172 (Tex. 2015) (describing the business judgment rule as "generally protect[ing] corporate officers and directors, who owe fiduciary duties to the corporation, from liability for acts that are within the honest exercise of their business judgment and discretion"). In terms similar to provisions permitting directors to rely on information and expertise supplied by others, the BOC permits officers, in the discharge of a duty, to rely on information, opinions, reports, or statements of other officers or employees, attorneys, accountants, investment bankers, or other professionals or experts. Tex. Bus. Orgs. Code § 3.105; *see also* Tex. Bus. Corp. Act art. 2.42 (expired Jan. 1, 2010). BOC Section 21.418, detailing procedures for valid interested-director transactions, also applies to interested-officer transactions. *See also* TBCA Article 2.35-1 (expired Jan. 1, 2010).

5. Shareholders

Courts of appeals have generally held that shareholders, even in a closely held corporation, do not owe one another fiduciary duties. *See Hoggett v. Brown*, 971 S.W.2d 472, 488 (Tex.App.–Houston [14th Dist.] 1997, pet. denied); *see also Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355 (Tex. App.–Houston [1st Dist.] 2012, pet. granted, judgm't vacated w.r.m.); *Schoellkopf v. Pledger*, 739 S.W.2d 914, 920 (Tex.App.–Dallas 1984), rev'd on other grounds, 762 S.W.2d 145 (Tex. 1988); *Kaspar v. Thorne*, 755 S.W.2d 151 (Tex.App.–Dallas 1988, no writ); *Pabich v. Kellar*, 71 S.W.3d 500 (Tex.App.–Ft. Worth 2002, pet. denied).

In *Willis v. Donnelly*, 199 S.W.3d 262 (Tex. 2006), the Texas Supreme Court expressly refrained from addressing the question of whether a majority shareholder in a closely held corporation owes a minority shareholder a general fiduciary duty under Texas law. An employee asserted a breach-of-fiduciary-duty claim against the controlling shareholders of two corporations based on the corporations' failure to issue him stock that was promised to him. Assuming without deciding that the relationship of majority and minority shareholder can give rise to a fiduciary duty, the supreme court held that the record did not support the existence of such a duty because the employee never became a shareholder. Because the employee's claim was that he was denied shareholder status, his only potential relief was for breach of contract.

In *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014), the Texas Supreme Court stated that it had "never recognized a formal fiduciary duty between majority and minority shareholders in a closely-held corporation," citing *Willis v. Donnelly*, and the court noted that no party had asked the court to do so. The court went on to say that "[t]he dissent's contention that this Court should recognize a common-law duty between majority and minority shareholders, rather than between corporate controllers and the corporation, for [misapplication of corporate funds and diversion of corporate opportunities] is contrary to well-established law."

Although shareholders do not generally owe one another fiduciary duties, the relationship between particular shareholders may constitute a confidential relationship giving rise to fiduciary duties when influence has been acquired and confidence has been justifiably reposed. *Flanary v. Mills*, 150 S.W.3d 785 (Tex.App.–Austin 2004, pet. denied) (stating that "[a] person is justified in placing confidence in the belief that another party will act in his or her best interest only where he or she is accustomed to being guided by the judgment or advice of the other party, and there exists a long association in a business relationship, as well as personal friendship"). The supreme court in *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014), acknowledged that an informal fiduciary duty may be owed by a shareholder to another shareholder based on a moral, social, domestic, or purely personal relationship of trust and confidence prior to and independent from the parties' business relationship. On remand of that case, the Dallas Court of Appeals held that the evidence did not support the jury's finding of a confidential relationship between the plaintiff minority shareholder and other shareholders of the family-owned corporation at issue in the case. *Ritchie v. Rupe*, 2016 WL 145581 (Tex.App.–Dallas 2016, pet. denied).

In *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgm't vacated w.r.m.), the court noted that the vast majority of intermediate appellate courts in Texas have declined to recognize a broad formal fiduciary duty by a majority shareholder to a minority shareholder in a closely held corporation, but the court concluded that case law supports the proposition that a controlling shareholder owes a formal fiduciary duty to a minority shareholder in the context of the communication of an offer to purchase the minority shareholder's shares, including an offer to redeem the shares where the redemption will result in an increase in the controlling shareholder's ownership of the corporation.

Until 2014, courts of appeals in Texas had recognized the availability of various equitable remedies, including a court-ordered buyout, where a minority shareholder established that the majority shareholder engaged in "oppressive" conduct. "Oppressive" conduct was defined by the courts as:

> (1) majority shareholders' conduct that substantially defeats the minority's expectations that, objectively viewed, were both reasonable under the circumstances and central to the minority shareholder's decision to invest; or
>
> (2) burdensome, harsh, or wrongful conduct; a lack of probity and fair dealing in the company's affairs to the prejudice of some members; or a visible departure from the standards of fair dealing and a violation of fair play on which each shareholder is entitled to rely.

Davis v. Sheerin, 754 S.W.2d 375, 381-82 (Tex.App.—Houston [1st Dist.] 1988, writ denied) (awarding minority shareholder equitable buyout at fair value as determined by jury based upon the majority's refusal to recognize the minority's ownership in the corporation).

The seminal case in this area was *Davis v. Sheerin*. In the years after the *Davis* case, oppression cases in Texas appeared with increasing frequency. *See, e.g., Kohannim v. Katoli*, 440 S.W.3d 798 (Tex.App.–El Paso 2013, pet. denied); *Boehringer v. Konkel*, 404 S.W.3d 18 (Tex.App.–Houston [1st Dist.] 2013, no pet.); *ARGO Data Res. Serv., Inc. v. Shagrithaya*, 380 S.W.3d 249 (Tex. App.–Dallas 2012, pet. denied); *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355 (Tex. App.–Houston [1st Dist.] 2012, pet. granted, judgm't vacated w.r.m.); *Redmon v. Griffith*, 202 S.W.3d 225, 234 (Tex.App.–Tyler 2006, pet. denied); *Cotten v. Weatherford Bancshares, Inc.*, 187 S.W.3d 687, 699-700 (Tex.App.–Fort Worth 2006, pet. denied); *Pinnacle Data Servs., Inc. v. Gillen*, 104 S.W.3d 188 (Tex. App.–Texarkana 2003, no pet.); *Willis v. Bydalek*, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, pet. denied); *Four Seasons Equip., Inc. v. White (In re White)*, 429 B.R. 201 (Bankr. S.D. Tex. 2010).

In 2014, the Texas Supreme Court disapproved of the manner in which courts of appeals had been applying the oppression doctrine and significantly limited the reach of the oppression doctrine. In *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014), the court: (1) rejected the "reasonable expectations" and "fair dealing" tests for oppression that courts of appeals had been applying in Texas since 1988 and adopted a definition requiring abuse of authority by management with intent to harm an owner in disregard of management's honest business judgment; (2) held that a rehabilitative receivership is the only remedy for oppression under Section 11.404 of the BOC; and (3) declined to recognize a common-law cause of action for oppression. In the future, minority shareholders will thus seek to assert their grievances as breaches of fiduciary duty to the corporation (in a derivative suit in which the minority shareholder will be relieved of certain requirements in the context of a closely held corporation and may have the prospect of direct recovery under Tex. Bus. Orgs. Code § 21.563) or as violations of statutory provisions (e.g., shareholder right to examine corporate books and records under Tex. Bus. Orgs. Code § 21.218) or breach of contractual obligations to the extent applicable.

A few Texas cases have alluded to a fiduciary duty on the part of a majority shareholder running to the corporation. *See Hoggett v. Brown*, 971 S.W.2d 472, 488 n. 13 (Tex.App.–Houston [14th Dist.] 1997, pet. denied); *Schautteet v. Chester State Bank*, 707 F.Supp. 885, 889 (E.D. Tex. 1988). In a corporation that has modified its management structure to provide for operation and management directly by the shareholders under a shareholders' agreement, such shareholders have the duties and liabilities that would otherwise be imposed on directors. *See* Tex. Bus. Orgs. Code §§ 21.106, 21.727; *see also* Tex. Bus. Corp. Act art. 2.30-1F, art. 12.37C (expired Jan. 1, 2010).

B. Statutory Authorization to Modify Duties and Liabilities of Corporate Directors and Officers in Governing Documents

1. Exculpation

The BOC permits limitation or elimination of the liability of a corporate director in the certificate of formation within certain parameters. Tex. Bus. Orgs. Code § 7.001; *see also* Tex. Rev. Civ. Stat. art. 1302-7.06 (expired Jan. 1, 2010). Specifically, the statute provides that the certificate of formation of a corporation may limit or eliminate the liability of a director for monetary damages to the corporation or shareholders for an act or omission in the person's capacity as a director subject to certain exceptions. The statute does not permit elimination or limitation of liability for:

1) breach of the director's duty of loyalty;

2) an act or omission not in good faith that constitutes a breach of duty to the corporation or involves intentional misconduct or a knowing violation of the law;

3) a transaction from which the director received an improper benefit, whether or not the benefit resulted from an act within the scope of the director's duties; or

4) an act or omission for which liability is expressly provided by a statute.

This provision is sometimes summarized as generally permitting elimination of liability for duty-of-care violations by directors. If the standard of liability for a breach of the duty of care is simple negligence, this provision obviously provides meaningful protection from liability for such negligence. If the standard of liability for a breach of the duty of care is gross negligence or fraud, it is not clear whether a breach of the duty of care could be in "good faith" so as to fall outside the second exception above. The Texas Supreme Court has generally defined gross negligence to involve actual subjective awareness of an extreme degree of risk and conscious indifference to the rights, welfare, and safety of others. *See Transp. Ins. Co. v. Moriel*, 879 S.W.2d 10 (1994). *Moriel* was cited in *Weaver v. Kellogg*, 216 B.R. 563 (S.D. Tex. 1997) for the definition of gross negligence in the context of a director's duty. In *In re Life Partners Holdings, Inc. Shareholder Derivative Litigation*, 2015 WL 8523103 (W.D. Tex.

2015), the court stated that the question of whether claims for breach of care can be exculpated under Section 7.001 of the Business Organizations Code was a matter of first impression under Texas law. The court held that Section 7.001(b) authorizes the same scope of exculpation as the comparable statutory provision in Delaware, which Delaware courts have held authorizes exculpation for claims for breach of care based on gross negligence. The court observed that Section 7.001 either authorizes exculpation for breaches of care or it exculpates nothing at all.

2. Renunciation of Corporate Opportunity

Because Section 7.001 of the Business Organizations Code (which is the successor to Article 7.06 of the Texas Miscellaneous Corporation Laws Act) does not permit elimination of director liability for the breach of a duty of loyalty, corporate-opportunity issues ordinarily must be addressed at the time they arise. If a director makes full disclosure to the corporation regarding the business opportunity when it arises and the corporation declines the opportunity, the director is permitted to proceed; however, until 2003, the corporate statutes in Texas contained no specific statutory provisions indicating that a preemptive waiver in the governing documents would be effective so as to relieve a director from the obligation to first offer a business opportunity to the corporation before personally taking advantage of the opportunity. The Delaware General Corporation Law was amended in 2000 to expressly permit a corporation to renounce, in its certificate of incorporation or by action of the board of directors, any interest or expectancy in specified business opportunities or specified classes or categories of business opportunities presented to the corporation or its officers, directors, or shareholders. Del. Code Ann. tit. 8, § 122(17). The Texas Business Corporation Act (TBCA) was similarly amended in 2003, and Article 2.20(20) of the TBCA was carried forward in the BOC. Thus, the BOC provides that a corporation has the power to renounce, in its certificate of formation or by action of its board of directors, an interest or expectancy of the corporation in, or an interest or expectancy in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or one or more of its officers, directors, or shareholders. Tex. Bus. Orgs. Code § 2.101(21). This provision is included in the general powers provision of the BOC and applies to domestic entities of all types governed by the BOC.

3. Shareholders' Agreements

Another approach to limiting fiduciary duties in the corporate context is to utilize a shareholders' agreement under Sections 21.101-21.109 of the BOC. (These provisions are the successor to Article 2.30-1 of the TBCA.) Under these provisions, a corporation that is not publicly traded may be governed by a shareholders' agreement entered into by all persons who are shareholders at the time of the agreement. BOC Section 21.101(a) lists matters that may be included in a shareholders' agreement even though they are inconsistent with one or more provisions of the corporate statutes. Included in the list is a catch-all provision that states that such an agreement is effective even though it "otherwise governs the exercise of corporate powers, the management of the business and affairs of the corporation, or the relationship among the shareholders, the directors, and the corporation as if the corporation were a partnership or in a manner that would otherwise be appropriate only among partners and not contrary to public policy." Tex. Bus. Orgs. Code § 21.101(a)(11); *see also* Tex. Bus. Corp. Act art. 2.30-1A(9) (expired Jan. 1, 2010). Thus, it appears that fiduciary duties of those in a management role of a corporation governed by such an agreement may be modified or waived in ways not generally permitted by corporate law so long as such provisions would be permissible in the context of a partnership. (There may be a similar argument under Sections 21.714 and 21.719 of the BOC (*see also* Tex. Bus. Corp. Act arts. 12.32, 12.35 (expired Jan. 1, 2010)) for "close corporations" that comply with Subchapter O of BOC Chapter 21. The predecessor to Subchapter O of the BOC was the Texas Close Corporation Law found in Part 12 of the TBCA.)

4. Indemnification

BOC Chapter 8 outlines circumstances under which indemnification of directors, officers, and others is required, permitted, and prohibited. These indemnification provisions are somewhat lengthy and detailed. The predecessor provision in the TBCA was Article 2.02-1.

The BOC specifies circumstances under which a corporation is required to indemnify a director, permitted to indemnify a director, and prohibited from indemnifying a director. A corporation is required to indemnify a director or officer who is "wholly successful on the merits or otherwise" unless indemnification is limited or prohibited by the certificate of formation. Tex. Bus. Orgs. Code § 8.051, 8.003; *see also* Tex. Bus. Corp. Act art. 2.02-1H, U (expired Jan. 1, 2010). A corporation is prohibited from indemnifying a director who is found liable to the corporation or for improperly receiving a personal benefit if the liability was based on willful or intentional misconduct in the performance of the director's duty to the corporation, breach of the director's duty of loyalty to the corporation, or an act or omission not in good faith constituting a breach of duty to the corporation. Tex. Bus. Orgs. Code § 8.102(b)(3). *Cf.* Tex. Bus. Corp. Act art. 2.02-1C, E (corporation prohibited from indemnifying director who is found liable to corporation, or for improper receipt of personal benefit, if liability arose out of willful or intentional misconduct in performance of director's duty to corporation). A corporation is permitted, without the necessity of any enabling provision in the certificate of formation or bylaws, to indemnify a director who is determined to meet certain standards. Tex. Bus. Orgs. Code § 8.101, 8.102; *see also* Tex. Bus. Corp. Act art. 2.02-1B, E (expired Jan. 1, 2010). These standards require that the director: (1) acted in good faith; (2) reasonably believed the conduct was in the best interest of the corporation (if the conduct was in an official capacity) or that the conduct was not opposed to the corporation's best interest (in cases of conduct outside the director's official capacity); and (3) in the case of a criminal proceeding, had no reasonable cause to believe the conduct was unlawful. Tex. Bus. Orgs. Code § 8.101(a); *see also* Tex. Bus. Corp. Act art. 2.02-1B (expired Jan. 1, 2010). If a director is found liable to the corporation or on the basis of improperly receiving a personal benefit, indemnification, if permissible at all, is limited to reasonable expenses. Tex. Bus. Orgs. Code § 8.102(b); Tex. Bus. Corp. Act art. 2.02-1E (expired Jan. 1, 2010). Indemnification may be limited by the certificate of formation, or it may be mandated by the certificate of formation, bylaws, a resolution of the directors or shareholders, or a contract. Tex. Bus. Orgs. Code §§ 8.003, 8.103(c); *see also* Tex. Bus. Corp. Act art. 2.02-1G, U (expired Jan. 1, 2010). Directors may only be indemnified to the extent consistent with the statute. Tex. Bus. Orgs. Code § 8.004; *see also* Tex. Bus. Corp. Act art. 2.02-1M (expired Jan. 1, 2010).

Officers are required and permitted to be indemnified to the same extent as directors. Tex. Bus. Orgs. Code § 8.105(b), (c); *see also* Tex. Bus. Corp. Act art. 2.02-1O (expired Jan. 1, 2010). Officers, employees, agents, and others who are not also directors may be indemnified "to the extent consistent with other law...as provided by (1) [the corporation's] governing documents; (2) general or specific action of the [board of directors]; (3) resolution of the [corporation's shareholders]; (4) contract; or (5) common law." Tex. Bus. Orgs. Code § 8.105; *see also* Tex. Bus. Corp. Act art. 2.02-1O, Q (expired Jan. 1, 2010). Insurance or other arrangements providing indemnification for liabilities not otherwise indemnifiable under Chapter 8 are expressly permitted. Tex. Bus. Orgs. Code § 8.151; *see also* Tex. Bus. Corp. Act art. 2.02-1R (expired Jan. 1, 2010). Shareholder approval is required for self-insurance or another arrangement with a party other than a commercial insurer if the indemnification extends to liabilities the corporation would not otherwise have the power to indemnify.

Chapter 8 of the BOC governs any proposed indemnification by a domestic entity after January 1, 2010, even if the events on which the indemnification is based occurred before the BOC became applicable to the entity. Tex. Bus. Orgs. Code § 402.007. A special transition provision in the BOC regarding indemnification states that "[i]n a case in which indemnification is permitted but not required under Chapter 8, a provision relating to indemnification contained in the governing documents of a domestic entity on the mandatory application date that would otherwise have the effect of limiting the nature or type of indemnification permitted by Chapter 8 may not be construed after the mandatory application date as limiting the indemnification authorized by Chapter 8 unless the provision is intended to limit or restrict permissive indemnification under applicable law." Tex. Bus. Orgs. Code § 402.007. This provision will be helpful in interpreting some pre-BOC indemnification provisions, but its application will not always be clear; therefore, a careful review of indemnification provisions in pre-BOC governing documents is advisable.

Although Chapter 8 sets certain limits on the extent to which directors may be protected by the governing documents, more protective provisions are allowed pursuant to insurance, self-insurance, or other arrangements under Section 8.151. Additionally, indemnification beyond that permitted by Chapter 8 could possibly be achieved through a shareholders' agreement under Sections 21.101-21.109 of the BOC. *See also* Tex. Bus. Corp. Act art. 2.30-1 (expired Jan. 1, 2010). As noted above in the discussion of director exculpation, Sections 21.101-21.109 permit a corporation that is not publicly traded to be governed by a shareholders' agreement entered into by all persons who are shareholders at the time of the agreement. BOC Section 21.101 lists matters that may be included in a shareholders' agreement even though they are inconsistent with one or more provisions of the corporate statutes. Included in the list is a catch-all provision that states that such an agreement is effective even though it "governs the exercise of corporate powers, the management of the business and affairs of the corporation, or the relationship among the shareholders, the directors, and the corporation as if the corporation were a partnership or in a manner that would otherwise be appropriate only among partners and not contrary to public policy." Tex. Bus. Orgs. Code § 21.101(a)(11); *see also* Tex. Bus. Corp. Act art. 2.30-1A(9) (expired Jan. 1, 2010). Thus, it appears that indemnification beyond the parameters set by BOC Chapter 8 may be achieved under such an agreement if it would be permissible in a partnership and would not offend public policy. There may be a similar argument under Sections 21.714 and 21.719 of the BOC (*see also* Tex. Bus. Corp. Act arts. 12.32, 12.35 (expired Jan. 1, 2010)) for "close corporations" that comply with Subchapter O of BOC Chapter 21. The predecessor to Subchapter O of the BOC was the Texas Close Corporation Law found in Part 12 of the TBCA.

III. Limted Liability Companies

A. Fiduciary Duties of Managers and Managing Members

The provisions of the BOC governing LLCs (like the provisions of the predecessor Texas Limited Liability Company Act (TLLCA)) do not define or expressly impose fiduciary duties on managers or members of an LLC, but various provisions of the statute implicitly recognize that such duties may exist. Indeed, when acting as an agent of the LLC, a manager or managing member owes a duty of care pursuant to basic agency principles. RESTATEMENT (THIRD) OF AGENCY § 8.08; *see also* RESTATEMENT (SECOND) OF AGENCY § 379. Further, the agent status of a manager in a manager-managed LLC and a member in a member-managed LLC provides a basis under agency law to impose a duty of loyalty. *See* RESTATEMENT (THIRD) OF AGENCY §§ 8.01-8.06; *see also* Restatement (Second) of Agency §§ 387-398. In *Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193 (Tex. 2002), the Texas Supreme Court discussed the fiduciary nature of the agency relationship under Texas common law. Cases are beginning to recognize agency law as well as analogies to corporate or partnership law as a basis to impose fiduciary duties in the LLC context. *See ETRG Invs., LLC v. Hardee (In re Hardee)*, 2013 WL 1084494 (Bankr. E.D. Tex. 2013) (concluding managing member owed LLC formal fiduciary duties based on agency law; managing member owed formal fiduciary duties to LLC based on implication of Texas LLC law that managers and managing members owe fiduciary duties of care, loyalty, and obedience similar to corporate directors; managing member owed no fiduciary duties to other members); *Zayler v. Calicutt (In re TSC Sieber Servs., LC)*, 2012 WL 5046820 (Bankr. E.D. Tex. 2012) (finding individual who took over managerial control of LLC but had no formal office or ownership interest owed LLC a formal fiduciary duty based on agency law and an informal fiduciary duty based on circumstances giving rise to control).

Commentators and practitioners have generally assumed that managers in a manager-managed LLC and members in a member-managed LLC have fiduciary duties along the lines of corporate directors or general partners in a partnership. These duties would generally embrace a duty of obedience, duty of loyalty, and duty of care to the LLC. Duty-of-loyalty concerns underlie statutory provisions addressing interested-manager transactions and renunciation of business opportunities. *See* Tex. Bus. Orgs. Code §§ 2.101(21), 101.255; *see also* Tex. Rev. Civ. Stat. art. 1528n, art. 2.17 (expired Jan. 1, 2010); Tex. Bus. Corp. Act art. 2.02(20) (expired Jan. 1, 2010) (applicable by virtue of Tex. Rev. Civ. Stat. art. 1528n, art. 2.02A (expired Jan. 1, 2010)). Provisions of the BOC permitting governing persons (including managers and managing members of an LLC) to rely on various types of information in discharging a duty implicitly recognize that such persons are charged with a duty of care in their decision making. Tex. Bus. Orgs. Code § 3.102; *see also* Tex. Bus. Orgs. Code § 3.105 (reliance by officers on information in discharging a duty). Broad authorization to indemnify, insure, and advance expenses to members, managers, and other persons can be read to reflect some concern with liabilities to the LLC as well as to third parties. Tex. Bus. Orgs. Code § 101.402; *see also* Tex. Rev. Civ. Stat. art.1528n, art. 2.20 (expired Jan. 1, 2010). Provisions outlining procedures applicable to derivative proceedings reflect an underlying assumption that members need a mechanism to hold management accountable and a concern for balancing the rights and powers of owners and management in these situations. Tex. Bus. Orgs. Code §§ 101.451-101.463; *see also* Tex. Bus. Corp. Act art. 5.14 (expired Jan. 1, 2010) (applicable by virtue of Tex. Rev. Civ. Stat. art. 1528n, art. 8.12 (expired Jan. 1, 2010)). Finally, as further discussed below, the BOC provides that, to the extent managers or members are subject to duties and liabilities, including fiduciary duties, the company agreement may expand or restrict the duties and liabilities. Tex. Bus. Orgs. Code §§ 101.401, 101.052; *see also* Tex. Rev. Civ. Stat. art.1528n, art. 2.20 (expired Jan. 1, 2010).

Most of the Texas cases in which fiduciary duties have been an issue involve claims by a member against a fellow member for breach of fiduciary duty rather than claims based on a breach of fiduciary duty to the LLC. *Allen v. Devon Energy Holdings, L.L.C.* 367 S.W.3d 355 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgm't vacated w.r.m.) contains the most extensive analysis to date of the question of whether members of a Texas LLC are in a formal fiduciary relationship *vis a vis* one another. Before *Allen*, a number of other courts in Texas had encountered breach-of-fiduciary-duty claims asserted by an LLC member against a fellow member, but the discussion of those claims tended to be relatively cursory or uninformative. In *Allen*, a minority member of an LLC sued the LLC and its majority member and sole manager, alleging that the majority member/sole manager misrepresented and failed to disclose material facts in connection with the redemption of the minority member's interest in the LLC. The court declined to recognize a broad formal fiduciary duty on the part of a majority member to a minority member because Texas does not recognize such a relationship between majority and minority shareholders in closely held corporations, but the court concluded that corporate case law supported imposing a formal fiduciary duty in a situation like that at issue, i.e., that the majority member's position as the controlling member and sole manager was sufficient to create a formal fiduciary duty to the minority member in a transaction in which the minority member's interest was being redeemed (thus increasing the ownership of the majority member). The court also relied on the similarity of the relationship between the parties in this case and the relationship between the general partner and a limited partner of a limited partnership as support for recognizing a fiduciary duty between the controlling member/manager and passive minority member with respect to the operation and management of the LLC. The court did not address the scope of the fiduciary duty that was owed in this case. The court also concluded that an exculpation provision in the articles of organization referring to the manager's "duty of loyalty to [the LLC] or its members" could be read to create a fiduciary duty to the members individually.

Before the Texas Supreme Court's opinion in *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014), some courts had applied the shareholder oppression doctrine in the LLC context. As discussed above, the Texas Supreme Court defined oppression in very narrow terms and held that the remedy for oppression is limited to appointment of a receiver. Thus, *Ritchie v. Rupe* has virtually eliminated claims based on oppression in Texas.

In an unpublished opinion, the Dallas Court of Appeals concluded that members of an LLC do not necessarily owe other members fiduciary duties. *Suntech Processing Sys., L.L.C. v. Sun Commnc'ns, Inc.,* 2000 WL 1780236 (Tex. App.—Dallas 2000, pet. denied). The court relied on Texas case law rejecting the notion that co-shareholders of a closely held corporation are necessarily in a fiduciary relationship. That the articles of organization imposed upon members a duty of loyalty to the LLC did not mandate any such duty between the members according to the court.

In *Pinnacle Data Services, Inc. v. Gillen*, 104 S.W.3d 188 (Tex.App.–Texarkana 2003, no pet.), a member of an LLC sued the other two members alleging various causes of action based on the action of the other two members in amending the LLC articles of organization to change the LLC from a member-managed LLC to a manager-managed LLC and excluding the plaintiff member from management. The plaintiff member owned a 50% interest in the LLC. The regulations required the approval of 66 2/3% in interest to amend the articles of organization, while the articles of organization required the approval of 2/3 of the members. The defendant members relied on the provision in the articles of organization, and the court held that the provision in the articles controlled because the TLLCA permitted the regulations to contain any provision not inconsistent with the articles of organization. The court of appeals reversed the trial court's summary judgment in favor of the defendant members on the breach-of-fiduciary-duty claim, however, stating that the determination that the articles of organization controlled disposed of the breach-of-contract claim, but not the breach-of-fiduciary-duty claims. The court seemed to suggest that the duties of the defendants might be comparable to those of corporate directors and officers, but the court was not clear as to whether the presence of factors supporting an informal fiduciary relationship might be required.

In *Doonan v. Wood*, 224 S.W.3d 271 (Tex.App.–El Paso 2005, no pet.), the court rejected the breach-of-fiduciary-duty claim of an LLC's minority member and his spouse against an investment company limited partnership that made a loan to the LLC and acquired a membership interest. The court stated that the minority member's spouse did not establish that she was owed a fiduciary duty, and, assuming a fiduciary duty was owed to the minority member, the various acts alleged, including foreclosure on LLC assets and enforcement of the minority member's personal guaranty, did not raise any genuine issue of material fact as to breach of fiduciary duty because the actions were taken for legitimate business reasons rather than for the fiduciary to profit by taking advantage of its position.

In *Lundy v. Masson*, 260 S.W.3d 482 (Tex.App.–Houston [14th Dist.] 2008, pet. denied), a corporation asserted breach-of-fiduciary-duty claims against its former president. In the course of the opinion, the court revealed that the corporation was originally formed as an LLC and later converted to a corporation. The jury was instructed that the president owed the company a fiduciary duty, and the jury found that he breached his duty. The trial court entered a judgment for the corporation. On appeal by the former president, the court of appeals found that the evidence was sufficient to establish a breach of fiduciary duty and affirmed.

In *Gadin v. Societe Captrade*, 2009 WL 1704049 (S.D. Tex. 2009), the plaintiff, a 35% member of an LLC, sued the 65% member for breach of fiduciary duty, minority member oppression, and an accounting. The plaintiff alleged that there was an attempt to purchase his membership interest at an under-valued price, that he was forced to resign from the LLC, and that the defendant and its principals took clients, records, and financial information from the LLC. The defendant sought dismissal of the breach-of-fiduciary-duty claim on the basis that the plaintiff failed to state facts showing that a member of an LLC owes another member a fiduciary duty or that there was more than a subjective trust by the plaintiff in the defendant so as to support an informal fiduciary relationship. The plaintiff responded that he used his personal credit, business contacts, and name in order to fund the start-up and business operations of the LLC and that he relied upon the representations by the defendant and its principals that his investment of time and resources would make his stake in the LLC profitable. The court discussed formal and informal fiduciary relationships under Texas law and noted that the TLLCA did not directly address the duties owed by managers and members. The court stated that Texas courts have not yet held that a fiduciary duty exists as a matter of law among members in an LLC and noted that, where fiduciary duties among members have been recognized in other jurisdictions, the duties have been based on state-specific statutes. The court denied the defendant's motion to dismiss "[b]ecause the existence of a fiduciary duty is a fact-specific inquiry that takes into account the contract governing the relationship as well as the particularities of the relationships between the parties."

In *Entertainment Merchandising Technology, L.L.C. v. Houchin*, 720 F.Supp.2d 792 (N.D. Tex. 2010), the court, in responding to a claim that an individual owed a fiduciary duty by virtue of his status as officer of the LLC, stated that no Texas court has held that fiduciary duties exist between LLC members as a matter of law, and the court concluded that the statute of limitations barred the breach-of-fiduciary-duty claim in any event.

In *Mullen v. Jones (In re Jones)*, 445 B.R. 677 (Bankr. N.D. Tex. 2011), the court discussed at length the current state of Texas partnership law with respect to fiduciary duties of general partners. In the course of that discussion, the court noted that shareholders of a corporation do not generally owe other shareholders fiduciary duties and further noted that the law also seems to be developing toward the notion that members of a limited liability company do not necessarily owe other members fiduciary duties.

In *Federal Insurance Company v. Rodman*, 2011 WL 5921529 (N.D. Tex. 2011), the court stated that there is no formal fiduciary relationship created as a matter of law between members of an LLC, but the court recognized that an informal fiduciary relationship may arise under particular circumstances where there is a close, personal relationship of trust and confidence and concluded that an LLC member had sufficiently pled the existence of an informal fiduciary relationship with his fellow member based on an alleged long-standing friendship.

In *Cardwell v. Gurley*, 2011 WL 6338813 (E.D. Tex. 2011), aff'd on other grounds, 487 Fed. App'x 183 (5th Cir. 2012), the federal district court recited findings and conclusions of a Texas district court in previous litigation in which the district court concluded that the managing member of an LLC owed the other member direct fiduciary duties of loyalty, care, and disclosure, as well as owing duties to the LLC. The federal district court in this case held that the bankruptcy court did not err in giving preclusive effect to the state court's findings and conclusions and further held that the fiduciary duty owed by a managing member to his fellow LLC member was similar to the trust-type obligation owed by partners and corporate officers and thus sufficient to support an exception to discharge under Section 523(a)(4) of the Bankruptcy Code.

In *Haut v. Green Café Management, Inc.*, 376 S.W.3d 171 (Tex. App.–Houston [14th Dist.] 2012, no pet.), Haut, a minority owner of a corporation and an LLC, was found liable for breach of fiduciary duty to the companies, and he argued on appeal that he owed no formal or informal fiduciary duty to the companies as a matter of law. The only argument Haut made regarding an informal fiduciary duty was that there was no trial evidence that he had a special relationship of trust and confidence prior to and apart from the agreement made the basis of the suit. Because Haut designated only a partial record for appeal, the court of appeals said that it must presume the omitted evidence was relevant and supported the trial court's judgment on the jury's findings. Furthermore, the court stated that Haut's argument lacked merit even if the partial record did not require the court to presume that the evidence supported the jury's finding because Haut did not timely object to the trial court's failure to include in the charge an instruction that a pre-existing relationship of trust and confidence was necessary to find a fiduciary relationship. The court also rejected Haut's argument that the evidence did not support a finding that Haut breached his fiduciary duty.

In *Zayler v. Calicutt (In re TSC Sieber Services, LC)*, 2012 WL 5046820 (Bankr. E.D. Tex. 2012), the bankruptcy court found that the defendant breached a fiduciary duty to the debtor LLC. The LLC was a family-owned LLC in which the defendant was not formally issued a membership interest or given an office to avoid entangling the family business with unrelated legal problems of the defendant and to protect the family from any negative ramifications that might arise from any known association with the defendant. When the defendant's sister was injured and could no longer provide day-to-day supervision of the business, the plan to conceal any involvement of the defendant was altered, and the defendant's father (who served as chairman of the LLC) and sister requested that the defendant take direct managerial control of the business. The defendant had no written employment or consulting agreement but received authorized compensation for his management services. Eventually, the defendant was terminated by his sister after an internal audit revealed he had misappropriated a significant amount of funds from the LLC in her absence. The court found that the defendant owed a formal fiduciary duty to the LLC because he was an agent of the LLC. In addition, the court found that the circumstances giving rise to the managerial control gave rise to an informal fiduciary duty pursuant to which the defendant was required to place the interest of the LLC above his own. Based on the defendant's repeated breaches of fiduciary duty, the trustee was entitled to actual damages and a constructive trust over a residence obtained by the defendant with funds he unlawfully diverted from the LLC.

In *Vejara v. Levior International, LLC*, 2012 WL 5354681 (Tex. App.– San Antonio 2012, pet. denied), Vejara, appearing *pro se* on appeal, alleged that the jury erred in finding that she breached a fiduciary duty to her fellow member in an LLC and that the trial court abused its discretion by not reversing the jury's decision on Levior's breach-of-fiduciary-duty claim. Vejara argued that she owed no fiduciary duty to Levior because she was only a minority "shareholder" of the LLC. (The court referred to the owners or members of an LLC as "shareholders" throughout its opinion.) The first part of the jury question presupposed the existence of a fiduciary relationship between Vejara and Levior, and Vejara failed to object to the charge or request additional instructions. The appellate court held that Vejara waived her right to raise this complaint on appeal but went on to hold that the record showed the existence of a fiduciary duty on Vejara's part even if Vejara did not waive her right to complain about the existence of a fiduciary duty. The appellate court agreed that Vejara, as a minority shareholder of the LLC, did not owe a formal fiduciary duty to Levior as a matter of law since Texas does not recognize a broad formal fiduciary relationship between majority and minority shareholders in closely held companies. However, the court pointed out that Texas courts have recognized that the nature of the relationship between shareholders of an LLC may give rise to an informal fiduciary duty between the shareholders. Here, although not a majority shareholder, Vejara exhibited control and had intimate knowledge of the LLC's business affairs. Vejara created the company, entered leases on behalf of the company, held keys to the company's vans, and had exclusive access to the company's inventory held in storage. The appellate court concluded that Vejara's control and intimate knowledge of the LLC's affairs and plans gave rise to the existence of an informal fiduciary duty to Levior. The court of appeals concluded there was sufficient evidence to support the jury finding that Vejara breached her fiduciary duty to Levior and that the breach caused Levior injury.

In *ETRG Investments, LLC v. Hardee (In re Hardee)*, 2013 WL 1084494 (Bankr. E.D. Tex. 2013), an LLC and two of its members sought a determination that debts to them arising from activities of the debtor, Hardee, while he was managing member of the LLC were nondischargeable in Hardee's bankruptcy. The plaintiffs alleged that Hardee's debts to them were nondischargeable on the basis that the debts were obtained by actual fraud or false representations or as debts arising from a defalcation by a fiduciary and/or embezzlement. After the trial, the court concluded that a debt to the LLC representing over $250,000 in embezzled funds was nondischargeable as a debt arising from a defalcation by a fiduciary and embezzlement, and a debt to the LLC of approximately $248,000 arising from Hardee's failure to tender employment taxes owed to the IRS was nondischargeable as a debt arising from a defalcation by a fiduciary. The court concluded, however, that the two members who sought an exception to Hardee's discharge failed to establish that Hardee was in a formal or informal fiduciary relationship with them as would be required to render the debt to them for the unpaid tax liabilities nondischargeable as arising out of a defalcation by a fiduciary. The bankruptcy court's opinion consists of findings of fact and conclusions of law after the trial in the adversary proceeding.

The bankruptcy court determined that Hardee embezzled significant sums of money from the LLC and that his breaches of fiduciary duty included entering into an unauthorized lending relationship, not properly managing the LLC's affairs by diverting funds, and not tendering required tax payments to the IRS on behalf of the LLC. The failure to tender the required tax payments also clearly breached the regulations (i.e., company agreement) of the LLC. The court found that Hardee, as the sole person authorized to transact business and direct the financial activities of the LLC, including the payment of tax obligations, acted as an agent of the LLC and as such had a formal fiduciary relationship. The failure to tender the tax payments was a willful breach of duty and thus a defalcation while acting in a fiduciary capacity. As for Hardee's relationship to the other plaintiffs, Tomlin and Scott, the court found that these members failed to establish that Hardee had a formal fiduciary relationship with them. The company agreement governing the LLC did not impose or even address any fiduciary duties owed by and among the LLC members. Furthermore, the court found that Tomlin and Scott failed to establish that Hardee had an informal fiduciary relationship with them or a trust relationship that existed prior to the creation of the tax obligations at issue that would create fiduciary duties to the members.

In its conclusions of law, the bankruptcy court addressed the nondischargeability of debts arising from breach of fiduciary duties. The court addressed the concept of a fiduciary under federal bankruptcy law and the requirement that the relationship amount to a "technical" or "express" trust. The court then proceeded to set forth numerous conclusions of law regarding fiduciary duties as they related to this proceeding. The BOC, which governs LLCs, does not directly address or define the duties owed by managers and members but implies that certain duties may be owed and allows the contracting parties to specify the breadth of those duties in the LLC agreement. One type of fiduciary relationship recognized under Texas law is a formal fiduciary relationship that arises as a matter of law and includes relationships between principal and agent. An agent has authority to transact business or manage some affair for another person or entity and owes a duty of care. Texas law also recognizes that a fiduciary relationship exists between corporate officers or directors and the corporation they serve, and one of the duties imposed on corporate management is a duty of care that requires diligence and prudence in the management of the corporation's affairs. Although LLCs are not corporations in the strictest sense, Texas law implies that the fiduciary status of corporate officers and directors and their corresponding duties of care, loyalty, and obedience apply to managers and/or members governing the activities of an

LLC. Thus, imposition of fiduciary duties on the management of an LLC under Texas law is appropriate and warranted, and Hardee acted in a fiduciary capacity as to the LLC. Hardee was charged with insuring that all required payments of employment taxes were made by the LLC to the appropriate taxing authorities, and Hardee's failure in each instance to make the tax payments on behalf of the LLC constituted a breach of the fiduciary duties he owed the LLC. Therefore, the debt owed by the LLC to the IRS to satisfy its tax obligations for the period in which the defendant was the managing member of the LLC constituted a defalcation by a fiduciary and was excepted from discharge in Hardee's bankruptcy proceeding.

As for the individual members' request that any amount they were required to pay to satisfy the accrued IRS tax liabilities should also be a nondischargeable debt, the court noted a significant difference between a manager's fiduciary relationship to the LLC and the manager's relationship to fellow members. Case law has recognized that there is no formal fiduciary relationship created as a matter of law between members of an LLC. Thus, Hardee had no formal fiduciary relationship with either Tomlin or Scott. An informal fiduciary relationship is a confidential relationship arising from moral, social, domestic, or personal relationships in which one person trusts in and relies on another. The effect of imposing a fiduciary duty is to require the fiduciary party to place another's interest above its own, and a fiduciary relationship is thus not one that is created lightly. Hardee had no informal fiduciary relationship with either Tomlin or Scott. Any liability of Hardee to either Tomlin or Scott created by Hardee's failure to render tax payments on behalf of the LLC was not excepted from discharge as a result of a breach of fiduciary duties because the debtor owed no fiduciary duties to the members.

In *Kohannim v. Katoli*, 440 S.W.3d 798 (Tex.App.–El Paso 2013, pet. denied), the former spouse of a member who was awarded the member's 50% interest in a divorce was unable to recover for breach of fiduciary duty against the remaining 50% member because the trial court did not make the requested finding that the remaining member owed the former spouse a fiduciary duty and breached that duty. The court of appeals discussed formal and informal fiduciary relationships and concluded that the trial court deliberately refrained from finding the existence of a fiduciary duty and breach. The trial court made a finding that the 50% member owed the LLC a fiduciary duty and that the member breached that duty. The former spouse also asserted an oppression claim, and the court of appeals affirmed the trial court's finding that the 50% member engaged in oppression based on the member's failure to make distributions to the former spouse where the LLC regulations provided for distributions of "available cash," more than $250,000 in undistributed profit had accumulated in the company's accounts, and the 50% member paid himself for management services that were not performed. In *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014), the supreme court disapproved of the definition of oppression relied upon by the court of appeals in this case and held that a court is not authorized to employ remedies other than receivership for oppression.

In *Pacific Addax Co., Inc. v. Lau (In re Lau)*, 2013 WL 5935616 (Bankr. E.D. Tex. 2013), the debtors, John and Deborah Lau, were in the real estate business, and the plaintiffs sought a determination that the Laus' debts for the plaintiffs' losses in real estate ventures managed by the Laus were nondischargeable on various grounds, including as debts arising from fraud or defalcation in a fiduciary capacity. The plaintiffs' claims related to their investments in two real estate ventures, one of which was organized as an LLC. John and Deborah Lau were the sole members of an LLC that owned and sought to develop a tract of land. The plaintiffs purchased interests in the LLC and became members. John Lau exercised complete control over the LLC as the sole managing member. As the managing member of the LLC, John Lau issued capital calls, which were promptly paid by the plaintiffs. When the capital calls were made, John Lau supplied false information to the plaintiffs regarding the LLC, and the capital infusions made by the plaintiffs were diverted by John Lau for his own business purposes and those of another entity owed by the Laus. The plaintiffs received no return on their investments in the LLC. The court concluded that John Lau breached his fiduciary duties to the LLC and its members. The court noted that Chapter 101 of the BOC, like the predecessor TLLCA, does not directly address the duties owed by LLC managers and members but provides that the company agreement of an LLC may expand or restrict 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. The court stated that the statute thus implies that certain duties may be owed without defining them and allows the contracting parties to specify the breadth of those duties in the company agreement. The regulations of the LLC conferred on John Lau as the manager-member the power and authority to act on behalf of the company subject to limitations set forth in the regulations and "the faithful performance of the Managers' fiduciary obligations to the Company and the Members." Thus, the court concluded that John Lau stood in a fiduciary relationship to the plaintiffs as members of the LLC. The court stated that recognition of this fiduciary duty was consistent with the degree of control exercised by John Lau as the managing member. The court also concluded that John Lau's representations and acts in connection with the capital calls were acts of fraud and constituted defalcations. Because John Lau's debts to the plaintiffs arose from fraud and defalcation in a fiduciary capacity they were excepted from discharge. Additionally, the court concluded that Deborah Lau knowingly participated in her husband's breach of fiduciary duty and ratified the breach of duty by knowingly accepting the benefits derived from the breach. Thus, Deborah Lau's liability for these debts was excepted from discharge as well.

In *Brickley v. Scattered Corporation (In re H & M Oil & Gas, LLC)*, 514 B.R. 790 (Bankr. N.D. Tex. 2014), the bankruptcy court addressed the trustee's claims for breach of fiduciary duty against the former manager of the debtor LLC, an oil and gas company. The court stated that "[a]s its Manager, Greenblatt owed fiduciary duties to H & M, including the duties of care and loyalty." The court relied on case law in the corporate context in describing the standards of conduct required by these duties. Based on these precedents, the court analyzed whether Greenblatt breached the duties of loyalty and care owed to the debtor LLC as its manager by: (1) failing to timely pay drilling costs; (2) not requesting funds under the debtor-in-possession financing agreement (DIP agreement); and (3) not taking action against the LLC's post-petition lender related to the lender's breach of the DIP agreement.

The trustee argued that Greenblatt's repeated late payments of certain drilling costs and failures to request funds under the DIP agreement to prepay completion costs did not reflect the actions of a prudent manager in light of the attendant risks. The court disagreed. With respect to Greenblatt's decision to late-pay drilling costs, the court found no injury to the LLC resulted and that those late payments, even assuming they were imprudent, could not support a finding of breach of fiduciary duty without resulting injury. With respect to Greenblatt's decision not to prepay certain completion costs, the court concluded that Greenblatt correctly interpreted the consequences of prepaying versus not prepaying the costs at issue under the controlling joint operating agreement, and Greenblatt's decision was protected by the business judgment rule. The evidence did not show that Greenblatt's decision lacked a business purpose, was tainted by conflict of interest, or was the result of an obvious and prolonged failure to exercise oversight or supervision; therefore, the court concluded that Greenblatt's decision not to prepay completion costs based on his interpretation of the joint operating agreement was the result of an informed business judgment and was not a breach of the fiduciary duty of care owed to the LLC.

As to the allegation that Greenblatt breached his fiduciary duty by failing to take action on the LLC's behalf against the post-petition lender, the court concluded that the lender did not breach the DIP agreement, and thus Greenblatt's alleged failure to take action against the lender for breach of the agreement could not constitute a breach of fiduciary duty.

Because the court found Greenblatt did not breach his fiduciary duty, the court rejected the trustee's claim that Greenblatt's wage claim should be equitably subordinated based on Greenblatt's alleged breaches of fiduciary duty. The court found no other conduct by Greenblatt that would warrant subordination, and the court stated that the record did not show any injury to the LLC or its creditors or any benefit to Greenblatt from any alleged improprieties even if Greenblatt participated in inequitable conduct.

Greenblatt prevailed on a claim for indemnification under the indemnification provision of the LLC's regulations (i.e., company agreement). The provision required the LLC to indemnify the manager "against loss, liability or expense, including attorneys' fees, actually and reasonably incurred, if he or it acted in good faith and in a manner reasonably believed to be in or not opposed to the best interests of the Company as specified in this section, except that no indemnification shall be made in respect of any claim, issue or matter as to which the [manager] shall have been adjudged to be liable for gross negligence, willful misconduct or breach of fiduciary obligation in the performance of his or its duty to the Company...." The trustee argued that Greenblatt did not meet the standard for indemnification, but the court stated that it could not find that Greenblatt's actions were grossly negligent or constituted willful misconduct in light of the court's finding that he acted within the scope of his fiduciary duties owed to the LLC and that his actions fell within the scope of the business judgment rule. Because the record showed that Greenblatt acted in good faith and in a manner not opposed to the LLC's best interests, Greenblatt was entitled to indemnification of his expenses incurred in defending the complaint. The court concluded that the indemnification claim under the LLC regulations should be allowed as a general unsecured claim in the LLC's Chapter 11 case. (The court also concluded that Greenblatt had a claim for indemnification under the DIP agreement and that the claim should be allowed as an administrative expense of the Chapter 11 case.)

In *Bazan v. Munoz*, 444 S.W.3d 110 (Tex. App.–San Antonio 2014, no pet.), Munoz went into business with long-time friends, Carlo and Denise Bazan. The Bazans and Munoz made capital contributions to an LLC that purchased a night club, and the parties signed a company agreement under which Munoz and the Bazans each had a 50% interest in the business. Denise was designated the managing member, but she delegated the day-to-day operations to Carlo. Over time, Munoz became concerned about the finances of the business and eventually sued the Bazans for fraud by nondisclosure. Generally, no duty to disclose arises without evidence of a confidential or fiduciary relationship. The court stated that "Texas courts have not recognized a formal fiduciary relationship between majority and minority shareholders in a closely-held corporation, [but] they have recognized that–in the same manner that business partners owe each other and their partners a fiduciary duty–the nature of the relationships between shareholders in a limited liability company sometimes gives rise to an informal fiduciary relationship between them." The jury found that the parties in this case had an informal fiduciary relationship, and the evidence supported that finding based on a long-standing friendship predating their business relationship and testimony by Carlo and Denise that Munoz went into business with them because of their personal relationship and gave them a great deal of control because of his trust in them. The company agreement did not expressly disavow fiduciary duties, and Denise and Carlo even testified that they owed Munoz a duty of loyalty and were obligated to protect his financial interests in the business as they would protect their own.

In *Guevara v. Lackner*, 447 S.W.3d 566 (Tex. App.–Corpus Christi-Edinburg 2014, no pet.), Dr. Guevara sued Mark Lackner and Robert Lackner, fellow members of an LLC in which Dr. Guevara invested, for breach of fiduciary duty. The trial court granted a no-evidence summary judgment on this claim in favor of the Lackners. Based on a provision of the company agreement vesting sole control of the LLC in the Lackners as managers, Dr. Guevara alleged that the Lackners owed fiduciary duties of loyalty, good faith, fair dealing, full disclosure, and to account for all profits and property. Dr. Guevara alleged that the Lackners breached their duties by taking his money as a loan to purchase merchandise, conspiring to keep the profits, and suppressing information related to the transaction. He also alleged that the Lackners failed to use any business judgment in their dealings related to obligations owed by another member to the LLC. Dr. Guevara asserted that he was injured by the loss of funds he provided for the purchase of merchandise for the LLC and funds provided for other expenses of the LLC. The court noted that "Dr. Guevara's status as a co-shareholder or co-member in a closely held corporation does not automatically create a fiduciary relationship between co-shareholders or co-members." The court stated that Texas courts have recognized that an informal fiduciary duty may exist between shareholders of a closely held corporation under particular circumstances even though Texas courts have declined to recognize a broad formal fiduciary duty between majority and minority shareholders in closely held corporations. The court of appeals concluded that there was more than a scintilla of evidence of the existence of an informal fiduciary duty between the Lackners and Dr. Guevara, the breach of that duty, and injury to Dr. Guevara. The court pointed to evidence of the Lackners' control based on the provision of the company agreement that vested sole control of the management, business, and affairs of the LLC in the Lackners as managers. There was also evidence that the Lackners' role as managers gave them intimate knowledge of the daily affairs of the LLC and that Dr. Guevara did not have extensive knowledge of the operations and was not involved in the day-to-day operations. The summary-judgment evidence showed the Lackners did not disclose certain information to Dr. Guevara and that the Lackners' made decisions without knowledge of relevant facts. There was also evidence that the funds provided by Dr. Guevara to the LLC were lost. According to the court of appeals, this evidence amounted to more than a scintilla of evidence of the elements of a claim for breach of an informal fiduciary duty.

In *Macias v. Gomez*, 2014 WL 7011372 (Tex. App.– Corpus Christi-Edinburg 2014, no pet.), the minority members of an LLC obtained a summary judgment against Macias, the majority member, on Macias's claim against the minority members for breach of fiduciary duty. Macias argued on appeal that he at least raised a fact issue as to whether the minority members owed him a fiduciary duty based on their exercise of active control over the LLC. The court of appeals affirmed the trial court's summary judgment because Macias argued in the trial court that the minority members owed him a fiduciary duty as a matter of law, comparing the LLC to a partnership in which all partners owe one another a fiduciary duty. The court of appeals concluded that Macias did not fairly apprise the trial court of his "control" argument, and the summary judgment thus could not be reversed on that basis. The court stated in a footnote that it offered no opinion as to whether an LLC's members who control activities of the LLC owe a fiduciary duty to majority members.

In *Bigham v. Southeast Texas Environmental, LLC*, 458 S.W.3d 650 (Tex. App.–Houston [14th Dist.] 2015, no pet.), an LLC that was pursuing environmental contamination litigation sued two individuals, Bigham and Hollister, who were to receive a percentage of the proceeds of the litigation pursuant to a power-of-attorney agreement with Bigham. Under the power-of-attorney agreement, Bigham was to manage the litigation. The LLC alleged that Bigham and Hollister breached their fiduciary duties by sabotaging the litigation. The jury found that Bigham and Hollister had a relationship of trust and confidence with the LLC, that they failed to comply with their fiduciary duties, and that the breaches were committed with malice. The jury also found actual and exemplary damages. The court of appeals stated that it was undisputed that Hollister owed fiduciary duties as a member of the LLC. (Hollister's fiduciary duties were not based on the power of attorney because he was not a signatory to the power of attorney even though he was designated under the power of attorney to receive a percentage of the LLC's recovery in the environmental contamination litigation. Although the court referred to Hollister's duties as relating to his status as member, an earlier portion of the opinion indicated that the LLC was manager-managed and referred to a Texas Franchise Tax Public Information Report signed by Hollister and listing Hollister as managing member.) Bigham owed the LLC fiduciary duties solely based on the power of attorney. The court reviewed the evidence and concluded that it was sufficient to support the jury's finding that Bigham and Hollister did not comply with their fiduciary duties. Based on the evidence, the jury could have concluded that Bigham and Hollister violated their fiduciary duties by threatening to withhold Hollister's cooperation in the litigation when Hollister, as a member, had a duty to achieve an optimal result at trial, irrespective of whether he received any proceeds under the power of attorney.

In *Siddiqui v. Fancy Bites, LLC*, 504 S.W.3d 349 (Tex. App.—Houston [14th Dist.] 2016, pet. denied), two LLC members who asserted claims for breach of fiduciary duty against two other members relied on *Guevara v. Lackner* for "the proposition that 'Texas courts have…recognized that an informal fiduciary duty *may* exist between the shareholders in a closely held corporation, depending on the circumstances.'" Although the court of appeals acknowledged that some appellate courts have held that an informal fiduciary duty may arise between shareholders in a closely held corporation under certain circumstances in the absence of a pre-transaction relationship, the court stated that it had not adopted such an expansive view and "has consistently determined that informal fiduciary duties do not arise in business transactions…unless the special relationship of trust and confidence existed before the transaction at issue." Moreover, the members in this case were each co-equal managers and owners of the LLCs with equal rights of control and access to books and records. Any control exercised by two of the members resulted because the other two members chose not to participate fully in the LLC's affairs. The two members who sought to hold the other two members liable for breach of fiduciary duty did not testify that they had any relationship other than a business relationship with the other two members, and they did not testify that they trusted or relied on the other two members in any particular respect to manage the venture for them. Thus, the court of appeals held that the trial court erred in rendering judgment based on breach of fiduciary duties.

In *Angel v. Tauch (In re Chiron Equities, LLC)*, 552 B.R. 674 (Bankr. S.D. Tex. 2016), the court concluded that a manager/minority member owed the LLC, but not the other member, fiduciary duties.

In *B Choice Ltd. v. Epicentre Development Association LLC*, 2017 WL 1227313 (S.D. Tex. 2017), report and recommendation adopted, 2017 WL 1160512 (S.D. Tex. 2017), the court concluded that a fact issue existed as to whether the officers and manager of an LLC owed a fiduciary duty to the plaintiff member. The court recognized that no Texas court has held that fiduciary duties exist between members of an LLC as a matter of law but stated that the recognition of a fiduciary duty in the LLC context is typically a question of fact. The court relied on *Allen v. Devon Energy Holdings, LLC*, 367 S.W.3d 355, 392 (Tex. App.–Houston [1st Dist] 2012, pet. granted, judgm't vacated w.r.m.), in which the court of appeals discussed the similarities between an LLC and a partnership. The manager of the LLC at issue in *B Choice Ltd.* was empowered by the operating agreement with "full and exclusive right, power, and authority to manage the affairs of the Company." The court found this structure and the plaintiff's minority membership created a situation similar to a limited partnership. Thus, the court refused to grant summary judgment on the breach-of-fiduciary-duty claim against the LLC's officers and manager.

Bankruptcy courts in some cases have analyzed breach-of-fiduciary-duty claims against LLC members who were also officers of the LLC in terms of the duties of corporate officers without indicating any recognition that an LLC is not actually a corporation. *See Floyd v. Option One Mortg. Corp. (In re Supplement Spot, LLC)*, 409 B.R. 187 (Bankr. S.D. Tex. 2009) (relying on corporate law for the proposition that corporate officers have fiduciary duties to creditors in analyzing fraudulent transfer of LLC funds to pay mortgage debts of LLC officer); *Sherman v. FSC Realty LLC (In re Brentwood Lexford Partners, L.L.C.)*, 292 B.R. 255 (Bankr. N.D. Tex. 2003) (discussing and relying on duties owed by corporate officers to corporation and creditors in analyzing claims against LLC officers arising from distributions while LLC was insolvent and officers' resignation from LLC and formation of new LLC to which some business was transferred); *Anderson v. Mega Lift Sys., L.L.C. (In re Mega Sys., L.L.C.)*, 2007 WL 1643182 (Bankr. E.D. Tex. 2007) (citing corporate case law rejecting proposition that duties are owed to corporate creditors when debtor approaches zone of insolvency in addressing breach-of-fiduciary-duty claim against LLC's president/majority owner).

For cases in other states that have addressed fiduciary duties of managers or members, see Elizabeth S. Miller, *More Than a Decade of LLP and LLC Case Law: A Cumulative Survey of Cases Dealing With Limited Liability Partnerships and Limited Liability Companies*, June 2007, and subsequent case law updates available at http://www.baylor.edu/law.

B. Statutory Authorization to Modify Duties and Liabilities of Members and Managers in Governing Documents

1. Exculpation

Prior to 1997, Article 8.12 of the TLLCA followed the corporate approach to exculpation of directors by incorporating by reference Article 7.06 of the Texas Miscellaneous Corporation Laws Act (Tex. Rev. Civ. Stat. art. 1302-7.06 (expired Jan. 1, 2010)). The original version of Article 8.12 of the TLLCA indicated that a manager's liability could be eliminated in the articles of organization to the extent permitted for a director under Article 1302-7.06. In 1997, amendments to the statute effected a significant departure from this approach. The reference to Article 1302-7.06 was eliminated from the TLLCA, and a new provision, Article 2.20B, was added 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 of the regulations.

This provision (which is included in the BOC at Section 101.401) was modeled after similar provisions in the Delaware LLC and limited partnership acts[2] and leaves the extent to which duties and liabilities may be limited or eliminated to be determined by the courts as a matter of public policy. There is scant case law addressing this statutory power to limit duties and liabilities in Texas LLCs. The only case to discuss the contractual freedom of members in this regard is *Allen v. Devon Energy Holdings, L.L.C.* 367 S.W.3d 355 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgm't vacated w.r.m.). In that case, the court noted that LLCs are expressly excluded from the statutory restriction on the limitation or elimination of liability of governing persons in Section 7.001 of the BOC, and the court stated that the members of an LLC are "free to expand or eliminate, as between themselves, any and all potential liability" of a manager of the LLC as the members see fit. The court also concluded that an exculpation provision in the articles of organization that largely tracked Section 7.001 of the BOC and referred to the manager's "duty of loyalty to [the LLC] or its members" could be read to create a fiduciary duty to the members individually. Section 7.001(d) of the BOC was amended in 2013 to clarify that the company agreement may eliminate the liability of a manager or managing member to the LLC and the other members to the same extent that a corporation's certificate of formation may eliminate a director's liability under Section 7.001 and to such further extent allowed by Section 101.401. There are no express prohibitions or limitations in Section 101.401 with respect to the limitation or elimination of liability of a manager or managing member to the LLC or the members. It should be noted that a distinction can be drawn between the limitation or elimination of duties and the limitation and elimination of liabilities. If the liability of a governing person is contractually eliminated, but the duty still exists, a breach of the duty could give rise to equitable relief (such as injunctive relief or receivership) even though the person could not be held liable for damages. Redefining or eliminating duties, on the other hand, narrows or eliminates not only potential liability for damages by the party who would otherwise owe the duty, but determines whether there is a breach at all, thus affecting the availability of equitable relief as well.

In addition to permitting the expansion or restriction of fiduciary duties of members and managers in the company agreement (Tex. Bus. Orgs. Code § 101.401), an LLC also has the specific

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[2] The Delaware statutes were amended in 2004 to expressly permit the elimination of fiduciary duties (but not the implied covenant of good faith and fair dealing) in a limited partnership agreement or LLC agreement. *See* Delaware Limited Liability Company Act § 18-1101. These amendments were a response by the Delaware General Assembly to a Delaware Supreme Court opinion pointing out that the prior Delaware provision did not explicitly authorize elimination of fiduciary duties. *See Gotham Partners, L.P. v. Hollywood Realty Partners, L.P.*, 817 A.2d 160 (Del. 2002) (noting, in response to Chancery Court opinions indicating that the Delaware limited partnership act permitted a limited partnership agreement to *eliminate* fiduciary duties, that the statute actually stated that fiduciary duties and liabilities could be *expanded* or *restricted*, but did not state that they could be *eliminated*).

power to renounce company opportunities. Tex. Bus. Orgs. Code § 2.101(21); *see also* Tex. Rev. Civ. Stat. art. 1528n, art. 2.02A (expired Jan. 1, 2010) (pursuant to which Tex. Bus. Corp. Act art. 2.02(20) (expired Jan. 1, 2010) applied to an LLC).

Thus far, courts in other jurisdictions have been inclined to give effect to contractual provisions limiting fiduciary duties and specifying permissible conduct of LLC managers and members. In the first LLC case addressing issues of this sort to a significant degree, the Ohio Court of Appeals interpreted and enforced a provision of an operating agreement limiting the scope of a member's duty not to compete with the LLC. *McConnell v. Hunt Sports Enters.*, 725 N.E.2d 1193 (Ohio App. 1999). In this case, the court stated that LLC members (of what was apparently a member-managed LLC) are in a fiduciary relationship that would generally prohibit competition with the business of the LLC. The court concluded, however, that members may contractually limit or define the scope of the fiduciary duties. Specifically, the court recognized the validity of a provision in the operating agreement of an Ohio LLC that provided as follows:

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

Under this provision, the court found that a member was clearly and unambiguously permitted to compete against the LLC to obtain a hockey franchise sought by the LLC. The court rejected an argument that the provision only allowed members to engage in other types of businesses. The court commented that action related to obtaining the franchise or "the method of competing" could constitute a breach of duty if it amounted to "dirty pool," but noted the trial court's finding that the competing members had not engaged in willful misconduct, misrepresentation, or concealment.

For cases in other states that have addressed contractual provisions addressing fiduciary duties of managers or members, see Elizabeth S. Miller, *More Than a Decade of LLP and LLC Case Law: A Cumulative Survey of Cases Dealing With Limited Liability Partnerships and Limited Liability Companies*, June 2007, and subsequent case law updates available at http://law.baylor.edu.

2. <u>Indemnification</u>

Prior to 1997, the TLLCA provided that an LLC was permitted to indemnify members, managers, and others to the same extent a corporation could indemnify directors and others under the TBCA and that an LLC must, to the extent indemnification was required under the TBCA, indemnify members, managers, and others to the same extent. Thus, applying these provisions in the LLC context, indemnification was mandated in some circumstances even if the articles of organization and regulations were silent regarding indemnification. On the other hand, there were certain standards and procedures that could not be varied in the articles of organization or regulations. Article 2.20A of the TLLCA was amended in 1997 to read as follows:

> Subject to such standards and restrictions, if any, as are set forth in its articles of organization or in its regulations, a limited liability company shall have the power to

indemnify members and managers, officers, and other persons and purchase and maintain liability insurance for such persons.

Tex. Rev. Civ. Stat. art. 1528n, art. 2.20A (expired Jan. 1, 2010). Sections 8.002, 101.052, and 101.402 of the BOC generally carry forward this approach. Thus, the current LLC indemnification provisions neither specify any circumstances under which indemnity would be required nor place any limits on the types of liabilities that may be indemnified. It will be left to the courts to determine the bounds equity or public policy will place on the obligation or power to indemnify. Thus, for example, if a company agreement states that a manager or member "shall be indemnified to the maximum extent permitted by law," it is not clear how far the indemnification obligation extends. Would the LLC be required to indemnify for bad-faith acts or intentional wrongdoing?

IV. General Partnerships (including Limited Liability Partnerships (LLPs)) and Limited Partnerships (including Limited Liability Limited Partnerships (LLLPs))

A. Fiduciary Duties of Partners in General Partnership (including LLP)

The principle that general partners owe their partners and the partnership fiduciary duties is oft-recited in the case law. Perhaps the most famous case in this area is Justice Cardozo's opinion in *Meinhard v. Salmon*, 249 NY 458, 164 N.E. 545 (1928). Texas cases have reiterated the unyielding duty-of-loyalty standard set forth in that case. *See Huffington v. Upchurch*, 532 S.W.2d 576 (Tex. 1976); *Johnson v. Peckham*, 132 Tex. 148, 120 S.W.2d 786 (1938); *Kunz v. Huddleston*, 546 S.W.2d 685 (Tex.App.–El Paso 1977, writ ref'd n.r.e.). On the other hand, the duty of care has received little attention in the case law. In the Texas Revised Partnership Act (TRPA), which became effective January 1, 1994, the legislature defined a partner's duties of care and loyalty and adopted provisions intended to clarify the extent to which contractual modification of the duties is permissible.

The Texas Uniform Partnership Act (which became effective in Texas in 1962 and expired in 1999) addressed only certain aspects of the fiduciary duties of partners. In fleshing out the fiduciary duties of partners, courts have often spoken in broad, sweeping terms. At times, courts have even referred to partners as "trustees." The current statutory provisions include a more comprehensive description of partner duties than the Texas Uniform Partnership Act but eschew some of the broader language found in some cases. BOC Sections 152.204-152.207, which carry forward the provisions of Section 4.04 of the TRPA, certainly describe the core of what has traditionally been referred to by the courts as partner fiduciary duties, but the Bar Committee comments to Section 4.04 of the TRPA reflect the Committee's hope that the statutorily described duties will not be expanded by loose use of "fiduciary" concepts from other contexts or by the broad rhetoric from some prior cases. *See* Tex. Rev. Civ. Stat. art. 6132b-4.04 (expired Jan. 1, 2010), Comment of Bar Committee – 1993. In fact, the drafters of the TRPA quite deliberately refrained from using the term "fiduciary," and the statutes explicitly provide that a partner is not a trustee and is not to be held to such a standard. Tex. Rev. Civ. Stat. art. 6132b-4.04(f) (expired Jan. 1, 2010); Tex. Bus. Orgs. Code § 152.204(d). On the other hand, the statutes leave courts some flexibility because the duties are not listed or described in exclusive terms. Furthermore, as was the case under the TRPA, the BOC provides that every partner is an "agent" of the partnership. Tex. Bus. Orgs. Code § 152.301; Tex. Rev. Civ. Stat. art. 6132b-3.02(a) (expired Jan. 1, 2010). An agent owes the principal fiduciary duties under Texas common law (*see, e.g.*, *Johnson v. Brewer & Pritchard, P.C.,* 73 S.W.3d 193 (Tex. 2002)), and the principles of law and equity supplement Chapter 152 of the BOC unless otherwise provided by Chapters 151, 152, and 154. Tex. Bus. Orgs. Code § 152.003.

Few cases have explored in any depth whether the duties as they are described under the TRPA and BOC differ significantly from the common-law duties. The Texas Supreme Court addressed Section 4.04 of the TRPA in one case and indicated in passing that the law as it applied in that case was not changed by the TRPA; however, the case was actually governed by the Texas Uniform Partnership Act. *See M.R. Champion, Inc. v. Mizell*, 904 S.W.2d 617 (Tex. 1995). In *Johnson v. Brewer & Pritchard, P.C.,* 73 S.W.3d 193, 199-200 (Tex. 2002), a case involving the fiduciary duty owed by an agent to a principal, the Texas Supreme Court noted that it had historically held that partners owe one another certain fiduciary duties but that it "need not consider here the impact of the provisions of the Texas Revised Partnership Act on duties partners owe to one another." In *Ingram v. Deere*, 288 S.W.3d 886, 892 (Tex. 2009), the court characterized Section 4.04 of the TRPA as "recognizing the unwaivable duties of care and loyalty and the obligation of good faith required of partners under the Texas Revised Partnership Act" and cited case law "recognizing 'as a matter of common law that '[t]he relationship between...partners... is fiduciary in character.'" The court did not analyze the duties of partners, however, because the court held that there was no legally sufficient evidence that the parties in that case were partners.

In *Red Sea Gaming, Inc. v. Block Investments (Nevada) Co.*, 338 S.W.3d 562 (Tex.App.–El Paso 2010, pet. denied), the court of appeals relied upon the non-exclusive nature of the description of the duty of loyalty set forth in the TRPA to conclude that a jury instruction that included a requirement that a partner show it "fully and fairly disclosed all important information" concerning the purchase of the other partner's partnership interest was consistent with the statutory duties set forth in Section 4.04 of the TRPA. *See also Zinda v. McCann St., Ltd.*, 178 S.W.3d 883 (Tex.App.–Texarkana 2005, pet. denied) (citing case law and Section 4.04 of the TRPA and stating that partners owe one another "fiduciary" duties as a matter of law, including a duty to make full disclosure of all matters affecting the partnership, a duty to account for all partnership property and profits, and a strict duty of good faith and candor). In *American Star Energy and Minerals Corp. v. Stowers*, 457 S.W.3d 427 (Tex. 2015), the Texas Supreme Court cited *Zinda v. McCann Street, Ltd.*, for the proposition that the duty of care owed by a partner under Section 152.204(a)(2) of the BOC imposes a disclosure obligation in some circumstances. Specifically, the court suggested that "[w]hen a partnership is served with a lawsuit, [the duty of care] may require the partner served to apprise the other partners." *Am. Star Energy*, 457 S.W.3d at 434-35 (citing *Zinda v. McCann St., Ltd.*, 178 S.W.3d 883, 890 (Tex. App.–Texarkana 2005, pet. denied) for the proposition that "'[p]artners have a duty to one another to make full disclosure of all matters affecting the partnership....'").

As pointed out by Judge Jernigan in a 2011 bankruptcy opinion, federal courts applying Texas law have generally assumed that partners' duties under the current statutes are consistent with their duties under common law without any analysis of the impact of the TRPA on partners' common-law duties. *Mullen v. Jones (In re Jones)*, 445 B.R. 677 (Bankr. N.D. Tex. 2011) (further discussed below). In 2004, a Fifth Circuit Court of Appeals case pointed out that the TRPA "significantly amended" partnership law in 1994 to "refine the nature and scope of partners' duties to each other" and stated that some aspects of the statutory duties may not be "fiduciary" in nature for purposes of certain provisions of the Bankruptcy Code, but the court did not reach any conclusions as to how or if the statutory duties of partners are materially different from the duties imposed on partners at common law. *See Gupta v. E. Idaho Tumor Inst., Inc. (In re Gupta)*, 394 F.3d 347 (5th Cir. 2004).[3]

Subsequent to *In re Gupta*, a number of federal courts, including the Fifth Circuit Court of Appeals itself, addressed duties of partners under Texas law without considering whether or to what extent the statutory changes affected the analysis of such duties. In *Wilson v. Cantwell*, 2007 WL 2285947 (N.D. Tex. 2007), the district court cited Section 152.204 of the BOC for the proposition that partners owe the partnership and other partners the "fiduciary" duties of loyalty and care and that

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[3] After Gupta was found liable to Eastern Idaho Tumor Institute, Inc. ("Eastern Idaho") for breach of their joint venture agreement and breach of fiduciary duty, Gupta filed for Chapter 7 bankruptcy. Eastern Idaho argued that Gupta's liability for breach of fiduciary duty was non-dischargeable under Section 523(a)(4) of the Bankruptcy Code, which renders debts that arise from "fraud or defalcation while acting in a fiduciary capacity" non-dischargeable. The bankruptcy court granted Eastern Idaho summary judgment, and the district court affirmed. The Fifth Circuit noted that it has held a trust relationship must exist prior to the wrong and with reference to it in order to constitute a "technical trust" within the non-dischargeability provision. The court acknowledged, however, that it has not hesitated to characterize debts as non-dischargeable where they arose from misappropriation by persons serving in a traditional, pre-existing fiduciary capacity as understood by state law principles. Thus, debts of corporate officers to the corporation or a minority shareholder, as well as debts of a managing partner of a limited partnership to the limited partners (*LSP Inv. P'ship v. Bennett (In re Bennett)*, 989 F.2d 779 (5th Cir. 1993)), have been held non-dischargeable. At the time it decided *Bennett*, the court noted a split among lower court decisions as to whether co-equal partners owe each other "fiduciary" duties for purposes of Section 523(a)(4). The court acknowledged that two circuit courts since *Bennett* have concluded debts of a partner toward fellow partners or the partnership are non-dischargeable on this ground and no circuit court has held to the contrary. Eastern Idaho attempted to simplify the issue by characterizing Gupta as a managing partner, but the court declined to view Gupta in such a manner because there was no such finding in the state court proceedings and the evidence suggested that the venture was managed jointly. The court stated that Gupta's precise role, whether as manager or co-equal venturer would be irrelevant if all partners are fiduciaries to each other for purposes of Section 523(a)(4); however, the court stated that Texas law, as articulated under the TRPA, failed to support that broad proposition. The court noted that Texas law was significantly amended by the TRPA in 1994 to "refine the nature and scope of partners' duties to each other." The court quoted the provision of the TRPA that states a partner, in that capacity, is not a trustee and is not held to the same standards as a trustee (Tex. Rev. Civ. Stat. art. 6132b-4.04(f)) as well as the State Bar Committee Comment explaining that Section 4.04 "defines partnership duties and implies that they are not to be expanded by loose use of 'fiduciary' concepts from other contexts or by the rhetoric of some prior cases." The court went on to state, however, that it was not saying Texas partners no longer owe special duties to each other. The court noted that Section 4.04 defines duties of loyalty and care, together with obligations to discharge those duties in good faith and in the best interests of the partnership. The court observed that the duty of loyalty expressly includes a duty of accounting to the partnership and holding and using property or money for the partnership's benefit during its existence and winding up. Under these provisions, the court concluded that certain duties may rise to the level of "fiduciary" for purposes of Section 523(a)(4). The court discussed the Texas Supreme Court's comments in *M.R. Champion, Inc. v. Mizell* and concluded that it appeared the duty to account for money owed to the partnership may constitute a pre-existing, express or technical trust for purposes of Section 523(a)(4). Because the jury findings underlying the judgment against Gupta in state court did not tie the damages for breach of fiduciary duty to specific instances of misconduct that might correlate to areas of responsibility that may still be deemed "fiduciary" under Texas partnership law, the court reversed the lower court's summary judgment in favor of Eastern Idaho. The jury's finding of Gupta's fiduciary duty was predicated on "a relationship of trust and confidence," a standard the Fifth Circuit previously determined was too broad to satisfy the federal standard under Section 523(a)(4). A separate finding of Gupta's breach of fiduciary duty based on general phrases concerning the duty (e.g., to conduct transactions that were "fair and equitable" to Eastern Idaho), rather than on specific events or actions that might fall within the parameters of the TRPA, was likewise insufficient.

partners must discharge their duties in good faith and in the best interest of the partnership. Bankruptcy courts have cited both case law and Section 4.04 of the TRPA for the proposition that partners owe one another and the partnership "fiduciary" duties that include the duties of loyalty and care. *See Wallace v. Perry (In re Perry)*, 423 B.R. 215 (Bankr. S.D. Tex. 2010); *Leal v. Mokhabery (In re Leal)*, 360 B.R. 231 (Bankr. S.D. Tex. 2007); *see also West v. Seiffert (In re Houston Drywall, Inc.)*, 2008 WL 2754526 (Bankr. S.D. Tex. 2008) (citing Section 152.205 of the BOC along with Texas case law for the proposition that partners owe one another "fiduciary" duties and stating that Texas courts have analogized the duty owed by a general partner to a limited partner to that owed by a trustee to a beneficiary).

In *McBeth v. Carpenter*, 565 F.3d 171 (5th Cir. 2009), the Fifth Circuit Court of Appeals stated that "[u]nder Texas law, managing partners owe trust obligations to the partnership, having a duty of loyalty and due care as well as being under an obligation to discharge their duties in good faith and in the reasonable belief that they are acting in the best interest of the partnership," citing Section 4.04 of the TRPA. Notwithstanding the court's observation in *Gupta* (discussed in the footnote above) that the TRPA significantly amended Texas law "to refine the nature and scope of partners' duties" and to provide that a partner is not held to a trustee standard, the court quoted from Texas case law analogizing a general partner in a limited partnership to a trustee. *See also FNFS, Ltd.v. Harwood (In re Harwood*), 637 F.3d 615 (5th Cir. 2011) (relying upon *In re Bennett*, a 1993 Fifth Circuit opinion, and *McBeth v. Carpenter* to conclude that an officer of a corporate general partner who is entrusted with the management of the limited partnership and who exercises control over the limited partnership in a manner analogous to those cases owes a fiduciary duty to the partnership that satisfies Section 523(a)(4) of the Bankruptcy Code).

The most extensive analysis to date of the impact of the statutory developments under Texas partnership law on the common-law fiduciary duties of partners is found in *Mullen v. Jones (In re Jones)*, 445 B.R. 677 (Bankr. N.D. Tex. 2011). In determining whether the debtor owed a non-dischargeable debt to the plaintiff under Section 523(a)(4) of the Bankruptcy Code, the bankruptcy court first examined whether the debtor was acting in a fiduciary capacity *vis a vis* the plaintiff. After noting that the debtor, as an officer and director of the corporate general partner of a limited partnership, stood in a fiduciary relationship to the corporation and its shareholders under Texas corporate law, the court proceeded to analyze the nature of the relationship of the corporate general partner to the partnership and the limited partners under Texas partnership law. The court noted that a large amount of common law stands for the proposition that a general partner occupies a fiduciary role with respect to the limited partners, but the court recognized that significant amendments to the Texas partnership statutes in 1994 impact the analysis of fiduciary duties in the partnership context. The court summarized the statutory developments, explaining that the Texas Uniform Partnership Act only used the term "fiduciary" when referring to a partner's duty to account for any benefit and hold as trustee any profits obtained in connection with the partnership without the consent of other partners, but that case law under the Texas Uniform Partnership Act consistently referred to a partner as a fiduciary.

The bankruptcy court then discussed the approach taken in the TRPA, which rejected the notion of a partner as a trustee and specifically set forth the duties of partners in precise terms. The court noted that the Official Comments state that these changes were meant to reign in the loose use of fiduciary concepts. Finally, the court noted that the BOC contains language nearly identical to the TRPA.

Despite these changes since the Texas Uniform Partnership Act, the court observed that very little case law has addressed the significance of the changes. The court pointed out that the Fifth Circuit case of *In re Gupta* came closest to confronting the significance of the changes. As noted above, in that case, the Fifth Circuit did not tackle the meaning or ramifications of the new Texas partnership statute with respect to the notion of "fiduciary capacity" under Section 523(a)(4) but did note that partners still owe "special duties to each other," some of which "may rise to the level of a 'fiduciary' for purposes of § 523(a)(4)." 394 F.3d at 351. A few years later, without mentioning the statutory changes, the Fifth Circuit, in *McBeth v. Carpenter,* 565 F.3d 171 (5th Cir. 2009), held that all partners in a partnership are fiduciaries. Ultimately, the bankruptcy court in *Mullen v. Jones* concluded that the changes in Texas statutory partnership law in recent years expunged the concept of a partner as a *per se* fiduciary but did not eliminate the fiduciary status of a managing general partner because of the control exercised by such a partner. The court reasoned that the new statutory language, which makes clear that a partner is not *per se* a fiduciary, puts partners and partnerships on a parity with shareholders and corporations in that shareholders do not generally owe fiduciary duties to other shareholders. Based on the roles in which fiduciary duties are owed in the corporate context and longstanding case law regarding the fiduciary duties of a managing partner in the partnership context, the court concluded that control is the key to determining whether a partner is a fiduciary. Thus, the court held that Texas case law holding that there is an express trust satisfying the strict test for "fiduciary capacity" under Section 523(a)(4) is still good law in the context of a managing general partner.

The court in *Jones* then looked at the two-tiered structure of the limited partnership to determine how it affected the fiduciary duties owed by the debtor. The debtor was president, a director, and 51% shareholder of the corporate general partner. The court relied on two Fifth Circuit cases, *LSP Investment Partnership v. Bennett (In re Bennett)*, 989 F.2d 779 (5th Cir. 1993) and *McBeth v. Carpenter*, 565 F.3d 171 (5th Cir. 2009), to conclude that the debtor, as manager of the managing general partner, owed fiduciary duties to the partnership and the partners. In *Bennett*, the Fifth Circuit held that the fiduciary obligations imposed on managing partners of a limited partnership under Texas law were sufficient to meet the Section 523(a)(4) test and that the same level of fiduciary duty should apply to the managing partner of a managing partner. *McBeth* was not a Section 523(a)(4) case, but the Fifth Circuit again held that a person or entity acting in complete control of a limited partnership stands in the same fiduciary capacity to the limited partners as a trustee stands to the beneficiary of a trust even in a two-tiered partnership structure. Thus, the court concluded that the debtor owed the plaintiff fiduciary duties through at least two avenues: (1) in his capacity as officer and director of the corporate general partner (since the plaintiff was a shareholder); and (2) in his capacity as the control person/manager of the general partner (since the plaintiff was a limited partner).

The bankruptcy court next analyzed whether the debtor committed a defalcation in a fiduciary capacity, i.e., whether he breached or neglected fiduciary duties, whether he was at least reckless in doing so, and whether a reasonable person in the debtor's position reasonably should have known better. The court described the duties of loyalty and care and the obligation of good faith set forth in the TRPA and further noted how cases have described a partner's duties. The court then concluded that the debtor committed defalcation while acting in his fiduciary capacity by repeatedly spending partnership funds for his own personal use and allowing others involved in the business to do the same. The court stated that lack of fraudulent intent and apparent lack of business savvy did not matter because a reasonable person should have known better. The court stated that spending partnership funds for one's lavish lifestyle is not administering the partnership's affairs solely for the benefit of the partnership, nor was the debtor complying with the partnership agreement, abiding by his duty not to misapply funds, acting with utmost good faith, fairness, and honesty, or making full disclosure of matters affecting the partnership.

Finally, the court determined the amount of the "debt" to the plaintiff that had arisen as a result of the debtor's defalcation. The court measured this debt based on the amount of the misappropriated partnership funds. The court also awarded exemplary damages because Texas courts have held that breach of fiduciary duty is a tort for which exemplary damages may be recoverable and there was clear and convincing evidence that the standard for exemplary damages under the Texas Civil Practice and Remedies Code was met. Under the Texas Civil Practice and Remedies Code, exemplary damages may only be awarded if a claimant proves by clear and convincing evidence that the harm to the claimant resulted from actual fraud, malice, or gross negligence. Although the court concluded there was no actual fraud or malice on the part of the debtor, the court found the evidence did establish gross negligence as defined by the statute.

In the years since the bankruptcy court's analysis in *Mullen v. Jones (In re Jones)*, 445 B.R. 677 (Bankr. N.D. Tex. 2011), most courts in Texas have not specifically analyzed whether a partner's statutory duties under the TRPA and BOC are "fiduciary" in character. Many courts explicitly or implicitly characterize the statutory duties of partners as "fiduciary," citing Texas case law in addition to the duty provisions of the TRPA and BOC. *See Lopez v. Hernandez (In re Hernandez)*, 565 B.R. 367 (Bankr. W.D. Tex. 2017); *Nguyen v. Hoang*, 507 S.W.3d 360 (Tex. App.–Houston [1st Dist.] 2016, no pet.); *Westergren v. Jennings*, 441 S.W.3d 670 (Tex. App.–Houston [1st Dist.] 2014, no pet); *SEC v. Helms*, 2015 WL 1040443 (W.D. Tex. 2015); *Drexel Highlander Ltd. P'ship v. Edelman (In re Edelman)*, 2014 WL 1796217 (Bankr. N.D. Tex. 2014), aff'd, 2015 WL 5714728 (N.D. Tex. 2015). Some courts continue to discuss fiduciary duties of partners under Texas law without referring to the statutory provisions at all. *Art Midwest Inc. v. Atl. Ltd. P'ship* XII, 742 F.3d 206 (5th Cir. 2014); *CBIF Ltd. P'ship v. TGI Friday's Inc.*, 2017 WL 1455407 (Tex. App.–Dallas 2017, pet. filed); *Thunder Rose Enters., Inc. v. Kirk*, 2017 WL 2172468 (Tex. App.–Corpus Christi 2017, pet. filed); *Light v. Whittington (In re Whittington)*, 530 B.R. 360 (Bankr. W.D. Tex. 2014); *Naples v. Lesher*, 2014 WL 1856846 (Tex. App.–Texarkana 2014, no pet.); *Serengeti Resort, LLC v. Esperanza*, 2014 WL 235336 (Tex. App.–San Antonio 2014, no pet.); *Pacific Addax Co., Inc. v. Lau (In re Lau)*, 2013 WL 5935616 (Bankr. E.D. Tex. 2013). And some courts describe and apply the statutory duties without expressly characterizing the duties as "fiduciary." *See Jerry L. Starkey, TBDL, LP v. Graves*, 448 S.W.3d 88 (Tex. App.–Houston [14th Dist.] 2014, no pet.).

In *Bruce v. Cauthen*, 515 S.W.3d 495 (Tex. App.–Houston [14th Dist.] 2017, pet denied), the court held that a partner failed to preserve for appeal his argument that a partner's statutory duties are not the equivalent of common-law fiduciary duties.

1. <u>Duty of Care</u>

A partner owes a duty of care to the partnership and the other partners. Tex. Bus. Orgs. Code § 152.204(a); *see also* Tex. Rev. Civ. Stat. art. 6132b-4.04(a) (expired Jan. 1, 2010). The duty is defined in BOC Section 152.206 (*see also* Tex. Rev. Civ. Stat. art. 6132b-4.04(c) (expired Jan. 1, 2010)) as a duty to act in the conduct and winding up of the partnership business with the care of an ordinarily prudent person under similar circumstances. An error in judgment does not by itself constitute a breach of the duty of care. Further, a partner is presumed to satisfy this duty 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. Tex. Bus. Orgs. Code §§ 152.206, 152.204(b); Tex. Rev. Civ. Stat. art. 6132b-4.04(c), (d) (expired Jan. 1, 2010). These provisions obviously draw on the corporate business judgment rule in articulating the duty of care. Nevertheless, it is unclear in the final analysis if the standard is 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. *See Ferguson v. Williams*, 670 S.W.2d 327 (Tex.App.–Austin 1984, writ ref'd n.r.e.). It is unlikely the drafters intended to up the ante in this regard. On the other hand, the TRPA stopped short of expressly specifying gross negligence as the standard (which is the standard specified in the Revised Uniform Partnership Act).

In a case governed by the TRPA, a bankruptcy court rejected a partner's claim for damages based on mismanagement of the other partner, stating that business ventures and partnerships involve risks, and that there is no legal remedy available to a businessman who is disappointed by the partnership's actual revenues or profits absent a contractual guarantee or tortious conduct. According to the court, poor management performance, absent a showing of wrongful conduct, is not actionable. *Leal v. Mokhabery (In re Leal)*, 360 B.R. 231, 239 (Bankr. S.D. Tex. 2007). Although the court noted earlier in the opinion that the TRPA governed the case and cited provisions in Section 4.04, the court did not discuss the relationship between the duty of care as described in Section 4.04 and its conclusions regarding the mismanagement claim. The court also rejected a claim for damages based on the other partner's poor recordkeeping, although the court later appeared to allude to the partner's poor recordkeeping as a breach of fiduciary duty.

Relying on the TRPA, a Texas bankruptcy court concluded a partner breached his duty of care in the winding up of a partnership by failing to honor an indemnification clause in an agreement with the other partners. *Wallace v. Perry (In re Perry)*, 423 B.R. 215, 285-86 (Bankr. S.D. Tex. 2010). In the course of its discussion of the duty of care, the court stated that "the business judgment rule does not apply to partnership decisions made by partners in a partnership." 423 B.R. at 288. This assertion is patently at odds with the language of Section 4.04(c) of the TRPA (recodified in Section 152.206(b) and (c) of the BOC) and the Bar Committee Comment. See Tex. Rev. Civ. Stat. art. 6132b-4.04(c) (expired Jan. 1, 2010), Comment of Bar Committee–1993 ("This subsection, along with subsection (d), incorporates the so-called 'business judgment rule,' ...."). The more pertinent questions are what effect the business judgment rule has on the standard of liability of a partner and the circumstances under which it applies. Indeed, assuming the business judgment rule applies to a general partner, the court held in the alternative that the business judgment rule was not a valid defense because the partner was not disinterested in relation to his failure to indemnify the other partners.

In *American Star Energy and Minerals Corp. v. Stowers*, 457 S.W.3d 427 (Tex. 2015), the Texas Supreme Court cited *Zinda v. McCann Street, Ltd.*, for the proposition that the duty of care owed by a partner under Section 152.204(a)(2) of the BOC imposes a disclosure obligation in some circumstances. Specifically, the court suggested that "[w]hen a partnership is served with a lawsuit, [the duty of care] may require the partner served to apprise the other partners." *Am. Star Energy*, 457 S.W.3d at 434-35 (citing *Zinda v. McCann St., Ltd.*, 178 S.W.3d 883, 890 (Tex. App.–Texarkana 2005, pet.

denied) for the proposition that "'[p]artners have a duty to one another to make full disclosure of all matters affecting the partnership....'").

Under the BOC, provisions based on Article 2.41D of the TBCA are applicable not only to directors of a corporation, but to governing persons of other types of entities as well. Under these provisions, a partner may, in good faith and with ordinary care, rely on information, opinions, reports, or statements of specified persons when the partner is discharging a duty such as the duty of care. Tex. Bus. Orgs. Code § 3.102.

2. <u>Duty of Loyalty</u>

Unlike the duty of care, a partner's duty of loyalty was the subject of a good deal of case law prior to the passage of the TRPA. In the BOC, like the predecessor TRPA, a partner's duty of loyalty is described as including:

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

Tex. Bus. Orgs. Code § 152.205; *see also* Tex. Rev. Civ. Stat. art. 6132b-4.04(b) (expired Jan. 1. 2010). These provisions embrace the typical areas traditionally encompassed by the duty of loyalty, e.g., self-dealing and conflicts of interest, usurpation of partnership opportunity, and competition. To temper some of the broader expressions of partner duties in the case law, however, the statute specifically states that a partner does not breach a duty merely because his conduct furthers his own interest and that a partner is not a trustee and should not be held to a trustee standard. *See* Tex. Bus. Orgs. Code §§ 152.204(c), (d); *see also* Tex. Rev. Civ. Stat. art. 6132b-4.04(e), (f) (expired Jan. 1, 2010). A court has some room to find that conduct not specifically embraced in the three categories listed nevertheless implicates the duty of loyalty in a given case since the statute states that the duty of loyalty "includes" the matters set forth above.

A bankruptcy court cited both case law and Section 4.04 of the TRPA for the proposition that partners owe one another and the partnership "fiduciary" duties. *See Leal v. Mokhabery (In re Leal)*, 360 B.R. 231 (Bankr. S.D. Tex. 2007). The court stated that the duties include the aspects of a partner's duty of loyalty specified in Section 4.04 of the TRPA, as well as an obligation not to usurp opportunities for personal gain, a strict duty of good faith and candor, and an obligation of the utmost good faith, fairness, and honesty in their dealings with each other in matters pertaining to the partnership. 360 B.R. at 235-36. The court noted at one point in its opinion that a partner who withdraws ceases to owe the fiduciary duties of a partner (e.g., the duty not to compete under Section 4.04 of the TRPA only applies to a partner); however, a withdrawn partner owes the duties owed by a former agent following termination of the agency relationship. 360 B.R. at 241. (As noted above, a partner is by statute an "agent" of the partnership, and an agent owes a fiduciary duty to the principal under Texas common law. Tex. Bus. Orgs. Code § 152.301; Tex. Rev. Civ. Stat. art. 6132b-3.02(a) (expired Jan. 1, 2010); *Johnson v. Brewer & Pritchard, P.C.,* 73 S.W.3d 193 (Tex. 2002). The principles of law and equity supplement the partnership statutes unless otherwise provided by the statutes. Tex. Bus. Orgs. Code § 152.003.)

In *McBeth v. Carpenter*, 565 F.3d 171 (5th Cir. 2009), the Fifth Circuit Court of Appeals stated that "[u]nder Texas law, managing partners owe trust obligations to the partnership, having a duty of loyalty and due care as well as being under an obligation to discharge their duties in good faith and in the reasonable belief that they are acting in the best interest of the partnership," citing Section 4.04 of the TRPA. *See also FNFS, Ltd. v. Harwood (In re Harwood*), 637 F.3d 615 (5th Cir. 2011); *Zinda v. McCann St., Ltd.*, 178 S.W.3d 883 (Tex. App.–Texarkana 2005, pet. denied); *Wilson v. Cantwell*, 2007 WL 2285947 (N.D. Tex. 2007). A bankruptcy court cited Section 152.205 of the BOC along with Texas case law for the proposition that partners owe one another "fiduciary" duties and stated that Texas courts have analogized the duty owed by a general partner to a limited partner to that owed by a trustee to a beneficiary. *See West v. Seiffert (In re Houston Drywall, Inc.)*, 2008 WL 2754526 (Bankr. S.D. Tex. 2008). Numerous other courts have explicitly or implicitly characterized the statutory duty of loyalty under the TRPA or BOC as a fiduciary duty consistent with the common-law duty of loyalty owed by a partner. *See, e.g., Lopez v. Hernandez (In re Hernandez)*, 565 B.R. 367 (Bankr. W.D. Tex. 2017); *Nguyen v. Hoang*, 507 S.W.3d 360 (Tex. App.–Houston [1st Dist.] 2016, no pet.); *Westergren v. Jennings*, 441 S.W.3d 670 (Tex. App.–Houston [1st Dist.] 2014, no pet); *SEC v. Helms*, 2015 WL 1040443 (W.D. Tex. 2015); *Drexel Highlander Ltd. P'ship v. Edelman (In re Edelman)*, 2014 WL 1796217 (Bankr. N.D. Tex. 2014), aff'd, 2015 WL 5714728 (N.D. Tex. 2015).

In a somewhat unusual application of the duty of loyalty, a court held that a partner dealt with the partnership in an adverse manner and thus breached his duty of loyalty under Section 4.04(b) of the TRPA when the partner cancelled partnership meetings that were necessary to determine the entity's direction and chose instead to go to the movies. *Wallace v. Perry (In re Perry)*, 423 B.R. 215, 285-86 (Bankr. S.D. Tex. 2010). In *Mullen v Jones (In re Jones)*, 445 B.R. 677 (Bankr. N.D. Tex. 2011), the bankruptcy court concluded that the changes in Texas statutory partnership law in recent years expunged the concept of a partner as a *per se* fiduciary but did not eliminate the fiduciary status of a managing general partner because of the control exercised by such a partner. The court reasoned that the new statutory language makes clear that a partner is not *per se* a fiduciary and puts partners and partnerships on a parity with shareholders and corporations inasmuch as shareholders do not generally owe fiduciary duties to other shareholders. Based on the roles in which fiduciary duties are owed in the corporate context and longstanding case law regarding the fiduciary duties of a managing partner in the partnership context, the court concluded that control is the key to determining whether a partner is a fiduciary.

3. Duties Owed to Transferees of Deceased Partners

In 2003, Section 4.04(a) of the TRPA was amended to provide that partners owe the duties of loyalty and care to "transferees of deceased partners under Section 5.04(b)" in addition to the other partners and the partnership. *See also* Tex. Bus. Orgs. Code § 152.204(a). This amendment was requested by Representative Will Hartnett. Prior to this amendment, some courts had held that partners owe no fiduciary duties to assignees or transferees. *See Griffin v. Box*, 910 F.2d 255, 261 (5th Cir.1990) (applying Texas law and stating that general partners did not owe a fiduciary duty to transferees of partnership interests who had not been admitted as substituted partners); *Adams v. United States*, 2001 WL 1029522 (N.D. Tex.2001) (stating that remaining partners did not owe a fiduciary duty to assignees of the deceased partner under Texas law); *but see Bader v. Cox*, 701 S.W.2d 677, 685 (Tex.App.–Dallas 1985, writ ref'd n.r.e.) (stating that surviving partners owed fiduciary duties to the representative of a deceased partner under the Texas Uniform Partnership Act).

As a default rule, the BOC (like the predecessor TRPA) provides that the partnership interest of a deceased partner is automatically redeemed by the partnership for its fair value as of the date of death of the partner; thus, the statutory default provisions do not give rise to transferees of a deceased partner. *See* Tex. Bus. Orgs. Code § 152.601; *see also* Tex. Rev. Civ. Stat. art. 6132b- 7.01(a) (expired Jan. 1, 2010). Rather, the deceased partner's personal representative, surviving spouse, heirs, and devisees are regarded as creditors until paid. Tex. Bus. Orgs. Code § 152.406(a)(2)(A). If, however, a partnership agreement negates the automatic redemption provision under the statutes, the personal representative, surviving spouse, heirs, and devisees of a deceased partner will be regarded as transferees of the deceased partner's partnership interest to the extent they succeed to the deceased partner's partnership interest, and BOC Section 152.204(a) would apply. Tex. Bus. Orgs. Code § 152.406(a)(2)(B).

4. Obligation of Good Faith

The BOC imposes on a partner the obligation to discharge any duty and exercise any rights or powers in conducting or winding up partnership business in good faith and in a manner the partner reasonably believes to be in the best interest of the partnership. Tex. Bus. Orgs. Code § 152.204(b); *see also* Tex. Rev. Civ. Stat. art. 6132b- 4.04(d) (expired Jan. 1, 2010). Though courts may be tempted to elevate this language into an independent duty, this obligation is not stated as a separate duty, but merely as a standard for discharging a partner's statutory or contractual duties. *See* Tex. Rev. Civ. Stat. art. 6132b-4.04, Bar Committee Comment–1993.

5. Duty to Provide or Disclose Information

The BOC requires that partners be furnished complete and accurate information on request. Tex. Bus. Orgs. Code § 152.213(a); *see also* Tex. Rev. Civ. Stat. art. 6132b-4.03(c) (expired Jan. 1, 2010). Furthermore, the partnership must provide access to its books and records to partners and their agents and attorneys for inspection and copying. Tex. Bus. Orgs. Code § 152.212(a)(c); *see also* Tex. Rev. Civ. Stat. art. 6132b-4.03(b) (eff. Jan. 1, 2010). The Texas Uniform Partnership Act did not address whether or when a partner has a duty to disclose information absent a request, and the current statutes are silent on this point as well. Case law has traditionally imposed upon partners a duty of disclosure in certain circumstances, such as when a partner is purchasing the partnership interest of a fellow partner. *See, e.g., Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 175 (Tex.1997); *Johnson v. Peckam*, 132 Tex. 148, 120 S.W.2d 786, 788 (1938); *Harris v. Archer*, 134 S.W.3d 411, 431 (Tex.App.–Amarillo 2004, pet. denied); *Johnson v. Buck*, 540 S.W.2d 393, 399 (Tex.App.—Corpus Christi 1976, writ ref'd n.r.e.).

In *American Star Energy and Minerals Corp. v. Stowers*, 457 S.W.3d 427 (Tex. 2015), the Texas Supreme Court suggested that there are circumstances in which a partner owes another partner a duty to disclose information. Specifically, the court suggested that "[w]hen a partnership is served with a lawsuit, [the duty of care] may require the partner served to apprise the other partners." *Am. Star Energy*, 457 S.W.3d at 434-35 (citing *Zinda v. McCann St., Ltd.*, 178 S.W.3d 883, 890 (Tex. App.–Texarkana 2005, pet. denied) for the proposition that "'[p]artners have a duty to one another to make full disclosure of all matters affecting the partnership....'").

In *Red Sea Gaming, Inc. v. Block Investments (Nevada) Co.*, 338 S.W.3d 562 (Tex.App.–El Paso 2010, pet. denied), the court of appeals relied upon the non-exclusive nature of the description of the duty of loyalty set forth in the TRPA to conclude that a jury instruction that included a requirement that a partner show it "fully and fairly disclosed all important information" concerning the purchase of the other partner's partnership interest was consistent with the statutory duties set forth in Section 4.04 of the TRPA. *See also McBeth v. Carpenter*, 565 F.3d 171 (5th Cir. 2009) (citing case law and the TRPA in discussing the duties of partners and concluding that the defendant partners had an affirmative duty to disclose material information to the plaintiff limited partners); *Lopez v. Hernandez (In re Hernandez)*, 565 B.R. 367 (Bankr. W.D. Tex. 2017) (stating that partners in Texas owe duties of loyalty and care, that partners must discharge those duties in good faith, and that the duty of loyalty includes a duty to account to the partnership for property and profits pursuant to Tex. Bus. Orgs. Code §§ 152.204, 152.205, and relying on case law for the proposition that partners owe one another a general duty of full disclosure with regard to matters affecting a partner's interests); *Zinda v. McCann St., Ltd.*, 178 S.W.3d 883 (Tex.App.–Texarkana 2005, pet. denied) (citing case law and the TRPA and stating that partners owe one another fiduciary duties that include a duty to make full disclosure of all matters affecting the partnership and strict duty of good faith and candor).

B. Fiduciary Duties of Partners in Limited Partnership (including LLLP)

1. <u>General Partners</u>

Case law has held general partners in a limited partnership to fiduciary standards. *See Hughes v. St. David's Support Corp.*, 944 S.W.2d 423 (Tex.App.–Austin 1997, writ denied)("[I]n a limited partnership, the general partner stands in the same fiduciary capacity to the limited partners as a trustee stands to a trust."); *McLendon v. McLendon*, 862 S.W.2d 662 (Tex.App.–Dallas 1993, writ denied)("In a limited partnership, the general partner acting in complete control stands in the fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of a trust."); *Crenshaw v. Swenson*, 611 S.W.2d 886 (Tex.Civ.App.–Austin 1980, writ ref'd n.r.e.)(same); *Watson v. Ltd. Partners of WCKT*, 570 S.W.2d 179 (Tex.Civ.App.–Austin 1978, writ ref'd n.r.e.)(same).

Though courts have been inclined to refer to a general partner of a limited partnership as a "trustee," a general partner is no longer automatically analogous to a trustee. The general partnership statutes negate the trustee standard, and a general partner in a limited partnership has the liabilities of a partner in a general partnership to the other partners and the partnership unless the limited partnership statutes or the partnership agreement provide otherwise. Tex. Bus. Orgs. Code § 153.152(a)(2); *see also* Tex. Bus. Orgs. Code § 153.003(a) (providing that the provisions of Chapter 152 of the BOC govern limited partnerships in a case not provided for by Chapter 153). These provisions "linking" the law governing general partnerships to limited partnership law are consistent with provisions contained in the predecessor Texas Revised Limited Partnership Act (TRLPA). *See* Tex. Rev. Civ. Stat. art. 6132a-1, § 4.03(b) (expired Jan. 1, 2010); Tex. Rev. Civ. Stat. art. 6132a-1, § 13.03 (expired Jan. 1, 2010). Thus, a general partner in a limited partnership has the duties of care and loyalty and obligation of good faith set forth in Chapter 152 of the BOC (discussed above) but should no longer automatically be described as a "trustee."

Notwithstanding the explicit statutory rejection of the trustee standard, some courts continue to analogize partners to trustees. For example, in *McBeth v. Carpenter*, 565 F.3d 171, 177 (5th Cir. 2009), the Fifth Circuit Court of Appeals stated that "[u]nder Texas law, managing partners owe trust obligations to the partnership, having a duty of loyalty and due care as well as being under an obligation to discharge their duties in good faith and in the reasonable belief that they are acting in the best interest of the partnership," citing Section 4.04 of the TRPA. The court quoted from Texas case law analogizing a general partner in a limited partnership to a trustee. *See also FNFS, Ltd. v. Harwood (In re Harwood)*, 637 F.3d 615 (5th Cir. 2011) (stating individual who was director/officer of corporate general partner stood in same fiduciary capacity to limited partners as trustee to beneficiaries of trust); *S.E.C. v. Helms*, 2015 WL 1040443 (W.D. Tex. 2015) (citing Sections 153.152(a) and 152.204 of the BOC for the proposition that the general partner of a limited partnership owes fiduciary duties to the partnership and the limited partners and citing case law for the proposition that a general partner acting in complete control stands in the same fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of the trust); *Pacific Addax Co., Inc. v. Lau (In re Lau)*, 2013 WL 5935616 (Bankr. E.D. Tex. 2013) (citing Texas case law for the proposition that a general partner of a limited partnership "'owes trust obligations to the partnership'" and "'stands in the same fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of a trust'"); *West v. Seiffert (In re Houston Drywall, Inc.)*, 2008 WL 2754526 (Bankr. S.D. Tex. 2008) (citing Section 152.205 of the BOC and case law for the proposition that partners owe one another fiduciary duties and stating that Texas courts have analogized a general partner's duty to a limited partner to that owed by a trustee to a beneficiary).

Not only the general partner, but those in control of the general partner have been held to fiduciary standards. *See, e.g., FNFS, Ltd. v. Harwood (In re Harwood)*, 637 F.3d 615 (5th Cir. 2011); *LPS Inv. P'ship v. Bennett (In re Bennett),* 989 F.2d 779 (5th Cir. 1993); *Edelman v. Drexel Highlander Ltd. P'ship*, 2015 WL 5714728 (N.D. Tex. 2015); *Light v. Whittington (In re Whittington)*, 530 B.R. 360 (Bankr. W.D. Tex. 2014); *Mullen v. Jones (In re Jones)*, 445 B.R. 677 (Bankr. N.D. Tex. 2011); *Pacific Addax Co., Inc. v. Lau (In re Lau*), 2013 WL 5935616 (Bankr. E.D. Tex. 2013); *CBIF Ltd. P'ship v. TGI Friday's Inc.*, 2017 WL 1455407 (Tex. App.–Dallas 2017, pet. filed). "While the use of multi-tiered organizational structures may have formerly provided an absolute shield to individuals seeking protection from liability to subsidiary entities, strict adherence to that standard has eroded as the expanding use of entities, rather than individuals, as general partners has forced the courts to engage in a closer examination of the responsibilities imposed upon, and the protections granted to, those individuals whose actions and/or omissions directly determine the conduct of any entity serving as a general partner of a limited partnership." *FNFS, Ltd. v. Harwood (In re Harwood)*, 404 B.R. 366, 394-95 (Bankr. E.D. Tex. 2009), aff'd, 427 B.R. 392 (E.D. Tex. 2010), aff'd, 637 F.3d 615 (5th Cir. 2011).

In *FNFS, Ltd. v. Harwood (In re Harwood)*, 637 F.3d 615 (5th Cir. 2011), the Fifth Circuit Court of Appeals affirmed the district court's judgment affirming the bankruptcy court's judgment that the debtor's debts arising from loans obtained from a limited partnership managed by the debtor in his capacity as officer and director of the general partner were nondischargeable under Section 523(a)(4). The court of appeals agreed with the lower courts that Harwood, who was president, a director, and a 50% shareholder of the corporate general partner of a limited partnership, owed a fiduciary duty to the partnership and that he engaged in a defalcation in that capacity in connection with loans he obtained from the limited partnership. The court relied upon *In re Bennett* and *McBeth v. Carpenter* to conclude that an officer of a corporate general partner who is entrusted with the management of the limited partnership and who exercises control over the limited partnership in a manner analogous to those cases owes a fiduciary duty to the partnership that satisfies Section 523(a)(4). The court emphasized that it is not only the control that the officer actually exerts over the partnership, but also the trust and confidence placed in the hands of the controlling officer, that leads to a finding of a fiduciary relationship for purposes of Section 523(a)(4). Thus, the court examined the evidence regarding the control entrusted to and exercised by Harwood to ascertain whether he owed a fiduciary duty to both tiers of the organization.

Harwood did not dispute that he owed a fiduciary duty to the corporate general partner as an officer and director of the corporation but contended he owed no duty to the partnership since he was not a partner and did not exercise a level of control over its affairs to justify recognition of fiduciary obligations to the partnership. The court rejected Harwood's attempt to distinguish the cases relied upon by the court. Harwood relied on the fact that he was not the sole shareholder and sole director of the corporate general partner, whereas *In re Bennett* involved an individual who was managing partner of a limited partnership that was general partner of the limited partnership, and *McBeth v. Carpenter* involved the president and sole owner of the general partner of the limited partnership. The court focused on Harwood's control, and the court agreed with the bankruptcy and district courts that the board's entrustment in Harwood of the management of the partnership's affairs combined with the practically complete control that Harwood actually exercised over the partnership's management compelled the conclusion that Harwood stood in the same fiduciary capacity to the limited partners as a trustee to beneficiaries of a trust. Thus, Harwood acted in a fiduciary capacity within the meaning of Section 523(a)(4).

As discussed above, the bankruptcy court in *Mullen v. Jones (In re Jones)*, 445 B.R. 677 (Bankr. N.D. Tex. 2011), concluded that the changes in Texas statutory partnership law in recent years expunged the concept of a partner as a *per se* fiduciary but did not eliminate the fiduciary status of a managing general partner because of the control exercised by such a partner. The court reasoned that the new statutory language makes clear that a partner is not *per se* a fiduciary and puts partners and partnerships on a parity with shareholders and corporations in that shareholders do not generally owe fiduciary duties to other shareholders. Based on the roles in which fiduciary duties are owed in the corporate context and longstanding case law regarding the fiduciary duties of a managing partner in the partnership context, the court concluded that control is the key to determining whether a partner is a fiduciary. The court then looked at the two-tiered structure of the limited partnership to determine how it affected the fiduciary duties owed by the debtor, who was president, a director, and 51% shareholder of the corporate general partner. The court relied on *In re Bennett* and *McBeth v. Carpenter* to conclude that the debtor, as manager of the managing general partner, owed fiduciary duties to the partnership and the partners. The court concluded that the debtor owed the plaintiff fiduciary duties through at least two avenues: (1) in his capacity as officer and director of the corporate general partner (since the plaintiff was a shareholder); and (2) in his capacity as the control person/manager of the general partner (since the plaintiff was a limited partner).

Texas courts have recognized a tort cause of action for knowing participation in another person's breach of fiduciary duty, and this cause of action has been asserted against affiliates and third parties for knowingly participating in the breach of fiduciary duty owed by a general partner or other affiliate of a partnership. *See, e.g., CBIF Ltd. P'ship v. TGI Friday's Inc.*, 2017 WL 1455407 (Tex. App.–Dallas 2017, pet. filed) (holding individual manager of entity general partner of limited partnership venturer in joint venture liable for participating in breaches of fiduciary duty owed by venturer; holding individual liable for participating in breaches of fiduciary duty owed by related entities who exercised control over limited partnership); *Graham v. Mortg. Corp. v. Hall*, 307 S.W.3d 472 (Tex. App.–Dallas 2010, no pet.) (concluding limited partner established a probable right of recovery against the partnership's lender for participating in breaches of duty owed by the general partner to the limited partners based on the general partner's use of partnership property to secure payment of loans to affiliates of the general partner).

The impact of the 2003 amendment to TRPA Section 4.04(a), carried forward in BOC Section 152.204(a), which provides that the duties of loyalty and care are owed to transferees of deceased partners, should be considered in the context of limited partnerships. One can expect that the personal representative, surviving spouse, heirs, and devisees of a deceased limited partner whose interest is not bought out will assert that the general partner owes them fiduciary duties under BOC Section 152.204(a) by virtue of the linkage of the general partnership statutes to the limited partnership statutes.

Title 1 of the BOC contains some provisions based on corporate law that are not found in the predecessor TRLPA. Under the BOC, provisions based on Article 2.41D of the TBCA are applicable not only to directors of a corporation, but to governing persons of other types of entities as well. Under these provisions, a general partner in a limited partnership may, in good faith and with ordinary care, rely on information, opinions, reports, or statements of specified persons when the partner is discharging a duty such as the duty of care. Tex. Bus. Orgs. Code § 3.102. Furthermore, the BOC provides that a limited partnership may renounce, in its certificate of formation or by action of its general partners, an interest or expectancy in specified business opportunities or a specified class of business opportunities. Tex. Bus. Orgs. Code § 2.101(21).

2. Limited Partners

There has been some uncertainty with regard to whether limited partners owe fiduciary duties to the partnership or other partners. While the duties enumerated in Section 4.04 of the TRPA might literally have been read to apply to limited partners (by virtue of the linkage of the TRPA to the TRLPA under TRLPA Section 13.03), such an approach was not a logical application of the statutes. Some provisions of the TRPA clearly only applied to general partners even though the TRLPA was silent in such regard and the TRPA acted as a gap filler. Ordinarily, limited partners should not owe fiduciary duties as limited partners because they are merely passive investors. There is case law in other jurisdictions holding that limited partners do not, based solely on their status as limited partners, have fiduciary duties, and three appellate courts in Texas have so held. *See Villa W. Assocs. v. Kay*, 146 F.3d 798 (10th Cir. 1998); *Herzog v. Leighton Holdings, Ltd. (In re Kids Creek Partners)*, 212 B.R. 898 (N.D.

Ill. 1997); *Strebel v. Wimberly*, 371 S.W.3d 267 (Tex.App.–Houston [1st Dist.] 2012, pet. denied); *AON Props. v. Riveraine Corp.,* 1999 WL 12739 (Tex.App.–Houston [14th Dist.] 1999, no pet.)(not designated for publication); *Crawford v. Ancira*, 1997 WL 214835 (Tex.App.–San Antonio 1997, no pet.)(not designated for publication). The unpublished opinions by Texas Courts of Appeals lack precedential weight because the decisions were issued prior to 2003, but the recent decision of the First District Court of Appeals in *Strebel v. Wimberly* at last provided precedent in Texas for the proposition that limited partners do not, solely based on their status as limited partners, owe other limited partners fiduciary duties under Texas law, refuting and distinguishing the *Zinda* and *McBeth* cases (discussed below) to the extent that they suggest otherwise.

In *Zinda v. McCann Street, Ltd.*, 178 S.W.3d 883 (Tex.App.–Texarkana 2005, pet. denied), the court of appeals concluded that three limited partners owed fiduciary duties to the other limited partner based on the general proposition that a partnership is a fiduciary relationship and that partners owe one another certain fiduciary duties. The court relied upon statements from case law dealing with general partners and cited Section 4.04 of the TRPA without providing any explanation for applying these principles to limited partners. Ultimately, the court found the evidence sufficient to support the jury's finding that the defendants satisfied their fiduciary duty to the plaintiff, concluding that the defendant limited partners had treated the plaintiff fairly.

In *McBeth v. Carpenter*, 565 F.3d 171, 177-78 (5th Cir. 2009), the Fifth Circuit Court of Appeals analyzed whether a general partner and certain limited partners owed a fiduciary duty to other limited partners. The court stated that "[u]nder Texas law, managing partners owe trust obligations to the partnership, having a duty of loyalty and due care as well as being under an obligation to discharge their duties in good faith and in the reasonable belief that they are acting in the best interest of the partnership," citing Section 4.04 of the TRPA. The court also quoted Texas case law analogizing a general partner in a limited partnership to a trustee. With respect to limited partners, the court stated that Texas law recognizes fiduciary obligations between limited partners and applies the same partnership principles that govern the relationship between a general partner and limited partners. In addition to relying on decisions by courts of appeals in Texas that have failed to distinguish between general and limited partners' duties (*Zinda v. McCann St., Ltd.*, 178 S.W.3d 883, 890 (Tex.App.–Texarkana 2005, pet. denied) and *Dunnagan v. Watson*, 204 S.W.3d 30, 46-47 (Tex.App.–Fort Worth 2006, pet. denied)), the court stated that the Texas Supreme Court has made no distinction between the fiduciary duties of general and limited partners. The court quoted from *Insurance Co. of North America v. Morris*, 981 S.W.2d 678, 674 (Tex. 1998), a case in which the supreme court referred to the fiduciary duties that arise in certain formal relationships, "including attorney-client, partnership, and trustee relationships." The Fifth Circuit in *McBeth* noted parenthetically that *Insurance Co. of North America v. Morris* was a case evaluating claims involving limited partnerships, implying that the supreme court's statement regarding partner fiduciary duties was intended to encompass limited partners; however, the supreme court did not discuss or analyze the duties of limited partners in that case. That case involved claims by investors in a limited partnership against an insurance company that was seeking reimbursement from the investors with regard to payment made on surety bonds. The relationship in issue was that of surety and principal, and the supreme court concluded that the surety-principal relationship is not generally of a fiduciary nature and that the insurance company did not have any affirmative duty of disclosure to the investors.

In *McBeth v. Carpenter*, the evidence showed that Carpenter was in a position of control over the partnership by virtue of his control of the LLC general partner, and the court thus concluded that Carpenter owed the plaintiffs a fiduciary duty. Likewise, the court concluded that the limited partner defendants owed the plaintiffs a fiduciary duty as co-limited partners in the partnership and as entities controlled by Carpenter. The court noted in a footnote that it was not bound by unpublished cases cited by the defendant limited partners for the proposition that limited partners do not owe one another fiduciary duties. Further, the court stated that, even accepting the argument that limited partners do not ordinarily owe one another fiduciary duties, Carpenter's position of control over the limited partner defendants, and the fact that it was often unclear on whose behalf he was acting, was a basis to impose fiduciary duties on the limited partners in this case. The court did not address whether or to what extent Section 153.003(c) of the BOC (discussed below) would have made any difference in the court's analysis if it had been applicable.

In *Strebel v. Wimberly*, 371 S.W.3d 267 (Tex.App.–Houston [1st Dist.] 2012, pet. denied), the court addressed the argument of a limited partner that his fellow limited partner owed him fiduciary duties of loyalty and care under the Texas Revised Partnership Act because the Texas Revised Limited Partnership Act contains no provisions on duties of limited partners. The court discussed the *Zinda* and *McBeth* cases as well as the unpublished *Crawford* and *AON Properties* cases in Texas and reconciled the cases as follows:

> [We hold] that status as a limited partner alone does not give rise to a fiduciary duty to other limited partners. That is not to say, however, that a party who is a limited partner does not owe fiduciary duties to other limited partners when that party, wearing a different hat, exerts operating control over the affairs of the limited partnership. For example, when a limited partner also serves as an officer of the limited partnership, as in *McBeth*, that partner may owe fiduciary duties based on his agency relationship to the partnership and the other limited partners, without regard to the limited partner role. The existence and scope of that duty will be defined not by the law governing limited partners, but rather by the relevant laws and contracts governing the role under which the party is exercising authority.

Strebel, 371 S.W.3d at 281.

The BOC contains provisions clarifying that a limited partner is not subject to the duties of a general partner based solely on the limited partner's status as a limited partner. BOC Section 153.003(b) provides that "[t]he powers and duties of a limited partner shall not be governed by a provision of Chapter 152 that would be inconsistent with the nature and role of a limited partner as contemplated by this chapter," and BOC Section 153.003(c) provides that "a limited partner shall not have any obligation or duty of a general partner solely by reason of being a limited partner." These new provisions were necessitated by the structure of the BOC. Chapter 1 defines "partner" as including both general and limited partners. A literal application of this definition, along with the general linkage provision of Section 153.003(a) (providing that the provisions of Chapter 152 of the BOC govern limited partnerships in a case not provided for by Chapter 153), would cause all of the provisions in Chapter 152 governing general partnerships to apply to limited partners as well as general partners where Chapter 153 was silent on an issue. The language in Section 153.003(b) was added to make clear that provisions of Chapter 152 that would be inconsistent with the nature of a limited partner (e.g., provisions conferring agent status and apparent authority on each partner) do not apply to limited partners. The language in Section 153.003(c) specifically makes it clear that limited partners do not have the duties of a general partner (e.g., duties of loyalty and care) solely by reason of being a limited partner.

There is case law in some jurisdictions suggesting that limited partners should be subject to fiduciary duties to the extent they actually have control in management matters, e.g., because of control of the general partner. *See RJ Assocs., Inc. v. Health Payors' Org. Ltd. P'ship*, 1999 WL 550350 (Del. Ch. 1999) (containing dictum suggesting that, unless a partnership agreement provides to the contrary, any limited partner owes fiduciary duties to the partnership); *KE Prop. Mgmt. v. 275 Madison Mgmt.,* 1993 WL 285900 (Del. Ch. 1993); *Red River Wings, Inc. v. Hoot, Inc.*, 751 N.W.2d 206 (N.D. 2008) (holding that majority limited partners who controlled or acted in concert with the general partner could be held personally liable to the minority limited partners for breach of fiduciary duties) and cases cited therein. In *CBIF Ltd. P'ship v. TGI Friday's Inc.*, 2017 WL 1455407 (Tex. App.–Dallas 2017, pet. filed), the court stated that a limited partner owes a fiduciary duty to the partnership and the other partners if the limited partner exercises control over the operation of the business, and the jury's unchallenged findings of dominance and control by a limited partner provided the basis for recognizing a fiduciary duty on the part of the limited partner. The court went on to affirm the liability of an individual's knowing participation in the limited partner's fiduciary duty based on the individual's knowledge of the fiduciary relationships and actual awareness of the breach. As noted above, there is also case law in Texas recognizing a fiduciary duty on the part of those who control the general partner. See *FNFS, Ltd. v. Harwood (In re Harwood)*, 637 F.3d 615 (5th Cir. 2011); *LPS Inv. P'ship v. Bennett (In re Bennett),* 989 F.2d 779 (5th Cir. 1993); *Mullen v. Jones (In re Jones)*, 445 B.R. 677 (Bankr. N.D. Tex. 2011); *cf. Strebel v. Wimberly*, 371 S.W.3d 267 (Tex.App.–Houston [1st Dist.] 2012, pet. denied) (recognizing that limited partner may owe fiduciary duties to other limited partners by virtue of exerting control over limited partnership in other capacities).

C. Statutory Authorization to Modify Duties and Liabilities of Partners

1. <u>Modification of Duties and Liabilities Under General Partnership Statutes</u>

The partnership agreement cannot eliminate the duties of care and loyalty or the obligation of good faith in a general partnership; however, the statutes do permit the partnership agreement to modify the duties of care and loyalty and the obligation of good faith, subject to a "not manifestly unreasonable" standard. Tex. Bus. Orgs. Code § 152.002(b)(2), (3), (4); *see also* Tex. Rev. Civ. Stat. art. 6132b-1.03(b)(2), (3), (4) (expired Jan. 1, 2010).

With respect to the partners' duty of care, the BOC provides that the partnership agreement may not eliminate the duty of care but may determine the standards by which the performance of the obligation is to be measured if the standards are "not manifestly unreasonable." Tex. Bus. Orgs. Code § 152.002(b)(3); *see also* Tex. Rev. Civ. Stat. art. 6132b-1.03(a)(3) (expired Jan. 1, 2010). How far, then, can the partnership agreement go? If the statutory standard is simple negligence (*see* discussion of the duty of care under II.A above), will a gross negligence standard in the partnership agreement pass muster as "not manifestly unreasonable?" One would think that it should. *See Jerry L. Starkey, TBDL, L.P. v. Graves*, 448 S.W.3d 88 (Tex. App.—Houston [14^{th} Dist.] 2014, no pet.)

With respect to the partners' duty of loyalty, the BOC provides that the partnership agreement may not eliminate the duty of loyalty but may identify specific types or categories of activities that do not violate the duty of loyalty if "not manifestly unreasonable." Tex. Bus. Orgs. Code § 152.002(b)(2); *see also* Tex. Rev. Civ. Stat. art. 6132b-1.03(a)(2) (expired Jan. 1, 2010). One obvious issue here, in addition to the meaning of "manifestly unreasonable," is how "specific" these provisions must be in identifying types or categories of activities. The answer may depend upon the circumstances, such as the sophistication of the parties, scope of activities of the partnership, etc. Provisions in partnership agreements permitting partners to engage in competition and to take advantage of business opportunities are fairly commonplace. Under the BOC, a domestic entity may "renounce, in its certificate of formation or by action of its governing authority, an interest or expectancy of the entity in, or an interest or expectancy of the entity in being offered an opportunity to participate in, specified business opportunities or a specified class or category of business opportunities presented to the entity or one or more of its managerial officials or owners." Tex. Bus. Orgs. Code § 2.101(21). This provision applies to a general partnership governed by the BOC, but it is not clear whether it adds anything significant to the provisions of Section 152.002(b)(2) since a general partnership does not file a certificate of formation.

Finally, the BOC provides that the obligation of good faith may not be eliminated by the partnership agreement, but the agreement may determine the standards by which the performance is to be measured if the standards are "not manifestly unreasonable." Tex. Bus. Orgs. Code § 152.002(b)(4); *see also* Tex. Rev. Civ. Stat. art. 6132b-1.03(a)(4) (expired Jan. 1, 2010). 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.

It should be noted that the BOC contains no express limitations on the extent to which the partnership agreement may eliminate a partner's liability to the partnership and the other partners.[4] In fact, in 2013, the legislature highlighted the expansive contractual freedom provided partners in this regard by amending Chapter 7 of the BOC to clarify that the partnership agreement may eliminate the liability of a partner to the partnership and the other partners to the same extent that a corporation's certificate of formation may eliminate a director's liability under section 7.001 and to such *further* extent allowed by Chapter 152 of the BOC. Tex. Bus. Orgs. Code § 7.001(d)(1). Although Chapter 152 states that the duties of care and loyalty may not be completely eliminated, Chapter 152 does not address elimination of liability of partners *vis a vis* one another and the partnership. A distinction can be drawn between the elimination of *duties* and the elimination or indemnification of *liabilities*. If the *liability*

[4]In one case decided prior to the passage of the TRPA, a court dealt with a mismanagement claim against a general partner in a limited partnership where the partnership agreement stated that the general partner would not be liable absent willful malfeasance or fraud. *Grider v. Boston Co., Inc.*, 773 S.W.2d 338 (Tex.App.–Dallas 1989, writ denied). The court assumed the clause was enforceable to protect the general partner against the mismanagement claim. The court stated that, when the parties bargain on equal terms, a fiduciary may contract for the limitation of liability. Public policy would preclude, according to the court, limitation of liability for (1) self-dealing, (2) bad faith, (3) intentional adverse acts, and (4) reckless indifference with respect to the interest of the beneficiary. *Id*. at 343.

of a general partner is contractually eliminated or indemnified, but the *duty* still exists, a breach of the duty could give rise to equitable relief (such as injunctive relief or receivership) even though the general partner could not be held liable for damages or would be held harmless by the partnership. Redefining or eliminating duties, on the other hand, narrows or eliminates not only potential liability for damages by the partner who would otherwise owe the duty, but determines whether there is a breach at all, thus affecting the availability of equitable relief as well. While there are strong arguments for enforcing broad indemnification and exculpation provisions in view of the statutory scheme, a court might balk at enforcing contractual elimination of all remedies, including equitable remedies.

2. <u>Modification of Duties and Liabilities Under Limited Partnership Statutes</u>

Chapter 153 of the BOC does not address the extent to which the duties and liabilities of general partners in a limited partnership may be altered by agreement of the partners except to state as follows:

> Except as provided by this chapter, the other limited partnership provisions, *or a partnership agreement*, a general partner of a limited partnership:...(2) has the liabilities of a partner in a partnership without limited partners to the partnership and to the other partners.

Tex. Bus. Orgs. Code § 153.152(a)(2) (emphasis added); *see also* Tex. Rev. Civ. Stat. art. 6132a-1, § 4.03(a) (expired Jan. 1, 2010). This language indicates that the partnership agreement may modify the liabilities of a general partner. It is not clear whether it is an authorization without express limits or is linked to the provisions in BOC Section 152.002 that prohibit elimination of duties and set a "manifestly unreasonable" floor for contractual variation.

Chapter 7 of the BOC was amended in 2013 to clarify that the partnership agreement may eliminate the liability of a general partner to the partnership and the other partners to the same extent that a corporation's certificate of formation may eliminate a director's liability under section 7.001 and to such further extent allowed by Chapters 152 and 153 of the BOC. Tex. Bus. Orgs. Code § 7.001(d)(2). There are no express prohibitions or limitations in Chapter 152 or 153 with respect to the limitation or elimination of liability (as opposed to duties) of a general partner to the partnership or the partners. As noted above, a distinction can be drawn between the limitation or elimination of duties and the limitation and elimination of liabilities. If the liability of a general partner is contractually eliminated, but the duty still exists, a breach of the duty could give rise to equitable relief (such as injunctive relief or receivership) even though the general partner could not be held liable for damages. Redefining or eliminating duties, on the other hand, narrows or eliminates not only potential liability for damages by the partner who would otherwise owe the duty, but determines whether there is a breach at all, thus affecting the availability of equitable relief as well.

In *Jerry L. Starkey, TBDL, L.P. v. Graves*, 448 S.W.3d 88 (Tex. App.—Houston [14th Dist.] 2014, no pet.), the court of appeals stated that Section 152.002(b) of the BOC does not permit the partnership agreement to disclaim the statutory duties of care and loyalty entirely, but the court stated that the limited partnership agreement did not disclaim all statutory duties and liability. Under the limited partnership agreement, the general partner was not liable in damages or otherwise for an act or omission unless such act or omission was performed or omitted fraudulently or constituted gross negligence or willful misconduct.

In *Strebel v. Wimberly*, 371 S.W.3d 267 (Tex.App.–Houston [1st Dist.] 2012, pet. denied), the court of appeals gave effect to a waiver of fiduciary duties in a limited partnership agreement (governed by the Texas Revised Limited Partnership Act) that provided: "The General Partner shall not have duties (including fiduciary duties) except as expressly set forth in this agreement." The agreement did not specify any fiduciary duties. The general partner of the limited partnership was an LLC, and Wimberly argued that Strebel, the managing member of the LLC, took actions that breached a fiduciary duty to Wimberly as a limited partner. The court concluded that the actions of which Wimberly complained were all taken by Strebel in his capacity as managing member of the general partner and could not form the basis of a breach-of-fiduciary-duty claim because the fiduciary duties of the general partner had been expressly disclaimed in the limited partnership agreement. The court stated that general partners in a limited partnership owe fiduciary duties to the limited partners but noted that "the supreme court has emphasized the importance of honoring parties' contractual terms defining the scope of their obligations and agreements, including limiting fiduciary duties that might otherwise exist." The court stated that "[t]his is especially true in arms-length business transactions in which the parties are sophisticated businessmen represented by counsel, as the parties were here."

3. Indemnification Under General Partnership Statutes

The BOC provides, as a default rule, for repayment of a partner who reasonably incurs a liability in the proper conduct of the business or for the preservation of its business or property. Tex. Bus. Orgs. Code § 152.203(d); *see also* Tex. Rev. Civ. Stat. art. 6132b-4.01(c) (expired Jan. 1, 2010). The BOC also provides that a domestic entity, which would include a general partnership, has the power to "indemnify and maintain liability insurance for managerial officials, owners, members, employees, and agents of the entity or the entity's affiliates." Tex. Bus. Orgs. Code § 2.101(16); *see also* Tex. Rev. Civ. Stat. art. 6132b-3.01(15) (expired Jan. 1, 2010) (providing that a partnership has the power to "indemnify a person who was, is, or is threatened to be made a defendant or respondent in a proceeding and purchase and maintain liability insurance for such person"). The indemnification provisions of Chapter 8 of the BOC do not apply to a general partnership other than to specify that the partnership agreement of a general partnership may adopt provisions of Chapter 8 or include "other provisions" for indemnification, "which will be enforceable." Tex. Bus. Orgs. Code § 8.002. There are no specified limits on a general partnership's power to indemnify, and the partnership agreement governs the relations of the partners except to the extent the statute specifically restricts the partners' ability to define their relationship under BOC Section 152.002(b). Tex. Bus. Orgs. Code § 152.002(a); *see also* Tex. Rev. Civ. Stat. art. 6132b-1.03(a) (expired Jan. 1, 2010).

4. Indemnification Under Limited Partnership Statutes

In the BOC, one set of indemnification provisions governs both corporations and limited partnerships. *See* Tex. Bus. Orgs. Code §§ 8.001-8.152. The TRLPA contained indemnification provisions patterned largely after the TBCA provisions. *See* Tex. Rev. Civ. Stat. art. 6132a-1, §§ 11.01-11.21 (expired Jan. 1, 2010). A limited partnership is required to indemnify a general partner who is "wholly successful on the merits or otherwise" unless indemnification is limited or prohibited by a written partnership agreement. Tex. Bus. Orgs. Code §§ 8.051-8.003; *see also* Tex. Rev. Civ. Stat. art. 6132a-1, §§ 11.08, 11.21 (expired Jan. 1, 2010). The limited partnership is prohibited from indemnifying the general partner if the general partner was found liable to the limited partnership or for improperly receiving a personal benefit if the liability was based on the general partner's willful or intentional misconduct in the performance of a duty to the limited partnership, breach of the partner's duty of loyalty to the limited partnership, or an act or omission not in good faith constituting a breach of duty to the limited partnership. Tex. Bus. Orgs. Code § 8.102(b)(3); *cf.* Tex. Rev. Civ. Stat. art. 6132a-1, §§ 11.03, 11.05 (prohibiting indemnification of general partner found liable to limited partners or partnership, or for improperly receiving personal benefit, if liability arose out of willful or intentional misconduct in performance of duty to limited partnership). Under the TRLPA, a limited partnership was permitted, *if provided in a written partnership agreement*, to indemnify a general partner who was determined to meet certain standards. Tex. Rev. Civ. Stat. art. 6132a-1, §§ 11.02, 11.05 (expired Jan. 1, 2010). The BOC provides for such permissive indemnification without the necessity of any provisions in the partnership agreement. Tex. Bus. Orgs. Code §§ 8.102, 8.103. The standards for permissive indemnification require that the general partner acted 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. Tex. Bus. Orgs. Code § 8.101; *see also* Tex. Rev. Civ. Stat. art. 6132a-1, § 11.02 (expired Jan. 1, 2010). If a general partner is found liable to the limited partnership or on the basis of improperly receiving a personal benefit, permissible indemnification is limited to reasonable expenses. Tex. Bus. Orgs. Code § 8.102(b); *see also* Tex. Rev. Civ. Stat. art. 6132a-1, § 11.05 (expired Jan. 1, 2010). A general partner may only be indemnified to the extent consistent with the statutes. Tex. Bus. Orgs. Code § 8.004; *see also* Tex. Rev. Civ. Stat. art. 6132a-1, § 11.13 (expired Jan. 1, 2010).

Limited partners, officers, employees, and agents who are not also general partners may be indemnified to the extent consistent with other law as provided by the partnership agreement, general or specific action of the general partner, contract, or common law. Tex. Bus. Orgs. Code § 8.105; *see also* Tex. Rev. Civ. Stat. art. 6132a-1, §§ 11.15, 11.17 (expired Jan. 1, 2010). Insurance, self-insurance, or other arrangements providing indemnification for liabilities for which Chapter 8 does not otherwise permit indemnification is expressly permitted. Tex. Bus. Orgs. Code § 8.151; Tex. Rev. Civ. Stat. art. 6132a-1, § 11.18 (expired Jan. 1, 2010).

Chapter 8 of the BOC governs any proposed indemnification by a domestic entity after January 1, 2010, even if the events on which the indemnification is based occurred before the BOC became applicable to the entity. Tex. Bus. Orgs. Code § 402.007. A special transition provision in the BOC regarding indemnification states that "[i]n a case in which indemnification is permitted but not required under Chapter 8, a provision relating to indemnification contained in the governing documents of a domestic entity on the mandatory application date that would otherwise have the effect of limiting the nature or type of indemnification permitted by Chapter 8 may not be construed after the mandatory application date as limiting the indemnification authorized by Chapter 8 unless the provision is intended to limit or restrict permissive indemnification under applicable law." Tex. Bus. Orgs. Code § 402.007. This provision will be helpful in interpreting some pre-BOC indemnification provisions, but its application will not always be clear; therefore, a careful review of indemnification provisions in pre-BOC governing documents is advisable.

V. Advancement

The issue of advancement of expenses in connection with a proceeding should also be considered in connection with indemnification and exculpation. Chapter 8 of the BOC contains provisions authorizing advancement of expenses in the corporate and limited partnership contexts pursuant to specific procedures. Chapter 8 permits advancement of expenses to a governing person upon a written affirmation by the governing person that the person has met the standard necessary for indemnification and a written undertaking to repay the amount paid or reimbursed if it is finally determined that the person has not met the standard or that indemnification is prohibited. Tex. Bus. Orgs. Code § 8.104(a); *see also* Tex. Bus. Corp. Act art. 2.02-1K (expired Jan. 1, 2010); Tex. Rev. Civ. Stat. art. 6132a-1, § 11.11 (expired Jan. 1, 2010). The written undertaking need not be secured and may be accepted by the entity without regard to the person's ability to make repayment. Tex. Bus. Orgs. Code § 8.104(c); *see also* Tex. Bus. Corp. Act art. 2.02-1L (expired Jan. 1, 2010); Tex. Rev. Civ. Stat. art. 6132a-1, § 11.12 (expired Jan. 1, 2010). Advancement of expenses of governing persons can be made mandatory by provisions in the governing documents or a contract or by action of the owners or governing authority. Tex. Bus. Orgs. Code § 8.104(b); *see also In re Aguilar*, 344 S.W.3d 41 (Tex. App.–El Paso 2011, no pet.) (applying Texas Business Corporation Act advancement provisions and enforcing bylaw provision that stated corporation "shall" advance expenses); Tex. Bus. Corp. Act art. 2.02-1K (expired Jan. 1, 2010); Tex. Rev. Civ. Stat. art. 6132a-1, § 11.11 (expired Jan. 1, 2010). Advancement for officers, agents, and employees who are not governing persons is permitted to the extent consistent with other law as provided by the governing documents, action of the governing authority or owners, contract, or common law. Tex. Bus. Orgs. Code § 8.105; *see also* Tex. Bus. Corp. Act art. 2.02-1P, Q (expired Jan. 1, 2010); Tex. Rev. Civ. Stat. art. 6132a-1, §§ 11.15, 11.17 (expired Jan. 1, 2010).

Chapter 8 does not apply to an LLC or general partnership unless the governing documents of such an entity adopt the provisions of Chapter 8. Tex. Bus. Orgs. Code § 8.002. In the LLC context, the BOC authorizes advancement of expenses without specifying procedures. *See* Tex. Bus. Orgs. Code §§ 101.402(a)(2) (stating that LLC may "pay in advance or reimburse expenses incurred by a person"); *cf.* Tex. Rev. Civ. Stat. art.1528n, art. 2.20(A) (expired Jan. 1, 2010) (referring to LLC's power to indemnify and provide insurance, but not explicitly mentioning advancement). The BOC does not specifically address advancement by a general partnership other than to authorize the partnership agreement to contain provisions on advancement. *See* Tex. Bus. Orgs. Code § 8.002(b). There is no provision of the BOC that specifically limits the extent to which advancement could be provided by the partnership agreement. *See* Tex. Bus. Orgs. Code §§ 2.101, 8.002(b), 152.002.

VI. Conclusion

Fiduciary-duty issues in the context of business organizations are not controlled by case law alone. The statutes governing the various types of business organizations contain provisions relating to fiduciary duties and liabilities arising from such duties, and the governing documents of a particular entity may contain provisions affecting the fiduciary duties and liabilities of those involved in the business. Whether the different approaches to fiduciary duties, liabilities, and indemnification under the various Texas business entity statutes amount to a significant difference between the entities might be debated; however, subtle differences may certainly prove significant in particular cases.

RECENT DELAWARE CASES INTERPRETING LLC AGREEMENTS IN ACQUISITION CONTEXT: *MILLER v. HCP & Co.* AND *IN RE OXBOW CARBON LLC UNITHOLDER LITIGATION*

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Recent Delaware Cases Interpreting LLC Agreement in Acquisition Context:
Miller v. HCP & Co.* and *In re Oxbow Carbon LLC Unitholder Litigation

Two recent Chancery Court decisions addressed the implied covenant of good faith and fair dealing in connection with interpretation of LLC operating agreements in the context of sales of the LLCs. In *Miller v. HCP & Co.*, C.A. No. 2017-0291-SG (Del. Ch. Feb. 1, 2018), the court held that the terms of the operating agreement relating to a sale of the LLC to an unaffiliated third party did not leave a gap to be filled by the implied covenant of good faith and fair dealing, and the board of managers was not required to conduct an auction process to maximize the price. In *In re Oxbow Carbon LLC Unitholder Litigation*, C.A. No. 12447-VCL (Del. Ch. Feb. 12, 2018), the court held that the implied covenant of good faith and fair dealing called for application of a "top off" provision to enable certain minority members (who owned approximately one-third of the LLC units) to enforce an exit sale under the LLC agreement by providing additional consideration necessary to satisfy the threshold required to be received under the agreement by two later admitted members (owned by the majority holder and holding less than 1.5% of the units) who would be able to block the sale absent satisfaction of the threshold.

Miller v. HCP & Co., C.A. No. 2017-0291-SG, 2018 WL 656378 (Del. Ch. Feb. 1, 2018).

Vice Chancellor Glasscock dismissed a claim for breach of the implied covenant of good faith and fair dealing against an LLC's board of managers for approving a sale of the LLC that resulted in the plaintiff (a co-founder of the LLC) receiving far less than the plaintiff claimed he would have received if there had been an open auction process. The LLC agreement waived all fiduciary duties and granted the board sole discretion to approve a sale to an unaffiliated third party, and the court refused to impose an obligation to conduct an auction process to maximize the price under the implied contractual covenant of good faith and fair dealing.

In 2016, Trumpet Search, LLC's founders and a private equity group that owned a majority stake in the LLC entered into a second amended and restated operating agreement (the "OA"). The private equity group (the "HCP Entities") owned most of the Class D and E units of the LLC, and the waterfall provisions of the OA provided that the HCP Entities were entitled to most of the first $30 million received on a sale of the LLC before any sales proceeds would be available to holders of other classes of membership units. The HCP Entities had the right under the OA to appoint four of the seven managers, and the OA further obligated all members to consent to any sale approved by a majority of the managers. If a sale was to an unaffiliated third party, the OA gave the managers sole discretion as to the manner of the sale. The OA waived all fiduciary duties among the members and by the managers to the members.

Less than a year after the OA was adopted, the HCP Entities championed a sale of the LLC to an unaffiliated third party at an initial offer by the third party of $31 million. The HCP-appointed managers decided not to conduct an open sales process, and the non-affiliated managers were given little time to pursue alternative buyers. The LLC was able to pursue an abbreviated sales process, and the third party was pressured into increasing its offer to $41 million and then to $43 million. The managers approved the sale at $43 million, but the plaintiffs argued that an open auction would have resulted in a substantially higher price.

The plaintiffs argued that the HCP-appointed managers had an incentive to negotiate a sale price up to $30 million, but little incentive to negotiate for any higher price. The plaintiffs acknowledged that the OA eliminated fiduciary duties but argued that the implied covenant of good faith and fair dealing implied that any sale of the LLC required an open-market sale or auction to ensure maximum value for all members. The court pointed out, however, that the incentive the plaintiffs complained of was obvious, and the court concluded that the parties considered the conditions under which a contractually permissible sale could take place and gave the board of managers sole discretion to approve the manner of a sale, subject to only one protection for the minority—that the sale be to an unaffiliated third party. The parties avoided the possibility of a self-dealing transaction but enabled the HCP Entities to structure a deal favorable to their interests. The implied covenant is meant to enforce the intent of the parties and fill a gap that was not anticipated, and the court concluded that there was no unanticipated gap to be filled in this case. The court noted that the OA was presumably drafted to attract capital investment by allowing an exit on terms favorable to the investors. Implying an auction requirement that would put at risk a sale favorable to the HCP Entities would deprive them of a negotiated-for benefit. The plaintiffs regretted their agreement, but the implied covenant is not a mechanism to modify a contract where remorse has set in.

The court commented that an entire fairness review would have applied if the parties had chosen to employ the corporate form with its common-law fiduciary duties. "Here, the member forewent the suite of common-law protections available with the corporate form, and instead chose to create an LLC." The parties made a conscious choice to eliminate the implied default fiduciary duties that apply in the LLC context despite the presence of a controlling party with an incentive to pursue a quick sale and a board with sole discretion to approve the sale so long as the sale was not to an insider.

The court rejected the plaintiffs' argument that the OA did not address the methods of marketing the LLC and that the OA conferred on the board of managers sole discretion only with respect to the form of the transaction (i.e, as a merger, asset sale, transfer of interests, etc.). The court quoted the relevant provision of the OA as follows: "'the Board shall determine in its sole discretion the manner in which [a sale of all Trumpet membership units to an independent third party] shall occur, whether as a sale of assets, merger, transfer of Membership Interests or otherwise.'" The court found that the plain and unambiguous meaning of this provision gave the board "unfettered discretion to determine both how the company will be marketed and how the sale will be structured, *so long as* the transaction does not involve insiders."

The court acknowledged cases that have applied the implied covenant to contractual grants of sole discretion, but the court distinguished those cases on the basis that they involved an unqualified grant of sole discretion that might be abused for self-interested reasons. In this case, the parties explicitly addressed the potential for self-dealing by providing that the board of managers did not retain sole discretion to sell the company to insiders. Thus, the gap that some courts have discerned in contractual grants of sole discretion was recognized and filled by the OA in this case.

The court pointed out that the terms of the OA regarding the procedure for informing the members of a sale suggested that the parties contemplated that the LLC might be sold through a private negotiation rather than an open-market process. Further, the court noted that there was no allegation that the defendants' conduct was arbitrary, unreasonable, or unanticipated in light of the deal structure allowed by the agreement (i.e., there were no allegations of fraud, kickbacks, or a purpose of harming the non-affiliated members—actions the court said could implicate the implied covenant).

In sum, in the absence of any gap for an auction sale to fill, the defendants' motion to dismiss was granted.

In re Oxbow Carbon LLC Unitholder Litigation, C.A. No. 12447-VCL, 2018 WL 2018 WL 818760 (Del. Ch. Feb. 12, 2018).

Vice Chancellor Laster held that the implied covenant of good faith and fair dealing called for interpreting an exit sale right to include a provision that allowed minority members owning approximately one-third of the LLC to enforce a sale by providing additional consideration necessary to satisfy the threshold of consideration required to be received by two later admitted members owning a very small amount of equity where the later admitted members would be able to block the sale absent satisfaction of the threshold. The one-third minority members secured a transaction that met the requirements for an exit sale and proved that the majority member breached a requirement of the LLC agreement to use reasonable efforts to support an exit sale. The court's lengthy and detailed post-trial decision—more than 170 pages—addressed the merits of the issues briefed by the parties but did not fashion a remedy because the parties did not focus on the remedy in their briefing. The court thus ordered additional briefing regarding the appropriate remedy.

Two minority LLC members (who collectively owned approximately one-third of the LLC's equity) claimed that they had the contractual right to force the LLC to engage in an exit sale under an exit sale provision (the "Exit Sale Right") of the LLC agreement. The LLC agreement defined an "Exit Sale" as a transfer of all, but not less than all, of the then-outstanding equity securities of the LLC and/or all of the assets of the LLC. The primary contractual dispute centered around language in the Exit Sale Right stating that the exercising party "'may not require any other Member to engage in such Exit Sale unless the resulting proceeds to such Member (when combined with all prior distributions to such Member) equal at least 1.5 times such Member's aggregate Capital Contributions to date.'" The court referred to this provision as the "1.5x Clause."

The court explained that one reading of the 1.5x Clause would allow a member to participate in a sale if the 1.5x Clause was not satisfied as to the member, but such a member would not be required to participate and would thus be left behind if the other members sold their interests (the "Leave Behind Theory"). Another reading of the provision would prevent a sale from going forward if the Exit Sale did not satisfy the 1.5x Clause for any member because the sale would no longer involve all, but not less than all, of the then-outstanding equity securities of the LLC (the "All Securities Requirement"). Under this reading, failure to satisfy the 1.5x Clause as to any member enabled the member to block the Exit Sale (the "Blocking Theory").

In response to the Blocking Theory, two variants of a "Top Off Theory" posited that an Exit Sale could go forward even though it did not satisfy the 1.5x Clause for certain members if those members were topped off with additional funds sufficient to satisfy the 1.5x Clause. Under the "Waterfall Top Off," transaction proceeds would first be used to satisfy the 1.5x Clause, and the remaining proceeds would be distributed pro rata. The "Seller Top Off" theory would allow minority members who exercised the Exit Sale Right to provide additional consideration to any members who needed it to satisfy the 1.5x Clause. A problem with the Top Off Theory was that it conflicted with a requirement of the LLC agreement that an Exit Sale treat members equally by offering them the same terms and conditions and allocating the proceeds by assuming that the aggregate purchase price was distributed pro rata to all unit holders (the "Equal Treatment Requirements"). The Equal Treatment Requirements would require all members to receive the same per unit consideration in an Exit Sale. If the members needed different amounts to satisfy the 1.5x Clause, the Equal Treatment Requirements would require all members to receive the highest amount necessary to satisfy the 1.5x Clause for any member (the "Highest Amount Theory").

The Exit Sale Right specified that the consideration for an Exit Sale must exceed "Fair Market Value," defined as a valuation based on going concern value without lack-of-liquidity or minority discounts. Under the valuation process established pursuant to the LLC agreement, investment bankers determined that the Fair Market Value of the LLC was $2.65 billion, which equated to $169 per unit.

The minority members exercised the Exit Sale Right and secured a buyer whose offer satisfied the Fair Market Value requirement. However, a pro rata distribution of the consideration would not satisfy the 1.5x Clause for two members who owned 1.4% of the LLC's equity (the "Small Holders"). The Small Holders, who were controlled by the majority holder, invested in the LLC in 2011 and 2012 at a price of $300 per unit. Taking into account the distributions they had received to date, they would have to receive $414 per unit to satisfy the 1.5x Clause. The other members had already received sufficient distributions to satisfy the 1.5x Clause.

The majority member invoked the Highest Amount Theory and filed this lawsuit claiming that the minority members could not enforce the Exit Sale Right because the proposed transaction did not generate proceeds of $414 per unit. Relying on the Leave Behind Theory, the minority members argued that they could force everyone else to participate in the Exit Sale.

In response to motions for summary judgment filed by the parties, the court had previously held that the plain language of the LLC agreement supported the Highest Amount Theory. However, the court recognized the harsh result produced by the Highest Amount Theory (which effectively blocked an Exit Sale), and the court observed in its summary judgment ruling that the implied covenant of good faith and fair dealing might have a role to play.

After the summary judgment ruling, the minority members amended their pleadings to advocate a Top Off. Although they appeared to prefer a Waterfall Top Off, the court said they seemed satisfied with a Seller Top Off. The minority members also claimed for the first time that the Small Holders had never been admitted as members. The court rejected this challenge on the basis of laches.

The court stated that the trial record demonstrated that the original LLC agreement intentionally left open the terms on which new members would be admitted to the LLC, thereby leaving a gap. The LLC agreement allowed the board of directors to fill the gap by determining the terms and conditions for admission of new members, but the board did not fill the gap when the Small Holders were admitted in 2011 and 2012. According to the court, the LLC "largely failed to follow proper formalities, and Oxbow did not obtain approvals that the LLC Agreement required. Consequently, a gap exists as to whether the 1.5x Clause covers the Small Holders."

Based on the trial record, the court concluded that the majority member would not have insisted on the Highest Amount option, nor would the members have insisted on the Leave Behind option, if the parties had addressed the issue when the Small Holders were admitted in 2011 and 2012. The court said that it was possible they would have agreed on the Waterfall Top Off to satisfy the 1.5x Clause, but the court found that they likely would have agreed to a Seller Top Off.

According to the court, issues of compelling fairness required application of the implied covenant of good faith and fair dealing to fill the gap created when the Small Holders were admitted. Otherwise, the fortuitous admission of the Small Holders would gut the Exit Right and allow the majority member to defeat the commitment he made in 2007. The evidence showed that the majority member and his counsel believed until 2016 that the minority members could use a Top Off to satisfy the 1.5x Clause for the Small Holders. In 2016, the majority member and his counsel "stumbled across" the combination of provisions that produce the Highest Amount interpretation. The court explained that "the Highest Amount Interpretation is the only reading that gives effect to the LLC Agreement as a whole," but "it produces an extreme and unforeseen result in this case because of the failure to address the Small Holders' rights when the Company admitted them as members in 2011 and 2012." The court found that it would be "inequitable for the majority member to benefit now from the LLC's failure to follow proper formalities," and the court thus relied on the implied covenant of good faith and fair dealing to incorporate into the Exit Sale Right a Seller Top Off for the Small Holders.

The court further found that the minority members proved that the majority member breached a requirement in the LLC agreement to use reasonable efforts to effect an Exit Sale. The majority member admitted that he set out to "obstruct," "derail," and "delay" an Exit Sale. The court rejected the majority member's contention that the minority members had unclean hands and held that the minority members were entitled to a remedy because they secured an offer that met the requirements for an Exit Sale. Because the briefing of the parties focused on liability and not the remedy, the court ordered further briefing on an appropriate remedy.

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Entity Selection for the M&A Lawyer

2018 Business Law Section Spring Meeting

April 12-14, 2018

CHOICE OF ENTITY

Investors have the choice of using the following forms of entities:

- Corporation
- Limited Liability Company
- Partnership (general or limited)
- Statutory Trust

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CHOICE OF ENTITY

Factors to be considered in connection with choosing an entity are numerous but include, without limitation, the following:

- Limited liability for the investors
- Tax considerations based on the form of entity
- Raising additional capital or funding in the future
- The ability to order the duties and rights among the investors
- Exit strategies for the investors
- Costs associated with forming the entity selected

WHY DELAWARE

Once the entity type is selected, investors should consider the jurisdiction in which to form the entity. By far Delaware is the jurisdiction of choice for most entities. Although there are many factors related to Delaware's preeminence, we believe the following five factors are the reasons why Delaware is consistently the most popular jurisdiction to form new entities:

1. Delaware Statutes – Each of the Delaware entity statutes is updated regularly to ensure that it remains top-notch.

2. Delaware Courts – The Delaware courts have significant expertise in dealing with complex entity and business transaction litigation, and a rich case law that provides business planners with the answer to how certain issues might be decided by a Delaware Court.

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WHY DELAWARE

3. Delaware Legislature – The Delaware legislature works with the Delaware Bar to regularly update each of the statutes to meet the needs of the market.

4. Delaware Secretary of State – The Delaware Secretary of State is customer friendly and works fast and efficiently to assist business entities with consummating complex business transactions, providing expedited services within 1 hour, 2 hours or 24 hours depending upon the service requested.

5. National Familiarity – Practitioners in the US are generally familiar with Delaware entities, which adds to the preeminence of Delaware as the jurisdiction of choice.

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DEFAULT PROVISIONS

Assuming that the investors eschew a long-form limited liability company agreement and rely primarily on the default provisions of the Delaware LLC Act, the parties involved should understand the various default provisions that will apply.

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DEFAULT PROVISIONS

- *Management* – Under Section 18-402 of the Delaware LLC Act, management will be by the members holding more than 50% of the profits in the LLC.

- *Voluntary Withdrawal* – Under Section 18-603 of the Delaware LLC Act, a member is not entitled to resign.

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DEFAULT PROVISIONS

- *Dissolution* – Under the Delaware LLC Act, a member does not have a unilateral right to withdraw from a limited liability company prior to its dissolution.

- *Fiduciary Duties* – Under Delaware law, unless the Limited Liability Company Agreement provides otherwise, a manager, managing member or other controlling person would owe fiduciary duties.

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DEFAULT PROVISIONS

- *Inspection Rights*.
  - Section 18-305 of the Delaware LLC Act provides statutory inspection rights that are independent of any contractual rights provided in a governing document.

- *Bankruptcy of Investor*.
  - Under Section 18-304 of the Delaware LLC Act a person ceases to be a member of an LLC upon such person's bankruptcy or other insolvency event.

DISTRIBUTIONS

Default Provisions – Under the Delaware LLC Act, a member is only entitled to receive an interim distribution when and in such amounts, as are provided in the LLC Agreement.

DISTRIBUTIONS

Unless otherwise agreed upon up front, failure to provide for how and when distributions will be made can cause dissention later on.

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VOTING THRESHOLDS

Under Delaware law, a Delaware limited liability company will be member managed by members holding more than fifty percent (50%) in interest in the profits.

VOTING THRESHOLDS

In light of the default voting provisions, parties should consider the appropriate voting thresholds for material actions, including the following:

- Distributions
- Raising additional capital
- Incurring indebtedness
- Hiring and firing officers
- Amendments to the LLC Agreement
- Selling, leasing or licensing a material portion of the assets
- Assignment of interests
- Changing the nature of the business
- Entering affiliate transaction
- Dissolution

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FIDUCIARY DUTIES

Under Delaware law

- Unless otherwise provided in the limited liability company agreement, the traditional fiduciary duties applicable to a Delaware corporation apply to the managing and controlling persons of an LLC:
  - The duty of care
    - Equates to a gross negligence standard of care.
  - The duty of loyalty
    - Act in the best interest of the LLC and its investors.

FIDUCIARY DUTIES

In the event that fiduciary duties are eliminated, a party is left solely with an implied covenant of good faith and fair dealing claim.

- In general, the implied covenant of good faith and fair dealing:
  - Protects a party from being deprived of the fruits of the bargain;
  - Is based on reasonable expectations at the time contract was entered into;
  - Applies to the exercise of discretionary authority.
- *Sole discretion* standards as set forth in agreements without more have been interpreted by the courts to mean the person has the singular authority to consider and decide the matter but is still subject to applicable duties of loyalty and good faith that would otherwise apply. *See Paige Capital Management LLC v. Lerner Mater Fund, LLC*, 2011 WL 3505355 (Del. Ch. Aug. 8, 2011).

FIDUCIARY DUTY WAIVERS

The Delaware LLC Act permits the modification or elimination of fiduciary duties; provided that the implied covenant of good faith and fair dealing cannot be eliminated.

ALTERNATIVE ENTITIES – FIDUCIARY DUTIES

- Delaware courts will review the specific governing document and the standards therein to determine the duties or standard of care of the controller. *See El Paso Pipeline GP Co., L.L.C.* v. *Brinckerhoff 2016 WL 7380418* (noting that the prevalence of entity-specific provisions in an area of law defined by expansive contractual freedom requires a nuanced analysis and renders deriving 'general principles' a cautious enterprise.)
  - Such a review is necessary to determine the standard of care applicable to the transaction and the method of authorization. *See Brinckerhoff v. Enbridge Energy Company Inc*., et al., 2017 WL 1046224 at * 3 (Supreme Court found that the Court of Chancery did not consider the controller's conduct under the correct standard applicable to the transaction).

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INDEMNIFICATION AND EXCULPATION

- *Indemnification*
  - Subject to public policy limitations, Delaware law allows parties to include indemnification provisions that will permit a person to be indemnified by the LLC for his or her own acts.
  - Delaware law has been interpreted to permit a party to have its expenses advanced prior to the final disposition of such action upon such terms as the parties agree upon pursuant to the LLC Agreement.
- *Exculpation*
  - Subject to public policy limitations, Delaware law allows parties to include exculpation provisions in a limited liability company agreement that will protect a person from personal liability.

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FIDUCIARY DUTIES, INDEMNIFICATION, EXCULPATION AND ADVANCEMENT

It is critical for the drafters of an LLC Agreement to consider fiduciary duty waivers, indemnification, exculpation and advancement together to make sure all of the pieces fit together.

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MEMBER EXIT

- The Delaware LLC Act does not provide a member with a right to withdraw.
- Parties should consider upfront how each party would want to exit the investment in the LLC.

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MEMBER EXIT
DRAG ALONG

As parties consider options related to an exit, care should be taken with respect to any drag-along provision. Recent case law in this area has indicated that the drag-along provision should be drafted carefully in order to accurately reflect the intent of the parties.

Practice Points Include:

- Draft the procedures to be followed in connection with a drag-along clearly and with specificity and eliminate any unnecessary procedures.

    * In exercising a drag-along the exercising parties should carefully follow all procedures.

- Carefully draft the drag-along provision to include the type of transaction that the parties want to trigger the exercise of the drag-along. *See Petroandina Resources Corporation N.V. v. Harvest Natural Resources Inc*., C.A. No. 10584-VCL (Del. Ch. Aug. 16, 2016) (enjoining stock sale as breach of stockholder agreement where stock sale involved stock consideration but agreement permitted sales "for cash consideration only").

- Consider the intersection of applicable fiduciary duties and the contractual right to consummate the transaction.

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REMOVAL

- Under the default provisions of the Delaware LLC Act, a member does not have the right to remove another member. In addition, unless otherwise provided, a party will not have the ability to remove a controlling member from such position.
- The inability to remove a controller, if coupled with a waiver of fiduciary duties can be particularly problematic for a minority investor.

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Transactions Involving LLCs

- The Delaware LLC Act is an enabling statute that sets forth default rules that can be adjusted by agreement. Therefore prior to entering into a transaction, a careful review of the limited liability company agreement is essential.

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Transactions Involving LLCs

- *Merger* – Under Section 18-209(b), unless modified by contract the merger can be approved by persons that own more than a 50% in the profits of the LLC.
    - Delaware's default LLC merger provision can, in some instances, provide those in control of the LLC with the ability to avoid super-majority votes, by amending the LLC Agreement in connection with the merger.
        - This opportunity exists if the merger consent requirement is different than the amendment provision. *See Section 18-209(f) permitting an amendment to a limited liability company agreement pursuant to a plan of merger "notwithstanding any provision of the limited liability company agreement relating to amendment" to the limited liability company agreement.*

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Transactions Involving LLCs

- Sale of Limited Liability Company Interests
  - Nature of Limited Liability Company Interests
    - A limited liability company interest, disaggregates the economic rights from the management rights.
    - Definition – The buyer must be careful to accurately define what is being transferred and ensure that the description is broad enough to include both economic interests and governance rights associated with the LLC interests.
    - Admission – In addition to transferring the limited liability company interest, it is also important to actually admit the transferee to the LLC, otherwise the transferee will merely be a holder of the economic interest therein.
    - Issuance – Issuance of limited liability company interests will typically require amendment of the LLC agreement.

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Transactions Involving LLCs

- Sale of Substantially all of the Assets of an LLC
  - No analog to DGCL Section 271.
  - The Delaware LLC Act does not provide a default approval mechanism for the sale of substantially all of the LLC's assets.
    - Authorization of the sale will be governed by the LLC Agreement, as will the related decision to cause a dissolution and liquidation of assets.

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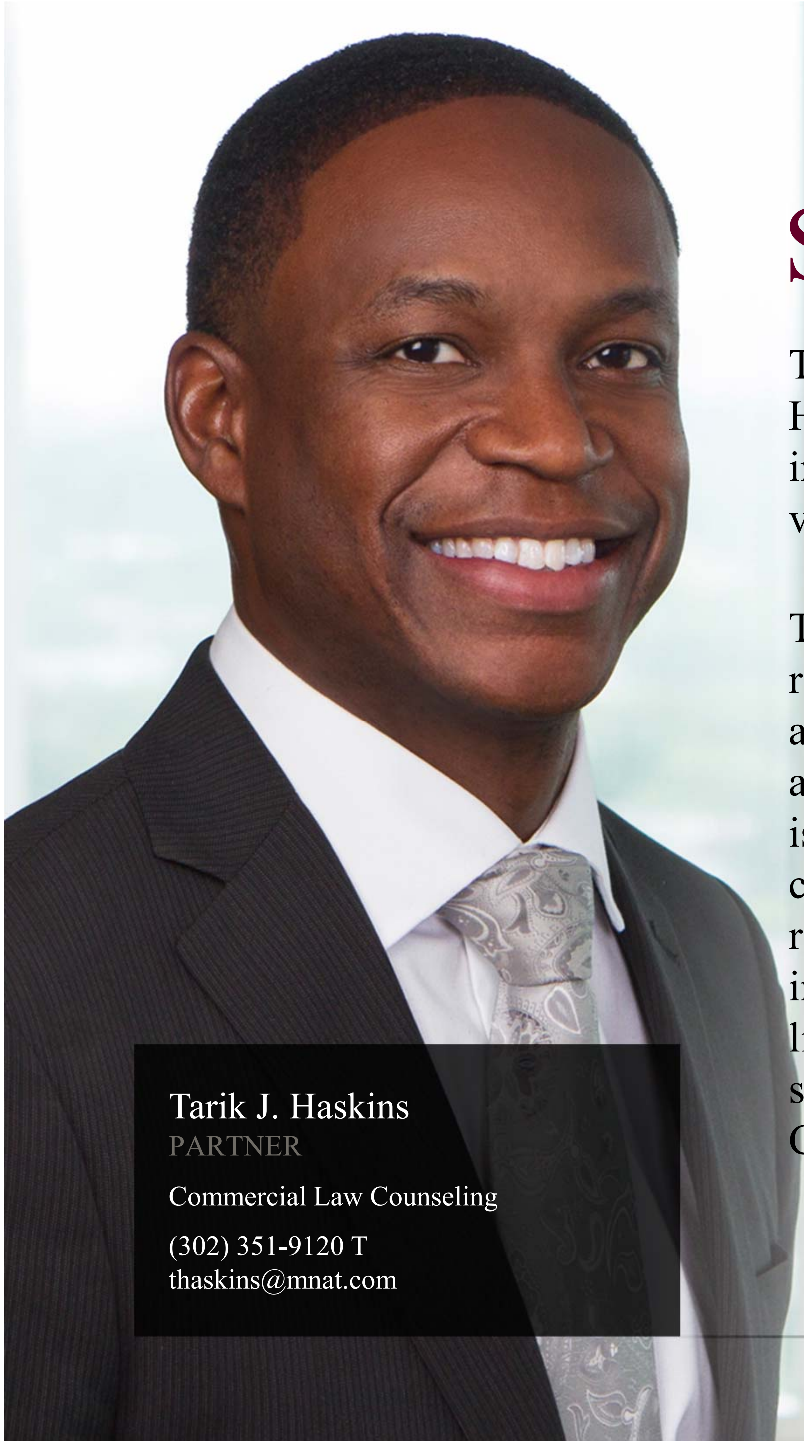
Transactions Involving LLCs

- Appraisal Rights
  - Unless provided by a merger agreement or in the limited liability company agreement of a constituent party to the merger, a member of a limited liability company does not have any appraisal rights.



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Speaker

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INTRODUCTION TO THE BUSINESS RELATED PROVISIONS OF THE 2017 TAX CUTS AND JOBS ACT:

INDIVIDUAL AND CORPORATE RATE STRUCTURES, SECs II AND III,
THE SECTION 199A DEDUCTION FOR CERTAIN PASS-THROUGH BUSINESS INCOME, SEC IV,
CHOICE OF FORM FOR DOMESTIC OPERATIONS, SEC V,
LIMITATION OF THE DEDUCTION OF BUSINESS INTEREST, SEC VI,
CARRIED INTERESTS, SEC VII,
OTHER SIGNIFICANT DOMESTIC CHANGES: BONUS DEPRECIATION, SECTION 179 DEDUCTION, NOLs, EXCESS BUSINESS LOSSES, AND LIKE KIND EXCHANGES, SEC VIII, AND
INTERNATIONAL, ADOPTION OF TERRITORIAL SYSTEM AND RELATED ANTI-BASE EROSION PROVISIONS, SEC IX

BY

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MARCH 6, 2018

FOR INCLUSION IN THE FORTHCOMING PRACTISING LAW INSTITUTE (PLI) BOOK:

BUSINESS TAXATION DESKBOOK:
CORPORATIONS, PARTNERSHIPS, S CORPORATIONS, AND INTERNATIONAL

[1] I would like to thank the following for their helpful comments on various parts of this article: (1) Professor James Puckett of Penn State Law; (2) Vasilios Vlahakis, a 2017 graduate of Penn State Law; and (3) my Penn State Law Research Assistants: Ryan Salem (a third year student), Koah Doud (a second year student), and Josh Hark (an undergrad). The discussion here will be integrated into a forthcoming PLI book by Professor Thompson entitled: *Business Taxation Deskbook: Corporations, Partnerships, Subchapter S, and International.*

TABLE OF CONTENTS

I INTRODUCTION

A. IN GENERAL

The purpose of this article is to introduce major provisions of the 2017 Tax Cuts and Jobs Act (TCAJA) impacting the domestic and international operations of the four principal ways of operating a business: (1) sole proprietorship, including a single member LLC; (2) partnership, including a multimember LLC; (3) S corporation; and (4) C corporation. The article also introduces the TCAJA's general tax treatment of individuals, principally as it relates to the rate structure and the business related activities of individuals.

Unless otherwise indicated, all references to "Section" or "§" followed by a number are references to a section of the Internal Revenue Code as amended by the TCAJA. References to "§" followed by a roman numeral, are references to internal sections of this article. For ease of reference, many of the defined terms in the TCAJA are capitalized here and, in some cases, are given an abbreviated name, such as Qualified Business Income ("QBI").

The references in this article to the legislative history of the TCAJA are to the Joint Explanatory Text of the Committee of Conference (H. Rept. 115-466, Dec. 15, 2017) [the "Conference Report"], and the page references in this article to the Conference Report are to the provisions of the Wolters Kluwer, *Explanation of the TCAJA*[2] that contain the Conference Report.

The article proceeds as follows:

- Section II examines the individual "Rate Structure Changes" for both ordinary income and capital gains;
- Section III looks at the corporate rate structure changes, including the individual tax on dividends and the dividends received deduction;
- Section IV explores new Section 199A, which provides for a deduction for certain flow-through business income of sole proprietorships, partnerships, and S corporations;
- Section V provides a "First Take" on the impact of the TCAJA on the choice of form decision for domestic operations: C corporation, or flow-through entity;
- Section VI examines the new limitation on the deduction for business interest:
- Section VII discusses the treatment under the TCAJA of carried interest, that is, profits interest earned by certain hedge fund and private equity managers;
- Section VIII introduces several significant changes impacting both individuals and corporations: (1) the depreciation rules, (2) the Section 179 deduction, (3) changes to

[2] Wolters Kluwer, *The Tax Cuts and Jobs Act, Law, Explanation and Analysis* (Dec. 2017) [the "Wolters Kluwer, *Explanation of the TCAJA*"]. For a general discussion of business tax concepts before the enactment of the TCAJA, *see e.g.*, Chapters 9, 21, 22, and 24 of Samuel C. Thompson, Jr., *Mergers, Acquisitions, and Tender Offers* (PLI, 2010, updated twice a year). These chapters are being revised to reflect the impact of the TCAJA.

the net operating loss deduction, (4) the limitation on excess business losses of an individual, and (5) changes to the like kind exchange provision, Section 1031;

- Section IX looks a several changes in the international tax arena, including (1) the adoption of a territorial system, (2) the tax on the elimination of the deferral benefit, (3) the taxation of foreign high return amounts, (4) the anti-base erosion rules, and (5) restrictions on income shifting through transfers of intangibles;
- Section X provides a "First Take" on the TCAJA's impact on the domestic M&A, that is, (1) taxable asset acquisitions, (2) taxable stock acquisitions, and (3) acquisitive reorganizations; and
- Section XI provides a brief conclusion.

B. EFFECTIVE DATES

The provisions of the TCAJA discussed in this article are generally effective for taxable years beginning after December 31, 2017. Thus, if the taxpayer is on the calendar year, the provisions of the TCAJA are generally already applicable. Some of the provisions are permanent, others are not.

II THE TCAJA'S INDIVIDUAL RATE STRUCTURE

A. TAX RATES ON ORDINARY INCOME OF A MARRIED TAXPAYER FILING A JOINT RETURN: THE RATE STRUCTURE CHANGES AND THE CHILD TAX CREDIT

1. Introduction

The TCAJA made across the board reductions in the individual rate structure on ordinary income (the "Rate Structure Changes") and increased the "Child Tax Credit" under Section 24 from $1,000 to $2,000 per child. The TCAJA also increased the threshold for the phase-out of the Child Tax Credit to $400,000 for a married couple filing jointly.

This section discusses the impact of the Rate Structure Changes and Child Tax Credit on the three hypothetical married taxpayers introduced below. It is assumed that all of the income of these taxpayers is ordinary income from employment, and consequently, for example, the deduction under Section 199A, added by the TCAJA, for pass-through business income (*see* § IV below) is not applicable. In each situation, the Rate Structure Changes are examined first and then the impact of the Child Tax Credit is examined.

Although most of the references here are to "the taxpayer," in all cases the assumption is that the taxpayer is married and files a joint return. In the first part of the analysis (§§ II.A.2-II.A.7 below), the taxpayer has three children; thereby giving the taxpayer five deductions for the personal exemption ("DPEs") in 2017.[3] In the second part of the analysis (§§ II.A.8 below), it is assumed that the taxpayer has, in the alternative, zero, 1, 2, and 3 children.

Before working through the examples of the three hypothetical taxpayers, we start with the rate structure for ordinary taxable income for 2017 and then consider the results of the Rate Structure Changes for 2018.

The computation of a taxpayer's tax liability involves a complex process, and the computations here use simplifying assumptions that are designed to illustrate the basic principles underlying the Rate Structure Changes and Child Tax Credit implemented by the TCAJA.

2. Comparing the 2017 and 2018 Rate Structures for Ordinary Taxable Income of a Married Taxpayer Filing Jointly

Table A sets out the rate structures for 2017 and for 2018, reflecting the Rate Structure Changes implemented by the TCAJA on the ordinary taxable income of a married taxpayer filing jointly.[4]

[3] A husband and wife filing jointly have two DPEs (*see* Treas. Reg. § 1.151-1(b)), and there is a DPE for each child. *See* § 151.

[4] *See* Wolters Kluwer, *Explanation of the TCAJA*, *supra* note 2, page 756 for the 2017 rate tables, and page 762 for the 2018 rate tables. The 2018 rate tables are in Section 1(j)(2).

(a) SECTION II.A, TABLE A, RATE STRUCTURES FOR 2017 AND 2018 ON ORDINARY TAXABLE INCOME OF A MARRIED TAXPAYER FILING JOINTLY

Rates and Ranges/Brackets	**2017, Rate on Taxable Income**	**2017, Beginning Amount of Taxable Income**	**2017, Ending Amount of Taxable Income**	**2018, Rate on Taxable Income**	**2018, Beginning Amount of Taxable Income**	**2018, Ending Amount of Taxable Income**
1	10%	-0-	18,650	10%	-0-	19,050
2	15%	18,651	75,900	12%	19.051	77,400
3	25%	75,901	153,100	22%	77,401	165,000
4	28%	153,101	233,350	24%	165,001	315,000
5	33%	233,351	416,700	32%	315,001	400,000
6	35%	416,701	470,700	35%	400,001	600,000
7	39.6%	470,701	Unlimited	37%	600,001	Unlimited

The following are a couple of observations about these rate structures. First, both 2017 and 2018 have seven rate brackets. Second, except for the 10% bracket and the 35% bracket, which are the same for 2017 and 2018, each of the 2018 brackets is lower than its comparable 2017 bracket. For example, the seventh and highest bracket for 2017 is 39.6%, whereas the seventh and highest bracket for 2018 is 37%, 2.6 percentage points lower.

Third, the ranges of incomes that are subject to a particular bracket are wider in 2018 than in 2017. For example, in 2017, the 35% bracket applied to taxable income ranging from $416,701 to $470,700. On the other hand, for 2018, the 35% bracket applies to taxable income ranging from $400,001 to $600,000.

Fourth, this analysis demonstrates that the Rate Structure Changes enacted by the TCAJA are implemented by (1) except for the 10% and 35% brackets, reductions in the rates from 2017 to 2018, and (2) a broadening of the income ranges that are subject to the bracket, thereby making more income subject to tax at a lower rate.

3. Comparing the Changes in Tax Liability from 2017 to 2018

In comparing the tax treatment of our three hypothetical taxpayers in 2017 with the treatment in 2018, we cannot simply use the same taxable income in 2018 as we use in 2017. This is because, although the three hypothetical taxpayers have the same taxable incomes in 2017, they have different gross incomes in 2017, and the TCAJA made several changes to the computation of an individual's taxable income. Thus, although each of the taxpayers had the same taxable incomes in 2017, as a result of the TCAJA, the taxpayers have different taxable incomes in 2018.

For purposes of the analysis here, the focus is on the two most significant changes to the individual deductions implemented by the TCAJA: (1) the $10,000 limit on the deduction for state and local taxes (the "SALT Limitation") (*see* § 164(b)), and (2) the elimination of the deduction for the personal exemption (the "DPE Elimination") (*see* § 151(d)(5)). As noted, it is assumed that each of the taxpayers has three children, and that, therefore, for 2018, each taxpayer had 5 DPEs, before phase-out. (*See* § 151 for 2017)

After focusing on the computation of the potential tax liabilities of the taxpayers before the Child Tax Credit, the analysis shows the computation of tax liability after the Child Tax Credit.

Although the TCAJA also significantly expanded the standard deduction (*see* § 63(c)(7)), the assumption here is that each of our hypothetical taxpayers would continue to itemize and not utilize the expanded standard deduction. The principal reason for this is the continued deduction for home mortgage interest on mortgages of up to $750,000. *See* § 163(h)(3).

4. Base Levels of Taxable Income for 2017 and 2018 for the Three Hypothetical Taxpayers before Adjustments for 2018

Table B sets out the levels of taxable income for our three hypothetical taxpayers for 2017 and 2018, before the adjustments discussed below for 2018.

(a) SECTION II.A, TABLE B, TAXABLE INCOMES IN 2017 AND 2018, BEFORE ADJUSTMENTS FOR 2018

Illustrative Taxpayer's Taxable Incomes	**Moderate Income Taxpayer: $100,000 of Taxable Income**	**Above-Average Income Taxpayer: $225,000 of Taxable Income**	**High Income Taxpayer: $1,000,000 of Taxable Income**

As noted, the taxable income for 2018 is before the adjustments discussed below for changes resulting from the SALT Limitation and the DPE Elimination.

5. The Adjustments to the 2018 Taxable Income Required by the TCAJA: The SALT Limitation and the DPE Elimination

a. Introduction

This section first looks at the impact on the 2018 taxable incomes, as compared with the 2017 taxable incomes, of the three hypothetical taxpayers as a result of the enactment by the TCAJA of (1) the SALT Limitation, and (2) the DPE Elimination.

b. The SALT Deduction for 2017 and 2018

Prior to the enactment of the SALT Limitation, the median of the SALT deduction as a percentage of AGI was 4.5%.[5] For purposes of simplifying the analysis here, it is assumed, for each of the hypothetical taxpayers, that the SALT payments for 2017 and 2018 would have been 5% of their 2017 taxable incomes. Thus, Table C sets out the SALT payments made by each of the hypothetical taxpayers and the deductible SALT payments for both 2017 and 2018:

[5] Jared Walczak, *The State and Local Tax Deduction: A Primer*, Tax Foundation (March 15, 2017), available at https://taxfoundation.org/state-and-local-tax-deduction-primer/.

(a) SECTION II.A, TABLE C, SALT PAYMENTS IN 2017 AND 2018, BEFORE AND AFTER LIMITATION FOR 2018

Illustrative Taxpayer/SALT Treatment	**Moderate Income Taxpayer: $100,000 of Taxable Income**	**Above-Average Income Taxpayer: $225,000 of Taxable Income**	**High Income Taxpayer: $1,000,000 of Taxable Income**
SALT Payments = 5% of Taxable Income	$5,000	$11,250	$50,000
SALT Deduction in 2017	$5,000	$11,250	$50,000
SALT Deduction in 2018, SALT Limitation = $10,000	$5,000	$10,000	$10,000
Disallowed SALT Payment for 2018; Resulting in Increase in 2018 Taxable Income	-0-	$1,250	$40,000

Thus, under the assumptions here, as a result of the enactment of the SALT Limitation, the 2018 taxable incomes (as compared to the taxable incomes in 2017) would change as follows: (1) the taxable income of the Above-Average Income Taxpayer would increase by $1,250, and (2) the taxable income of the High Income Taxpayer would increase by $40,000. The taxable income of the Moderate Income Taxpayer would not change.

c. The Deductions for the Personal Exemption ("DPE") in 2017 and 2018

As noted above, the assumption here is that each of the hypothetical taxpayers is married and each has three children, thus giving five deductions for the personal exemption ("DPE") for 2017 before phase-out. For 2017, the DPE was $4,050, and assuming the same amount of DPE for 2018, five of these deductions equals $20,250. The DPE was phased out beginning at $313,800 of AGI for 2017, and it is assumed here that only the High Income Taxpayer is subject to the phase-out. Thus, for 2017, the Moderate Income Taxpayer and the Above-Average Income Taxpayer received the full deduction for the DPE, but the deduction was completely phased out for the High Income Taxpayer.

For 2018, the DPE Elimination applies, and consequently, the Moderate Income Taxpayer and the Above-Average Income Taxpayer will have a higher taxable income for 2018, compared to taxable income in 2017, in the amount of the DPE Elimination.

Table D sets out the DPE for 2017 and 2018, and also shows the impact on taxable income for 2018 for each of the taxpayers from the DPE Elimination for 2018.

(a) SECTION II.A, TABLE D, DEDUCTION FOR THE PERSONAL EXEMPTION FOR 2017 THAT IS NOT ALLOWED IN 2018

Illustrative Taxpayer/DPE	**Moderate Income Taxpayer: $100,000 of Taxable Income**	**Above-Average Income Taxpayer: $225,000 of Taxable Income**	**High Income Taxpayer: $1,000,000 of Taxable Income**
Deduction for the Personal Exemption, Allowed for 2017	$20,250	$20,250	-0- Because of the Phase-Out
Deduction for the Personal Exemption, Allowed for 2018	-0-	-0-	-0-
Disallowed Deduction for the Personal Exemption for 2018; Resulting in Increase in 2018 Taxable Income	$20,250	$20,250	-0-

Thus, under the assumption here, as a result of the DPE Elimination for 2018, as compared to the taxable income in 2017, the taxable income in 2018 of both the Moderate Income Taxpayer and the Above-Average Income Taxpayer would increase by $20,250. However, as a result of the phase-out, there is no impact on the taxable income of the High Income Taxpayer.

d. Summary of Adjustments to Taxable Incomes for 2018

Table E summarizes the impact for 2018 on the taxable incomes of the three hypothetical taxpayers as a result of (1) the enactment of the SALT Limitation, and (2) the DPE Elimination.

(a) SECTION II.A, TABLE E, SUMMARY OF INCREASES IN TAXABLE INCOME IN 2018 COMPARED TO 2017 UNDER THE ASSUMPTION THAT FOR 2018 THE ONLY CHANGES (DELTAs) ARE THE ENACTMENT OF THE (1) SALT LIMITATION, AND (2) DPE ELIMINATION

Illustrative Taxpayer/DPE	**Moderate Income Taxpayer: $100,000 of Taxable Income**	**Above-Average Income Taxpayer: $225,000 of Taxable Income**	**High Income Taxpayer: $1,000,000 of Taxable Income**
[1] Disallowed SALT Payment for 2018; Resulting in Increase in 2018 Taxable Income	-0-	$1,250	$40,000
[2] Disallowed Deduction for the Personal Exemption for 2018; Resulting in Increase in 2018 Taxable Income	$20,250	$20,250	-0-
[3] Total Change (Delta) in Taxable Income for 2018 as Compared to 2017	$20,250	$21,500	$40,000
[4] Taxable Income for 2018 Before the Delta	$100,000	$225,000	$1,000,000
[5] Taxable Income for 2018 After the Delta for the SALT Limitation and the DPE Elimination [4] + [3]	$120,250	$246,500	$1,040,000

To summarize, as a result of the SALT Limitation and the DPE Elimination, the taxable incomes of our three hypothetical taxpayers as shown on the last row in Table E are as follows:

- Moderate Income Taxpayer: $120,250,
- Above-Average Income Taxpayer: $246,500, and
- High Income Taxpayer: $1,040,000.

We now turn to the computation of the 2017 and 2018 tax liabilities, before the Child Tax Credit, of our three hypothetical taxpayers.

6. Summary of the Effects of the Rate Structure Changes and the SALT Limitation and the DPE Elimination

The Rate Structure Changes, on the one hand, and the SALT Limitation and DPE Elimination, on the other, have opposite effects. The Rate Structure Changes have a tax reducing effect, while the SALT Limitation and DPE Elimination have a tax increasing effect. The question for taxpayers is: What effect dominates? As will be seen from the analysis below, the answer to this question depends on the unique situation of each taxpayer. After focusing on these two changes, we will consider the impact of the Child Tax Credit.

7. Computation of Tax Liability of the Three Hypothetical Taxpayers for 2017 and 2018

a. Tax Liabilities Before the Child Tax Credit

With the above information, it is possible to compute the tax liabilities for our three hypothetical taxpayers (prior to the reductions, if any, resulting from the Child Tax Credit) for both 2017 and 2018. Table F shows the computation of the pre-credit tax liabilities and the tax reductions/increases for the three hypothetical taxpayers for 2017 and 2018 taking into account for 2018 the TCAJA's (1) Rate Structure Changes, (2) SALT Limitation, and (3) DPE Elimination.

(a) SECTION II.A, TABLE F, COMPUTATION OF PRE-CREDIT TAX LIABILITIES AND TAX REDUCTION/INCREASE FOR THE THREE HYPOTHETICAL TAXPAYERS FOR 2017 AND 2018 TAKING INTO ACCOUNT FOR 2018 THE TCAJA's: (1) RATE STRUCTURE CHANGES, (2) SALT LIMITATION, AND (3) DPE ELIMINATION

Taxpayer/Tax Reduction, Increase	**2017 Moderate Income Taxpayer**	**2018 Moderate Income Taxpayer**	**2017 Above-Average Income Taxpayer**	**2018 Above-Average Income Taxpayer**	**2017 High Income Taxpayer**	**2018 High Income Taxpayer**
[1] Taxable Income	$100,000	$120,250	$225,000	$246,500	$1,000,000	$1,040,000
[2] Minus						
[3] Top Marginal Bracket Starting Point on Taxpayer's Taxable Income	75,900	77,400	153,100	165,000	470,700	600,000
[4] Equals Marginal Taxable Income = [1]-[3]	24,100	42,850	71,900	81,500	529,300	440,000
[5] Multiplied by:						
[6] Marginal Tax Rate, From Table A	.25	.22	.28	.24	.396	.37
[7] Equals: Marginal Tax Liability [6]X[4]	6,025	9,427	20,132	19,560	209,602	162,800
[8] Base Tax on Taxable Income below Top Marginal Bracket Starting Point on Taxpayer's Taxable Income, From § 1, Table	10,452	8,907	29,752	28,179	131,628	161,379
[9] Pre-Credit Tax Liability [7]+[8]	16,477	18,334	49,884	47,739	341,230	324,179
[10] Tax Reduction or Increase from 2017 to 2018		$1,857 Tax Increase, an 11% Tax Increase		$2,145 Tax Decrease, a 4% Tax Decrease		$17,051 Tax Decrease, a 5% Tax Decrease

To summarize the results prior to the Child Tax Credit: First, the Moderate Income Taxpayer with $100,000 of taxable income in 2017 has an 11% pre-credit tax increase in 2018. The principal reason for this is that, as a result of the DPE Elimination, the taxpayer's taxable income for 2018 is $20,250 higher than her taxable income in 2017. This results in an 11% pre-credit tax increase for this taxpayer even though there is no impact from the SALT Limitation.

Second, the Above-Average Income Taxpayer with $225,000 of taxable income in 2017 has a 4% pre-credit tax decrease in 2018. This is the case even though her income for 2018 is $21,500 higher than in 2017. This increase in her taxable income is attributable to the (1) $1,250 increase resulting from the SALT Limitation, and (2) a $20,250 increase attributable to the DPE Elimination. However, the combination of the wider brackets and the lower rates prevented this taxpayer from having a pre-credit tax increase like the Moderate Income Taxpayer.

Third, the High Income Taxpayer has a 5% tax reduction, even though her taxable income was $40,000 higher in 2018 than in 2017. The reason for this result is that the combination of the wider brackets and the lower rates (*i.e.*, 37% rather than 39.6%) prevented this taxpayer from having a tax increase like the Moderate Income Taxpayer. Also, because of the phase-out this taxpayer does not get the benefit of the Child Tax Credit.

b. Tax Liabilities After the Child Tax Credit

Table G provides a computation of tax liability of the three hypothetical taxpayers after the Child Tax Credit. As indicated, prior to 2018, this credit was $1,000 per child; for taxable years beginning in 2018, this credit is $2,000 per child before phase-out. Table G shows the tax liability and tax reduction/increase for the three hypothetical taxpayers for 2017 and 2018 taking into account for 2018 the TCAJA's: (1) rate structure changes, (2) salt limitation, (3) DPE elimination, and (3) the Child Tax Credit.

(a) SECTION II.A, TABLE G, COMPUTATION OF AFTER-CREDIT TAX LIABILITY AND TAX REDUCTION/INCREASE FOR THE THREE HYPOTHETICAL TAXPAYERS FOR 2017 AND 2018 TAKING INTO ACCOUNT FOR 2018 THE TCAJA's: (1) RATE STRUCTURE CHANGES, (2) SALT LIMITATION, (3) DPE ELIMINATION, AND (3) THE CHILD TAX CREDIT

Taxpayer/Tax Reduction, Increase	**2017 Moderate Income Taxpayer**	**2018 Moderate Income Taxpayer**	**2017 Above-Average Income Taxpayer**	**2018 Above-Average Income Taxpayer**	**2017 High Income Taxpayer**	**2018 High Income Taxpayer**
[1] Pre-Credit Tax Liability, From Table F, Row [9]	16,477	18,334	49,884	47,739	341,230	324,179
[2] Pre-Credit Tax Reduction or Increase from 2017 to 2018, From Table F, Row [10]		$1,857 Tax Increase, an 11% Tax Increase		$2,145 Tax Decrease, a 4% Tax Decrease		$17,051 Tax Decrease, a 5% Tax Decrease
[3] Child Tax Credit	3,000	6,000	-0- Because of Phase-Out	6,000	-0-	-0-
[4] After Child Tax Credit Tax Liability [1] –[3]	13,477	12,334	49,884	41,739	341,230	324,179
[5] After-Credit Tax Reduction or Increase from 2017 to 2018		$1,143 Tax Decrease, an 8% Tax Decrease		$8,145 Tax Decrease, a 16% Tax Decrease (Because He Did Not Get the Child Tax Credit in 2017 Because of the Phase-Out, But Gets It in 2018)		$17,051 Tax Decrease, a 5% Tax Decrease

Thus, as shown on Row [5], with the Child Tax Credit, all of the taxpayers receive tax decreases ranging from 8% for Moderate Income Taxpayer to 16% for the Above-Average Income Taxpayer, and then back down to 5% for the High Income Taxpayer.

8. Illustration of the Pre-Credit and Post-Credit Effects on Moderate Income Families ($100,000 of Taxable Incomes) with from Zero to Three Children

a. Introduction

This section analyzes the impact on the following four Moderate Income Taxpayers of the DPE Elimination and the Child Tax Credit provisions of the TCAJA: Taxpayers A, B, C, and D, each with $100,000 of taxable income before the DPE Elimination. As noted in Table E above, these taxpayers are not impacted by the SALT Limitation. For 2017, each had the number of DPEs (from 2 to 5) indicated in Table H below.

(a) SECTION II.A, TABLE H, NUMBER ANE DOLLAR AMOUNT OF DPEs FOR MODERATE INCOME TAXPAYERS (A, B, C, AND D) FOR 2017

Taxpayer/Number of DPEs for 2017	**Moderate Income Taxpayer A**	**Moderate Income Taxpayer B**	**Moderate Income Taxpayer C**	**Moderate Income Taxpayer D**
2 DPEs	Married, No Children, 2 DPEs in 2017, \$8,100			
3 DPEs		Married, One Child, 3 DPEs in 2017, \$12,150		
4 DPEs			Married, Two Children, 4 DPEs in 2017, \$16,200	
5 DPEs				Married, Three Children, 5 DPEs in 2017, \$20,250

b. Impact of the DPE Elimination

Table I computes for 2018, the pre-credit tax increase or decrease in taxable income for each of these Moderate Income Taxpayers resulting from the DPE Elimination. For 2018, each Taxpayer has the taxable income noted in Row [1] of Table I below, which reflects the impact of DPE Elimination shown in Table H above. Note that the taxable incomes increase as the number of the DPE Eliminations increase.

(a) SECTION II.A, TABLE I, COMPUTATION OF PRE-CREDIT TAX LIABILITIES AND TAX REDUCTION/INCREASE FOR MODERATE INCOME TAXPAYERS FILING JOINT RETURNS IN 2017 AND 2018 WITH 0, 1, 2, AND 3 CHILDREN

Taxpayer/Tax Reduction, Increase	**2017 Moderate Income Taxpayer, Regardless of Number of Children**	**2018 Moderate Income Taxpayer A with No Children, and without 2 DPE's of $8,100**	**2018 Moderate Income Taxpayer B with 1 Child, and without 3 DPE's of $12,150**	**2018 Moderate Income Taxpayer C with 2 Children, and without 4 DPE's of $1620**	**2018 Moderate Income Taxpayer D with 3 Children and without 5 DPE's of $20,250**
[1] Taxable Income	$100,000	$108,100	$112,150	$116,200	$120,250
[2] Minus					
[3] Top Marginal Bracket Starting Point on Taxpayer's Taxable Income	75,900	77,400	77,400	77,400	77,400
[4] Equals Marginal Taxable Income = [1]-[3]	24,100	30,700	34,750	38,800	42,850
[5] Multiplied by:					
[6] Marginal Tax Rate, From Table A	.25	.22	.22	.22	.22
[7] Equals: Marginal Tax Liability [6]X[4]	6,025	6,754	7,645	8,536	9,427
[8] Base Tax on Taxable Income below Top Marginal Bracket Starting Point on Taxpayer's Taxable Income, From § 1, Table	10,452	8,907	8,907	8,907	8,907
[9] Pre-Credit Tax Liability [7]+[8]	16,477	15,661	16,552	17,443	18,334
[10] Pre-Credit Tax Decrease or Increase from 2017 to 2018		$816 Tax Decrease, which is a 5% Tax Decrease	$75 Tax Increase, which is a 0.5%	$966 Tax Increase, which is a 5% Tax Increase	$1,857 Tax Increase, which is an 11% Tax Increase

Row]10] of Table I shows that Moderate Income Taxpayer A, who is married without children receives a 5% pre-credit tax decrease under the TCAJA, whereas, Moderate Income Taxpayers

B, C, and D experience pre-credit tax increases of 0.5%, 5%, and 11%, respectively. In other words, the more children these Moderate Income Taxpayers have, the higher their pre-credit tax increases. This is because the more children a family has, the more the tax increasing effect from the DPE Elimination exceeds the tax reducing effect from the Rate Structure Changes.

c. Impact of the Child Tax Credit

This brings us to the computation in Table J of the impact on these Moderate Income Taxpayers of the TCAJA's expansion of the Child Tax Credit. Row [1] of Table J shows the Pre-Credit Tax Liability of each of these taxpayers for 2017 and 2018, and Row [2] shows the Pre-Credit Tax Reduction or Increase from 2017 to 2018.

The Post-Child Tax Credit Tax Reduction or Increase from 2017 to 2018 for each of these Taxpayers is shown as follows:

- Column [B], Row [2] for the taxpayer who has no children,
- Column [C], Row [5] for the taxpayer with one child,
- Column [D], Row [8] for the taxpayer with two children, and
- Column [E], Row [11] for the taxpayer with four children.

(a) SECTION II.A, TABLE J, COMPUTATION OF AFTER-CREDIT TAX LIABILITIES AND TAX REDUCTION/INCREASE FOR THE MODERATE INCOME TAXPAYERS FILING JOINT RETURNS IN 2017 AND 2018 WITH 0, 1, 2, AND 3 CHILDREN

Taxpayer/Tax Reduction, Increase	**[A] 2017 Moderate Income Taxpayer**	**[B] 2018 Moderate Income Taxpayer A with No Children, and without 2 DPE's of $8,100**	**[C] 2018 Moderate Income Taxpayer B with 1 Child, and without 3 DPE's of $12,150**	**[D] 2018 Moderate Income Taxpayer C with 2 Children, and without 4 DPE's of $16,200**	**[E] 2018 Moderate Income Taxpayer D with 3 Children and without 5 DPE's of $20,250**
[1] Pre-Credit Tax Liability, Table I Row [9]	$16,477 (without respect to the number of children)	$15,661	$16,552	$17,443	$18,334
[2] Pre-Credit Tax Reduction or Increase from 2017 to 2018		$816 Tax Decrease, which is a 5% Tax Decrease [A][1] – [B][1]	$75 Tax Increase, which is a 0.5% [A][1] – [C][1]	$966 Tax Increase, which is a 5% Tax Increase [A][1] – [D][1]	$1,857 Tax Increase, which is an 11% Tax Increase [A][1] – [E][1]
[3] Child Tax Credit, One Child	1,000	NA	2,000	NA	NA
[4] Post-Credit Tax Liability [1] – [3]	15,477	NA	$14,552	NA	NA
[5] Post-Credit Tax Reduction or Increase from 2017 to 2018	NA	NA	$925 Tax Decrease, which is a 5% Tax Decrease [A][4] – [C][4]	NA	NA
[6] Child Tax Credit, 2 Children	2,000	NA	NA	4,000	NA
[7] Post-Credit Tax Liability [1] – [6]	14,477	NA	NA	13,443	NA
[8] Post-Credit Tax Reduction or Increase from 2017 to 2018	NA	NA	NA	$1,034 Tax Decrease, which is a 7% Tax Decrease [A][7] – [D][7]	NA
[9] Child Tax Credit, 3 Children	3,000	NA	NA	NA	6,000
[10] Post-Credit Tax Liability [1] – [9]	13,477	NA	NA	NA	12,334
[11] Post-Credit Tax Reduction or Increase from 2017 to 2018	NA	NA	NA	NA	$1,143 Tax Decrease, which is a 8% Tax Decrease [A][10] – [D][10]

Table K presents a summary comparison from Table J of the pre- and post-Child Tax Credit reductions or increases in tax liability.

(a) SECTION II.A, TABLE K, SUMMARY COMPARISON OF PRE- AND POST-CREDIT TAX REDUCTION/INCREASE FOR MODERATE INCOME TAXPAYERS FILING JOINT RETURNS IN 2017 ND 2018 WITH 0, 1, 2, AND 3 CHILDREN

Taxpayer/Tax Reduction, Increase	**2018 Moderate Income Taxpayer A with No Children, and without 2 DPE's of $8,100**	**2018 Moderate Income Taxpayer B with 1 Child, and without 3 DPE's of $12,150**	**2018 Moderate Income Taxpayer C with 2 Children, and without 4 DPE's of $16,200**	**2018 Moderate Income Taxpayer D with 3 Children and without 5 DPE's of $20,250**
[1] Pre-Credit Tax Reduction or Increase from 2017 to 2018	$816 Tax Decrease, which is a 5% Tax Decrease	$75 Tax Increase, which is a 0.5%	$966 Tax Increase, which is a 5% Tax Increase	$1,857 Tax Increase, which is an 11% Tax Increase
[2] Post-Credit Tax Reduction or Increase from 2017 to 2018	NA	$925 Tax Decrease, which is a 5% Tax Decrease	NA	NA
[3] Post-Credit Tax Reduction or Increase from 2017 to 2018	NA	NA	$1,034 Tax Decrease, which is a 7% Tax Decrease	NA
[4] Post-Credit Tax Reduction or Increase from 2017 to 2018	NA	NA	NA	$1,143 Tax Decrease, which is a 8% Tax Decrease

Table K shows that although pre-credit three of the four Moderate Income Taxpayers experience a tax increase, after taking into account the expanded Child Tax Credit, all of the taxpayers realize a tax decrease, ranging from 5% to 8%. The tax decrease generally gets larger the more children the taxpayer has.

B. TAX RATES ON NET CAPITAL GAIN OF A MARRIED TAXPAYER FILING A JOINT RETURN, INCLUDING IMPACT OF OBAMACARE TAX ON NET INVESTMENT INCOME

The TCAJA did not significantly change the rate structure for the taxation of capital gains earned by individuals, thus net capital gain (generally the excess of long term capital gain over capital losses) is generally taxed at one of the following three rates: Zero, 15%, or 20%. For married taxpayers filing joint returns, for 2018, the breakpoint between the Zero Rate and the 15% Rate is $77,200 of taxable income, and the breakpoint between the 15% Rate and the 20% Rate is $479,000 of taxable income. These breakpoints are indexed for inflation.

Thus, as a general matter, with respect to the taxation of net capital gain for married taxpayers filing joint returns (1) taxpayers with less than $77,200 of taxable income will not be taxed on such gains, (2) taxpayers with between $77,200 and $479,000 of taxable income will be taxed at a 15% Rate on such gains, and (3) taxpayers with more than $479,000 of taxable income will be taxed at a 20% Rate on such gains.

In addition to the tax on capital gains, Obamacare imposes a 3.8% tax on net investment income of high income taxpayers. Therefore, the combined capital gains and Obamacare tax is 23.38%. For example, if an entrepreneur sells her long-held business for a $100 million capital gain, she will be taxed at a 23.8% rate, that is, her tax will be $23.8 million.

III THE TCAJA'S CORPORATE RATE STRUCTURE AND TAXATION OF DIVIDENDS PAID TO INDIVIDUALS AND TO CORPORATIONS

A. THE CORPORATE RATE

For corporations taxed under Subchapter C of the Internal Revenue Code, Sections 301 *et. seq*., the TCAJA replaces the prior graduated rate structure under Section 11, which had a maximum 35% rate. The replacement rate is a flat, across the board, 21% rate on the taxable income of C corporations; thus, the 21% rate applies without respect to the taxable income of the corporation. *See* § 11. The 21% rate applies equally to (1) the local C corporation with $100,000 of taxable income, and (2) a large publicly held C corporation with $100,000,000 of taxable income.

B. THE RATE ON DIVIDENDS RECEIVED BY INDIVIDUALS

The TCAJA continues the general treatment of dividends received by individual shareholders from (1) domestic C corporations, and (2) foreign corporations that are publicly traded on a U.S. market. *See* § 1(h)(11). These dividends are referred to as "Qualified Dividend Income," and they are treated as part of Net Capital Gain, which, as discussed above, is taxed at one of the following three rates: Zero, 15%, or 20%, depending on the level of the taxpayer's taxable income. Thus, for example, as a general matter, high-income taxpayers will be subject to a 20% rate on Qualified Dividend Income, plus the Obamacare rate of 3.8% on net investment income, for a combined rate of 23.8%.

C. THE COMBINED CORPORATE AND INDIVIDUAL RATES BEFORE AND AFTER THE TCAJA

Table A sets out the computation of the combined corporate and individual shareholder rates on dividends distributed by a domestic C corporation to an individual shareholder in the highest bracket, which is 23.8% for such dividends. As demonstrated in the Table, pre-TCAJA, the combined rate was 50% and after the TCAJA, the combined rate is 36%.

(a) SECTION III.C, TABLE A, COMPARING THE COMBINED CORPORATE AND SHAREHOLDER RATES ON DIVIDENDS PRIOR TO AND AFTER THE TCAJA

PRE- AND POST TCAJA/ CORPORATE AND SHAREHOLDER LEVEL TAXES	**TREATMENT PRE-TCAJA**	**TREATMENT AFTER TCAJA**
[1] Corporate Taxable Income	$10,000,000	$10,000,000
[2] Maximum Corporate Tax Rate	35%	21%
[3] Corporate Tax Liability [2]X[1]	3,500,000	2,100,000
[4] After Tax Cash, which is Assumed to be Distributed to the Shareholder [1]-[3]	6,500,000	7,900,000
[5] Maximum Shareholder Rate on Dividends	23.8%	23.8%
[6] Shareholder Tax on Dividends [5]X[4]	1,547,000	1,880,200
[7] Total of Corporate and Shareholder Taxes [3]+[6]	$5,047, 000 or 50% of the Corporation's Taxable Income	$3,980,200 or 36% of the Corporation's Taxable Income

Of course, there generally is no requirement that corporations distribute dividends, so the shareholder tax could be deferred indefinitely in the absence of the applicability of one of the anti-deferral provisions discussed next.

D. THE BENEFIT OF DEFERRAL AND THE ANTI-DEFERRAL PROVISIONS

1. Introduction

The 21% corporate rate will be an enhanced incentive for corporations to retain earnings in order to defer the tax on dividends, which would be taxed at a maximum 23.8% rate, or salaries to owners, which would be taxed at a maximum 37% rate. At least three provisions are designed to prevent this type of deferral: (1) the Accumulated Earnings Tax (§ 531 *et seq*.), (2) the Personal Holding Company Tax (§ 541 *et seq*.), and (3) the IRS's reasonable compensation requirement. Each of these anti-deferral provisions is examined briefly in this section.

2. Purposes of the Accumulated Earnings Tax and Personal Holding Company Tax and Why the IRS Would Be Concerned with Them

The purpose of the Accumulated Earnings Tax and the Personal Holding Company Tax is to prevent the accumulation of earnings in a corporation for the purpose of tax avoidance.[6] Both taxes are penalty taxes imposed at the corporate level and can be avoided if the corporation distributes its earnings. Neither of these taxes applies to S corporations. *See* § 1363(a).

A Tax Notes article reports as follows that the IRS may give increased attention to these two long-standing, but not frequently imposed, taxes:

> Brett York, attorney-adviser, Treasury Office of Tax Legislative Counsel, said . . . the interaction between . . . the lowered 21 percent corporate tax rate and the unchanged accumulated earnings and undistributed personal holding company taxes under sections 531 and 541 would be an example of pressure placed on older provisions that Treasury is considering.
>
> Those taxes could apply when taxpayers try to shelter income through corporations to take advantage of the lower rate. The personal holding company and accumulated earnings tax rules impose additional taxes on some C corporations that inappropriately retain rather than distribute earnings to avoid individual income tax for their shareholders.[7]

3. Basic Operation of the Accumulated Earnings Tax

Section 531 imposes an Accumulated Earnings Tax ("AET") for each taxable year on the Accumulated Taxable Income ("ATI") of every corporation described in section 532. The rate of the tax is 20%.

Pursuant to Section 532, the tax applies to "every corporation [other than, *e.g.*, S corporations and personal holding companies] formed or availed of for the purpose of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed." Thus, the AET does not apply unless "the purpose" of the accumulation is tax avoidance.

There is significant complexity, not discussed here, in the AET. It is not a self-assessed tax, and will only apply when the IRS successfully imposes it.

4. Basic Operation of the Personal Holding Company Tax

The Personal Holding Company Tax ("PHCT") is a penalty tax imposed on certain closely held corporations that are engaged in passive investment activities. Pursuant to Section 541, the tax is equal to 20% of the "undistributed personal holding company income," which is generally passive income, such as dividends and interest retained in the corporation.

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[6] For a general introduction to the Accumulated Earnings Tax and the Personal Holding Company Tax, *see, e.g.*, Samuel C. Thompson, Jr. *Taxation of Business Entities*, Ch 12 (2nd Ed. 2001).

[7] Jonathan Curry & Nathan Richman, *Treasury Weighing Impact of New Law as Guidance Plan Awaits*, Tax Notes Weekly (Jan. 29, 2018).

For the tax to apply the corporation must meet the definition of a "Personal Holding Company ("PHC"). To be classified as a PHC two elements must be satisfied: (1) a passive income element, requiring that a large amount of the income be passive, and (2) a stock ownership requirement, requiring that the stock of the corporation be closely held.

5. Constructive Dividends and the Reasonable Compensation Requirement

Section 162 limits a taxpayer's ordinary and necessary expense deductions to a "reasonable" allowance for compensation. A significant amount of case law under Section 162 addresses attempts by C corporations to pay what the IRS believes to be unreasonably large salaries to employee/shareholders in order to have the income taxed at the employee/shareholder level and not at the corporate level. If the IRS is successful, the excess salary is treated as (1) a non-deductible payment at the corporate level, thus raising the corporation's tax liability, and (2) a constructive dividend (*see, e.g.*, § 1.301-1(j)) to the shareholder.

Thus, in the past, there has been an incentive for a C corporation to pay an unreasonably high salary to an employee/shareholder. However, with the 21% corporate rate enacted by the TCAJA, there may be an incentive for C corporations to pay an unreasonably low salary to an employee/shareholder, thus deferring the shareholder level tax.

The IRS has been successful in requiring S corporations to pay reasonable salaries in order to prevent such corporations from avoiding Social Security taxes on wages. The position of the IRS is set out in Rev. Rul. 74-44, [8] which provides:

> [T]he "dividends" paid [by the S corporation] to the shareholders in 1972 were in lieu of reasonable compensation for their services. Accordingly, the 100x dollars paid to each of the shareholders was reasonable compensation for services performed by him, rather than a distribution of the corporation's earnings and profits. Such compensation was "wages" and liability was incurred for [Social Security taxes[.]

It can be expected that the IRS will attempt to apply similar principles to C corporations that pay unreasonably low salaries (or for example, make loans) to shareholders.

E. THE MOST TAX EFFICIENT MIX BETWEEN SALARY AND DIVIDENDS

A March 2018 article in Tax Notes examines the post-TCAJA "most tax-efficient mix of salary and dividends payable to the sole shareholder-employee of a C corporation." [9] The article concludes that "after the enactment of the [TCAJA], the mix shifts substantially to dividends."

[8] Rev. Rul. 74-44 | 1974-1 C.B. 287.

[9] Peter Rivera and Donald Williamson and A. Blair Staley, *Optimizing Salary and Dividends of a C Corporation After TCJA*, 158 Tax Notes 1335).

F. THE RATE ON INTER-CORPORATE DIVIDENDS

The TCAJA modified the treatment of certain inter-corporate dividends from domestic C corporations to domestic C corporations. *See* § 243. Table B summarizes the treatment of inter-corporate dividends both prior to and after the enactment of the TCAJA.

(a) SECTION III.E, TABLE A, COMPARING THE TREATMENT OF INTER-CORPORATE DIVIDENDS PRIOR TO AND AFTER THE TCAJA

PRE- AND POST TCAJA/ TYPE OF INTER-CORPORATE DIVIDENDS	TREATMENT PRE-TCAJA	TREATMENT AFTER TCAJA
Dividends from an at least 80% owned sub	Fully deductible by parent; therefore, not subject to tax; this is the case particularly with corporations filing consolidated returns	Same as Pre-TCAJA
Dividends from a corporation that is owned (1) less than 80%, but (2) at least to the extent of 20% by the corporate recipient of the dividends	Deductible to the extent of 80%	Now deductible to the extent of 65%
Dividends from a corporation that is owned less than 20% by the corporate recipient of the dividends	Deductible to the extent of 70%	Now deductible to the extent of 50%

IV THE TCAJA'S DEDUCTION FOR CERTAIN PASS-THROUGH INCOME OF INDIVIDUALS, SECTION 199A[10]

A. INTRODUCTION AND THE ASSUMPTIONS

1. In General

Section 199A, which was added to the Code by the TCAJA, introduces a deduction that has never before been available in the Code: a deduction for certain pass-through business income (*i.e.*, "Qualified Business Income," or "QBI," defined below) earned by owners of (1) sole proprietorships, including single member LLCs; (2) partnerships, including multimember LLCs; and (3) S corporations. As would be expected, there are many twists and turns in this legislation, and before examining the basic operation of Section 199A, it is important to set out what is not discussed here and some basic assumptions.

2. What Is Not Covered Here and the Assumptions

First, in certain cases, the deduction is also available to the owners of REITS, cooperatives, publicly traded partnerships, and specified agricultural or horticultural cooperatives, but this article does not address the deduction for any of these specialized entities. Second, this article assumes that (1) the taxpayer has only one job or one flow-through business, (2) the only income that is applicable is ordinary income from employment or the business, (3) all income is earned in the U.S., and (4) the taxpayer has no capital gain or loss, operating loss, interest income or expense, or dividend income. Third, although Section 199A applies to individuals, trusts, and estates, only its applicability to individuals is considered here. Fourth, the article does not address the special rules applicable to "acquisitions, dispositions, and short taxable years." *See* § 199A(b)(5). Fifth, all of the illustrations are based on the assumption that the taxpayer is married and files a joint return. Sixth, a change in any of these assumptions could result in a change in the analysis and outcome.

Before discussing the complex technical aspects of Section 199A, it is helpful to focus on the big picture, which is discussed next.

B. THE BIG PICTURE: THE ORIGIN OF SECTION 199A AND BASIC ILLUSTRATION OF THE TAX STAKES UNDER IT

1. The Origin of Section 199A

The apparent origin of Section 199A is a tax proposal made by President Trump when he was a candidate for president. Specifically his "Business Tax" proposal said:

- Business Tax

[10] *See generally* Tony Nitti, *Tax Geek Tuesday: Making Sense Of The New '20% Qualified Business Income Deduction*, Forbes (Dec. 26, 2017), available at https://www.forbes.com/sites/anthonynitti/2017/12/26/tax-geek-tuesday-making-sense-of-the-new-20-qualified-business-income-deduction/#29e05bd644fd.

- The Trump Plan will lower the business tax rate from 35 percent to 15 percent, and eliminate the corporate alternative minimum tax. This rate is available to all businesses, both small and large, that want to retain the profits within the business[.][11]

As discussed below, while the proposal was for a 15% rate, the rate adopted by the TCAJA is effectively around 29%. Also, under the original proposal, shareholders of S corporations, and owners of partnerships and LLCs presumably would have received the benefit of the 15% rate only on retained earnings but not on income distributed to the shareholders or owners. As will be seen below, this is not the case with Section 199A, which applies whether the applicable income is retained or distributed.

2. Illustration of the Tax Stakes under Section 199A

As discussed more fully below, Section 199A provides a deduction of 20% of Qualified Business Income ("QBI"), which is generally certain flow-through active business income. Given the maximum individual rate under the TCAJA of 37% (*see* § II.A.2), if all of a taxpayer's income is QBI, after giving effect to the Section 199A deduction, a taxpayer in the 37% bracket would be subject to a rate of approximately 29% on her taxable income prior to the Section 199A deduction.

This general reduction from a top marginal rate of 37% to a top marginal rate of approximately 29% can be illustrated as follows: Assume a taxpayer has $1,000,000 in taxable income all of which is QBI. After taking account of the 20%, or $200,000, Section 199A deduction, the taxable income is reduced to $800,000. With a maximum rate of approximately 37% on the $800,000 of taxable income, the tax would be $296,000 (*i.e.*, .37 X $800,000 = $296,000), which is an approximate 29% rate on the taxable income before the Section 199A deduction.

C. THE FOUR ILLUSTRATIVE TAXPAYERS AND BASKETS OF INCOME

1. The Four Illustrative Taxpayers

In attempting to grasp the basic contours of Section 199A, it is helpful to look at the treatment under the provision of the following four married taxpayers, who file jointly, and their hypothetical three different baskets of ordinary income:

> (1) Stephen Curry, the famous basketball player for the NBA champion Golden State Warriors, who earns all of his income as an employee ("Curry's Employment Income");

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[11] *See e.g.*, Samuel C. Thompson, Jr, *The Clinton vs. Trump Debate on Economic Growth: A Citizen's Guide to the Issues* (Dec. 2016) [Thompson, *The Clinton vs. Trump Debate*], Ch 23, Sec N, available at https://pennstatelaw.psu.edu/citizens%E2%80%99-guide-clinton-vs-trump-debate-economic-growth. Long after the proposal by Trump during the campaign, the provision became known as the "Corker-Kickback." The name is in response to an alleged personal benefit Senator Corker received from an amendment to the provision. *See, e.g.*, David Leonhardt, *The Corker Handout (not Kickback)*, New York Times (Dec. 19, 2017), available at https://www.nytimes.com/2017/12/19/opinion/bob-corker-tax-bill.html.

(2) Steve of Steve's Bike Shop, a sole proprietorship, who earns all of his income from the sale and repair of bikes (Steve's Flow-Through Active Income);[12]

(3) Donald Trump, who earns all of his income from the holding of real estate properties through a sole proprietorship in which he is not actively engaged ("Trump's Flow-Through Passive Real Estate Income"); and

(4) Donald Trump's Lawyer who earns all of his income from the practice of law through his sole proprietorship ("Lawyer's Flow-Through Professional Services Income").

I chose Curry and Steve, because they were singled out in the House Committee Report on its version of the TCAJA, with the Report stating that although Steve would receive a deduction, Curry would not.[13] I chose Trump because it is important to compare his treatment, which will give him a significant deduction, with that of Curry, who will not get the deduction. Finally, I chose Trump's lawyer to illustrate how certain professional service providers can, under certain circumstances, receive the benefit of the deduction.

2. The Three Levels of Income of Our Four Illustrative Taxpayers

For each of these four taxpayers, it is assumed that each taxpayer has the following three mutually exclusive levels of taxable income, all of which is ordinary income earned as employment income or business income within the U.S.:

- Moderate Income: $100,000;
- High Income: $1,000,000; and
- Super-High Income: $30,000,000.

Thus, for purposes of this analysis, we assume that each of our taxpayers (Curry, Steve, Trump, and Trump's Lawyer) each has, in the alternative, these three levels of income: $100,000, $1,000,000, and $30,000,000.

As will be discussed below, Section 199A has two phase-outs. While these two phase-outs are discussed generally below, they are not illustrated with the assumptions here regarding the levels

[12] In this paper the term "flow-through" entity encompasses sole proprietorships, partnerships, and S corporations.

[13] Samuel C. Thompson, Jr., *The Curry/Trump Split in Tax Reform*, Tax Notes 151 (Jan 1, 2018) and Samuel C. Thompson, Jr., *Taxing Trump and Curry under the Republican Plan*, 157 Tax Notes 1149 (Nov. 20, 2017). Specifically, the House Republicans said: "Our legislation will ensure this much-needed tax relief goes to the local job creators it's designed to help by distinguishing between the individual wage income of NBA All-Star Stephen Curry and the pass-through business income of Steve's Bike Shop." The apparent reason the House Republican's chose Curry to indicate a taxpayer who would not get the deduction is because Curry has refused to go to the White House for a celebration with President Trump of the Warriors' NBA victory. I point out in *Taxing Trump and Curry under the House Plan* that a more meaningful comparison under the proposal is (1) the treatment of President Trump compared to the treatment of Curry, rather than (2) the treatment of Steve's Bike Shop compared to the treatment of Curry. And, I go on to show that under the House provision President Trump would get a "huge" tax cut compared to Curry. As demonstrated here, this is also true under the final TCAJA, which followed the Senate Bill.

of income earned by our four illustrative taxpayers, because the Moderate Income assumption of $100,000 is below both phase-outs and the High Income and Super-High Income assumptions are above both phase-outs.

3. Discussion of the Illustrative Taxpayers after a Discussion of the Basic Operation of Section 199A

The discussion of the impact of Section 199A on our four illustrative taxpayers is presented in Section IV.H, after a discussion of the basic operation of Section 199A in Sections IV.D through G.

D. APPLICATION OF SECTION 199A TO PARTNERSHIPS AND S CORPORATIONS

1. In General

Although the examples here are based on the assumption that the Qualified Business Income ("QBI") is earned through a sole proprietorship, similar principles apply to partnerships and S corporations. Section 199A(f)(1)(A) provides: "In the case of a partnership or S corporation—this section shall be applied at the partner or shareholder level[.]" Further, each partner or shareholder is allocated "such person's allocable share" of (1) "Qualified Items," (2) "W-2 Wages," and (3) "unadjusted basis immediately after acquisition of Qualified Property." The terms Qualified Items, W-2 Wages, and Qualified Property are explored below. Section 199A(f)(1)(A) provides guidance on the manner for computing an owner's allocable share of such items.

2. Reasonable Compensation, Guaranteed Payments, and Section 707(a) Payments

a. In General

While Section 199A applies to QBI allocated to partners and shareholders of S corporations, it does not apply to (1) reasonable compensation paid to shareholders of S corporations, and (2) guaranteed payments and Section 707(a) payments made to partners. *See* § 199A(c)(4). Guaranteed payments under Section 707(c) are payments to a partner that are "determined without regard to the income of the partnership," and Section 707(a) payments include payments to a partner made pursuant to "transactions with a partnership other than [the partner's] capacity as [a partner]."

In describing the Senate Amendment, which generally was followed in the Conference, the Conference Report explains:

> Qualified Business Income does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer. Similarly, qualified business income does not include any guaranteed payment for services rendered with respect to the trade or business, [§ 707(c)] and to the extent provided in regulations, does not include any amount paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services. [§ 707(a)]

Section 199A does not seem to require a (1) payment of reasonable compensation, or (2) Section 707(a) or (c) payment, but rather simply provides that QBI does not include such payments. This approach is different from the approach of the House bill, which treated only the "capital percentage" of business income, generally 30%, as QBI. However, for the reasons stated in Section III.D, it is clear that in the case of an S corporation, the IRS can require a payment of reasonable compensation.

It would appear that the Treasury does not have the authority under Section 199A to treat any portion of the compensation of a partner or proprietor as reasonable compensation.

b. Is There a Policy Justification for Treating S Corporations Different from Sole Proprietorships and Partnerships?

There would seem to be no tax policy justification under Section 199A for the application of the reasonable compensation concept to an S corporation, but not to its sister pass-through entities, that is, a sole proprietorship and a partnership. This is particularly the case given that a sole proprietorship and a partnership can be organized as an LLC. From a policy perspective, amounts that are in economic substance attributable to services rendered should be excluded from the QBI concept without respect to the form of the entity: sole proprietorship, partnership, or S corporation.

For certainty on the treatment of reasonable compensation under Section 199A, we will have to await regulations.

E. BRIEF INTRODUCTION TO A SPECIFIED SERVICE TRADE OR BUSINESS ("SSTorB") AND A NON-SSTorB

Special rules are applicable to a Specified Service Trade or Business ("SSTorB"), which is generally a professional services flow-through business like, for example, a law firm or accounting firm. These rules are explored in Section IV.E, and Section IV.H illustrates the application of these rules to the Lawyer's Flow-Through Professional Services Income.

Section IV.F discusses the general operation of Section 199A in the context of a Non-SSTorB, such as Steve's Bike Shop and Trump's real estate business.

F. INTRODUCTION TO SECTION 199A, QUALIFIED BUSINESS INCOME OF A NON-SSTorB

1. In General

Section 199A(a) provides that "a taxpayer other than a corporation [*i.e.*, an individual, including an individual partner or S shareholder] [is] allowed as a deduction for any taxable year an amount equal to the sum of" the amounts specified in (1) Section 199A(a)(1) (the "Section 199A(a)(1) Deduction Amount"), and (2) Section 199A(a)(2) (the "Section 199A(a)(2) Deduction Amount").

The Section 199A(a)(2) Deduction Amount is zero if there are no cooperative dividends, which is the assumption here. Consequently, the balance of the analysis addresses the computation of the Section 199A(a)(1) Deduction Amount, which is the amount of the deduction allowed under Section 199A(a)(1).

2. The Section 199A(a)(1) Deduction Amount and the Section 199A(b)(2) C-QBIA Deduction Amount for a Non-SSTorB

a. Introduction

The Section 199A(a)(1) Deduction Amount is equal to the "*lesser of*—(A) the Combined Qualified Business Income Amount [the "C-QBIA"] of the taxpayer or (B) an amount equal to 20 percent of the . . . taxable income of the taxpayer for the taxable year[.]" *See* § 199A(a)(1)(A) and (B). As discussed below, unless limited, the C-QBIA is 20% of the QBI. For purposes of the discussion here, it is assumed that the C-QBIA is not more than 20% of the taxpayer's taxable income, which would normally be the case. Thus, in all the situations analyzed here, the Section 199A(a)(1) Deduction Amount is equal to the C-QBIA, which is defined in Section 199A(b) and is referred to here as the "Section 199A(b)(2) C-QBIA Deduction Amount," discussed next.

b. The Combined Qualified Business Income Amount (C-QBIA) for a Non-SSTorB, Section 199A(b)(2)

i. *C-QBIA In General*

Section 199A(b)(1) defines C-QBIA as an amount equal to the "sum of (1) the amounts determined under paragraph (2) for each Qualified Trade Or Business ["QTorB"] carried on by the taxpayer," plus (2) certain amounts related to REITs and publicly traded partnerships, not discussed here.

The term QTorB is defined in the next subsection, and as noted, the assumption here is that there is just one QTorB; thus, the C-QBIA for each of the taxpayers considered here is the amount determined under Section 199A(b)(2) for the taxpayer's QTorB (the "Section 199A(b)(2) C-QBIA Deduction Amount").

To summarize, in the discussion here, the Section 199A(a)(1) Deduction Amount is the same as the Section 199A(b)(2) C-QBIA Deduction Amount, which is the term used hereafter in describing the deduction under Section 199A. Before determining the Section 199A(b)(2) C-QBIA Deduction Amount, it is necessary to look at the definition of QTorB, which is examined next.

ii. *Definition of Qualified Trade or Business [QTorB]--a Non-SSTorB*

The term QTorB is defined in Section 199A(d)(1) to mean "any trade or business other than—(A) a Specified Service Trade or Business ["SSTorB"], or (B) the trade or business of performing services as an employee [the "Employee Exception"]." It first should be noted that the statute does not define the term "trade or business," and consequently, in interpreting that term, advisers must look be general principles such as Revenue Ruling 73-522, 1973-2 C.B. 226, which held that net leasing does not constitute a trade or business.

Under the "Employee Exception" under Section 199A(d)(1)(B), Curry's activities as an employee do not constitute a QTorB. And, under the "SSTorB Exception" to the QTorB concept in Section 199A(d)(1)(A), the income earned in an SSTorB, such as the Lawyer's Flow-Through Professional Services Income, will not qualify for the Section 199A(a) deduction. However, as will be seen below, there is a big exception to this exception for certain income from an SSTorB (the "Exception to the SSTorB Exception"). However, before considering (1) the SSTorB Exception, and (2) the Exception to the SSTorB Exception, we first determine the Section 199A(b)(2) C-QBIA Deduction Amount for a QTorB that is a Non-SSTorB.

Two illustrations of QTorBs that are Non-SSTorB are (1) Steve's Bike shop, and (2) Trump's real estate business. To summarize these general conclusions with respect to our four illustrative taxpayers:

- Curry's employment income does not qualify for the C-QBIA Deduction,
- Steve's and Trump's flow-through Non-SSTorB business income does qualify for the C-QBIA Deduction, and
- The Lawyer's flow-through SSTorB business income qualifies, as will be seen below, only to a limited extent.

iii. *Computation of the Section 199A(b)(2) C-QBIA Deduction Amount for a Non-SSTorB*

(a) In General

This section examines the computation of the Section 199A(b)(2) C-QBIA Deduction Amount for a Non-SSTorB such as Steve's Bike Shop and Trump's real estate business. Section 199A(b)(2), which sets out the amount of the C-QBIA deduction, provides:

> (2) *Determination of deductible amount for each trade or business*.— The amount determined under this paragraph with respect to any Qualified Trade Or Business is the *lesser of*—
>
> > (A) 20 percent of the taxpayer's Qualified Business Income ["QBI"] with respect to the Qualified Trade Or Business [the "20% of QBI Limitation"], or
> >
> > (B) the greater of— (i) 50 percent of the W–2 wages with respect to the Qualified Trade Or Business [the "50% of W-2 Wages Limitation"], or (ii) the sum of 25 percent of the W–2 wages with respect to the Qualified Trade Or Business [the "25% of W-2 Wages"], plus 2.5 percent of the unadjusted basis immediately after acquisition of all Qualified Property ["QP" and "2.5% of QP" and the "25% of W-2 Wages--2.5% of QP Limitation"].

Before considering the definitions of (1) QBI, which is the flow-through business income that qualifies for the deduction, (2) W-2 Wages, and (3) QP, it is helpful to summarize this provision.

The Section 199A(b)(2) C-QBIA Deduction Amount for a Non-SSTorB is the lesser of (1) the 20% of QBI Limitation, and (2) the greater of (a) the 50% of W-2 Wages Limitation, and (b) the 25% of W-2 Wages--2.5% of QP Limitation. One way of making sense of this formula is to say there are in essence two limitations that matter, and the Section 199A(b)(2) C-QBIA Deduction Amount is the lesser of these two. The first limitation is the 20% of QBI Limitation. The second limitation is either (1) the 50% of W-2 Wages Limitation, or (2) the 25% of W-2 Wages--2.5% of QP Limitation, whichever is larger. And, the Section 199A(b)(2) C-QBIA Deduction Amount is the lesser of the two limitations.

The greater of (1) the 50% of W-2 Wages Limitation, and (2) the 25% of W-2 Wages--2.5% of QP Limitation, is referred to here as the "Potential Cutback on the 20% C-QBIA Deduction." As long as this Potential Cutback on the 20% C-QBIA Deduction is larger than 20% of QBI, there is no cutback. It would appear that in every case taxpayers will prefer that the Potential Cutback on the 20% C-QBIA Deduction exceed the 20% of QBI Limitation. In such case, the taxpayer will receive the maximum Section 199A(b)(2) C-QBIA Deduction Amount.

We next (1) examine the definitions of QBI, W-2 Wages, and QP, (2) illustrate the computation of the Section 199A(b)(2) C-QBIA Deduction Amount for a Non-SSTorB, and (3) look at the phase-in rule that applies to the Potential Cutback on the 20% C-QBIA Deduction, that is, the greater of the 50% of W-2 Wages Limitation and the 25% of W-2 Wages--2.5% of QP Limitation.

(b) Definition of Qualified Business Income, QBI and Qualified Items of Income et. cet., QI

QBI is defined in Section 199A(c) as "for any taxable year, the net amount of Qualified Items Of Income, Gain, Deduction, And Loss ["QI"] with respect to any qualified trade or business [QTorB] of the taxpayer."

QI is defined in Section 199A(c)(3)(A) as the "items of income, gain, deduction, and loss to the extent such items are—(i) effectively connected with the conduct of a trade or business within the United States . . ., and (ii) included or allowed in determining taxable income for the taxable year." As indicated, the assumption here is that all of the income is U.S. business income and, therefore, qualifies as QI.

Passive income, such as dividends and investment interest, are not included in QI, *see* § 199A(c)(3)(B), and a special rule applies to the carryover of a QBI loss, *see* § 199A(c)(2). These concepts are not discussed further here.

To simplify the analysis, the assumption here is that all of the taxable income earned by Steve, Trump, and the lawyer is QBI and that they have no other income. As indicated, all of Curry's income is employment income and, therefore, is not earned in a QTorB.

(c) Definition of W-2 Wages in the 50% of W-2 Wages Limitation

W-2 Wages are defined, in essence, as the wages that are (1) attributable to a QBI, (2) subject to withholding, and (3) paid "with respect to employment of employees by such person during the calendar year ending during such taxable year." *See* § 199A(b)(4). Thus, the W-2 Wages are all of wages paid by a QTorB with respect to QBI. Obviously, the larger the wages, the larger the 50% of W-2 Wages Limitation.

As noted in Section IV.D.2, payments made to a partner under Section 707(c) (*i.e*., guaranteed payments) and Section 707(a) (*i.e*., transactions other than in the capacity of partner) are treated the same as reasonable compensation in determining what does not constitute QBI. However, such payments to partners presumably do not constitute W-2 Wages for purposes of computing the limitations on the deduction for QBI. If these payments were treated like W-2 Wages for purposes of the limitation, there could be a larger C-QBIA Deduction Amount.

(d) Definition of Qualified Property, QP, in the W-2 Wages--2.5% of QP Limitation

Qualified Property (QP) means "with respect to any Qualified Trade Or Business [QTorB] for a taxable year, tangible property of a character subject to the allowance for depreciation under section 167" that satisfies the following three conditions: (1) the property is "held by, and available for use in, the Qualified Trade Or Business at the close of the taxable year," (2) the property is "used at any point during the taxable year in the production of Qualified Business Income," and (3) the "depreciable period [generally 10 years] for [the property] has not ended before the close of the taxable year." *See* § 199A(b)(6). Thus, QP generally will be most of the depreciable property held by the QTorB.

Note that in the 25% of W-2 Wages--2.5% of QP Limitation, if, for example, the QP is 100, then 2.5 would enter into the computation of the Limitation. Obviously, the larger the capital base (*i.e*., the depreciable base) of the QTorB, the larger the Limitation and the more likely there would be no limitation on the deduction of 20% of QBI.

(e) Illustration of the Computation of the Section 199A(b)(2) C-QBIA Deduction Amount

As discussed above, the Section 199A(b)(2) C-QBIA Deduction Amount for a Non-SSTorB is the lesser of two limitations. The first limitation is the 20% of QBI Limitation. The second limitation is either (1) the 50% of W-2 Wages Limitation, or (2) the 25% of W-2 Wages--2.5% of QP Limitation, whichever is larger. As noted these latter two limitations are referred to jointly as the Potential Cutback on the 20% C-QBIA Deduction.

These limitations can be illustrated as follows: Assume that QBI is 100, W-2 Wages is 60, and QP is 100. In such case the three limitations are as follows:

(1) the 20% of QBI Limitation is 20 (*i.e.*, 20% of 100 = 20) ,
(2) the 50% of W-2 Wages Limitation is 30 (*i.e*., 50% of 60 = 30), and
(3) the 25% of W-2 Wages--2.5% of QP Limitation is 17.5 (*i.e.*, (25% of 60 = 15)+(2.5% of 100=2.5), (15+2.5 = 17.5)).

Thus, (1) the 50% of W-2 Wages Limitation of 30 exceeds that 20% of QBI Limitation, and (2) the 25% of W-2 Wages--2.5% of QP Limitation of 17.5 is less than the 20% of QBI Limitation.

Since the greater of these Potential Cutbacks on the 20% C-QBIA Deduction (*i.e.*, 30) exceeds 20% of the QBI (*i.e.*, 20), the Section 199A(b)(2) C-QBIA Deduction Amount is 20.

(f) No Carryover of Excess Limitation

For a taxable year, the 20% of QBI Limitation will likely be either higher or lower than the higher of (1) the 50% of W-2 Wages Limitation, or (2) the 25% of W-2 Wages--2.5% of QP Limitation. These latter two limitations are referred to as the "Wage or Wage-QP Limitation." In any event, either an excess of (1) the 20% of QBI Limitation, over (2) the Wage or Wage-QP Limitation, or an excess of (1) the Wage or Wage-QP Limitation, over (2) the 20% of QBI Limitation will not be carried back or forward to another year. Thus the C-QBIA Deduction Amount is determined on a year by year basis.

(g) Discussion of the Principles behind the Three Limitations

The computation of the 20% of QBI Limitation is straightforward once the amount of QBI has been determined. The 50% of W-2 Wages Limitation is also straightforward once the W-2 Wages of the QTorB has been determined. Notice that the greater the W-2 Wages paid by the QTorB, the larger the 50% of W-2 Wages Limitation. As long as 50% of the W-2 Wages of a QTorB exceeds the 20% of QBI Limitation, the taxpayer will be able to deduct 20% of QBI. Thus, if a QTorB has substantial W-2 Wages, it is likely that 50% of such wages will exceed the 20% of QBI Limitation, and consequently, the taxpayer will receive a deduction for 20% of QBI.

On the other hand, if a QTorB has (1) a large amount of QBI, and (2) a small amount of W-2 Wages, there could be a significant restraint on the ability to deduct 20% of QBI. The confluence of these two factors likely will occur with QTorBs that are successful real estate developers like Trump. As I understand it, these real estate developers generally have large amounts of income and capital, but because of the use of independent contractors, they have small numbers of employees. Thus, under the Senate Bill, real estate developers were unlikely to receive the full benefit of the 20% of QBI deduction.

The Conference addressed this conundrum by adding to the Code the 25% of W-2 Wages--2.5% of QP Limitation. The Conference Report explains:

> The conference agreement modifies the wage limit applicable to taxpayers with taxable income above the threshold amount to provide a limit based either on wages paid or on wages paid plus a capital element. Under the conference agreement, the limitation is the greater of (a) 50 percent of the W-2 wages paid with respect to the qualified trade or business, or (b) the sum of 25 of percent of the W-2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property.
>
> For purposes of the provision, qualified property means tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the taxable year, and which is used in the production of qualified business income, and for which the depreciable period has not ended before the close of the taxable year. The depreciable period with respect to qualified property of a taxpayer

means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (a) the date 10 years after that date, or (b) the last day of the last full year in the applicable recovery period that would apply to the property under section 168 (without regard to section 168(g)).

For example, a taxpayer (who is subject to the limit) does business as a sole proprietorship conducting a widget-making business. The business buys a widget-making machine for $100,000 and places it in service in 2020. The business has no employees in 2020. The limitation in 2020 is the greater of (a) 50 percent of W-2 wages, or $0, or (b) the sum of 25 percent of W-2 wages ($0) plus 2.5 percent of the unadjusted basis of the machine immediately after its acquisition: $100,000 x .025 = $2,500. The amount of the limitation on the taxpayer's deduction is $2,500.[14]

It is certainly conceivable that Trump's tax lawyer or other tax advisor could have been instrumental in having the Conference Committee adopt this provision, because it seems to be targeted to benefit taxpayers like Trump whose businesses have large capital bases.

(h) Quick Rule of Thumbs Regarding the Applicability of the Three Limitations

As a quick rule of thumb for determining whether there is likely to be a limitation on the deduction for 20% of QBI, the following four-step process could be followed.

First, determine the amount of the QBI, say 100.

Second, determine if the W-2 Wages of the QBI are at least 40% of the QBI, that is, 40. If so, the taxpayer will be allowed the full deduction for 20% of QBI because the 50% of W-2 Wages Limitation (20) is equal to the 20% of QBI Limitation.

Third, assuming there are no W-2 Wages, determine if the QI is at least 800% of the QBI, that is, 800. If so, the taxpayer will be allowed the full deduction for 20% of QBI because 2.5% of 800, the 800 capital base, is 20.

Fourth, if the Second and Third Steps do not result in the full deduction of 20% of QBI, determine if the computation of 25% of W-2 Wages plus 2.5% of QP are at least equal to 20% of QBI. If so, there is no limitation.

(i) Phase-in of the (1) 50% of W-2 Wages Limitation, and (2) the 25% of W-2 Wages--2.5% of QP Limitation: The Ratable Reduction Concept

(i) General Principles

The 50% of W-2 Wages Limitation and the 25% of W-2 Wages--2.5% of QP Limitation (the "Potential Cutback on the 20% C-QBIA Deduction") for Non-SSTorB QBI are phased-in pursuant to Section 199A(b)(3), which sets out the following three rules:

[14] Wolters Kluwer, *Explanation of the TCAJA, supra* note 1, at 775.

- *Potential Cutback on the 20% C-QBIA Deduction Not Applicable*,
- *Potential Cutback on the 20% C-QBIA Deduction Fully Applicable*, and
- *Ratable Reduction Concept*.

(ii) First Rule, Potential Cutback on the 20% C-QBIA Deduction Not Applicable

Pursuant to Section 199A(b)(3)(A), the Potential Cutback on the 20% C-QBIA Deduction does not apply if the taxpayer's taxable income does not exceed the "Threshold Amount," which is $157,500 for single taxpayers and $315,000 for taxpayers filing joint returns, adjusted for inflation. *See* § 199A(b)(3)(A) and § 199A(e)(2). (As noted, only the joint return is discussed here.)

In such case, the Section 199A(b)(2) C-QBIA Deduction Amount for a Non-SSTorB is equal to 20% of QBI. Thus, for example, if taxable income and QBI are $300,000, the Section 199A(b)(2) C-QBIA Deduction Amount is $60,000 (*i.e*., 20% of $300,000).

(iii) Second Rule, Potential Cutback on the 20% C-QBIA Deduction Fully Applicable

If the taxpayer's taxable income exceeds the Threshold Amount, plus "$100,000 in the case of a joint return," the Potential Cutback on the 20% C-QBIA Deduction is fully applicable. Thus, if the taxpayer filing a joint return has, for 2018, taxable income exceeding $415,000 (*i.e*., $315,000 plus $100,000), the Potential Cutback on the 20% C-QBIA Deduction is fully applicable. For example, assume that the taxpayer has (1) $500,000 of taxable income and QBI, (2) W-2 Wages of $100,000, and (3) no QP. In such case, (1) the 20% of QBI Limitation is $100,000 (*i.e*., 20% of $500,000), and (2) the 50% of W-2 Wages Limitation is $50,000 (*i.e*., 50% of $100,000). Consequently, the Section 199A(b)(2) C-QBIA Deduction Amount is $50,000, which is the lesser of (1) the 20% of QBI Limitation (*i.e*., $100,000) and (2) the 50% of W-2 Wages Limitation (*i.e*., $50,000).

(iv) Third Rule, the Ratable Reduction Concept

In a very complex provision, Section 199A(b)(3)(B), which is titled "Phase-In of Limit for Certain Taxpayers," sets out what is referred to here as the "Ratable Reduction Concept." This concept applies if the following two conditions are satisfied.

(1) First, the taxpayer's taxable income is between the (a) Threshold Amount (*i.e*., $315,000), and (b) the Threshold Amount plus $100,000 (*i.e*., $415,000). This range of taxable incomes is referred to here as the "Ratable Reduction Concept Range." Note that (a) where taxable income is less than the Threshold Amount, the Potential Cutback on the 20% C-QBIA Deduction Are Not Applicable, and (b) where taxable income is more than the Threshold Amount plus $100,000, the Potential Cutback on the 20% C-QBIA Deduction Are Fully Applicable.

(2) Second, "[t]he amount determined under paragraph (2)(B) [*i.e*., the Potential Cutback on the 20% C-QBIA Deduction] . . . is less than the amount determined under paragraph (2)(A) [*i.e*., the 20% of QBI Limitation][.]" Note that when the *Potential Cutback on the 20% C-QBIA Deduction Is Fully Applicable*, the Section 199A(b)(2)

C-QBIA Deduction Amount is the lesser of (a) the 20% of QBI Limitation, and (b) the Potential Cutback on the 20% C-QBIA Deduction.

Where these two conditions are satisfied (*i.e*., (1) income is within the Ratable Reduction Concept Range, and (2) the Potential Cutback on the 20% C-QBIA Deduction is less than the 20% of QBI Limitation), the Section 199A(b)(2) C-QBIA Deduction Amount "shall be applied . . . [1] without regard to subparagraph (B) [*i.e*., the Potential Cutback on the 20% C-QBIA Deduction] thereof and [2] by reducing the amount determined under subparagraph (A) [*i.e*., the 20% of QBI Limitation] . . . by the amount determined under clause (ii) [*i.e*., the "Ratable Reduction Concept"]." Thus, the 20% of QBI Limitation continues to apply, but subject to the Ratable Reduction Concept.

To summarize, if (1) the taxpayer's taxable income is within the Ratable Reduction Concept Range (*i.e*., for 2018, between $315,000 and $415,000), and (2) the Potential Cutback on the 20% C-QBIA Deduction is less than the 20% of the QBI Limitation, then under the Ratable Reduction Concept there is a Ratable Reduction in the amount of the Section 199A(b)(2) C-QBIA Deduction Amount.

This leads us to the Ratable Reduction Concept in Section 199A(b)(3)(B)(ii); it provides that the "[a]mount of reduction . . . is the amount which bears the same ratio to the Excess Amount as—(I) the amount by which the taxpayer's taxable income for the taxable year exceeds the threshold amount, bears to (II) . . . $100,000 in the case of a joint return[.]"

The "Excess Amount" is defined in Section 199A(b)(3)(B)(iii) as "the excess of—(I) the amount determined under paragraph (2)(A) [*i.e*., the 20% of QBI Limitation], over (II) the amount determined under paragraph (2)(B) [*i.e*., the Potential Cutback on the 20% C-QBIA Deduction].

This Ratable Reduction Concept can be expressed mathematically as follows:

Amount of Reduction = X, where:

X/Excess Amount = [Taxable Income-Threshold Amount]/$100,000

(v) Illustration of Ratable Reduction Concept

This Ratable Reduction Concept is best illustrated by an example, which is based on the following three factual assumptions:

First, assume that the taxpayer has taxable income is $365,000, which means that the taxable income exceeds the Threshold Amount (*i.e*., $315,000) by $50,000 and is within the Ratable Reduction Concept Range.

Second, assume that all of the taxable income is QBI, and consequently the 20% QBI Limitation is $73,000 (*i.e*., 20% of $365,000). Note that in the absence of the Ratable Reduction Concept, the taxpayer would have a $73,000 Section 199A(b)(2) C-QBIA Deduction Amount. However, because the taxpayer's taxable income (*i.e*., $365,000) exceeds the Threshold Amount (*i.e*., $315,000), but does not exceed the Threshold Amount plus $100,000 (*i.e*., $415,000), the Ratable Reduction Concept applies.

Third, assume that the 50% Wage Limitation applies for purposes of the Potential Cutback on the 20% C-QBIA Deduction (*i.e*., the 50% Wage Limitation exceeds the 25% of W-2 Wages--2.5% of QP Limitation), and there is $100,000 of W-2 Wages. Consequently, this gives rise to a 50% W-2 Wage Limitation of $50,000. Thus, if the Potential Cutback on the 20% C-QBIA Deduction were fully applicable, the Section 199A(b)(2) C-QBIA Deduction Amount would be limited to $50,000.

Fourth, since the $73,000 20% of QBI Limitation exceeds the $50,000 50% Wage Limitation, there is an Excess Amount in the amount of $23,000. This Excess Amount is subject to reduction by the Ratable Reduction Concept.

To summarize these assumptions (1) taxable income is $365,000, (2) the 20% QBI Limitation is $73,000, (3) the 50% Wage Limitation, which is applicable, is $50,000, and (4) the Excess Amount is $23,000.

With the above data we can now turn to the formula for determining the amount of the reduction (X) in the Ratable Reduction Concept:

Amount of Reduction = X, where:

X/Excess Amount = [Taxable Income-Threshold Amount]/$100,000 =

X/Excess Amount ($23,000) = [Taxable Income ($365,000) – Threshold Amount $315,000)]/$100,000 =

X/$23,000 = $50,000/$100,000

X = $11,500

Thus, the Section 199A(b)(2) C-QBIA Deduction Amount is $73,000 - $11,500 or $61,500. As noted, the $11,500 disallowed amount is not carried over.

(vi) Summary of the Ratable Reduction Concept

To summarize: The Ratable Reduction Concept applies when (1) the taxpayer's taxable income is within the Ratable Reduction Range, and (2) the Potential Cutback on the 20% C-QBIA Deduction Amount is less than the 20% of QBI Limitation. In such case, there is a Ratable Reduction in the Section 199A(b)(2) C-QBIA Deduction Amount. For the balance of the discussion it is assumed that the Ratable Reduction Concept is not applicable.

G. THE "SSTorB EXCEPTION" AND THE "EXCEPTION TO THE SSTorB EXCEPTION"

1. In General

This section addresses the "SSTorB Exception" to the QTorB concept, and the "Exception to the SSTorB Exception." Recall that under the assumptions here, each taxpayer is conducting only one trade or business.

2. The Specified Service Trade of Business (SSTorB), Exception to QTorB

As discussed above, C-QBIA includes income from a taxpayer's QTorB, and pursuant to the SSTorB Exception, an SSTorB is not a QTorB. As the first principle in defining the term SSTorB, Section 199A(d)(2)(A) defines it to mean "any trade or business [of an employee or owner]—(A) which is described in section 1202(e)(3)(A)[.]" Section 1202(e)(3)(A) encompasses "any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees."[15]

As the second principle, Section 199A(d)(2)(A) provides that the trades or businesses described in Section 1202(e)(3)(A) are to be "applied without regard to the words 'engineering [and] architecture[.]'" Thus, while, for example, law and accounting fall within the term SSTorB, engineering and architecture do not. Consequently, income earned by, for example, Trump's Lawyer is SSTorB, but the income earned by Trump's architect is not.

Under the third principle, under Section 199A(d)(2)(B), SSTorB includes any trade or business "(B) which involves the performance of services that consist of investing and investment management, trading, or dealing in securities . . ., partnership interests, or commodities[.]" Thus, investment advisory and investment banking services are included within the term SSTorB.

To reiterate, under this SSTorB Exception, income from SSTorB generally will not qualify for the Section 199A deduction. Now we turn to the exception to the exception.

3. The Exception to the SSTorB Exception

Under Section 199A(d)(3), an "Exception to the SSTorB Exception" applies "[i]f, for any taxable year, the taxable income of any taxpayer is less than the sum of the threshold amount [$157,500 for single taxpayers and $315,000 for joint returns, adjusted for inflation, *see* § 199A(e)(2)] plus $50,000 ($100,000 in the case of a joint return)[.]"

If the taxable income is less than the threshold amount, the SSTorB Exception is not applicable. Thus, for example, if a married lawyer or accountant who files a joint return has less than $315,000 in taxable income for 2018, the SSTorB Exception is not applicable. On the other hand, if the same lawyer or accountant has more than $415,000 of taxable income in 2018, the

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[15] For an exploration of this "reputation or skill" concept, *see e.g.*, Martin A. Sullivan, *Economic Analysis: Do Skills and Reputation Nix the Passthrough Deduction?*, 158 Tax Notes 1320 (March 5, 2018).

SSTorB Exception is fully applicable, and the taxpayer gets no benefit from Section 199A. And, if the taxpayer's income is between $315,000 and $415,000 (the "SSTorB Exception Phase-Out Range"), pursuant to Section 199A(d)(3), the SSTorB Exception is phased-out over that range pursuant to a complex formula, not examined here. As indicated, the threshold amounts are indexed for inflation.

The application of this Exception to the SSTorB Exception is illustrated below when considering the taxation of the Lawyer's Professional Services Income.

H. APPLICATION OF SECTION 199A TO THE FOUR ILLUSTRATIVE TAXPAYERS

This section discusses the impact on each of the four illustrative taxpayers (*i.e.*, Curry, Steve, Trump, and Trump's Lawyer) of the standard rates of tax for 2018 under Section 1, as enacted by the TCAJA. There are three different levels of assumed taxable income adjusted, where applicable, for the Section 199A deduction. It is also assumed that (1) all of the taxable income of Steve and Trump is QBI, and (2) because Steve, Trump, and Trump's Lawyer are active in the business, none of the income is subject to the Obamacare 3.8% tax on Net Investment Income (*see* § 1411).

The computations are made on the assumption that these four taxpayers have, in the alternative, the following amounts of taxable income, before taking into account the deduction, if any, under Section 199A: $100,000, $1,000,000, and $30,000,000. None of these levels of taxable income are within (1) the Ratable Reduction Concept Range, or (2) the SSTorB Exception Phase-Out Range. For 2018, both ranges are $315,000 to $415,000.

In each case, it is assumed that the Potential Cutback on the 20% C-QBIA Deduction exceeds 20% of the QBI, and therefore, the Section 199A(b)(2) C-QBIA Deduction Amount, if applicable, is equal to 20% of the Taxable Income/QBI. As a back-of-the-hand reality check on this conclusion, in the case of Steve's Bike Shop, it is likely that 50% of his firm's W-2 Wages would equal at least 20% of his QBI. And, in the case of Trump, who presumably does not have significant W-2 Wages, it seems reasonable to assume that 2.5% of his QP, that is, depreciable base, is likely to be more than the 20% of QBI Limitation. Thus, for Trump, where the taxable income and QBI is assumed to be $1,000,000, 20% of QBI is $200,000, and his QP would have to be 800% of his taxable income or $8,000,000. If this were so, the Section 199A(b)(2) C-QBIA Deduction Amount would equal 20% of QBI, because 2.5% of $8,000,000 = $200,000. In general, with Trump, it seems safe to assume that his QP would likely be at least 800% of his taxable income and QBI.

As noted previously, QBI does not include reasonable compensation paid by an S corporation or 707(a) or (c) payments made by a partnership to a partner. The assumption here is that all of the income is earned as an employee in the case of Curry and as sole proprietors in the case of Steve, Trump and Trump's Lawyer. The payment of a $1 of reasonable compensation, would reduce the Section 199A(b)(2) C-QBIA Deduction Amount by 20 cents.

These computations are made on the following tables: Table A, Curry; Table, B, Steve; Table C, Trump; Table D, Trump's Lawyer; and Table E, Summary. As previously indicated, the computations are made on the assumption that each taxpayer has taxable income of $100,000, $1,000,000, or $30,000,000.

(a) SECTION IV.H, TABLE A, COMPUTATION OF TAX LIABILITY FOR CURRY

ILLUSTRATIVE TAXPAYER: CURRY	**Moderate Income Taxpayer: $100,000 of Taxable Income/QBI**	**High Income Taxpayer: $1,000,000 of Taxable Income/QBI**	**Super-High Income Taxpayer: $30,000,000 of Taxable Income/ QBI**
Curry's Employment Income. Note that this income does not qualify in any respect for the Section 199A deduction	Taxed on Full $100,000 of Taxable Income under Section 1, at (1) $8,907, plus (2) 22% of the Excess Over $77,400 (*i.e.*, 22% of $22,600 = $4,972), which is a Tax Liability of $13,879 or 13.8% of Taxable Income	Taxed on Full $1,000,000 of Taxable Income under Section 1, at (1) $161,379, plus (2) 37% of the Excess Over $600,000 (*i.e.*, 37% of $400,000 = $148,000), which is a Tax Liability of $309,379 or 31% of Taxable Income	Taxed on Full $30,000,000 of Taxable Income under Section 1, at $161,379 plus 37% of the Excess Over $600,000 (*i.e.*, 37% of $29,400,000 = $10,878,000); thus, tax liability is $161,379 + $10,878,000, which is $11,039,379 or 36% of Taxable Income

(b) SECTION IV.H, TABLE B, COMPUTATION OF TAX LIABILITY FOR STEVE

ILLUSTRATIVE TAXPAYER: STEVE	**Moderate Income Taxpayer: $100,000 of Taxable Income/QBI**	**High Income Taxpayer: $1,000,000 of Taxable Income/QBI**	**Super-High Income Taxpayer: $30,000,000 of Taxable Income/ QBI**
Steve's Flow-Through Active Income	Receives the Deduction for 20% of QBI and, therefore, has $80,000 of Taxable Income subject to tax under § 1 at (1) $8,907, plus (2) 22% of the Excess Over $77,400 (*i.e.*, 22% of $2,600 = $572), which is a Tax Liability of $9,479 or 9.5% of Taxable Income before the Section 199A Deduction. Note that if Steve operated as an S or partnership and there were reasonable compensation or Section 707(a) or (c) payments to Steve, there would be a reduction in the amount of QBI.	Receives the Deduction for 20% of QBI and, therefore, has $800,000 of Taxable Income subject to tax under § 1 at (1) $161,379, plus (2) 37% of the Excess Over $600,000 (*i.e.*, 37% of $200,000 = $74,000), which is a Tax Liability of $235,379 or 24% of Taxable Income before the Section 199A Deduction. Note that if Steve operated as an S or partnership and there were reasonable compensation or Section 707(a) or (c) payments to Steve, there would be a reduction in the amount of QBI.	Receives the Deduction for 20% of QBI and, therefore, has $24,000,000 of Taxable Income subject to tax under § 1 at (1) $161,379, plus (2) 37% of the Excess Over $600,000 (*i.e.*, 37% of $23,400,000 = $8,658,000), which is a Tax Liability of $8,819,379 or 29% of Taxable Income before the Section 199A Deduction. Note that if Steve operated as an S or partnership and there were reasonable compensation or Section 707(a) or (c) payments to Steve, there would be a reduction in the amount of QBI.

(a) SECTION IV.H, TABLE C, COMPUTATION OF TAX LIABILITY TRUMP

ILLUSTRATIVE TAXPAYER: TRUMP	**Moderate Income Taxpayer: $100,000 of Taxable Income/QBI**	**High Income Taxpayer: $1,000,000 of Taxable Income/QBI**	**Super-High Income Taxpayer: $30,000,000 of Taxable Income/ QBI**
Trump's Flow-Through Passive Real Estate Income	Receives the Deduction for 20% of QBI and, therefore, has $80,000 of Taxable Income subject to tax under § 1 at (1) $8,907, plus (2) 22% of the Excess Over $77,400 (*i.e.*, 22% of $2,600 = $572), which is a Tax Liability of $9,479 or 9.5% of Taxable Income before the Section 199A Deduction. Note, President Trump has a full-time job, and consequently, there would be no reasonable compensation or Section 707(a) or (c) payments if he operated as an S corporation or partnership.	Receives the Deduction for 20% of QBI and, therefore, has $800,000 of Taxable Income subject to tax under § 1 at (1) $161,379, plus (2) 37% of the Excess Over $600,000 (*i.e.*, 37% of $200,000 = $74,000), which is a Tax Liability of $235,379 or 24% of Taxable Income before the Section 199A Deduction. Note, President Trump has a full-time job, and consequently, there would be no reasonable compensation or Section 707(a) or (c) payments if he operated as an S corporation or partnership.	Receives the Deduction for 20% of QBI and, therefore, has $24,000,000 of Taxable Income subject to tax under § 1 at (1) $161,379, plus (2) 37% of the Excess Over $600,000 (*i.e.*, 37% of $23,400,000 = $8,658,000), which is a Tax Liability of $8,819,379 or 29% of Taxable Income before the Section 199A Deduction. Note, President Trump has a full-time job, and consequently, there would be no reasonable compensation or Section 707(a) or (c) payments if he operated as an S corporation or partnership.

(a) SECTION IV.H, TABLE D, COMPUTATION OF TAX LIABILITY FOR TRUMP'S LAWYER

ILLUSTRATIVE TAXPAYER: TRUMP'S LAWYER	**Moderate Income Taxpayer: $100,000 of Taxable Income/QBI**	**High Income Taxpayer: $1,000,000 of Taxable Income/QBI**	**Super-High Income Taxpayer: $30,000,000 of Taxable Income/ QBI**
Lawyer's Flow-Through Professional Services Income	Even though this taxpayer has an SSTorB, the SSTorB Exception applies and the taxpayer receives the Deduction for 20% of QBI and, therefore, has $80,000 of Taxable Income subject to tax under § 1 at (1) $8,907, plus (2) 22% of the Excess Over $77,400 (*i.e.*, 22% of $2,600 = $572), which is a Tax Liability of $9,479 or 9.5% of Taxable Income before the Section 199A Deduction. Same Treatment as Steve and Trump. Note that if Lawyer operated as an S or partnership and there were reasonable compensation or Section 707(a) or (c) payments to Lawyer, there would be a reduction in the amount of QBI.	Because the benefit of the SSTorB Exception is completely Phased Out, Taxed on Full $1,000,000 of Taxable Income under Section 1, at (1) $161,379, plus (2) 37% of the Excess Over $600,000 (*i.e.*, 37% of $400,000 = $148,000), which is a Tax Liability of $309,379 or 31% of Taxable Income. Same treatment as Curry.	Because the benefit of the SSTorB Exception is completely Phased Out, Taxed on Full $30,,000,000 of Taxable Income under Section 1, at $161,379 plus 37% of the Excess Over $600,000 (*i.e.*, 37% of $29,400,000 = $10,878,000); thus, tax liability is $161,379 + $10,878,000, which is $11,039,379 or 36% of Taxable Income Same treatment as Curry.

The above information is summarized in the following Table E.

(b) SECTION IV.H, TABLE E, SUMMARY OF TAX LIABILITIES FOR CURRY, STEVE, TRUMP, AND TRUMP'S LAWYER

ILLUSTRATIVE TAXPAYER/CURRY, STEVE, TRUMP, TRUMP'S LAWYER	**Moderate Income Taxpayer: $100,000 of Taxable Income/QBI**	**High Income Taxpayer: $1,000,000 of Taxable Income/QBI**	**Super-High Income Taxpayer: $30,000,000 of Taxable Income/ QBI**
Curry's Employment Income. Note that this income does not qualify in any respect for the Section 199A deduction	Tax Liability of $13,879 or 13.8% of Taxable Income	Tax Liability of $309,379 or 31% of Taxable Income	Tax Liability of $10,878,000 or 36% of Taxable Income
Steve's Flow-Through Active Income	Tax Liability of $9,479 or 9.5% of Taxable Income before the Section 199A Deduction.	Tax Liability of $235,379 or 24% of Taxable Income before the Section 199A Deduction.	Tax Liability of $8,819,379 or 29% of Taxable Income before the Section 199A Deduction.
Trump's Flow-Through Passive Real Estate Income	Tax Liability of $9,479 or 9.5% of Taxable Income before the Section 199A Deduction.	Tax Liability of $235,379 or 24% of Taxable Income before the Section 199A Deduction.	Tax Liability of $8,819,379 or 29% of Taxable Income before the Section 199A Deduction. .
Lawyer's Flow-Through Professional Services Income	Tax Liability of $9,479 or 9.5% of Taxable Income before the Section 199A Deduction.	Tax Liability of $309,379 or 31% of Taxable Income. Same treatment as Curry.	Tax Liability of $10,878,000 or 36% of Taxable Income. Same treatment as Curry.

I. DETERMINATION OF THE MOST TAX EFFICIENT SALARY WHERE SOLE SHAREHOLDER OF S-CORP IS ALSO SOLE EMPLOYEE OF S-CORP AND S-CORP DOES NOT HAVE SIGNIFICANT QUALIFIED PROPERTY: A FIRST MODEL

This section seeks to set out a basic model for determining the most tax efficient salary to be paid to a sole employee/shareholder ("Sole Employee/Shareholder") of an S corporation ("S-Corp"). It can be expected that models similar to this one will be developed to help guide taxpayers to the most tax efficient manner of structuring businesses that qualify for the Section 199A deduction, This section addresses the following factual situation:

(1) Sole Employee/Shareholder is in the 37% marginal bracket on ordinary income and as a consequence, Sole Employee/Shareholder's effective tax rate on QBI is 29.6%;

(2) S-Corp has very little Qualified Property (QP), and as a consequence, the 25% of W-2 Wages--2.5% of QP Limitation is less than the 50% of W-2 Wages Limitation; and

(3) For the 2018 taxable year, S.Corp has $1M of taxable income before salary paid to Sole Employee/Shareholder all of which is QBI and none of which is attributable to an SSTorB.

These facts could easily be present in a situation in which an S-Corp was engaged in an architectural or engineering business, because such a business is not an SSTorB.

The issue addressed here is: Taking into account Sole Employee/Shareholder's 37% marginal rate on ordinary income and 29.6% effective rate on QBI, what is the most tax efficient salary for S-Corp to pay to Sole Employee/Shareholder?

This is a complex question, and for purposes of the analysis here, it is assumed that the salary is $100,000, $300,000, or $500,000. As will be seen, of these three salaries, the most tax efficient salary is $300,000, because a higher effective tax rate is associated with both the $100,000 salary and the $500,000 salary. It is assumed that each of these salaries is reasonable.

Table A presents an analysis of the tax rate imposed on Sole Employee/Shareholder under the above assumptions. In the table, M = million and K = thousand.

(a) SECTION IV.I, TABLE A, DETERMINING THE MOST TAX EFFICIENT SALARY TO BE PAID TO SOLE EMPLOYEE/SHAREHOLDER

Salary/Item	$100K Salary	$300K Salary	$500K Salary
[1] Taxable Income/QBI before Salary	$1M	$1M	$1M
[2] W-2 Salary to Employee/Shareholder	100K	300K	500K
[3]After Salary Taxable Income/QBI: [1] - [2]	900K	$700K	$500K
[4] 50% of W-2 Wages Limitation: 50% of [2]	50K	150K	250K
[5] 20% C-QBIA Deduction: 20% of [3]	180K	140K	100K
[6] Excess, if any, of (1) 50% of W-2 Wages Limitation, over (2) 20% C-QBIA Deduction: [4] – [5]	NA	10K	150K
[7] Excess, if any, of (1) 20% C-QBIA Deduction, over (2) 50% of W-2 Wages Limitation: [5] – [4]	130K	NA	NA
[8] Allowed C-QBIA Deduction Amount: [4] ≤ [5]	50K	140K	100K
[9] Taxable Income After Salary and C-QBIA Deduction Amount: [3] – [8]	850K	560K	400K
[10] Tax Liability on Salary: 37% of [2]	37K	111K	185K
[11] Tax Liability on Taxable Income After Salary and C-QBIA Deduction Amount: 37% of [9]	314.5K	207.2K	148K
[12] Tax Liability: [10] + [11]	351.5K	318K	333K
[13] Effective Tax Rate	35.1%	31.8%	33.3%

Table A demonstrates that under the assumptions here, the most tax efficient salary is $300K, because with this salary, Sole Employee/Shareholder has a 31.8% effective rate of tax on her $1M of taxable income, whereas with the $100K salary the effective rate is 35.1% and with the $500K salary, the effective rate is 33.3%.

J. SOME "FIRST TAKE" POLICY OBSERVATIONS

There are many tax policy questions with Section 199A, and this section presents some "First Take" policy observations. First, the provision violates the fundamental tax principle of horizontal equity by taxing similarly situated taxpayers differently. For example, in focusing just on the case of $1M of taxable income in Table E, what could be the policy justification for taxing Curry at a 31% rate, Steve at a 24% rate, Trump, at 24% rate, and Trump's Lawyer at a 31% rate?

Second, the provision violates the principle of vertical equity by, in some cases, taxing higher income taxpayers at a lower rate than lower income taxpayers. For example, as shown in Table E, with $30M of taxable income, Trump would be taxed at a 29% rate, while Trump's Lawyer with $1M of taxable income would be taxed at a 31% rate.

Third, as noted above, it is not sensible to treat the three flow-through forms (*i.e.*, sole proprietorship, S corporation, and partnership) differently with respect to reasonable compensation, which does not qualify for the Section 199A(a)(1) Deduction. The standard should be the same across all flow-through entities. This was apparently the case with the House version of the TCAJA, which employed a rule distinguishing between, in essence, equity returns and compensation returns.

Fourth, the reasonable compensation exception has a perverse incentive for leisure over work, because with respect to taxable income that is all QBI, the higher the taxpayer's salary, the higher the taxpayer's effective tax rate. For example, assume that after his presidency, (1) Trump returns to work in his business, which is organized as an S corporation, (2) all of the corporation's taxable income is QBI, and (3) the corporation pays him a reasonable salary. In such case, Trump's after-presidency/working effective tax rate would be higher than his presidency/non-working effective tax rate. I refer to this incentive as the "Kick-Back at Mar-a-Lago Rule."

Fifth, as originally proposed by Trump during the campaign (*see* § IV.B.1), the reduced tax would only apply to retained earnings of the business, but the TCAJA does not contain such a provision. A strong policy argument could be made for taxing earnings retained in the active conduct of a business at lower rate than distributed earnings, but this is not the case with Section 199A.

V THE TCAJA'S IMPACT ON THE CHOICE OF FORM DECISION FOR DOMESTIC OPERATIONS: A "FIRST TAKE"[16]

A. INTRODUCTION

The individual and corporate rate structures (*see* §§ II and III) and the deduction for Qualified Business Income ("QBI") (*see* §§ IV) adopted by the TCAJA require a reconsideration of the choice of form (*i.e*., entity) decision for domestic business operations: (1) C corporation, or (2) "Flow-through Entity" (*i.e*., sole proprietorship, including single member LLC, partnership, including multiple member LLC, and S corporation).

Before the TCAJA, it generally was the case that a Flow-through Entity was preferred over a C corporation. This was largely because of the 35% maximum rate on corporations and the 50% combined corporation-shareholder maximum rate when taking into the account the impact on shareholders of dividends and capital gains on sale of the corporation. *See* Table A in Section III.C. As indicated in this Table A, dividends are taxed at a maximum rate of 23.8%, and the same maximum rate applies to capital gains. .

Specifically, reconsideration of the choice of form issue is required in view of the TCAJA's (1) retention of the maximum 23.8% rate on dividends and capital gains of individuals (*see* § III.C.), and (2) adoption of (a) a 21% rate for C corporations (*see* § III.A.), (b) a maximum 37% rate on ordinary income (*see* § II.A.), and (c) a 29% maximum rate on QBI (*see* § IV.F.).

B. ASSUMPTIONS

Choice of form decisions can be very difficult and must be based on the specific facts. However, for the purposes of this "First Take," the choice of form will be between a C corporation ("C-Corp" or "CC") and an S corporation ("S-Corp" or "SC"), and the following are the basic assumptions:

- A single shareholder ("Sole Shareholder") forms C-Corp and, in the alternative, S-Corp.
- Sole Shareholder initially contributes to the entity property with a fair market value of $10 million.
- The adjusted basis to Sole Shareholder of the initial investment is, in the alternative, $10 million and zero. Consequently, the entity's initial adjusted basis for the initial investment will be either $10 million or zero (*see* § 362), and Sole Shareholder's basis for her stock will be either $10 million or zero (*see* § 358). During the period of business operations, it is assumed that the basis is not reduced by depreciation, amortization or otherwise. This could happen, for example, if the property was land.

[16] *See generally* Jessica Cory, Stuart Odell, Liz Stieff, & Mark Wilensky, *C Corporation or Pass through? Analyzing the Decision in the Wake of the Tax Act of 2017*, Slide Deck for ABA Tax Section Webinar (Feb. 28, 2018); Steven B. Gorin, *Choice of Entity In Light of 2017 Tax Law Changes*, Thompson Coburn LLP (a slide deck, contact sgorin@thompsoncoburn.com; D. Larry Crumbley and James R. Hasselback, *Attractiveness of S Corporations After 2017*, 158 Tax Notes 1207 (Feb. 26, 2018); and Bradley T. Borden, *Choice-of-Entity Decisions Under the New Tax Act* (Feb. 2018), available at http://ssrn.com/abstract=3119829.

- The entity's taxable income before a salary is paid to Sole Shareholder is 10% of the invested capital at the beginning of the particular year, starting with $10 million in the first year.
- Sole Shareholder's salary is 20% of taxable income before such salary, and it is assumed that this is a reasonable salary. It is not clear under Section 199A whether there is a requirement for an S corporation to pay a reasonable salary, but here a reasonable salary is paid.
- Sole Shareholders tax rate on the salary is the maximum 37% rate.
- The SALT Limitation is not applicable to property taxes paid by S-Corp because they relate to S-Corp's trade or business. *See* § 164(b)(6) (flush language).
- C-Corp's tax rate is 21%.
- The after-tax income is retained in the business; however, with S-Corp, it is assumed that the corporation distributes to Sole Shareholder an amount equal to Sole Shareholder's tax liability.
- All of the taxable income of S-Corp is QBI, and the phase outs under Section 199A are not applicable. Therefore, Sole Shareholder receives the QBI Deduction with respect to all of S-Corp's taxable income, resulting in a maximum 29.6% rate. The taxable income of C-Corp does not qualify as QBI.
- Each year, the year-end capital base of the entity (after taking into account all profits and salaries) experiences a 5% increase in value. Thus, the fair market value of the assets grows beyond the retained earnings.
- After operating under these assumptions for five years, the entity is sold in an asset sale for the fair market value of the assets, which is assumed to be the amount of the year-end capital base for the fifth year. The proceeds of the asset sale are immediately distributed to Sole Shareholder in liquidation of the corporation. On the liquidation of C-Corp, Sole Shareholder is subject to a 23,8% capital gains tax. *See* § 331 (receipt by shareholder of proceeds in a liquidation is a capital gain transaction to the shareholder) and § 1(h) (maximum capital gains rate). On the liquidation of S-Corp, Sole Shareholder has no gain or loss, because of the basis increase in her stock resulting from the operations and sale of assets. *See* § 1367. It is assumed that the sale of assets by S-Corp produces capital gain that is imputed to Sole Shareholder and taxed at a 23.8% rate.
- This analysis does not focus on the salary paid to Sole Shareholder because the salary arrangements are similar for both C-Corp and S-Corp.
- The analysis focuses only on the impact of the Federal income tax and does not take into account the potential effects of state and local taxes, Social Security Taxes, or the Medicare Tax. However, in computing the tax on capital gains, consideration is given to the Obamacare 3.8% tax on Net Investment Income, which increases the maximum tax rate on capital gains and dividends to 23.8%.
- Although the analysis does not take account of the impact of a step-up in basis after death under Section 1014, at the end of the basic analysis, there is a brief discussion of the impact of Section 1014. *See* § V.C.8.
- For purposes of this analysis, it is assumed that the corporation is not a "Qualified Small Business" ("QSB") under Section 1202. A QSB is a C corporation that meets an active trade or business requirement and has aggregate gross assets of less than $50 million. AA 50% or 100% exclusion for income from the sale of stock of a QSB applies for such stock "acquired by the taxpayer at its original issue."

- No consideration is given here to the Personal Holding Company or the Accumulated Earnings Tax rules, which are introduced in Section III.D. However, as indicated in Section III.D, given the 21% corporate rate, more issues with these taxes are likely to arise.
- No consideration is given to the impact of the Alternative Minimum Tax (AMT), which after the TCAJA continues to apply to individuals, but no longer applies to corporations.
- The treatment of partnership business operations should produce similar results as those for S-Corp.
- All amounts are in either millions ("M") of dollars or thousands ("K") of dollars.

C. THE ANALYSIS

1. Introduction

The analysis proceeds, under the above assumptions, as follows. First, the section discusses the results if the entity is organized as C-Corp (Table A) and then the results if the entity is organized as S-Corp (Table B). Second, the section discusses the impact of a sale of assets followed by a liquidation at the end of the fifth year on C-Corp and Sole Shareholder (Table C) and S-Corp and Sole Shareholder (Table D). The section compares the results for C-Corp with those for S-Corp (Table E), makes some observations about the choice of form under the TCAJA, and addresses the impact of the Section 1014 step-up in basis rule. Because choiceof form issues are essentially fact driven, there is significant detail set out in the following analysis.

2. C-Corp Operating Results for Five Years

Table A presents the results on C-Corp and Sole Shareholder under the above assumptions for five years of operations of C-Corp. The Table is set out over several pages and has 20 rows.

(a) SECTION V.C TABLE A, CHOICE OF FORM, C-CORP: FIVE YEARS OF OPERATIONS

TABLE A, ROWS [1] – [8] OF [20] Year/Item	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
[1] FMV of Capital Available to CC at the Beginning of the Year, *i.e.*, For Year 1 $10M; For Years 2-5, Row: [16] from the preceding Year	$10M	$11.1M	$12.2M	$13.6M	$15M
[2] CC's Profit Rate	10%	10%	10%	10%	10%
[3] CC's Taxable Income Before SS's Salary: [2] X [1]	1M	1.1M	1.2M	1.3M	1.5M
[4] SS's Salary as a Percentage of CC's Taxable Income Before such Salary	20%	20%	20%	20%	20%
[5] SS's Salary: [4] X [3]	200K	220K	240K	260K	300K
[6] SS's Tax Rate on Salary	37%	37%	37%	37%	37%
[7] SS's Tax on Salary: [6] X [5]	74K	81K	88K	96K	111K
[8] SS's Salary After Tax: [5] – [7]	126K	139K	151K	164K	189K

TABLE A, ROWS [9] – [16] OF [20] Year/Item	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
[9] CC's Taxable Income: [3] – [5]	800K	880K	960K	1M	1.2M
[10] CC's Tax Rate	21%	21%	21%	21%	21%
[11] CC's Tax Liability: [10] X [9]	168K	184K	201K	210K	252K
[12] CC's After-Tax Retained Earnings: [9] - [11]	632K	696K	759K	790K	948K
[13] CC's Preliminary (*i.e.*, Before Appreciation) End-of-Year Capital Base: [1] + [12]	10.6M	11.7M	13M	14.3M	15.9M
[14] Rate of Appreciation on Preliminary End of Year Capital Base	5%	5%	5%	5%	5%
[15] Appreciation in Capital Base: [14] X [13]	530K	585K	650K	715K	795K
[16] CC's Final Capital Base at the End of the Year: [13] + [15]; Presumed FMV of CC's End-of-Year Assets	11.1M	12.2M	13.6M	15M	16.6M

TABLE A, ROWS [17] – [19] OF [20] Year/Item	Year 1	Year 2	Year 3	Year 4	Year 5
[17] Adjusted Basis of CC's Assets Assuming Zero Basis for Initial Capital: [12] For Year 1; for Subsequent Years, [17] from Preceding Year + [12] From Current Year	632K	1.3M	2M	2.7M	3.6M
[18] Adjusted Basis of CC's Assets Assuming FMV Basis for Initial Capital: Year 1: [1] + [12]; Years 2-5: [18] from preceding year + [12]	10.6M	11.2M	12M	12.7M	13.6M
[19] SS's End-of-Year Basis of Stock in CC When Adjusted Basis of Assets Contributed Was Zero	-0-	-0-	-0-	-0-	-0-

TABLE A, ROW [20] OF [20] Year/Item	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
[20] SS's End-of-Year Basis of Stock in CC When Adjusted Basis of Assets Contributed Was $10M	10M	10M	10M	10M	10M

3. S-Corp Operating Results for Five Years

Table B presents the results on S-Corp and Sole Shareholder under the above assumptions for five years of operations of S-Corp. The Table has 21 rows and, like Table A, is set out over several pages.

(a) SECTION V.C, TABLE B, CHOICE OF FORM, S-CORP: FIVE YEARS OF OPERATIONS

TABLE B, ROWS [1] – [7] OF [21] Year/Item	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
[1] FMV of Capital Available to SC at the Beginning of the Year, *i.e.*, For Year 1 $10M; For Years 2-5, Row: [17] from the preceding Year	$10M	11M	12.1M	13.3M	14.7M
[2] SC's Profit Rate	10%	10%	10%	10%	10%
[3] SC's Taxable Income (QBI) Before SS's Salary [2] X [1]	1M	1.1M	1.2M	1.3M	1.4M
[4] SS's Salary as a Percentage of CC's Taxable Income Before such Salary	20%	20%	20%	20%	20%
[5] SS's Salary: [4] X [3]	200K	220K	240K	260K	280K
[6] SS's Tax Rate on Salary	37%	37%	37%	37%	37%
[7] SS's Tax on Salary: [6] X [5]	74K	81K	88K	96K	103K

TABLE B, ROWS [8] – [15] OF [21] Year/Item	Year 1	Year 2	Year 3	Year 4	Year 5
[8] SS's Salary After Tax: [5] – [7]	126K	139K	152K	164K	177K
[9] SC's Taxable Income Imputed to SS as QBI: [3] – [5]	800K	880K	960K	1M	1.1M
[10] SS's Tax Rate on QBI	29%	29%	29%	29%	29%
[11] SS's Tax Liability on Imputed QBI: [10] X [9]	232K	255K	278K	290K	319K
[12] SC's Distribution to SS of Cash to Cover Tax Liability from Imputed QBI: [11]	232K	255K	278K	290K	319K
[13] SC's Retained Earnings After the Tax Distribution: [9] – [12]	568K	625K	682K	710K	781K
[14] SC's Preliminary End of the Year Capital Base: [1] + [13]	10.5M	11.6M	12.7M	14M	15.4M
[15] Rate of Appreciation on Preliminary End of Year Capital Base	5%	5%	5%	5%	5%

TABLE B, ROWS [16] – [19] OF [21] Year/Item	Year 1	Year 2	Year 3	Year 4	Year 5
[16] Appreciation Amount in Capital Base: [15] X [14]	525K	580K	635K	700K	770K
[17] SC's Final Capital Base at the End of the Year: [14] + [16]; Presumed FMV of CC's End of Year Assets	11M	12.1M	13.3M	14.7M	16.1M
[18] Adjusted Basis of SC's Assets Assuming Zero Basis for Initial Capital: [13] For Year 1; for Subsequent Years, [18] from Preceding Year + [13] From Current Year	568K	1.1M	1.7M	2.4M	3.1M
[19] Adjusted Basis of SC's Assets Assuming FMV Basis for Initial Capital: Year 1: [1] + [13]; Years 2-5: [19] from Preceding Year + [13] from Current Year	10.5M	11.1M	11.7M	12.4M	13.1M

TABLE B, ROWS [20] – [21] OF [21] Year/Item	Year 1	Year 2	Year 3	Year 4	Year 5
[20] SS's End of Year Basis of S-Corp's Stock when Assets Contributed Had an Adjusted Basis of Zero; For Year 1: Zero + [13]; For Years 2-5: [20] from Prior Year + [13] for Current Year [*See* § 1367]	568K	1.1M	1.7M	2.4M	3.1M
[21] SS's End of Year Basis of S-Corp's Stock when Assets Contributed Had an Adjusted Basis of $10M For Year 1: $10M + [13]; For Years 2-5: [21] from Prior Year + [13] for Current Year [*See* § 1367]	10.5M	11.1M	11.7M	12.4M	13.1M

4. Similar Aggregate Salaries

The above analysis demonstrates that under the assumptions here, the aggregate salaries paid by C-Corp and S-Corp are similar in amount. *See* For C-Corp Table A Row 5, and for S-Corp, Table B, Row 5. Thus, during the five-year period of operations the money taken out of the corporation is about the same.

5. Assumed Sale of C-Corp and S-Corp at the End of Year 5 Followed by Distribution of After-Tax Proceeds in a Liquidating Distribution

a. Introduction

This section computes the results that would be obtained if at the end of year 5, the corporation's assets were sold for the amount of the "Final Capital Base," which is the amount shown on (1) row [16] of Table A, Choice of Form C-Corp, and (2) row [17] of Table B, Choice of Form S-Corp. As demonstrated, the Final Capital Base includes an assumed annual 5% rate of appreciation in the year-end Capital Base. *See* Table A, Rows [13] - [16], and Table B, Rows [14] - 17]. It is reasonable to assume that in many businesses there will be an increase in value beyond retained earnings.

These Final Capital Base amounts are shown on row [1] of, respectively, (1) Table C, Sale of C-Corp's Assets, and (2) Table D, Sale of S-Corps Assets.

b. Sale of C-Corp

Table C shows the impact on C-Corp and Sole Shareholder from the sale of C-Corp's assets for fair market value at the end of the five year period and the distribution at the end of such year of the after-tax proceeds to Sole Shareholder in a liquidating distribution.

(a) SECTION V.C, TABLE C, SALE OF C-CORP's ASSETS AT THE END OF YEAR 5, WITH ALTERNATIVE ASSUMPTIONS OF A ZERO AND $10M BASIS OF INITIAL ASSETS

Basis Assumptions/Computation of Gains	**[A] Zero Basis for Initial Capital Contribution**	**[B] $10 Million Basis for Initial Contribution**
[1] CC's Final Capital Base at the End of Year 5, Presumed FMV of CC's End-of-Year Assets (From Table A, Row [16])	$16.6M	$16.6M
[2] Adjusted Basis of CC's Assets at the End of Year 5, Assuming Zero Basis for Initial Capital (From Table A, Row [17])	3.6M	NA
[3] Adjusted Basis of CC's Assets Assuming FMV Basis for Initial Capital (From Table A Row [18])	NA	13.6M
[4] CC's Gain Realized on Sale of Assets: [A][1] – [A][2]; and [B][1] – [B][3]	13M	3M
[5] CC's Tax Rate	21%	21%
[6] CC's Tax Liability [A][5] X [A][4] and [B][5] – [B][4]	2.7M	630K
[7] CC's After Tax Cash: [A][1] – [A][6] and [B][1] – [B][6]	13.9M	16M
[8] Amount Distributed to Shareholder in Liquidation: [7]	13.9M	16M
[9] SS's Adjusted Basis for Stock: (From Table A, Rows [19] and [20])	-0-	10M
[10] SS's Capital Gain on the Liquidation: [8] – [9]	13.9M	6M
[11] SS's Tax Rate on the Capital Gain from the Liquidation	23.8%	23.8%
[12] SS's Tax Liability [11] X [10]	3.3M	1.4M
[13] SS's After-Tax Cash: [8] – [12]	10.5M	14.5M

Row 13 in Table C shows that after the five years of operations and the sale followed by liquidation with (1) a zero basis for the contributed property, Sole Shareholder will have $10.5M after the corporate and shareholder level taxes, and (2) with a $10M fair market value basis for the contributed property, the Sole Shareholder would have $14.5M after such taxes.

c. Sale of S-Corp

Table D shows the impact on Sole Shareholder from (1) the sale of S-Corp's assets for fair market value at the end of the five year period, and (2) the distribution of the sale proceeds to Sole Shareholder. S-Corp is not taxed on the sale, and all of the gain realized by S-Corp is imputed to Sole Shareholder, who has a correlative increase in basis of her shares.

(a) SECTION V.C, TABLE D, SALE OF S-CORP's ASSETS AT THE END OF YEAR 5, WITH ALTERNATIVE ASSUMPTIONS OF A ZERO AND $10M BASIS OF INITIAL ASSETS

Basis Assumptions/Computation of Gains	**[A] Zero Basis for Initial Capital Contribution**	**[B] $10 Million Basis for Initial Contribution**
[1] SC's Final Capital Base at the End of the Year: Presumed FMV of SC's End of Year Assets and Sale Price (From Table B, row [17])	$16.1M	$16.1M
[2] Adjusted Basis of SC's Assets Assuming Zero Basis for Initial Capital (From Table B, row [18])	3.1M	NA
[3] Adjusted Basis of SC's Assets Assuming FMV Basis for Initial Capital (From Table A Row [19])	NA	13.1M
[4] Gain Realized [A][1] – [A][2]; and [B][1] – [B][3]	13M	3M
[5] Amount of Capital Gain Imputed to SS: [4]	13M	3M
[6] SS's Tax Rate	23.8%	23.8%
[7] SS's Tax Liability [6] X [5]	3M	700K
[8] SS's After-Tax Cash: [1] – [7]	13.1M	15.3M

Row 8 in Table D shows that after five years of operation and the sale with (1) a zero basis for the contributed property, Sole Shareholder will have $13.1M after the single level of shareholder tax, and (2) with a $10M fair market value basis for the contributed property, the Sole Shareholder will have $15.3M after such taxes.

6. Comparing the Results C-Corp Vs S-Corp: Five Years of Operations Followed by Sale of Assets and Liquidation

Table E summarizes the bottom line of the comparative analysis. It shows that under the assumptions here, with both a zero and fair market value of the contributed property, Sole Shareholder has more after-tax income with S-Corp than with C-Corp.

(a) SECTION V.C, TABLE E, COMPARING AFTER-TAX IMPACT ON SOLE SHAREHODER FROM FIVE YEARS OF OPERATING AS C-CORP OR S-CORP FOLLOWED BY SALE OF ASSETS AND LIQUIDATION

Basis Assumptions/C and S-Corp	**[A] After-Tax Cash Flow with Zero Basis for Initial Capital Contribution**	**[B] After-Tax Cash Flow with $10 Million Basis for Initial Contribution**
C-Corp, Row [13] of Table C	$10.5M	$14.5M
S-Corp, Row [8] of Table D	13.1M	15.3M

7. Some Preliminary Observations

The above analysis was prepared without any preconceived view on what the outcome would be. Further, as noted, the analysis would change under different factual assumptions. However, on the basis of this analysis, the following points should be considered when confronting any choice of form issue:

- Point 1: As demonstrated in Table E, even with the 21% corporate rate, the after-tax results of operating in a flow-through entity may be more beneficial than the after-tax results of operating as a C corporation.
- Point 2: Even with the 21% corporate rate, as demonstrated in Section III.B, the combined corporate and shareholder rate on dividends is 36%. This combined rate (1) exceeds the 29.6% maximum rate on QBI, which is only available to owners of flow-through entities, and (2) is less than the 37% maximum rate on ordinary income, such as salaries.
- Point 3: Notwithstanding the 21% corporate rate, if appreciated property is contributed to a C corporation or property held by a C corporation appreciates in value, it will be virtually impossible to avoid taxable gain at the corporate level on the sale of the property or on the distribution of the property to the shareholders in liquidation or otherwise. *See* §§ 311 and 336. As a general matter, once appreciated property gets into a C corporation, it cannot get out without triggering a taxable gain. Even if the C corporation is acquired in a tax free reorganization, the acquiring firm would still have appreciated property and would be taxed on the sale of the property. *See, e.g.*, § 362.
- Point 4: If appreciated property is contributed to an S corporation or property of an S corporation appreciates in value, there will be taxable income if the S corporation either sells the property or distributes the property to the shareholders. *See* §§ 311 and 336. Generally, the corporation would not be subject to tax on the gain and the gain would flow through to the shareholder. For example, assume that Sole Shareholder contributes to S-Corp property with a FMV of $10M and a basis of zero.

After the contribution, Sole Shareholder has a zero basis for her stock (*see* § 358), and S-Corp has a zero basis for the property (*see* § 362). Assume further that Sole Shareholder determines that it was a bad idea to contribute the property to S-Corp and, therefore, decides to liquidate S-Corp the next day. In such case, as a result of the liquidation in which Sole Shareholder gets her $10M of contributed property back, S-Corp has a taxable gain of $10M that flows through to Sole Shareholder. Thus, Sole Shareholder has effectively triggered a gain in a deemed sale to herself.

- Point 5: As indicated by Points 3 and 4, carefully consider whether it is tax efficient to contribute appreciated property to a C or an S corporation. One alternative may be to lease the property to the corporation.
- Point 6. If a C corporation converts to an S corporation, there may be a corporate level tax at the time of disposition by the S corporation of property that had a built-in-gain at the time of the conversion. *See* § 1374.
- Point 7: Generally, for partnerships, it is possible to get appreciated property both into (§ 721) and out of (§ 731) the partnership on a tax free basis.

8. What is the Impact of Section 1014 on the Analysis Assuming Sole Shareholder Dies Immediately before the Sale?

a. Introduction

If Sole Shareholder dies immediately before the sale, pursuant to Section 1014, the basis of her stock will be stepped up to fair market value of such stock as of the date of death. For purposes of this analysis, (1) consideration is given only to the situation in which Sole Shareholder's initial basis of the contributed property was zero (the "Zero Initial Basis Assumption"), and (2) it is assumed that the fair market value of the stock would be equal to the fair market value of the assets of C-Corp and S-Corp at the time of her death.

b. Fair Market Value of Assets of C-Corp and S-Corp at the End of Year 5

On the basis of the previous analysis, Table F shows the fair market value of the assets of C-Corp and S-Corp at the end of year 5.

(a) SECTION V.C, TABLE F, FAIR MARKET VALUE OF ASSETS OF C-CORP AND S-CORP AT THE END OF YEAR 5

Corp/FMV of Assets	C-Corp	S-Corp
Fair Market Value of Assets as of December 31, Year 5	$16.6M, from Table C, [A][1]	$16.1M, from Table D, [A][1]

Table F shows that after (1) the corporate tax rate of 21% on C-Corp, (2) the tax distribution by S-Corp to Sole Shareholder to cover her 29% tax rate on the QBI, and (3) the assumed 5% appreciation in assets, the fair market value of the assets of C-Corp exceeds that fair market value of the assets of S-Corp by $500K. Given the tax distribution by S-Corp, this difference is principally attributable to the 8 percentage point difference between the 21% rate on C-Corp and the 29% rate on the QBI of Sole Shareholder of S-Corp. This difference can be shown directly by comparing the aggregate over the five years of (1) the retained earnings of C-Corp, which is

$3.6M (*see* the total of Row [12] of Table A), with (2) the retained earnings of S-Corp, which $3.1M (*see* the total of Row [13] of Table B). To reiterate, C-Corp's retained earnings are higher because it is subject to a 21% corporate rate, whereas Sole Shareholder is subject to a 29% rate on QBI.

c. Tax Consequences at the End of Year 5 to C-Corp and Estate of Sole Shareholder from the Sale by C-Corp of Its Assets followed by Distribution of the After-Tax Proceeds in Liquidation

Now we turn to the results upon the death of Sole Shareholder, which is immediately followed by (1) the sale by C-Corp of its assets, and (2) a liquidating distribution by C-Corp of the after-tax proceeds to "Estate" of Sole Shareholder.

In this case, because of the step-up in basis of Sole Shareholder's stock to fair market value,[17] the Estate has no gain or loss on the receipt of the liquidating distribution. The amount of the distribution is the excess of (1) the fair market value of C-Corp's assets, which is presumed to be the selling price, over (2) C-Corp's tax liability from the sale of the assets. This excess is shown in Row [A][7] of Table C as $13.9M. Thus, with a C-Corp, Estate has $13.9M after the payment by C-Corp of its tax from the sale.

d. Tax Consequences at the End of Year 5 to S-Corp and Estate of Sole Shareholder from the Sale by S-Corp of Its Assets followed by Distribution of the After-Tax Proceeds in Liquidation

Now, we turn to the results from the death of Sole Shareholder, which is immediately followed by (1) the sale by S-Corp of its assets, and (2) a liquidating distribution by S-Corp of the after-tax proceeds to the "Estate" of Sole Shareholder.

Although the Estate gets a step-up in the basis of S-Corp's stock, there is no step-up in the basis of S-Corp's assets. On the other hand, if S-Corp were a partnership and a proper election were made under Section 754, then under Section 743, there also would be a step-up to fair market value in the basis of the partnership's asset to the extend those assets were allocated to Estate.

However, all is not loss for S-Corp and the non-electing partnership. In each case as a result of the liquidation there could be a shareholder/partner loss that offsets the entity level gain that is allocated to the shareholder.

For example, when S-Corp sells its assets for $16.1 (*see* Row [A][1], Table D), it will have a taxable gain of $13M (*see* Row [A][4], Table D). This gain will be allocated to Estate and will increase the basis of Estate's stock, which by reason of Section 1014 will have been stepped up to fair market value. Consequently, immediately before the liquidation of S-Corp, the Estate's basis for the stock of S-Corp will be $13M higher than the fair market value of the cash that is distributed in liquidation. As a consequence, Estate will have a $13M capital loss as a result of the liquidation. Assuming that S-Corp's gain is capital gain, the capital loss realized by Estate should completely offset S-Corp's gain.

[17] In determining the fair market value of the stock, consideration would be given to the corporate tax liability paid on the sale.

e. Comparing the Impact of the Section 1014 Basis Step-up in Stock of C-Corp and S-Corp

The above analysis shows that, under the above circumstances, including the Zero Initial Basis Assumption, if the sale of the corporation's assets and liquidating distribution take place after the death of Sole Shareholder, then Estate will have after-tax cash of::

- $13.9M from C-Corp, and
- $16.1M from S-Corp.

The reason for this dramatic difference is that under the assumptions here (1) C-Corp is fully taxed on the sale of its appreciated assets (which includes the built-in-gain at the time of contribution), and (2) because of the offsetting loss on the liquidation, Sole Shareholder is not taxed on the sale by S-Corp of its assets.

f. The Bottom Line on Choice of Form

While this sale after death of owner analysis further tips the scales in favor of a flow-through entity, it must be emphasized that the choice of form decision is highly sensitive to the facts of the particular situation.

VI THE TCAJA's LIMITATION ON THE DEDUCTION FOR BUSINESS INTEREST[18]

A. INTRODUCTION

1. In General

The TCAJA replaced the former Section 163(j), which addressed earnings stripping, with new Section 163(j), which is titled "Limitation on Business Interest." Standard earnings stripping transactions involved, for example, a U.S. parent corporation becoming indebted to its foreign sub located in a low tax jurisdiction. In such case, in the absence of a disallowance of the interest deduction under, *inter alia*, either (1) Section 163(j),[19] or (2) the debt to equity regulations under Section 385,[20] the interest paid by the U.S. parent to the foreign sub would be (1) deductible in the U.S., where after the TCAJA, the deduction would save 21% in taxes, and (2) taxable in the sub's country, where the tax would be lower than 21% and possibly zero.

The Section 163(j) limitation applies, *inter alia*, to (1) sole proprietors, including the owner of a single member LLC that is treated as a sole proprietorship, (2) partners, including members in a multi-member LLC that is treated as a partnership, (3) shareholders of S corporations, and (4) C corporations.

Section 163(j) is a broad, and likely effective, new limitation on the deductibility of interest that should take pressure off the necessity, from a tax perspective, to distinguish between debt and equity, which is the focus of the very complex regulations under Section 385.

2. What Is Not Covered Here and the Assumptions

Special rules and exceptions, not discussed here, apply to (1) an electing real property trade or business (*e.g.*, real estate development companies) (*see* § 163(j)(7)(A)(ii)); (2) an electing farming business (*see* § 163(j)(7)(A)(iii)); (3) certain public utilities (*see* § 163(j)(7)(A)(iv)); and (4) floor plan financing interest, which relates to the financing of motor vehicles (*see* § 163(j)(9)).

Special rules apply to partnerships and S corporations, and for that reason, Section VI.B discusses the applicability of Section 163(j) to C corporations and sole proprietors, and Section VI.D discusses the applicability of the section to partnerships and S corporations.

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[18] For a discussion of various aspects of the interest limitation *see generally* Tony Nitti, *Tax Geek Tuesday: How Does The New Limitation On Deducting Business Interest Expense Work?*, Forbes (Feb. 6, 2018) available at https://www.forbes.com/sites/anthonynitti/2018/02/06/tax-geek-tuesday-how-does-the-new-limitation-on-deducting-business-interest-expense-work/#1c796b2b7abb.

[19] The former Section 163(j) is discussed generally in Thompson, *Mergers, Acquisitions, and Tender Offers*, *supra* note 1 at Ch. 22.

[20] Section 385 and the regulations thereunder are discussed generally in Thompson, *Mergers, Acquisitions, and Tender Offers*, *supra* note 1 at Chs. 9 and 22.

3. Exemption for Certain Small Businesses

Pursuant to Section 163(j)(3), the limitation is generally not applicable to a taxpayer in a taxable year in which the "the average annual gross receipts of [the taxpayer] for the 3-taxable-year period ending with the taxable year which precedes such taxable year does not exceed $25,000,000." The assumption here is that this exemption does not apply.

B. THE GENERAL INTEREST LIMITATION APPLICABLE TO C CORPORATIONS AND SOLE PROPRIETORS

1. Reason for Focusing on C Corporations and Sole Proprietors

As indicated, special and highly complex rules apply to partnerships and S corporations, and consequently, this Section VI.B discusses the applicability of Section 163(j) to a C corporation (Corporation X). Generally, the rules applicable to a C corporation would also apply to a sole proprietor.

2. The Basic Rule and Preliminary Illustration

Section 163(j)(1), which sets out the general limitation, provides that the "amount allowed as a deduction . . . for any taxable year for Business Interest shall not exceed the sum of— (A) the Business Interest Income of such taxpayer for such taxable year [the "Business Interest Income Limitation"], [plus] (B) 30 percent of the Adjusted Taxable Income of such taxpayer for such taxable year [the "30% of Adjusted Taxable Income Limitation"][.]"[21] These limitations are referred to here as the "Section 163(j)(1) Interest Limitation" and are illustrated in the following example:

> Assume that for the taxable year, a C corporation's (1) Adjusted Taxable Income is $100 million, (2) Business Interest is $55 million, and (3) Business Interest Income is $5 million. In such case, the $55 million of Business Interest is deductible only to the extent of the sum of (1) the Business Interest Income Limitation (*i.e.*, $5 million), plus (2) the 30% of Adjusted Taxable Income Limitation (*i.e*., 30% of $100 million or $30 million). Thus, only $35 million of the Business Interest is deductible. As discussed below, the disallowed $20 million of Business Interest can be carried over to the next year.

Note that taxpayers will want their Adjusted Taxable Income to be as high as possible, because the higher the Adjusted Taxable Income, the higher the Section 163(j)(1) Interest Limitation, meaning more interest can be deducted.

The definitions of the terms Business Interest, Business Interest Income, and Adjusted Taxable Income are discussed next.

3. "Business Interest" and the Exception for a "Preferred Trade or Business"

Section 163(j)(5) defines the term Business Interest to mean "any interest paid or accrued on indebtedness properly allocable to a Trade or Business." This provision also states that Business Interest does not include investment interest (*e.g.*, margin interest incurred in the purchase of stock with credit). Investment interest is subject to the previously enacted Section 163(d), which

[21] The general limitation also includes floor plan financing interest, which is not discussed here.

generally limits the deduction for investment interest to the taxpayer's net investment income for the taxable year.

Section 163(j)(7) provides that, *inter alia*, the following trades or businesses do not constitute a Trade or Business for purposes of Section 163(j): (1) "the trade or business of performing services as an employee," (2) "any electing real property trade or business," (3) any "electing farming business," and (3) certain utilities. These trades or businesses are referred to here as "Preferred Trades or Businesses." They are preferred because they are not subject to the Section 163(j)(1) Interest Limitation.

For example, Section 163(j) does not apply to an employee because a trade or business conducted by an employee is a Preferred Trade or Business, and therefore, an employee is not subject to the Section 163(j)(1) Interest Limitation. On the other hand, the Section 163(j)(1) Interest Limitation does apply to a sole proprietor, a partnership, an S corporation, and a C corporation to the extent these businesses are not engaged in a Preferred Trade or Business.

For purposes of the analysis here, it is assumed that the business conducted is not a Preferred Trade or Business, and consequently "any interest paid or accrued on indebtedness properly allocable to [such] Trade or Business" is Business Interest.

4. "Business Interest Income"

Section 163(j)(6) defines "Business Interest Income" to mean "the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a Trade or Business that is not a [Preferred Trade or Business]." Thus, for example, Business Interest Income includes the interest earned by a C corporation on the investment of its working capital.

5. "Net Business Interest Expense"

The only possible way for the Section 163(j)(1) Limitation to apply is for the taxpayer's Business Interest to exceed its Business Interest Income. In other words, there must be a "Net Business Interest Expense." Consequently, to simplify the analysis here, it is assumed that the taxpayer has Net Business Interest Expense.

6. "Adjusted Taxable Income"

a. Introduction to Corporation X's EBIT and EBITDA

Before exploring the concept of Adjusted Taxable Income, it is helpful to focus on the similar accounting concepts of (1) Earnings Before Interest and Taxes ("EBIT"), and (2) Earnings Before Interest, Taxes, Depreciation, and Amortization ("EBITDA"). As will be seen, Adjusted Taxable Income is for taxable years (1) beginning before January 1, 2022, similar to EBITDA, and (2) beginning after December 31, 2021, similar to EBIT.

b. Why EBIT and EBITDA

Both EBIT and EBITDA are broader measures of income than taxable income, and they are often used in (1) credit analysis (*i.e.*, when a bank or other lender is evaluating a potential loan to a company), and (2) valuation, such as in determining the value of a target company. As an example of the use of these concepts in credit analysis, a leading book on corporate finance explains: "Banks prefer to lend to firms whose earnings cover interest payments with room to spare. Interest coverage is measured by the ratio of [EBIT] to interest payments."[22] The formula for determining interest coverage is:

Interest Coverage (*i.e.*, Times Interest Earned) = EBIT [Divided by] Interest Payments.

And, the book goes on to explain: "[D]epreciation [and amortization] is deducted when calculating the firm's earnings, even though no cash goes out the door."[23] Consequently, in computing the Cash Coverage Ratio, "we add back depreciation [and amortization] to EBIT to calculate operating cash flow [*i.e.*, EBITDA]."[24] The Cash Coverage Ratio is therefore:

Cash Coverage = [EBITDA] [Divided by] Interest Payments.

It is completely logical for Section 163(j), which is determining whether a taxpayer can take a deduction for interest that in many cases is paid to a related party, to rely on the EBIT and EBITDA concepts.

EBIT and EBITDA are best illustrated by examples, and Tables A-D below illustrate the concepts.

c. Table A, Net Income--After Tax Income

Table A sets out the income statement for Corporation X, displaying the amounts of (1) Revenues, (2) Cost of Goods Sold, (3) Expenses, including interest, depreciation and amortization, (4) Net Income Before Tax/Taxable Income, (5) Tax Liability, and (6) Net Income After-Tax. For reasons that will become apparent, the assumption here is that the computed amounts are the same for both the pre-2022 period and the post-2021 period.

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[22] Richard A Brealey, Stewart C. Myers, & Franklin Allen, *Principles of Corporate Finance*, 745 (12th Ed. 2017).
[23] *Id*. at 746.
[24] *Id*.

(a) SECTION VI.B, TABLE A, CORPORATIONS X's INCOME STATEMENT

Income Statement Amounts/Items:	**Amounts**	**Amounts**
[1] Revenues		$200 Million
Minus:		
[2] Cost of Goods Sold		$100 Million
Equals		
[3] Gross Profit [1]-[2]		$100 Million
Minus		
[4] Expenses		
[a] Selling and General Administrative Expenses	$20 Million	
[b] Interest Expense	$40 Million	
[c] Depreciation	$10 Million	
[d] Amortization Under Section 197	$5 Million	
[e]Total Expenses [4a+4b+4c+4d]		$75 Million
Equals:		
[5] Net Income Before Tax and Taxable Income		$25 Million
Minus		
[6] Taxes at 20%		$5 Million
Equals		
[7] Net Income After-Tax		$20 Million

Note that for ease of analysis the Net Income Before Tax and the Taxable Income are the same.

d. Table B, EBIT

Rows [8a and b] of Table B show that the adjustments to Table A to compute Corporation X's EBIT require that the Interest Expense and Taxes be added back to Net Income After-Tax.

(a) SECTION VI.B, TABLE B, CORPORATION X's EBIT

Income Statement Amounts/Items:	**Amounts**	**Amounts**
[1] Revenues		$200 Million
Minus:		
[2] Cost of Goods Sold		$100 Million
Equals		
[3] Gross Profit [1]-[2]		$100 Million
Minus		
[4] Expenses		
[a] Selling and General Administrative Expenses	$20 Million	
[b] Interest Expense	$40 Million	
[c] Depreciation	$10 Million	
[d] Amortization Under Section 197	$5 Million	
[e]Total Expenses [4a+4b+4c+4d]		$75 Million
Equals:		
[5] Net Income Before Tax/ Taxable Income		$25 Million
Minus		
[6] Taxes at 20%		$5 Million
Equals		
[7] Net Income After-Tax		$20 Million
Plus		
[8] The EBIT Add Backs		
[a] Interest Expense	$40 Million	
[b] Taxes	$5 Million	
[c] Total EBIT Add Backs [8a+8b]		$45 Million
Equals		
[9] EBIT		$65 Million

Thus, while Net Income After Tax is $20 Million, EBIT is $65 Million, more than twice the amount of Net Income After Tax. Note that in computing EBIT, the two add-backs (*i.e.*, interest and taxes) are both cash expenditures; as seen below, this is not the case with the additional EBITDA add-backs.

e. Table C, EBITDA

Table C shows the computation of Corporation X's EBITDA.

(a) SECTION VI.B, TABLE C, CORPORATION X's EBITDA

Income Statement Amounts/Items:	**Amounts**	**Amounts**
[1] Revenues		$200 Million
Minus:		
[2] Cost of Goods Sold		$100 Million
Equals		
[3] Gross Profit [1]-[2]		$100 Million
Minus		
[4] Expenses		
[a] Selling and General Administrative Expenses	$20 Million	
[b] Interest Expense	$40 Million	
[c] Depreciation	$10 Million	
[d] Amortization Under Section 197	$5 Million	
[e]Total Expenses [4a+4b+4c+4d]		$75 Million
Equals:		
[5] Net Income Before Tax/ Taxable Income		$25 Million
Minus		
[6] Taxes at 20%		$5 Million
Equals		
[7] Net Income After-Tax		$20 Million
Plus		
[8] The EBIT Add Backs		
[a] Interest Expense	$40 Million	
[b] Taxes	$5 Million	
[c] Total EBIT Add Backs [8a+8b]		$45 Million
Equals		
[9] EBIT		$65 Million
Plus		
[10] The Additional EBITDA Add Backs		
[a] Depreciation	$10 Million	
[b] Amortization	$5 Million	
[c] Total of the Additional EBITDA Add Backs [10a+10b]		$15 Million
Equals		
[11] EBITDA		$80 Million

Thus, at $80 Million, EBITDA is higher than EBIT by $15 Million. Note that both of the add-backs in computing EBITDA (*i.e.*, depreciation and amortization) are non-cash expenses, while the two add-backs in computing EBIT (*i.e.*, interest and taxes) are cash expenses.

f. Definition of Adjusted Taxable Income

i. *General Principles*

Finally, we get to the definition of Adjusted Taxable Income. In looking at this concept, keep in mind that the higher the Adjusted Taxable Income, the higher the Section 163(j)(1) Interest Limitation, which is good for the taxpayer.

Section 163(j)(8) defines Adjusted Taxable Income as the taxable income of the taxpayer that is computed without regard to (*i.e*., by not taking into account) several items discussed below. Thus, the starting point in computing Adjusted Taxable Income is taxable income, which is similar to the accounting concept of "Earnings Before Taxes." Corporation X's taxable income (Earnings Before Taxes) of $25 Million is set out on Row [5] of Tables A, B, and C; it can also be derived by starting with Net Income After Tax, which is $20 Million (Row [7]), and adding back the taxes, which is $5 million (Row [6]).

After starting with taxable income, Section 163(j)(8)(A) provides that the following items are not taken into account in computing Adjusted Taxable Income:

> (i) any item of income, gain, deduction, or loss which is not properly allocable to a Trade Or Business ["Non-TorB Items"],
>
> (ii) any Business Interest or Business Interest Income ["Net Business Interest Expense"],
>
> (iii) the amount of any net operating loss deduction under section 172 ["NOL Carryovers"],
>
> (iv) "the amount of any deduction allowed under section 199A" ["QBI Deduction"],
>
> (v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for Depreciation, Amortization, Or Depletion" ["DAD Deductions" and "Pre-2022 EBITDA-Adjusted Taxable Income" and "Post-2021 EBIT-Adjusted Taxable Income"].

ii. *Elaboration on Items of Income Not Taken into Account in Computing Adjusted Taxable Income*

Non-TorB Items, § 163(j)(8)(A)(i). These Items are allocable to Preferred Trades or Business, which are not taken into account in computing Adjusted Taxable Income. Thus, the income of such a business is not subject to the Section 163(j)(1) Interest Limitation. The assumption here is that all of the income (Revenues) discussed, including on Row [1] of Tables A, B, and C, is allocable to a Trade or Business.

Net Business Interest Expense, § 163(j)(8)(A)(ii) Net Business Interest Expense[25] is not taken into account, that is, it is added back to taxable income in computing Adjusted Taxable Income. This is the same with the computation of both EBIT and EBITDA. (*See* the adding back of Net

[25] If the taxpayer had Net Business Income and no carryovers of Business Interest, there would be no issue under Section 163(j).

Business Interest Expense on Row 8[a] of Tables B, and C). In any case in which the Section 163(j)(1) Interest Limitation could apply, the Net Business Interest Expense is added back to taxable income in computing Adjusted Taxable Income.

NOL Carryovers, § 163(j)(8)(A)(iii). In computing Adjusted Taxable Income, the loss giving rise to an NOL Carryover will have occurred in, and been taken account of, in a prior year; therefore, it should have no impact in computing Adjusted Taxable Income in the current year.

QBI Deduction, § 163(j)(8)(A)(iv). The QBI Deduction under Section 199A, which applies only to individuals and is discussed in Section IV, is a non-cash deduction like depreciation or amortization and, therefore, is properly added back in computing Adjusted Taxable Income.

Pre-2022 EBITDA-Adjusted Taxable Income and Post-2021 EBIT-Adjusted Taxable Income, § 163(j)(8)(A)(v). In the case of calendar year taxpayers, for tax years 2018-2021, such taxpayers compute Adjusted Taxable Income by not taking into account the DAD Deductions, thereby resulting for such period in an Adjusted Taxable Income concept that is similar to EBITDA (*i.e.*, "Pre-2022 EBITDA-Adjusted Taxable Income"). This is shown as $80 Million on Row [11] of Table C.

On the other hand, for tax years beginning in 2022, the taxpayer is required to take the DAD deductions in computing Adjusted Taxable Income, thereby resulting, for such period, in an Adjusted Taxable Income concept that is similar to EBIT (*i.e.*, "Post-2021 EBIT-Adjusted Taxable Income"). This is shown as $65 Million on Row [9] of Table B.

7. Computation of Corporation X's Section 163(j) Interest Limitation

Table D summarizes the application of the Section 163(j)(1) Interest Limitation to Corporation A's $40 Million of interest (*see* Row [4b] on Tables B and C) on the basis of the (1) Pre-2022 EBITDA-Adjusted Taxable Income, and (2) Post-2021 EBIT-Adjusted Taxable Income. The assumption is that there is $40 million of interest expense.

(a) SECTION VI.B, TABLE D, CORPORATION X's SECTION 163(j) INTEREST LIMITATION PRE-2022 AND POST-2021

Adjusted Taxable Income and Limitation/The Periods	**Adjusted Taxable Income**	**The Section 163(j)(1) Interest Limitation**	**Non- Deductible Interest**
Pre-2022 EBITDA-Adjusted Taxable Income Period	$80 Million	$24 Million	$16 Million
Post-2021 EBIT-Adjusted Taxable Income Period	$65 Million	$19.5 Million	$20.5 Million

Thus, years 2018 through 2021, $16 Million of the $40 Million of interest is not deductible, and for years 2022, $20.5 Million of the $40 Million of interest is not deductible. We turn now to the treatment of the non-deductible interest.

C. TWO COMMON SITUATIONS: (1) NET BUSINESS INTEREST EXPENSE EXCEEDS 30% ADJUSTED TAXABLE INCOME, AND (2) 30% OF ADJUSTED TAXABLE INCOME EXCEEDS NET BUSINESS EXPENSE

1. Introduction

In virtually every case one of two situations will occur in each taxable year of Corporation X:

> First, Net Business Interest Expense will exceeds 30% of Adjusted Taxable Income, and as a result of the Section 163(j)(1) Interest Limitation, there will be a "Disallowed Net Business Interest Expense;" or
>
> Second, 30% of Adjusted Taxable Income will exceed Net Business Interest Expense, and there will be "Excess 30%-Adjusted Taxable Income."

This section addresses these two situations for Corporation X, under the assumptions that Corporation X has (1) $100 Million in Adjusted Taxable Income, and (2) Net Business Interest Expense of either (a) $20 Million or $40 Million.

(a) SECTION VI.C, TABLE A, COMPUTATION OF CORPORATION X's (1) DISALLOWED NET BUSINESS INTEREST EXPENSE, AND (2) EXCESS 30% ADJUSTED TAXABLE INCOME

Disallowed Interest/Excess 30% Adjusted Taxable Income	**[A] Disallowed Net Business Interest Expense**	**[B] Excess 30% of Adjusted Taxable Income**
[1] Adjusted Taxable Income	$100 Million	$100 Million
[2] 30% Adjusted Taxable Income	$30 Million	$30 Million
[3] Alternative Net Business Interest Expense: $20M or $40M	$20 Million	$40 Million
[4] Disallowed Net Business Interest Expense [3]-[2], but Not Below Zero	-0-	$10 million
[5] Excess 30%-Adjusted Taxable Income [2]-[3], but Not Below Zero	$10 Million	-0-

Table A shows that under the above assumptions, when Corporation X has $20 Million of Net Business Interest, it has a $10 Million Excess 30%-Adjusted Taxable Income, and when

Corporation X has $40 Million of Net Business Interest, it has a $10 Million Disallowed Net Business Interest Expense. The treatment of these amounts is discussed next.

2. The Treatment of Corporation X's Disallowed Net Business Interest Expense

This section addresses the treatment of interest that is not deductible in a taxable year because of the Section 163(j)(1) Interest Limitation, such as the $10 Million in Table A above..

Under Section 163(j)(2), "the amount of any Business Interest not allowed as a deduction for any taxable year by reason of [the Section 163(j)(1) Interest Limitation] [is] treated as business interest paid or accrued in the succeeding taxable year." There is no limit to the ability to carry forward interest that is not deductible because of the Section 163(j)(1) Interest Limitation. Thus, Corporation X can carry forward indefinitely its Disallowed Net Business Interest Expense.

3. The Treatment of Corporation X's Excess 30%-Adjusted Taxable Income

This section addresses the treatment of the $10 Million of Excess 30%-Adjusted Taxable Income in Table A above, which arises because the Section 163(j)(1) Interest Limitation exceeds the Net Business Interest Expense. In this situation, Section 163(j) has nothing in it to give Corporation X any relief. Thus, in this situation Section 163(j) is saying to Corporation X: "Use all of your Section 163(j)(1) Interest Limitation in the tax year it arises, or lose any Excess 30%-Adjusted Taxable Income." As will be seen below in the discussion of partnerships, a slightly different rule applies there.

D. THE GENERAL INTEREST LIMITATION APPLICABLE TO PARTNERSHIPS AND S CORPORATIONS

1. Introduction

While the above principles generally apply to partnerships and S corporations at the entity level, special rules apply for these two entities for both (1) Disallowed Net Business Interest Expense, and (2) Excess 30%-Adjusted Taxable Income. This section discusses the general applicability of the partnership and S corporate rules to each of these cases. As will be seen, the partnership and S rules are the same with respect to the treatment of Excess 30%-Adjusted Taxable Income, but different with respect to the treatment of Disallowed Net Business Interest Expense. This section works through these very complicated rules by breaking the statutory structure into general principles.

2. The Statutory Structure

a. In General

Sections 163(j)(4)(A)-(C) sets out rules governing partnerships and Section 163(j)(4)(D) provides: "Rules similar to the rules of subparagraphs (A) and (C) shall apply with respect to any S corporation and its shareholders." Thus, the rules of Section 163(j)(4)(A) ("In General") and Section 163(j)(4)(C) ("Excess Taxable Income") apply to both S corporations and partnerships. On the other hand, the rules in Section 163(j)(4)(B) ("Special Rules for Carryforwards") apply only to partnerships.

b. First Principle, Section 163(j) Applies at the Entity Level for Both Partnerships and S Corporations

Section 163(j)(4)(A)(i) provides that for partnerships and S corporations, Section 163(j)(4) applies at "the partnership [and S corporation] level and any deduction for Business Interest [is] taken into account in determining the non-separately stated taxable income or loss of the partnership [§ 702(a)(8)] [or S corporation, §1366(a)(1)(B))." Thus, the first principle is that for both partnerships and S corporations, the Section 163(j)(1) Interest Limitation applies at the entity level.

c. Second Principle: No Double Counting of Adjusted Taxable Income for Partnerships and S Corporations

Section 163(j)(4)(A)(ii)(I) provides that the Adjusted Taxable Income of each partner or S corporation shareholder is "determined without regard to such partner's [or shareholder's] distributive share of any items of income, gain, deduction, or loss of such partnership [or S corporation]." Thus, instead of flowing through to the partner or S corporation shareholder, which is the normal case for tax items under Sections 702 and 1366, the Adjusted Taxable Income stays at the entity level. This second principle is referred to here as the "No Double Counting of Adjusted Taxable Income Rule." As seen next in the discussion of the third principle, there is an exception to this rule.

d. Third Principle: Flow Through of "Excess Taxable Income" for Partnerships and S Corporations that Have Excess 30%-Adjusted Taxable Income

This section addresses the situation where the partnership or S corporation has Excess 30%-Adjusted Taxable Income. This is the situation in column A of Table A in Section VI.C, where (1) the 30% Adjusted Taxable Income of $30 Million, exceeds (2) the Net Business Interest Expense of $20 Million, by $10 Million.

As an exception to the No Double Counting of Adjusted Taxable Income Rule, Section 163(j)(4)(A)(i)(II) provides that the Adjusted Taxable Income of a partner or shareholder of an S corporation is "increased by such partner's [or shareholder's] distributive share of such partnership's [or S corporation's] Excess Taxable Income."

This section goes on to say that "a partner's distributive share of partnership Excess Taxable Income shall be determined in the same manner as the partner's distributive share of nonseparately stated taxable income or loss of the partnership." In the case of a shareholder of an S corporation, the distributive share is determined by the percentage of stock ownership held by the shareholder.

The term "Excess Taxable Income" is defined as follows in the very complex Section 163(j)(4)(C):

> The term "Excess Taxable Income" means, with respect to any partnership [or S corporation], the amount which bears the same ratio to the partnership's [or S corporation's] Adjusted Taxable Income as—

(i) the excess (if any) of—

(I) [30% Adjusted Taxable Income] . . . , over
(II) [Net Business Interest Expense] . . . , bears to

(ii) [30% Adjusted Taxable Income] . . . .

Note that the amount in paragraph (i) is what is referred to here as Excess 30% Adjusted Taxable Income, that is, the excess of (1) 30% Adjusted Taxable Income, over (2) Net Business Interest Expense.

Using the Excess 30% Adjusted Taxable Income concept, Section 163(j)(4)(C) can be expressed mathematically as follows, where X equals Excess Taxable Income:

X [Divided by] [Adjusted Taxable Income] =
[Excess 30% Adjusted Taxable Income] [Divided by] [30% Adjusted Taxable Income]

To illustrate: Assume that a partnership or S corporation ("Flow-through Entity") has (1) $100 Million of Adjusted Taxable Income, and (2) $20 Million of Net Business Interest Expense. As seen in Section VI.C, Table A*, Computation of Corporation X's (1) Disallowed Net Business Interest Expense, and (2) Excess 30% Adjusted Taxable Income,* under these assumptions the Flow-through Entity would have Excess 30%-Adjusted Taxable Income in the amount of $10 Million, because the Section 163(j)(1) Interest Limitation of $30 Million would exceed the interest expense in such amount.

Thus, we know all of the terms in the equation except X, Excess Taxable Income, which can be calculated as follows:

X [Divided by] [Adjusted Taxable Income ($100 Million) =
[Excess 30% Adjusted Taxable Income ($10 Million] [Divided by] [30% Adjusted Taxable Income ($30 Million)] =

X/$100 Million = $10 Million/$30 Million =

X = $100 Million X $10 Million/$30 Million =

X = $33 Million

In this example, the Excess Taxable Income of the Flow-through Entity is $33 Million, and this amount is allocated among the owners of the entity. Thus, if, for example, the Flow-through Entity were held 50-50 by two owners, each would have additional Adjusted Taxable Income of $16.5 Million. There is no double counting because the Excess Taxable Income of the Flow-through Entity does not stay with the entity but is imputed up to the owners. As a result of the additional Adjusted Taxable Income of $16.5 Million, each owner would be allowed additional interest deductions of $4.95 Million (*i.e*., .3 X $16.5 Million). The combined potential interest deduction is $9.9, which is 30% of the $33 Million of Excess Taxable Income (*i.e.*, .3 X $33 Million = $9.9 Million).

e. Fourth Principle: Flow Through for Partnerships, But Not for S Corporations, of Disallowed Net Business Interest Expense that Would Otherwise be Carried Forward by the Partnership

i. *Introduction*

This section addresses the situation where the partnership or S corporation has Disallowed Net Business Interest Expense. This is the situation in column B of Table A in Section VI.C, where (1) the Net Business Interest Expense of $40 Million, exceeds (2) the 30% of Adjusted Taxable Income of $30 Million, by $10 Million.

ii. *Treatment of Disallowed Net Business Interest Expense of an S Corporation*

For S corporations, the treatment of Disallowed Net Business Interest Expense is simple: under the general rule of Section 163(j)(4)(A)(i), the section "applie[s] at the [S corporation] level[.]" This means that the S corporation's Disallowed Net Business Interest Expense is carried forward by the S corporation under Section 163(j)(2), just as it is carried forward by a C corporation.

iii. *Treatment of Disallowed Net Business Interest Expense of a Partnership*

For partnerships, the treatment of Disallowed Net Business Interest Expense is as complex as it is simple for S corporations. The rules are set out in Section 163(j)(4), which is entitled: "Special Rules for Carryforwards." Section 163(j)(4)(D) makes it clear that these rules do not apply to S corporations.

The best way to examine these rules is to start with the Conference Report, which describes the rules as follows:

> The Senate amendment provides a special rule for carryforward of disallowed partnership interest [*i.e.*, Disallowed Net Business Interest Expense]. In the case of a partnership, . . . any business interest that is not allowed as a deduction to the partnership for the taxable year [*i.e.*, Disallowed Net Business Interest Expense] is allocated to each partner in the same manner as nonseparately stated taxable income or loss of the partnership. [§ 163(j)(4)(B)(i)] The partner may deduct its share of the partnership's excess business interest in any future year, but only against excess taxable income attributed to the partner by the partnership the activities of which gave rise to the excess business interest carryforward. [§ 163(j)(4)(B)(ii)] Any such deduction requires a corresponding reduction in excess taxable income. Additionally, when excess business interest is allocated to a partner, the partner's basis in its partnership interest is reduced (but not below zero) by the amount of such allocation, even though the carryforward does not give rise to a partner deduction in the year of the basis reduction. [§ 163(j)(4)(B)(iii)(I)] However, the partner's deduction in a future year for interest carried forward does not reduce the partner's basis in the partnership interest. In the event the partner disposes of a

> partnership interest the basis of which has been so reduced, the partner's basis in such interest shall be increased, immediately before such disposition, by the amount that any such basis reductions exceed any amount of excess interest expense that has been treated as paid by the partner (*i.e.*, excess interest expense that has been deducted by the partner against excess taxable income of the same partnership). [§ 163(j)(4)(B)(iii)(I)][26]

The Conference Report makes it clear that "this special rule does not apply to S corporations and their shareholders."[27] Obviously, this carryforward rule will require significant record keeping.

E. IMPACT OF THE INTEREST LIMITATION ON BANKS

Under Section 163(j)(8), Adjusted Taxable Income is computed "without respect to . . . Business Interest and Business Interest Income[.]" Consequently, the Adjusted Taxable Income of a bank will not include either Business Interest or Business Interest Income. Thus, for a bank that is only engaged in the business of banking, Adjusted Taxable Income is zero because of the exclusion for both Business Interest and Business Interest Income.

If the limitation in Section 163(j) were only based on the 30% of Adjusted Taxable Income Limitation, a bank could not deduct any interest. However, as discussed above, the Section 163(j)(1) Interest Limitation is the aggregate of both (1) the Business Interest Income Limitation, and (2) the 30% of Adjusted Taxable Income Limitation. Thus, even though a bank may have zero Adjusted Taxable Income, it will still be able to deduct interest to the extent of the Business Interest Income Limitation.

To the extent a bank is engaged in a profitable non-banking business, such as investment banking, the bank will have positive Adjusted Taxable Income, and the Section 163(j)(1) Interest Limitation will be higher than the Limitation without the non-banking business.

[26] Wolters Kluwer, *Explanation of the TCAJA, supra* note 1, at 869.
[27] *Id*.

VII THE TCAJA'S TREATMENT OF CARRIED INTERESTS, SECTION 1061

A. WHAT ARE CARRIED INTERESTS?

A carried interest is the share of profits (*i.e*., a performance fee based on profitability) paid to the manager of certain private equity and hedge funds. Private equity funds generally raise equity from limited partners or the limited members of an LLC (*i.e*., generally accredited investors under the SEC rules) and borrow from financial institutions for the purpose of investing in leveraged buyouts ("LBOs"). In an LBO, the private equity fund generally acquires 100% of the equity of a target corporation, which could be a publicly held target.[28] Although hedge funds also raise equity from limited partners and invest in the securities of a firm, they generally do not take a controlling interest in the firm.

Carried interests are generally the share of profits paid to the managers of private equity and hedge funds to the extent the share of profits exceeds the profits attributable to the capital contributed to the fund by the manager. For example, private equity managers often receive annual fees of 2 and 20, meaning (1) 2% of the capital under management, and (2) 20% of the profits from the sale of the portfolio firms (*i.e*., the original target). The 2% management fee is ordinary income and is generally taxed at the taxpayer's highest marginal rate, which under the TCAJA is 37%. On the other hand, the 20% profits interest (the carry) is taxed as long term capital gains. Under both the TCAJA and prior law, taking account of the Obamacare 3.8% tax on net investment income, the maximum rate on capital gains is 23.8%.

B. CANDIDATE TRUMP'S PROPOSED TREATMENT OF CARRIED INTERESTS

During the Presidential campaign, President Trump proposed the elimination of the special treatment of "carried interests."[29] However, in the run up to the TCAJA during his presidency, he seemed to back off this campaign proposal. In any event, the TCAJA does not eliminate the capital gains treatment of carried interests, but as seen in the next section, it lengthens the holding period before a carried interest can qualify for the long term capital gains rate of 23.8%.

C. THE TCAJA'S TREATMENT OF CARRIED INTEREST UNDER SECTION 1061

This section discusses the basic principles in Section 1061, which is titled, "*Partnership Interests Held in Connection with Performance of Services*." This section applies to an "Applicable Partnership Interest," which is defined in Section 1061(c) generally as "any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer . . . in any Applicable Trade or Business[.]" An interest in a partnership includes an interest in an LLC that is treated as a partnership for Federal income tax purposes, which is normally the case for a domestic LLC.[30]

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[28] *See e.g*., Thompson, Mergers, Acquisitions and Tender Offers, *supra* note 1, at Ch. 14, which deals with LBOs.
[29] *See e.g.*, Thompson, *The Clinton vs. Trump Debate*, *supra* note 5, Ch 23. Sec V.
[30] See e.g., Thompson, Mergers, Acquisitions and Tender Offers, *supra* note 1, at Chs. 9 and 24.

An Applicable Trade or Business is defined in Section 1061(c)(2) as "any activity conducted on a regular, continuous, and substantial basis which . . . consists, in whole or in part, of— (A) raising or returning capital, and (B) either— (i) investing in (or disposing of) Specified Assets [*e.g.*, securities, commodities, and real estate] . . ., or (ii) developing specified assets." This definition of Applicable Trade or Business encompasses traditional private equity firms and hedge funds, and consequently, the partnership interests of the organizers of such firms and funds who provide "substantial services" to such firms and funds constitute Applicable Partnership Interests.

Notwithstanding this broad definition of Applicable Partnership Interest, Section 1061(c)(4) provides the concept does not include "(A) any interest in a partnership directly or indirectly held by a corporation," or "(B) any capital interest in the partnership[.]" However, the excepted capital interests are only those that provide "the taxpayer with a right to share in partnership capital commensurate with— (i) the amount of capital contributed (determined at the time of receipt of such partnership interest), or (ii) the value of such interest subject to tax under section 83 [*i.e*., generally requiring inclusion in income of property received for services] upon the receipt or vesting of such interest."

In this event, if the taxpayer has received an Applicable Partnership Interest, then under Section 1061(a)(1), the taxpayer has short term capital gains to the extent of:

> the excess (if any) of— (1) the taxpayer's net long-term capital gain with respect to such interests for such taxable year, over (2) the taxpayer's net long-term capital gain with respect to such interests for such taxable year computed by [in computing long term capital gain, substituting "3 years" for "1 year[.]"

Thus, for example, assume that during the 2018 taxable year, (1) a private equity management firm ("PE Management") disposes of one of its portfolio firms, which has been held for 2.5 years, for a gain of $100 million, (2) this is the only capital gain or loss transaction for PE Management in 2018, (3) PE Management is allocated $5 million of the gain attributable to its capital interest and $20 million with respect to its carried interest, and (4) the Limited Partners are allocated $75 million with respect to their capital interests. In such case, the treatment of PE Management and the Limited Partners with respect to their allocable shares is as follows:

- The Limited Partners have long term capital gains of $75 million,
- PE Management has long term capital gains on the $5 million attributable to its capital interest, and
- PE Management has short term capital gains on the $20 million carried interest.

Obviously, other things being equal, it is to PE Management's benefit to defer the sale until the three year holding period has run.

D. THE IRS ADDRESSES THE S CORPORATION ISSUE WITH CARRIED INTERESTS

As noted above, notwithstanding the broad definition of Applicable Partnership Interest, Section 1061(c)(4) provides that the concept does not include "(A) any interest in a partnership directly or indirectly held by a corporation[.]," It has been reported that some hedge fund managers have been taking the position that an interest held by an S corporation is not an Applicable Partnership Interest. The transactions are reportedly structured with the formation of a single member LLC that elects to be a corporation and then elects to be an S corporation.

This position motivated the Treasury and IRS to issue Notice 2018-18 (March 1, 2018), which provides in part: "The regulations will provide that the term "corporation" in section 1061(c)(4)(A) does not include an S corporation." Questions have been raised concerning the Treasury's authority to issue this interpretation.[31]

[3131] Miles Weiss, *Mnuchin's Move to End Hedge Fund Loophole Seen Facing Challenge*, Bloomberg BNA, Daily Tax Report (March 6, 2018).

VIII THE TCAJA's OTHER SIGNIFICANT CHANGES IMPACTING BOTH INDIVIDUALS AND CORPORATIONS

A. CHANGES TO THE DEPRECIATION RULES[32]

The TCAJA significantly liberalized the bonus depreciation rules for "Qualified Property," which generally is equipment and certain other non-real property. *See* § 168(k)(2). While the pre-TCAJA bonus depreciation rules only applied to acquisitions of new property, the TCAJA rules generally apply as well to acquisitions of used property acquired in an arm's length transaction.

Section 168(k)(6) provides that the "Applicable Percentage" (*i.e.*, the depreciation percentage) for Qualified Property is:

> (i) in the case of property placed in service after September 27, 2017, and before January 1, 2023, 100 percent,
>
> (ii) in the case of property placed in service after December 31, 2022, and before January 1, 2024, 80 percent,
>
> (iii) in the case of property placed in service after December 31, 2023, and before January 1, 2025, 60 percent,
>
> (iv) in the case of property placed in service after December 31, 2024, and before January 1, 2026, 40 percent, and
>
> (v) in the case of property placed in service after December 31, 2025, and before January 1, 2027, 20 percent.

Thus, for calendar year taxpayers, for taxable years 2018-2022, the taxpayer is allowed a 100% immediate write off of the cost of Qualified Property.

B. INCREASE IN THE SECTION 179 DEDUCTION

Under Section 179, in computing taxable income, a taxpayer may elect to deduct, within limits, the cost of certain qualifying depreciable business property (generally depreciable equipment used in the active conduct of a trade or business) that would otherwise have to be capitalized and subject to an allowance for depreciation. The deduction, if any, under Section 179 is taken before the deduction for depreciation in Section 168.

There is a "Maximum Amount" that can be deducted under Section 179, and the benefit of the deduction is phased-out beginning at a "Phase-Out Threshold Amount." Under the phase-out, the

[32] For a more complete discussion of this rule *see* Tony Nitti, *Tax Geek Tuesday: Changes To Depreciation In The New Tax Law*, Forbes (Jan. 2, 2018), available at https://www.forbes.com/sites/anthonynitti/2018/01/02/tax-geek-tuesday-changes-to-depreciation-in-the-new-tax-law/#5a471bfa2c4b.

Maximum Amount is reduced (but not below zero) on a dollar-for-dollar basis by the amount by which the cost of qualifying property placed in service during the taxable year exceeds the Phase-Out Threshold Amount. *See* § 179(b)(2). Section 179 also has a taxable income limitation that limits the deduction to the amount of the taxpayer's taxable income from the active conduct of a trade or business. *See* § 179(b)(3).

Among other changes to Section 179, the TCAJA increased both the Maximum Amount and Phase-Out Threshold Amount and indexed them for inflation beginning after 2018. The pre- and post-TCAJA Maximum Amounts and Phase-Out Threshold Amounts for 2018 are set out in Table A:

(a) SECTION VIII.B, TABLE A, PRE-AND POST-TCAJA MAXIMUM AMOUNT AND PHASE-OUT THRESHOLDS AMOUNTS UNDER SECTION 179

Pre, Post-TCAJA/Deduction	**Pre-TCAJA**	**Post-TCAJA**
Maximum § 179 Amount (Deduction)	$500,000	$1,000,000
Phase-Out Threshold Amount	$2,000,000	$2,500,000

Thus, for example, after the TCAJA, if an individual taxpayer, for her business, purchases during the taxable year a new machine that cost $1,000,000 and this is the only Section 179 property purchased during the year, the taxpayer would be allowed a deduction for the full $1,000,000. On the other hand, if the new machine cost $3,500,000, the taxpayer would not be allowed a deduction under Section 179, because the cost of the equipment exceeds the Threshold Amount by $1,000,000. However, the excess could qualify for 100% write off as bonus depreciation under Section 168(k).

C. CHANGES TO THE NET OPERATING LOSS DEDUCTION, SECTION 172

The TCAJA amended Section 172, which previously allowed net operating losses (NOLs) to be carried back two years and forward 20 years. Under the amendment, as a general matter, NOLs are not carried back and are carried forward indefinitely. However, NOLs carried forward can only offset 80% of taxable income in a taxable year.

D. LIMITATION ON EXCESS BUSINESS LOSSES OF NONCORPORATE TAXPAYERS

The TCAJA added Section 461(l), which is entitled "Limitation on excess business losses of noncorporate taxpayers." Under this provision, individuals are generally not allowed a deduction for "any Excess Business Loss . . . for the taxable year." The term Excess Business Loss is defined as follows in Section 461(l)(3):

> [T]he excess (if any) of—
>
> (i) the aggregate deductions of the taxpayer for the taxable year which are attributable to trades or businesses of such taxpayer . . . over

> (ii) the sum of— (I) the aggregate gross income or gain of such taxpayer for the taxable year which is attributable to such trades or businesses, plus (II) $250,000 (200 percent of such amount in the case of a joint return).

The dollar limitations are indexed for inflation (*see* § 461(l)(3)(B)), and disallowed loss is "treated as a net operating loss carryover to the following taxable year under section 172" (*see* § 461(l)(2)).

E. CHANGES TO SECTION 1031, LIKE KIND EXCHANGES

Prior to the TCAJA, Section 1031 provided for non-recognition treatment on the exchange of non-inventory business property for like kind, non-inventory business property. Thus, it applied to exchanges of both (1) business equipment for other business equipment, and (2) business real property for other business real property. In general, taxpayers engaging in a like kind exchange take a substituted basis (*i.e*., the basis of the old property plus the cash paid) for the new property.

For example, assume that (1) a taxpayer owns non-inventory business property A with an adjusted basis of $10K and a fair market value of $80K, which means the taxpayer has a $70K built-in gain in this property, and (2) the taxpayer exchanges business property A plus $20K in cash for "likekind" business property B that has a fair market value of $100K. In such case, under Section 1031, the taxpayer has non-recognition on the exchange and takes an adjusted basis of $30K for business property B (*i.e*., the $10K basis of property A plus the $20 cash paid for business property B). Thus, the taxpayer has property B with a built-in gain of $70K and has deferred the recognition of gain on property A.

The TCAJA amended Section 1031 to provide that it only applies to exchanges of real estate that is not held primarily for sale. *See* § 1031(a). Thus, Section 1031 no longer applies, for example, to an exchange of one piece of machinery for another.

IX THE TCAJA'S INTERNATIONAL PROVISIONS: AN INTRODUCTION TO THE TERRITORIAL AND RELATED PROVISIONS

A. INTRODUCTION

Sections 14101 to 14502 of the TCAJA amended numerous provisions of the Code that deal in various respects with international business transactions. Many of the changes are highly technical in nature and are not discussed here. However, several of the changes relating to the adoption of a territorial system for taxing foreign business income move the U.S. in a completely different direction with respect to the taxation of such income, and this section briefly introduces these provisions as follows:

- Section IX.B introduces the pre-TCAJA deferral system, and discusses the basic rules governing the newly adopted territorial system;
- In view of the transition to a territorial system and the end of the deferral system, Section IX.C briefly outlines the basic rules governing the taxation of previously deferred income; and
- As noted in Section IX.B.3, territorial systems are particularly susceptible to base erosion, and Section IX.D discusses four anti-base erosion provisions in the TCAJA.

B. ADOPTION OF A TERRITORIAL SYSTEM: THE PARTICIPATION EXEMPTION

1. Background on the Prior Deferral System and the Newly Adopted Territorial (*i.e.*, Participation Exemption) System

The TCAJA adopted a proposal, which has been around for a long time, to move the U.S. from its pre-TCAJA deferral system for taxing active foreign business income ("Active Foreign Income") of a foreign sub ("Foreign Sub") of a U.S. parent corporation ("U.S. Parent") to a territorial system for taxing such income. Most of the trading partners of the U.S. have territorial systems.

In the prior deferral system, the Active Foreign Income of a Foreign Sub was generally deferred from U.S. tax until the income was repatriated to the U.S. Parent in the form of dividends or otherwise, and at the time of the repatriation, the U.S. parent generally received a foreign tax credit with respect to foreign taxes paid on the repatriated income.

Under the newly adopted territorial system under Section 245A, the Active Foreign Income of the Foreign Sub is not subject to U.S. tax at the time of earning or at the time of repatriation, and on repatriation, the foreign tax credit with respect to the Active Foreign Income is not allowed.

The differences between the prior deferral system and the newly adopted territorial system can be illustrated as follows. Assume that under the prior deferral system, (1) in year 1, a newly formed Foreign Sub had $100M of Active Foreign Income on which it paid a 10% foreign tax of $10M and reinvested the $90M balance, (2) in year 2, Foreign Sub had no income or loss, and (3) on January 1 of year 3, Foreign Sub distributed to U.S. Parent, the $90M of retained Active

Foreign Income. Under the former deferral system, the $100M of Active Foreign Income would have been (1) deferred from U.S. tax in years 1 and 2, and (2) subject to U.S. tax in year 3. In addition, in year 3, U.S. Parent would have received a foreign tax credit for the $10M foreign tax paid by Foreign Sub. Thus, in year 3, U.S. Parent would have (1) included the full $100M in its taxable income, (2) been taxed at the 35% U.S. rate, or $35M, and (3) taken a foreign tax credit of $10M. Thus, the net tax owed to the U.S. in year 3 would have been $25M.

Under the territorial system (otherwise known as a participation exemption system) adopted by Section 245A, the Active Foreign Income of Foreign Sub is not subject to U.S. tax at the time it is earned, or at the time it is repatriated in year 3. However, the TCAJA retained the very complex subpart F and related rules for subjecting U.S. Parent to immediate U.S. taxation on certain Passive Foreign Income (*e.g.*, dividends and interest) earned by Foreign Sub. The discussion here assumes that Foreign Sub has only Active Foreign Income.

2. Brief Introduction to Section 245A

Even though Section 245A applies to certain partially owned foreign corporations, the discussion here focuses only on wholly-owned Foreign Subs, which is the normal situation. Section 245A(a) sets out the following general rule: "In the case of any dividend received from . . . [Foreign Sub] by a domestic corporation [U.S. Parent] . . . there shall be allowed as a deduction an amount equal to the Foreign-Source Portion of Such Dividend ["Foreign-Source Portion]." Under Section 245A(c)(1), the Foreign-Source Portion is "an amount which bears the same ratio to [the] dividend as— (A) Undistributed Foreign Earnings of [Foreign Sub], bears to (B) the total undistributed earnings of such foreign corporation." Section 245A(c)(3) defines Undistributed Foreign Earnings to mean, essentially, Active Foreign Income. Thus, as a general matter under Section 245A, if all of Foreign Sub's retained earnings are attributable to Active Foreign Income, then 100% of any dividend paid by Foreign Sub to Foreign Parent is deductible by Foreign Parent.

Section 245A(d) denies U.S. Parent both the foreign tax credit and the deduction for foreign taxes with respect to dividends that qualify for the Section 245A deduction.

3. Base Erosion Tax Abuse with a Territorial System

As indicated by the OECD's Base Erosion and Profits Shifting ("BEPS") project,[33] territorial tax systems, which predominate among OECD countries, are subject to significant base erosion, which involves, for example, payments by U.S. Parent to Foreign Sub that are deductible to U.S. Parent and not taxable (or subject to a low tax) to Foreign Sub. If this part of the transaction is successful (*i.e.*, deduction in the U.S. and no or low tax in the foreign country), which is often referred to as "double non-taxation," then with a territorial system, the income could be repatriated to the U.S. without tax. This type of transaction is sometimes referred to as "round tripping." As seen below, in view of the adoption of the territorial system, the TCAJA adopts several anti-base erosion provisions.

C. TAXATION OF PRE-TCAJA DEFERRED INCOME

[33] *See, e.g.,* OECD/G20, *Base Erosion and Profit Shifting Project* (2013).

In view of the adoption of the territorial system (*i.e.*, participation exemption system) in Section 245A, Section 965, which was added by the TCAJA, addresses the taxation of a Foreign Sub's pre-TCAJA deferred Active Foreign Income. It is generally believed that there may be as much as $3 trillion of such deferred Active Foreign Income. Section 965 taxes this deferred Active Foreign Income, but at reduced rates, with a taxpayer election to defer the tax.

While there are many complexities with Section 965, this section focuses only on the basic principles regarding (1) the mechanics for implementing the tax, (2) the rate of the tax, and (3) the election to defer the payment of the tax.

From a mechanical perspective, Section 965(a) generally increases the "Subpart F Income" of a "Deferred Foreign Income Corporation," such as Foreign Sub, by its "Accumulated Post-1986 Deferred Foreign Income," that is, its deferred Active Foreign Income. As a result of increasing the Subpart F Income of Foreign Sub, the deferred Active Foreign Income is imputed up to U.S. Parent under Section 951 of the rules governing a Controlled Foreign Corporation ("CFC"). Thus, Section 965 operates through the current CFC provisions.

Turning to the rate of the tax, notwithstanding the inclusion of deferred Active Business Income in U.S. Parent's income, Section 965(c) provides a "Participation Exemption" deduction for U.S. Parent. This deduction, which is extremely complex, basically results in taxing U.S. Parent on Foreign Sub's deferred, but now imputed, Active Business Income at one of the following two rates.

> First, to the extent the deferred Active Foreign Income is held by Foreign Sub in an "Aggregate Foreign Cash Position" (*i.e.*, a liquid position), the tax rate is 15.5%, and
>
> Second, to the extent that such income is held in a non- Aggregate Foreign Cash Position, the tax rate is 8%.

Finally, with respect to the payment of the tax, Section 965(h) generally permits U.S. Parent to elect to pay the Section 965 tax in eight instalments in the following amounts:

> (A) 8 percent of the net tax liability in the case of each of the first 5 of such installments,
>
> (B) 15 percent of the net tax liability in the case of the 6th such installment,
>
> (C) 20 percent of the net tax liability in the case of the 7th such installment, and
>
> (D) 25 percent of the net tax liability in the case of the 8th such installment.

D. INTRODUCTION TO THE TCAJA'S ANTI-BASE EROSION PROVISIONS

1. Introduction

This section provides brief introductions to the following anti-base erosion provisions that were enacted by the TCAJA:

- Section 59A, Tax on Base Erosion Payments of Taxpayers with Substantial Gross Receipts (§ IX.D.2);
- Section 951A, Current Inclusion of Global Intangible Low-Taxed Income ("GILTI") and the related deduction under Section 250 (§ IX.D.3);
- The new deduction in Section 250 for Foreign-Derived Intangible Income ("FDII") (§ IX.D.4); and
- The new definition of intangible property for purposes of both Section 482, which deals with transfer pricing, and Section 367, which deals with cross-border reorganizations and incorporations (§ IX.D.4).

To simplify the presentation, the focus is generally on U.S. Parent and its wholly-owned Foreign Sub.

2. Basic Principles of Section 59A, The Base Erosion and Anti-Abuse ("BEAT") Tax

a. Base Erosion: Hypothetical Facts

Section 59A is entitled "Tax on Base Erosion Payments of Taxpayers with Substantial Gross Receipts" and is commonly referred to as the BEAT. It is loaded with defined terms and complexity, and therefore, it is easy to get lost in the weeds. To help illustrate the general principles throughout this discussion we will refer to the following hypothetical facts:

- As indicated above, U.S. Parent, a C corporation, owns all of the stock of Foreign Sub;
- Before making deductible payments to Foreign Sub, U.S. parent had $100M of taxable income;
- U.S. Parent made (1) $60M of royalty payments to Foreign Sub for the use by U.S. Parent of intangible property owned by Foreign Sub, and (2) $15M of interest payments to Foreign Sub with respect to intercompany debt U.S. Parent owed to Foreign Sub. Both amounts were fully deductible in computing U.S. Parent's taxable income, which was $25M (*i.e.*, $100M - $60M - $15M);
- U.S. Parents tax liability was $5.25M (*i.e.*, $25M X .21);
- None of the interest is subject to limitation under Section 163(j), as enacted by TCAJA (*see* § VI), and the $15M of interest is U.S. Parent's only interest expense;
- Because of a tax treaty, neither the royalty payments nor the interest is subject to tax under Sections 881 and 882 or correlative withholding under Sections 1441 and 1442;
- The royalty and interest are not subject to tax in Foreign Sub's country; and
- Note that the royalty and the interest are what would normally be considered base erosion payments, because they (1) reduce U.S. tax liability, and (2) are not subject to tax when received by Foreign Sub.

b. In General and Corporations Subject to the Tax

Section 59A imposes a tax on base erosion payments made by a C corporation, like U.S. Parent, to a related foreign party, like Foreign Sub. However, the provision only applies to an "Applicable Taxpayer," which is defined in Section 59A(e) as a domestic C corporation that, *inter alia*, has "average annual gross receipts . . . for the 3-taxable-year period ending with the preceding taxable year [of] at least $500,000,000[.]" For purposes of the discussion here, it is assumed that U.S. Parent is an Applicable Taxpayer.

c. Section 59A(a)'s Imposition of the Base Erosion Minimum Tax Amount

The tax is imposed by Section 59A(a), which provides (from the perspective of U.S. Parent), that "for any taxable year [U.S. Parent is subject to an additional] tax equal to the Base Erosion Minimum Tax Amount for the taxable year."

d. Definition of Base Erosion Minimum Tax Amount

i. *In General and Illustration*

Under Section 59A(a), the Base Erosion Minimum Tax Amount is defined generally as "the excess (if any) of— (A) an amount equal to 10 percent . . . of the Modified Taxable Income of [U.S. Parent] for the taxable year, over (B) [U.S. Parent's adjusted] Regular Tax Liability[.]" For purposes of this discussion, it is assumed that there are no adjustments in computing U.S. Parent's Regular Tax Liability, and consequently, its Regular Tax Liability is the $5.25M tax liability set out above in the Hypothetical Facts.

Thus, if U.S. Parent's (1) Modified Taxable Income is $100M, and (2) Regular Tax Liability is $5.25M, then the Base Erosion Minimum Tax Amount would be $4.75M (*i.e.*, 10% of $100M = $10M - $5.25M = $4.75M).

For 2018, the tax rate is 5% rather than 10%, and beginning in 2026, the tax rate is stepped up to 12.5% from 10%. *See* §§ 59A(b)(1)(A) and (2). We now turn to the definition of Modified Taxable Income.

ii. *Definition of Modified Taxable Income*

(a) In General

Section 59A(c) defines Modified Taxable Income generally to mean "the taxable income of [U.S. Parent] . . . for the taxable year, determined without regard to . . . any Base Erosion Tax Benefit with respect to any Base Erosion Payment[.]" Thus, in order to determine Modified Taxable Income, we must first determine the Base Erosion Payments, if any, and the Base Erosion Tax Benefits, which are considered next.

(b) Base Erosion Payment

Pursuant to Section 59A(d)(1) the term Base Erosion Payment "means any amount paid or accrued by the taxpayer [*i.e.*, U.S. Parent] to a foreign person [*i.e.*, Foreign Sub] which is a Related Party [defined broadly] of the taxpayer and with respect to which a deduction is allowable under this chapter." Thus, (1) the $15M of interest paid by U.S. Parent to Foreign Sub on inter-company debt, and (2) the $60M of royalties paid by U.S. Parent to Foreign Sub for use of intangible property, are classic examples of Base Erosion Payments. A special exception applies under Section 59A(d)(5) for "services which meet the requirements for eligibility for use of the services cost method under section 482[.]"[34]

Also, Section 59A(d)(2) makes it clear that the provision can apply to the purchase by U.S. Parent of depreciable or amortizable property from Foreign Sub.

(c) Base Erosion Tax Benefit

The term Base Erosion Tax Benefit is defined (it appears, rather awkwardly) in Section 59A(c)(2) as "any deduction described in subsection (d)(1) [relating to Base Erosion Payments] which is allowed under this chapter for the taxable year with respect to any Base Erosion Payment." This presumably means that any deductible Base Erosion Payment is a Base Erosion Tax Benefit. Thus, if, for example, U.S. Parent pays to Foreign Sub interest on debt, and the interest is otherwise deductible, then the interest is a Base Erosion Tax Benefit.

Pursuant to Section 59A(c)(2)(B), as a general matter, an item is not a Base Erosion Tax Benefit, if it is subject to tax under Sections 871 or 881 (relating to tax on outbound payments of interest, dividends, *etc*.) and to withholding for such tax under Sections 1441 or 1442. As indicated, for purposes of the discussion here, it is assumed that this exception is not applicable because, as a result of a tax treaty, there is no withholding on the payments.

(d) Summary of the Definition of Modified Taxable Income

Basically, Modified Taxable Income is taxable income without the deductions for any Base Erosion Tax Benefit. For example, since in the Hypothetical Facts, U.S. Parent made deductible payments to Foreign Sub in amounts of $75M, these payments get added back to U.S. Parent's taxable income of $25M to get Modified Taxable Income of $100M.

iii. *Impact of Related Party and Non-Related Party Interest Payments*

Although in the Hypothetical Facts here, there is no non-Related Party interest payments, Section 59A(c)(3) sets out the following rule for "determining interest for which [a] deduction [is] allowed:"

> For purposes of applying paragraph (1) [relating to Modified Taxable Income], in the case of a taxpayer to which section 163(j) applies [*i.e*., generally large businesses, *see* § 163(j)(3)] for the taxable year, the reduction in the amount of interest for which a deduction is allowed by reason of such subsection shall be treated as allocable first to interest paid or accrued to persons who are not related parties with respect to the taxpayer and then to such related parties.

[34] *See e.g*., Stephen R.A. Bates, Mike McDonald, and Thomas A. Vidano, *BEAT and Low-Margin Services: Much Ado About No Markup*, Bloomberg BNA, Daily Tax Report (Feb. 23, 2018).

e. Illustration of the Computation of U.S. Parent's Base Erosion Minimum Tax Amount

With the above definitions, we can now compute U.S. Parent's Base Erosion Minimum Tax Amount. Pursuant to Section 59A(a), U.S. Parent's Base Erosion Minimum Tax Amount is "the excess (if any) of— (A) an amount equal to 10 percent . . . of the Modified Taxable Income of [U.S. Parent] for the taxable year [*i.e*., $100M], over (B) [U.S. Parent's adjusted] Regular Tax Liability [*i.e*. $5.25M][.]" Thus, U.S. Parent's Base Erosion Minimum Tax Amount is $4.75M.

f. Rule of Thumb as to the Circumstances in which there is Likely to be a Base Erosion Minimum Tax Amount

As a general matter, given the 10% rate on the tax, if the Base Erosion Tax Benefit is a little more than taxable income, then there may be a Base Erosion Minimum Tax Amount. For example, assume that U.S. Parent has (1) taxable income of $50M, and (2) Base Erosion Tax Benefits of $50M. In such case, (1) U.S. Parent's tax liability is $10.5 (*i.e*., $50M X .21 = $10.5); (2) its Modified Taxable Income is $100M, and (3) its Base Erosion Minimum Tax Amount is $10M (*i.e*., $100M X .1 = $10M). As a result, there is no Base Erosion Minimum Tax Amount.

3. Current Inclusion of Global Intangible Low-Taxed Income (GILTI")[35] and the Related Deduction

Pursuant to Section 951A(a) of the CFC provisions, U.S. Parent is required to "include in gross income [its] Global Intangible Low-Taxed Income for [the] taxable year." The term Global Intangible Low-Taxed Income ("GILTI") is defined in Section 951A(b) to mean the "excess (if any) of— (A) [U.S. Parent's] Net CFC Tested Income [*i.e*., a broad measure of Foreign Sub's income for such taxable year], over (B) [U.S. Parent's] Net Deemed Tangible Income Return [*i.e*., a 10% return on tangible (hard) assets held by Foreign Sub] for such taxable year."

Thus, GILTI is the income of Foreign Sub that Section 951A presumes is not attributable to hard assets. For example, assume that (1) U.S. Parent's Net CFC Tested Income from Foreign Sub is $100M, (2) Foreign Sub had no foreign tax liability, and (3) U.S. Parent's Net Deemed Tangible Income Return is $60M. In such case, U.S. Parent's GILTI would be $40M (*i.e*., $100M - $60M). And, the $40M would be included in U.S. Parent's subpart F income for the year, thus subjecting such income to U.S. tax.

Pursuant to Sections 960(d) and 78 (*i.e*., the gross up for foreign taxes), U.S. Parent would receive a deemed paid credit for any foreign taxes paid by Foreign Sub on the GILTI, but only to the extent of 80% of such taxes.

Notwithstanding the inclusion in income under Section 951A, pursuant to Section 250(a)(1)(B), U.S. Parent is "allowed as a deduction an amount equal [to] . . . (B) 50 percent of— (i) [the GILTI], and (ii) the amount treated as a dividend received by such corporation under section 78

[35] *See e.g*., Elizabeth J. Stevens H. David Rosenbloom, *GILTI Pleasures*, Tax Notes International Magazine (Feb. 12, 2018), available at http://www.capdale.com/gilti-pleasures.

[*i.e.*, the gross up for foreign taxes paid on the GILTI] which is attributable to the amount described in clause (i)." For tax years beginning after December 31, 2025, the deduction is reduced to 37.5 percent.

With a 21% corporate rate and a 50% deduction through 2025, the effective tax rate on GILTI is 10.5%.

4. Current Year Deduction of Foreign High Return Amounts

In addition to giving a deduction for 50% of GILTI, Section 250 also gives domestic corporations a deduction in the amount of 37.5 percent of [the corporation's] Foreign-Derived Intangible Income [FDII]." This provision is an incentive for U.S. corporations to locate their intangible in the U.S. It is not discussed further here.

5. Amendments to the Definition of Intangible Property

In an effort to make it more difficult for U.S. corporations to transfer their intangibles into foreign subs without the receipt of arm's length compensation, the TCAJA amended several provisions of the Code. These amendments are particularly important in view of the adoption of the territorial system, with its potential for base erosion.

First, the TCAJA amended the definition of intangible in Section 936(h)(3)(B), which is the operative provision defining intangible for purposes of Sections 482 and 367. As a result of the amendment, in addition to including in the definition of the term intangible such items as patents, trademarks, and other similar property, the term intangible now includes the following: :

> (vi) any goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its employment); or
>
> (vii) any other item the value or potential value of which is not attributable to tangible property or the services of any individual.

Second, the TCAJA amended 482, which deals with transfer pricing between related parties (*e.g.*, the sale by U.S. Parent of property to Foreign Sub) by adding the following:

> For purposes of this section, the Secretary shall require the valuation of transfers of intangible property [as defined in § 936(h)(3)(B)] (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.

Third, the TCAJA amended Section 367(d), which deals with transfers of intangibles in cross-border reorganizations and incorporations (*e.g.*, the transfer by U.S. Parent of its intangibles to Foreign Sub in exchange for stock of Foreign Sub). The TCAJA added the following language to Section 367(d), which is similar to the above the language added to Section 482:

(D)Regulatory authority.— For purposes of the last sentence of subparagraph (A) [i.e., treating a sale of intangibles as a sale for a contingent payment], the Secretary shall require—

(i) the valuation of transfers of intangible property, including intangible property transferred with other property or services, on an aggregate basis, or

(ii) the valuation of such a transfer on the basis of the realistic alternatives to such a transfer,

if the Secretary determines that such basis is the most reliable means of valuation of such transfers.

Taken together, these amendments should have the effect of reducing base erosion transactions involving intangibles.

X A "FIRST TAKE" ON THE IMPACT OF THE TCAJA ON DOMESTIC M&A

A. INTRODUCTION

The TCAJA will have a significant impact on M&A, and this section presents a "First Take" on some of the issues that transactional planners on both the buy side ("Acquiror") and the sell side ("Target" and "Target-Shareholder") will be required to consider for domestic deals.[36] The changes to the international rules, including the territorial provision and the related base erosion provisions discussed in Section IX, will have an impact on cross border deals, but this section focuses only on domestic M&A.

Section X.B starts the analysis by introducing (1) the three principal acquisition structures from a Federal income tax standpoint, and (2) the principal provisions of the TCAJA that will impact these transactions. Section X.C focuses on whether the Acquiror should be organized as a C corporation ("C-Corp") or S corporation ("S-Corp"). In general, the results for a partnership will be similar to the results for S-Corp. After addressing this issue, Section X.D sets out the Hypothetical M&A Facts that are the basis of the analysis here. A key assumption is that both Acquiror and Target are C corporations. The results would change if either or both were S corporations or partnerships.

In the final four sections, "First Take" comments are provided on the impact of the TCAJA on (1) taxable asset acquisitions (*see* § X.E), (2) taxable stock acquisitions (*see* §.X.F), and (3) acquisitive reorganizations (*see* § X.H). Also, a comparison of the results under the two taxable structures is provided (*see* § X.G).

B. THE IMPACT OF THE TCAJA ON ACQUISITION STRUCTURES

Although there are numerous potential acquisition structures from a Federal income tax standpoint, from a broad perspective these structures fall into the following basic categories: (1) taxable asset acquisitions, (2) taxable stock acquisitions, and (3) tax free acquisitive reorganizations, including stock, asset and merger reorganizations.

In determining which form to utilize for a particular transaction, it is necessary to take into account, *inter alia*, the impact, if any, of the TCAJA's (1) 21% corporate rate (*see* § III.A), (2) 100% bonus depreciation (*see* § VIII.A), (3) interest limitation (*see* § VI), and (4) retention of the maximum 23.8% rate on the long term capital gains of a high income individual, which reflects the combination of the 20% maximum rate on capital gains and the Obamacare 3.8% rate on Net Investment Income (*see* § II.B). The interest limitation in Section 163(j) clearly will cut back on the use of debt in acquisitions, particularly leveraged buyouts.[37] However, for the

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[36] For an analysis of pre-TCAJA domestic tax issues with mergers and acquisitions, *see, e.g.*, Thompson, *Mergers, Acquisitions and Tender Offers*, *supra* note 2, at Ch. 9.

[37] For a discussion of tax and non-tax aspects of LBOs *see, e.g.*, Thompson, *Mergers, Acquisitions and Tender Offers*, *supra* note 2, at Ch. 14.

purpose of the analysis here, it is assumed that the acquisitions of Target are made with cash that Acquiror has on its balance sheet.

C. SHOULD ACQUIROR BE ORGANIZED AS A FLOW-THROUGH ENTITY?

Determining if Acquiror should be organized as a flow-through entity is, of course, a difficult question, and the answer is dependent upon the unique facts. However, as a general matter this issue was addressed in Section V, which deals with choice of form. There, the analysis looked at the after-tax cash flow to the owner of the business under the following assumptions:

(1) The business was organized initially as C-Corp or, in the alternative, S-Corp;

(2) The initial basis of the assets was either zero or $10M, which was the fair market value of the assets;

(3) The initial basis of the owner's interest was either zero or $10M;

(4) The business operated profitably for five years; and

(5) At the end of the fifth year, the business was sold in an asset sale followed by a distribution of the after-tax proceeds to the shareholder in liquidation.

Table A below, which is the same as Table E in Section V.C, summarizes the after-tax cash flows to the owner under the above facts.

(a) SECTION X, TABLE A, COMPARING AFTER-TAX IMPACT ON SOLE SHAREHODER FROM FIVE YEARS OF OPERATING AS C-CORP OR S-CORP FOLLOWED BY SALE OF ASSETS AND LIQUIDATION (SAME AS TABLE E, SECTION V.C)

Basis Assumptions/C- and S-Corp	**[A] After-Tax Cash Flow with Zero Basis for Initial Capital Contribution**	**[B] After-Tax Cash Flow with $10 Million Basis for Initial Contribution**
C-Corp, Row [13] of Table C, Section V.C.	$10.5M	$14.5M
S-Corp, Row [8] of Table D, Section V.C.	$13.1M	$15.3M

As pointed out in Section V.C, this comparison shows that under the assumptions here, with both a zero and fair market value basis for the contributed property, Sole Shareholder has more after-tax income with S-Corp than with C-Corp. Also, as the analysis in Section V.C.8.e demonstrates, the advantages in favor of a pass-through entity over a C corporation can be even more dramatic as a result of the step-up in Sole Shareholder's basis at her death.

Of course, these analyses do not mean that Acquiror should necessarily be organized as an S corporation or a partnership, but it cautions against jumping to the conclusion that all Acquirors should be organized as C corporations or converted to C corporations. It should be noted that if a flow-through entity acquires stock of Target, a C corporation, , Target's taxable income would still be subject to the corporate tax; consequently, a flow-through entity would mainly be used as Acquiror in a taxable asset acquisition.

The balance of the analysis here assumes that both Acquiror and Target are C corporations. Although the assumption is that Target has one shareholder (*i.e.*, Target-Shareholder), as a general matter, the same tax results would occur with a similarly situated publicly held C corporation and shareholder.

D. HYPOTHETICAL M&A FACTS

To reiterate, with respect to the two taxable acquisitions, the goal is to get a "First Take" on the different tax results to Acquiror, Target, and Target-Shareholder in the following two alternative transactions: (1) an acquisition by Acquiror of Target's assets followed by a liquidation of Target, and (2) the acquisition by Acquiror of Target's stock. The analysis is based on the following Hypothetical M&A Facts, which require certain simplifying assumptions:

(1) Both Acquiror and Target are profitable C corporations.

(2) Acquiror is publicly held; Target is owned by Target-Shareholder.

(3) Target has assets with a fair market value of $100M and a basis of zero.

(4) All of Target's earnings and profits have been previously distributed.

(5) On purchase, all Target's assets would qualify for bonus depreciation of 100%. Although this is an unrealistic assumption, it will illustrate the most beneficial position from Acquiror's standpoint.

(6) Target has no NOLs.

(7) Target-Shareholder has a zero basis for her stock.

(8) A transaction will be structured as an acquisition by Acquiror of Target's assets or stock in either a taxable acquisition or tax-free reorganization.

(9) In the case of a taxable acquisition, Acquiror will use cash on its balance sheet; thus there is no interest limitation under the newly enacted Section 163(j).

(10) In the case of an acquisition of assets, Target will be liquidated immediacy after the sale.

(11) In the case of an acquisition of stock, Acquiror will not make a Section 338 election to step-up the basis of Target's assets. The discussion below explains why.

(12) After the acquisition of stock, Target will be included in Acquiror's consolidated tax return so the income and loss of all members of the consolidated group will be included in a single return.

E. TAXABLE ASSET ACQUISITIONS UNDER THE TCAJA: "FIRST TAKE" THOUGHTS

1. The Impact of 100% Bonus Depreciation

As noted, under the TCAJA, both used and new property can qualify for bonus depreciation. Therefore, in a taxable asset acquisition, Acquiror will be allowed bonus depreciation on any qualifying property (*e.g.*, equipment) it purchases from Target. Thus, 100% bonus depreciation will give Acquiror an enhanced incentive to allocate as much of the purchase price as possible to assets that will qualify for bonus depreciation. Target will generally be indifferent on the allocation issue, because all of Target's taxable gain, without respect to character, will be taxed at a rate of 21%. Thus, it is likely that more pressure will be put on Section 1060, which deals with the allocation of purchase price.

For example, if Acquiror acquires Target's assets for $100M and all of the assets qualify for bonus depreciation, then Acquiror would get an immediate tax savings of $21M, thus, reducing the cash needed to make the purchase from $100M to $79M. Of course, after the bonus depreciation, Acquiror would have a zero basis for the property acquired from Target. Consequently, if, for example, Acquiror were to later sell Target's assets in a taxable transaction for $100M, Acquiror would have a $100M taxable gain.

A collateral question with bonus depreciation is whether it will cause Acquiror to be willing to pay more than fair market value for Target's assets. For example, in the case of the $100M acquisition discussed above, will the $21M tax savings cause Acquiror to be willing to pay more than $100M? Will a market develop where Target begins to market itself for the bonus depreciation it can bring to Acquiror? Will Acquiror have an advantage over a potential competing acquiror that did not have sufficient taxable income to take advantage of the bonus depreciation?

It would appear that, in general, a private equity firm that acquires Target in an LBO would be able to pass the bonus depreciation through to its investors.

2. After-Tax Impact on Target-Shareholder from Target's Asset Sale Followed by Liquidation

This section computes the after-tax cash position of both Target-Shareholder and Acquiror resulting from (1) the acquisition by Acquiror for cash of Target's assets for $100M, the fair market value of such assets, (2) the immediate deduction of the $100M as bonus depreciation, and (3) the immediate liquidation of Target after paying its corporate tax liability. The results are set out in Table B.

(a) SECTION X, TABLE B, COMBINED TARGET AND TARGET-SHAREHOLDER TAX RATE ON TARGET'S ASSET SALE FOLLOWED BY LIQUIDATION

Amount/ Item	**Dollar Amount**
[1] Sale Price	$100M
[2] Target's Adjusted Basis of Assets	-0-
[3] Target's Gain Realized	$100M
[4] Target's Corporate Tax Rate	21%
[5] Target's Tax Liability [4] X [3]	21M
[6] Target's After-Tax Cash and Amount Distributed to Target-Shareholder in Liquidation [1] – [5]	79M
[7] Target-Shareholder's Adjusted Basis for Target Stock	-0-
[8] Target-Shareholder's Taxable Capital Gain	79M
[9] Target-Shareholder's Tax Rate on Capital Gain	23.8%
[10] Target-Shareholder's Tax Liability from Liquidation [9] X [8]	18.8M
[11] Target Shareholder's After-Tax Cash [6] – [10]	60.1M
[12] Combined Target and Target-Shareholder Tax Liabilities [5]+[10]	39.8M
[13] Combined Target and Target-Shareholder Tax Rate	39.8%

Thus, under the above assumptions, the combined corporate level and shareholder level taxes is 39.8%.

3. After-Tax Impact on Acquiror from Acquisition of Target's Assets

Even though Acquiror paid $100M for Target's assets, under the above assumptions, Acquiror is allowed a deduction of 100% of the cost as bonus depreciation. As a consequence, Acquiror's initial cost of $100M is immediately reduced by the $21M tax savings from the bonus depreciation. Therefore, Acquiror has acquired Target's assets with a fair market value of $100M for a net cash payment of $79M.

However, as noted above, Acquiror will have a zero basis for the acquired assets. Consequently, if, for example, the assets are in the future sold by Acquiror for $100M, Acquiror would have a $100M gain on which it would be taxed at $21M, thus reversing the benefit of the tax savings from the bonus depreciation. This shows that in this situation, from an economic perspective, the benefit of the bonus depreciation is the time value of money between (1) the year the Acquiror acquires the assets, and (2) the year the Acquiror sells the assets.

The after-tax benefit from depreciation and amortization (hereinafter referred to as depreciation) can range from (1) the 21% tax savings from bonus depreciation on all of Target's assets acquired in the acquisition, which in the example here is $21M, to (2) zero in the situation, for example, where all of the purchase price is allocated to non-depreciable and non-amortizable assets like land.

F. TAXABLE STOCK ACQUISITIONS UNDER THE TCAJA: "FIRST TAKE" THOUGHTS

1. Introduction

In a taxable stock acquisition of Target, three significant issues are (1) the impact the TCAJA will have on whether or not Acquiror will make a Section 338 election to step up the basis for Target's assets, (2) the price Target will pay for the stock, and (3) the after-tax cash position of both Target-Shareholder and Acquiror. These issues are addressed in this section.

2. Should Acquiror Make a "Unilateral Section 338 Election" to Step-Up the Basis of Target's Stock

a. General Principles under Section 338

This section addresses the "Unilateral Section 338 Election" by Acquiror under Section 338(g), which is a possibility in a situation like this where Target is a free-standing corporation. A "Joint Section 338 Election" by both Acquiror and the Parent of Target may be made under Section 338(h)(10) where Target is a subsidiary, which is not the case here. Thus, except for a brief note below on the potential impact of a Joint Section 338 Election on bonus depreciation, this article does not address the Joint Section 338 Election.

A Unilateral Section 338 Election applies where the stock of a corporation (Target) (*see* § 338(d)(2)) is acquired by another corporation (Acquiror) (*see* § 338(d)(1)) in a "Qualified Stock Purchase" (*i.e*., a purchase of at least 80% of Target's stock, *see* § 338(d)(3)). In such case, Acquiror may unilaterally elect under Section 338(g) to have the Target treated as if it had sold all of its assets (as "Old Target") and then purchased those assets at fair market value (as "New Target"). *See* § 338(a). The deemed sale of assets by Old Target takes place at the close of the day on which the Qualified Stock Purchase occurs (Acquisition Date). *See* §§ 338(a)(1) and (h)(2). New Target is deemed to have purchase those assets (Acquisition Date Assets) at the beginning of the day after the Acquisition Date. *See* § 338(a)(2). Thus, the election has the effect of both (1) triggering taxable gain in Target's appreciated assets, and (2) stepping up the basis of those assets to fair market value.

Pursuant to Treas. Reg. §1.338-10(a), the "deemed sale consequences are reported on the final return of Old Target filed for Old Target's taxable year that ends at the close of the acquisition date." Thus, the deemed sale items are included in the return with all of Old Target's other items of income and loss for the taxable year that ends on the Acquisition Date. New Target's first taxable year starts the day after the Acquisition Date, and none of Old Target's tax attributes, such as NOLs, pass over to New Target.

Acquiror owns all of the stock of Target at the time of the Unilateral Section 338 Election and the resulting deemed sale and deemed repurchase. This has both a detriment and a benefit for

Acquiror and its shareholders because: (1) Acquiror and its shareholders bear the economic burden of the "Section 338 Tax Liability" from the deemed sale of Target's assets, and (2) Acquiror and its shareholders receive the economic benefit of the step-up in the basis of Target's assets.

b. Unilateral Section 338 Elections: Before and After the TCAJA

As a general matter, prior to the TCAJA, Acquiror would not make a Unilateral Section 338(g) election unless Target had significant NOLs that could offset the gain and associated tax liability from the deemed sale.

This would appear still to be the case under the TCAJA. For example, assume that this year Acquiror purchased (for an amount discussed below) Target's stock and made a Unilateral Section 338 Election. In such case, Target would be deemed to have (1) sold its assets for $100M, thereby triggering an immediate $21M tax liability, and (2) repurchased its assets for $100M. Assuming the assets are all depreciable property, on a going forward basis, Acquiror's consolidated group, which would include Target, would get a $21M tax benefit from the $100M of depreciation over the period the depreciation is taken. Thus, the election would produce a $21M tax today in exchange for $21M of tax savings over the coming years, which, given the time value of money, would be a very bad deal for Acquiror. Consequently, Acquiror generally will not make a Unilateral Section 338 Election.

Even if the regulations under Section 338 were amended to give Acquiror's consolidated group the ability to take 100% bonus depreciation with respect to the deemed repurchased assets, a Unilateral Section 338 Election would not be sensible for Acquiror. This is because, assuming the election were made and Acquiror were allowed 100% bonus depreciation, the $100M gain would be completely offset by the $100M of bonus depreciation, so Acquiror would be back to a zero basis for Target's assets.

This leads to the bottom line: like the pre-TCAJA period, under the TCAJA, Acquiror generally will not make a Unilateral Section 338 Election.

c. How Much Should Acquiror Pay for Target's Stock?

We know from above that Acquiror would likely purchase Target's assets for the fair market value of those assets, which is $100M. When instead of buying assets, Acquiror purchases Target's stock, Acquiror will be gaining control of Target's $100M of assets. Thus, it may appear the Acquiror should be willing to pay for the stock of Target the same $100M it paid for the assets of Target. However, in making the stock acquisition, Acquiror must stay cognizant of the fact that Target will continue to have a zero basis for its assets, unless Acquiror makes a Unilateral Section 338 Election, which for the reasons discussed above, Acquiror is unlikely to make. Thus, while in the asset acquisition, Acquiror pays $100M for assets that will have a $100M basis, in the stock acquisition, Acquiror is, in essence, buying assets that, after the acquisition, will continue to have a zero basis.

With the zero basis for Target's assets, Acquiror does not get the benefit of the $21M tax savings it would have received with an asset acquisition. Thus, in the stock acquisition, it may appear that Acquiror should be willing to pay only $79M (*i.e.*, $100M - $21M).

The amount Acquiror should be willing to pay is a function of the present value, determined at the Acquiror's cost of capital, of the tax savings that would otherwise have been available in an asset acquisition. As a general matter, the sooner the depreciation deduction would have been taken and the tax savings realized in an asset acquisition, the greater the present value of the tax savings. Thus, in this situation the range of present values of the potential tax savings in an asset acquisition is from (1) $21M when all of the $100M purchase price in an asset acquisition would have been immediately deductible as bonus depreciation, to (2) zero when in an asset acquisition none of the $100M purchase price would have been deductible as depreciation. It must be noted, however, that even when none of the $100M purchase price would have been deductible as depreciation, Acquiror would have had $100M basis in the asset that would have been recovered on sale of the asset.

d. What is the Impact on Target Shareholder When Acquiror Offers the Following Discounts from the Fair Market Value of Target's Assets: $21M, $10.5M, and -O-?

This section computes the after-tax impact on Target Shareholder where, because of the analysis immediately above, Acquiror offers the following discounts from the fair market value of target's assets:

(1) $21M, because 100% of the assets would have been deductible in an asset acquisition;

(2) $10.5M, which is the present value of the loss, over time, of the $21M in tax benefits; and

(3) Zero, because none of the cost of the assets would have been deductible.

These discounts are referred to here as the "Present Value of the Lost Tax Benefits." Table C computes the after-tax impact on Target-Shareholder from the sale of her stock in Target under each of these three assumptions regarding Present Value of the Lost Tax Benefits.

(a) SECTION X, TABLE C, AFTER-TAX EFFECT ON TARGET-SHAREHOLDER IN STOCK ACQUISITION UNDER THREE DIFFERENT ASSUMPTIONS REGARGING THE PRESENT VALUE OF LOST TAX BENEFITS

Present Values/ Item	**[A] Present Value of the Tax Savings from Forgone Bonus Depreciation of the $100M Cost of Target's Assets Equals: $21M**	**[B] Present Value of the Tax Savings from Forgone Depreciation of the $100M Cost of Target's Assets Equals: One Half the Tax Savings Received Over Time: $10.5M**	**[C] Present Value of the Tax Savings from Forgone Depreciation of the $100M Cost Equals: Zero, because None of Target's Assets Would Have Been Depreciable**
[1] Fair Market Value of Target's Assets	$100M	$100M	$100M
[2] Discount from Fair Market Value of Assets Resulting from Loss of Depreciation	$21M	10.5M	-0-
[3] Purchase Price of Stock of Target	79M	89.5M	100M
[4] Target-Shareholder's Basis for Stock of Target	-0-	-0-	-0-
[5] Target Shareholder's Capital Gain from Sale of Stock [3] - [4]	79M	89.5M	100M
[6] Target-Shareholder's Tax Rate on Capital Gain	23.8%	23.8%	23.8%
[7] Target Shareholder's Tax Liability from Sale of Stock [6] X [5]	18.8M	21.3M	23.8M
[8] Target-Shareholder's After-Tax Cash Flow from Sale [3] – [7]	60.2M	68.2M	76.2M

Row [8] of Table C shows that Target-Shareholder's after-tax cash position ranges from (1) $60.2M with the assumption that all of the purchase price of Target's assets would have been immediately deductible as bonus depreciation, to (2) $76.2M with the assumption that none of the purchase price of Target's assets would have been deductible at any point. While both assumptions are unreasonable, they show the range of what Target-Shareholder could expect to receive, under the assumed facts, for the sale of the stock of Target. This brings us to the comparison in Section X.G of the after-tax results of the taxable asset acquisition with such results for a taxable stock acquisition.

e. Potential Bonus Depreciation in a Joint Section 338(h)(10) Election and a Spin-Off

There may be a possibility of getting bonus depreciation when making a Joint Section 338(h)(10) Election and in certain spin-off transactions.[38]

G. COMPARISON OF TAXABLE ASSET ACQUISITIONS WITH TAXABLE STOCK ACQUISITIONS UNDER THE TCAJA

To summarize, in a taxable asset acquisition, Target's assets are sold for their fair market value and then Target distributes the after-tax proceeds to Target-Shareholder in liquidation. Row [11] of Table B shows that in this transaction, Target-Shareholder has after-tax cash of $60.1M.

Turning to the taxable stock acquisition, Target-Shareholder's after-tax cash position depends on the assumptions regarding the amount and timing of the deductions that would have been available in an asset acquisition. Here Row [8] of Table C shows that the range of after-tax amounts runs from (1) $60.2M when Acquiror would have received 100% bonus depreciation for all of Target's assets, to (2) $76.2 when Acquiror would have received zero depreciation for Target's assets.

Thus, this analysis shows that even with the discount in the stock acquisition, the stock acquisition will produce an after-tax result to Target-Shareholder that is (1) no lower than what could have been the after-tax result in an asset acquisition, and (2) likely higher than what would have been the after-tax result in an asset acquisition. Thus, it is likely that even with the 21% tax rate and 100% bonus depreciation, generally it will be more tax efficient to structure a taxable transaction as a sale of stock rather than as a sale of assets. This is because with the correct computation of the discount in the stock acquisition, there will be the following two effects: (1) Acquiror will be no worse off than in an asset acquisition, and (2) Target-Shareholder likely will be better off.

H. REORGANIZATIONS UNDER THE TCAJA: "FIRST TAKE THOUGHTS"

For the following reasons, *inter alia*, the TCAJA will not kill reorganizations: Even under the TCAJA, Target-Shareholder will still want to avoid the 23.8% maximum tax on capital gains, and an acquisitive reorganization with all stock of Acquiror will avoid the tax. This will allow Target-Shareholder to hold the stock of Acquiror received in the reorganization until death, at which point the gain would be eliminated because of the step-up in basis under Section 1014.

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[38] Emily Foster, *Expensing Eligibility Unclear for Some Spinoff Transactions*, 158 Tax Notes 1269 (Feb. 26, 2018).

XI CONCLUSION

The TCAJA made significant changes in the tax law, and this paper provides a First Take on many of the provisions that will impact the conduct of business operations and transactions.