

CHOICE OF ENTITY ALTERNATIVES

By

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Choice and Acquisitions of Entities in Texas

**Houston, TX (live) – May 28, 2010
Dallas, TX (video) – June 25, 2010**

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APPENDIX E – Egan on Entities

CHOICE OF ENTITY ALTERNATIVES

BY

BYRON F. EGAN*

I. GENERAL.

A. **Introduction.** In the 81st Session of the Texas Legislature (the “2009 Legislative Session”), which convened on January 13, 2009 and adjourned *sine die* June 1, 2009, changes were made to the Texas statutes that govern and tax business entities. These changes affected the following five business entity forms:

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

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

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

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

¹ Act of May 9, 1961, 57th Leg., R.S., ch. 158, 1961 Tex. Gen. Laws 289; Act of May 17, 1979, 66th Leg., R.S., ch. 723, § 5, 1979 Tex. Gen. Laws 1782; Act of May 9, 1985, 69th Leg., R.S., ch. 159, § 76, 1985 Tex. Gen. Laws 692; Act of May 9, 1991, 72d Leg., R.S., ch. 901, §§ 83–85, 1991 Tex. Gen. Laws 3234-35; Act of May 31, 1993, 73d Leg., R.S., ch. 917, § 2, 1993 Tex. Gen. Laws 3912-13 (expired Jan. 1, 1999); see Susan S. Fortney, *Professional Responsibility and Liability Issues Related to Limited Liability Law Partnerships*, 39 S. TEX. L. REV. 399, 402 (1998).

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

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

Federal and state taxation of an entity and its owners for entity income is a major factor in the selection of the form of entity for a particular situation. Under the United States (“U.S.”) Internal Revenue Code of 1986, as amended (the “IRC”), and the “Check-the-Box” regulations promulgated by the Internal Revenue Service (“IRS”), an unincorporated business entity may be classified as an “association” taxable as a corporation subject to income taxes at the corporate level ranging from 15% to 35% of taxable net income, absent a valid S-corporation status election, which is in addition to any taxation which may be imposed on the owner as a result of distributions from the business entity.⁵ Alternatively, the entity may be classified as a partnership, a non-taxable “flow-through” entity in which taxation is imposed only at the ownership level. Although a corporation is classified only as a corporation for IRC purposes, an LLC or partnership may elect whether to be classified as a partnership. A single-owner LLC is disregarded as a separate entity for federal income tax purposes unless it elects otherwise. In addition to federal tax laws, an entity and its advisors must comply with federal anti money laundering and terrorist regulations.⁶

Texas does not have a state personal income tax. The Texas Legislature has replaced the Texas franchise tax on corporations and LLCs with a novel business entity tax called the “Margin Tax,” which is imposed on all business entities other than general partnerships wholly owned by individuals and certain “passive entities.”⁷ Essentially, the calculation of the Margin Tax is based on a taxable entity’s, or unitary group’s, gross receipts after deductions for either (x) compensation or (y) cost of goods sold, provided that the “tax base” for the Margin Tax may

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

³ TBOC § 402.005.

⁴ TBOC § 402.003.

⁵ See *infra* notes 80-93 and related text.

⁶ An entity and its advisors are charged with reviewing and complying with the Specially Designated Nationals List (“SDN List”) maintained by the Office of Foreign Assets Control (“OFAC”) within the United States (“U.S.”) Department of Treasury. U.S. citizens and companies (subject to certain exclusions typically conditioned upon the issuance of a special license) are precluded from engaging in business with any individual or entity listed on the SDN List. The SDN List and OFAC guidance are available on the OFAC website at <http://www.ustreas.gov/offices/enforcement/ofac/>.

⁷ See *infra* notes 113-214 and related text.

not exceed 70% of the entity's total revenues. This "tax base" is apportioned to Texas by multiplying the tax base by a fraction of which the numerator is Texas gross receipts and the denominator is aggregate gross receipts. The tax rate applied to the Texas portion of the tax base is 1% for all taxpayers, except a narrowly defined group of retail and wholesale businesses that will pay a ½ of 1% rate. For calendar year taxpayers, the Margin Tax is payable annually on May 15 of each year based on entity income for the year ending the preceding December 31.

The enactment of the Margin Tax changed the calculus for entity selections, but not necessarily the result. The LLC became more attractive as it can elect to be taxed as a corporation or partnership for federal income tax purposes, but the uncertainties as to an LLC's treatment for self-employment purposes continue to restrict its desirability in some situations.⁸

B. Statutory Updating.

Texas' entity statutes are continually being updated and improved through the efforts of the Texas Business Law Foundation and the Business Law Section of the State Bar of Texas.⁹ This updating process commenced in 1950 with the organization of the State Bar's Corporation Law Committee, which was succeeded in 1953 by what is now the Business Law Section and was later enhanced by the organization of the Texas Business Law Foundation.¹⁰ Continuing this tradition, the 75th Session of the Texas Legislature (the "1997 Legislative Session"), which adjourned *sine die* on June 2, 1997, brought Senate Bill 555 ("S.B. 555"), which became effective September 1, 1997, making numerous changes in Texas' business entity statutes, some of which were quite innovative.¹¹ The changes effected in 1999 and 2001 were relatively limited; however in the 78th Session of the Texas Legislature (the "2003 Legislative Session"), which convened January 14, 2003 and adjourned *sine die* on June 2, 2003, the TBOC was passed,¹² and significant changes were made to Texas' other entity statutes.¹³ In the 79th Session

⁸ See *infra* notes 562-574 and related text.

⁹ See Alan R. Bromberg, *Texas Business Organization and Commercial Law—Two Centuries of Development*, 55 SMU L. REV. 83, 113–14 (2002); Alan R. Bromberg, Byron F. Egan, Dan L. Nicewander, and Robert S. Trotti, *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 31 BULL. BUS. L. SEC. ST. B. TEX. 1 (1994); see generally Alan R. Bromberg, Byron F. Egan, Dan L. Nicewander, and Robert S. Trotti, *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 41 TEX. J. BUS. L. 41 (2005) (displaying the continually changing statutes).

¹⁰ See Bromberg, *supra* note 7, at 113–14; Bromberg et al., *Role of Business-Original*, *supra* note 7, at 1; Bromberg et al., *Role of Business-Updated*, *supra* note 7, at 44.

¹¹ Tex. S.B. 555, 75th Leg., R.S. (1997); Curtis W. Huff, *The New Business Organization Laws: Changes Made in the 75th Legislature to Address Modern Business Practices*, 34 TEX. J. BUS. L. 1 (1997).

¹² Tex. H.B. 1156, 78th Leg., R.S. (2003) by Rep. Helen Giddings, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=78R&Bill=HB1156> ("H.B. 1156"). The "Revisor's Report" for the TBOC is available at both www.texasbusinesslaw.org and on the Texas Legislative Council website at http://www.tlc.state.tx.us/legal/bocode/bo_revisors_report.html. The interim report from the House Sub-Committee studying the TBOC, which contains a side-by-side comparison of the TBOC and its source law, is available at <http://www.house.state.tx.us>.

¹³ See Tex. H.B. 1165, 78th Leg., R.S. (2003) by Rep. Burt R. Solomons, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=78R&Bill=HB1165>; see also Tex. H.B. 1637, 78th Leg., R.S. (2003) by Rep. Rene Oliveira, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=78R&Bill=HB1637>.

of the Texas Legislature (the “2005 Legislative Session”), which convened January 11, 2005 and adjourned *sine die* on May 30, 2005, changes were again made to the Texas entity statutes,¹⁴ including the TBOC.¹⁵ In the 80th Session of the Texas Legislature (the “2007 Legislative Session”), which convened January 9, 2007 and adjourned *sine die* on May 28, 2007, further changes were made to the TBOC and other Texas statutes affecting business entities.¹⁶ This tradition of updating Texas’ entity statutes through the efforts of the Business Law Section and the Texas Business Law Foundation continued in the 81st Session of the Texas Legislature (the “2009 Legislative Session”), which convened on January 13, 2009 and adjourned *sine die* June 1, 2009.¹⁷

C. Texas Business Organizations Code.

1. Background. In the 2003 Legislative Session, the TBOC, which was previously introduced and not passed in the 1999¹⁸ and 2001 Legislative Sessions, was again introduced and this time it passed.¹⁹ The TBOC in its current form²⁰ also includes amendments made during the 2005 Legislative Session, the 2007 Legislative Session and the 2009 Legislative Session.²¹ The TBOC is still a work in progress, and additional amendments will be made in 2011 and thereafter as gaps and ambiguities are discovered and as business organization practices and needs evolve. The TBOC provides considerable flexibility to organizations in establishing their capital structures, effecting business combination transactions and governing their internal affairs. It is a model for future statutes nationwide and solidifies Texas’ position as a leader in corporate law.

¹⁴ Tex. H.B. 1507, 79th Leg., R.S. (2005) by Rep. Burt Solomons, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=79R&Bill=HB1507>; Tex. H.B. 1154, 79th Leg., R.S. (2005) by Rep. Gary Elkins, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=79R&Bill=HB1154>; Tex. H.B. 1319, 79th Leg., R.S. (2005) by Rep. Helen Giddings, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=79R&Bill=HB1319> (“H.B. 1319”).

¹⁵ H.B. 1319.

¹⁶ See Tex. H.B. 1737, 80th Leg., R.S. (2007) by Rep. Helen Giddings, available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=80R&Bill=HB1737> (“H.B. 1737”), which become effective September 1, 2007; Daryl B. Robertson, *2007 Amendments to the Texas Business Organizations Code*, 42 Tex. J. of Bus. L. 257 (Fall 2007).

¹⁷ See Appendix D, which describes (i) S.B. 1442 by Sen. Troy Fraser (generally updating the TBOC), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=SB1442> (“S.B. 1442”), and (ii) H.B. 1787 by Rep. Burt Solomons (amending TBOC provisions pertaining to the designation of registered agents for service of process), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB1787>.

¹⁸ Thomas F. Blackwell, *The Revolution is Here: The Promise of a Unified Business Entity Code*, 24 J. CORP. L. 333, 359 (1999).

¹⁹ H.B. 1156. The Revisor’s Report for the TBOC is available at both www.texasbusinesslaw.org and on the Texas Legislative Council website at http://www.tlc.state.tx.us/legal/bocode/bo_revisors_report.html. The interim report from the House Sub-Committee studying the TBOC, which contains a side-by-side comparison of current and proposed law, is available at www.house.state.tx.us.

²⁰ TEX. BUS. ORGS. CODE. ANN. (Vernon 2010), available at <http://tlo2.tlc.state.tx.us/statutes/bo.toc.htm> (hereinafter “TBOC”).

²¹ H.B. 1319 (2005), H.B. 1737 (2007), S.B. 1442 (2009) and H.B. 1787 (2009).

2. Source Law Codified. The TBOC is principally a codification of the existing Texas statutes governing non-profit and for-profit private-sector entities, rather than substantive modifications to existing law.²² These statutes consist of the following: the Texas Business Corporation Act (the “TBCA”),²³ the Texas Non-Profit Corporation Act (the “TNPCA”),²⁴ the Texas Miscellaneous Corporation Laws Act (the “TMCLA”),²⁵ the Texas Limited Liability Company Act (the “LLC Act”),²⁶ the Texas Revised Partnership Act (the “TRPA”),²⁷ the Texas Revised Limited Partnership Act (the “TRLPA”),²⁸ the Texas Real Estate Investment Trust Act (the “TREITA”),²⁹ the Texas Uniform Unincorporated Nonprofit Associations Act (the “TUUNA”),³⁰ the Texas Professional Corporation Act (the “TPCA”),³¹ the Texas Professional Associations Act (the “TPAA”),³² the Texas Cooperative Associations Act (the “TCAA”),³³ and other existing provisions of Texas statutes governing private entities. Banks, trust companies, savings associations, insurance companies, railroad companies, cemetery organizations, and certain abstract or title companies organized under other special Texas statutes are not “domestic entities”³⁴ under the TBOC; therefore, they are governed by the TBOC only to the extent that the special Texas statute or its source laws incorporate the TBOC by reference or the TBOC is not inconsistent with the special statute.³⁵ Generally entities organized under Texas special statutes prior to January 1, 2006 are subject to the transition rules applicable to other Texas entities and will continue to generally reference the source law rather than the TBOC until January 1, 2010.³⁶

3. Hub and Spoke Organization of Code. The TBOC adopts a “hub and spoke” organizational approach under which provisions common to all entities are included in a central “hub” of the TBOC found in Title 1. These common provisions include, for example, the primary sections governing purposes and powers of entities, filings, meetings and voting, liability, indemnification of directors and partners, and mergers among entities. Outside Title 1,

²² Ad Hoc Codification Committee, *Report of the Codification Committee of the Section of Business Law of the State Bar of Texas on the Proposed Business Organizations Code*, Apr. 16, 2002, at 55, available at http://www.texasbusinesslaw.org/608127_6_date_12262000.pdf (hereinafter “Codification Comm. Report”).

²³ TEX. BUS. CORP. ACT ANN. arts. 1.01 *et. seq.* (Vernon Supp. 2010) (hereinafter “TBCA”).

²⁴ TEX. REV. CIV. STAT. ANN. art. 1396-1 (Vernon Supp. 2010) (hereinafter “TNPCA”).

²⁵ TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon Supp. 2010) (hereinafter “TMCLA”).

²⁶ TEX. REV. CIV. STAT. ANN. art. 1528n (Vernon Supp. 2010) (hereinafter “LLC Act”).

²⁷ TEX. REV. CIV. STAT. ANN. art. 6132b (repealed 1999) (hereinafter “TRPA”).

²⁸ TEX. REV. CIV. STAT. ANN. art. 6132a-1 (Vernon Supp. 2010) (hereinafter “TRLPA”).

²⁹ TEX. REV. CIV. STAT. ANN. art. 6138A (Vernon Supp. 2010) (hereinafter “TREITA”).

³⁰ TEX. REV. CIV. STAT. ANN. art. 1396-1B (Vernon Supp. 2010) (hereinafter “TUUNA”).

³¹ TEX. REV. CIV. STAT. ANN. art. 1528e (Vernon Supp. 2010) (hereinafter “TPCA”).

³² TEX. REV. CIV. STAT. ANN. art. 1528f (Vernon Supp. 2010) (hereinafter “TPAA”).

³³ TEX. REV. CIV. STAT. ANN. art. 1396-1A (Vernon Supp. 2010) (hereinafter “TCAA”).

³⁴ TBOC § 2.003.

³⁵ TBOC § 23.001.

³⁶ TBOC § 402.005. Note that the Texas Finance Code has been amended by H.B. 1962 to provide that bank associations and trust companies organized after January 1, 2006 are governed by the TBOC. Tex. H.B. 1962, §§ 12 and 68, 80th Leg., R.S. (2007), available at <http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=80R&Bill=HB1962>.

separate “spokes” contain provisions governing different types of entities which are not common or similar among the different entities. A detailed Table of Contents for the TBOC showing this organization appears in Appendix C of this article. To determine applicable law for a given business entity, one should look first to the general provisions in Title 1, and then to the entity-specific provisions containing additions and modifications to the general rules. However, where a direct conflict exists between a provision of Title 1 and a provision of any other Title, the other Title will govern the matter.³⁷

4. Effective Date. The TBOC became effective on January 1, 2006 and applies to all domestic entities either organized in Texas or resulting from a conversion that takes effect on or after that date.³⁸ Domestic entities already in existence on January 1, 2006 continued to be governed by then existing entity statutes until January 1, 2010,³⁹ at which time the source laws were repealed and all domestic entities became subject to the TBOC. However, such entities could elect to be governed by the TBOC prior to that date by making a filing with the Secretary of State of Texas and amending their governing documents as necessary.⁴⁰

5. Changes Made By the TBOC. The TBOC, which had been under development since 1995, was a joint project of the Business Law Section of the State Bar of Texas, the office of the Texas Secretary of State and the Texas Legislative Council,⁴¹ and was passed with the endorsement and strong support of the Texas Business Law Foundation. In the codification process, the general objective was not to make substantive revisions to the existing Texas statutes. However, the TBOC did change the form and procedures of many of the existing provisions, and some substantive changes did occur. Some of the more general changes, as well as basic transition and construction provisions, are summarized below. Other changes that are more entity-specific are addressed in the appropriate sections of this article.

(a) Vocabulary. In an effort to streamline laws that govern business entities, the TBOC uses new terms to denote concepts and filings that previously were common to many different entity types but under different names. For example, each entity typically has a particular person or set of persons which govern that type of entity. For limited partnerships, that person is the general partner; for corporations, it is the board of directors; and for LLCs, it is either the managers or members, as specified in the LLC’s formation documents. The TBOC replaces all those different terms and simply refers to the persons or entities that control the entity as that entity’s “governing authority.”⁴² Similarly, the name of the document a filing entity must file with the Secretary of State to be duly organized under Texas law is now simply called a “certificate of formation,” whereas previously each entity had its own name for such

³⁷ TBOC § 1.106(c).

³⁸ TBOC § 402.001(a).

³⁹ TBOC § 402.005.

⁴⁰ TBOC § 402.003.

⁴¹ Codification Comm. Report, *supra* note 19. The Bar Committee was primarily responsible for drafting the TBOC in collaboration with the Secretary of State and the Texas Legislative Council.

⁴² TBOC § 1.002(35).

document.⁴³ One other significant vocabulary change is that the Regulations of a limited liability company are now referred to as its “Company Agreement.”⁴⁴ Other changes include the shift in the titles of filings from “Application for Certificate of Authority to Transact Business”⁴⁵ to “Application for Registration,”⁴⁶ from “Articles of Amendment”⁴⁷ to “Certificate of Amendment,”⁴⁸ and from “Articles of Dissolution”⁴⁹ to “Certificate of Termination.”⁵⁰ Under the TBOC, a “domestic entity” is a corporation, partnership, LLC or other entity formed under the TBOC or whose internal affairs are governed by the TBOC,⁵¹ and a “foreign entity” is an organization that is formed under and the internal affairs are governed by the laws of a jurisdiction other than Texas.⁵² A Texas entity that is formed by a filing with the Secretary of State is called a “filing entity” and includes a corporation, LP, LLC, professional association and a real estate investment trust.⁵³ “Person” is defined by reference to § 311.005 of the Government Code.⁵⁴

(b) Certificate of Formation. In addition to changing the name of the formation document required of entities organizing in Texas, the TBOC has made small alterations to its required contents as well. For example, previously such a document had to state the entity’s period of duration. The TBOC eliminates this requirement, except for entities that will not exist perpetually.⁵⁵ However, it adds the requirement that the document state what type of entity shall be formed upon its filing.⁵⁶ Other requirements differ slightly for each entity.⁵⁷

⁴³ TBOC § 1.002(6). Comparable documents under pre-TBOC law include a corporation’s Articles of Incorporation, an LLC’s Articles of Organization, and a limited partnership’s Certificate of Limited Partnership.

⁴⁴ See TBOC § 101.052.

⁴⁵ See TBCA art. 8.01.

⁴⁶ See TBOC § 9.004.

⁴⁷ See TBCA art. 4.04.

⁴⁸ See TBOC § 3.053.

⁴⁹ See TBCA art. 6.06.

⁵⁰ See TBOC § 11.101.

⁵¹ TBOC § 1.002(18).

⁵² TBOC § 1.002(28).

⁵³ TBOC § 1.002(22).

⁵⁴ TBOC § 1.002(69-b). Government Code § 311.005 defines “person” as follows:

Sec. 311.005. GENERAL DEFINITIONS. The following definitions apply unless the statute or context in which the word or phrase is used requires a different definition:

* * *

(2) “Person” includes corporation, organization, government or governmental subdivision or agency, business trust, estate, trust, partnership, association, and any other legal entity.

* * *

⁵⁵ TBOC §§ 3.003, 3.005, and the related Revisor’s Report, *supra* note 12.

⁵⁶ TBOC § 3.005 and the related Revisor’s Report, *supra* note 12.

⁵⁷ TBOC § 3.005 provides the minimum requirements for all Certificates of Formation, and the sections immediately thereafter specify the additional information required for each type of entity.

(c) Filing procedures. In addition to changing the form of the document required to organize a Texas business entity, the TBOC streamlined the filing fees for a number of documents.⁵⁸ For example, the filing fees for a certificate of formation for all domestic entities are now set forth in TBOC Chapter Four, Subchapter D.⁵⁹ Additionally, the TBOC now authorizes a filing fee of \$50 for the pre-clearance of any document, whereas before, the Secretary of State was only authorized to charge such fee for pre-clearance of limited partnership documents.⁶⁰ Another procedural change is that previously, when certain entities sent in their formation document (i.e., articles of incorporation for a regular corporation), the Secretary of State would send back an official document in response (i.e., a certificate of incorporation).⁶¹ Now, however, upon receipt of a certificate of formation, the Secretary of State may simply return a written acknowledgement of the filing, and is not required to issue any additional certificates or documents.⁶² Filings are generally effective when filed, not when the Secretary of State acknowledges them.⁶³ Additionally, documents with delayed effective dates may now be abandoned at any time prior to effectiveness.⁶⁴

(d) Entity Names. The TBOC relaxes the requirements for indicating the business entity form in the entity's official name further than even the most recent revisions to pre-TBOC law. A business's name must still indicate the business's entity form, but with greater flexibility regarding placement and abbreviation thereof than was previously permitted.⁶⁵ For example, previously, a limited partnership had to include in its name "limited," "limited partnership," "L.P.," or "Ltd.," and the name could not contain the name of a limited partner except under limited circumstances.⁶⁶ Now, however, limited partnerships need only contain "limited," "limited partnership," or "an abbreviation of that word or phrase" in their names, without any restrictions on the inclusion of a limited partner's name.⁶⁷ Under the TBOC an LLP is called a limited liability partnership rather than a "registered" limited liability partnership as it was known under TRPA.⁶⁸

(e) Governance. Subject to contrary provisions in an entity's governing documents, the TBOC now permits the removal of officers with or without cause, doing away with the requirement in much of the source law that such removal must be in the entity's best interests.⁶⁹ Also, the TBOC extends to all types of domestic entities the right for officers and directors to rely on opinions, reports, and statements given by certain people in the

⁵⁸ See TBOC Chapter 4, Subchapter D.

⁵⁹ See *id.* and the related Revisor's Report, *supra* note 12.

⁶⁰ TBOC § 4.151 and the related Revisor's Report, *supra* note 12.

⁶¹ See TBCA art. 3.03.

⁶² See TBOC § 4.002 the related Revisor's Report, *supra* note 12.

⁶³ TBOC § 4.051.

⁶⁴ TBOC § 4.057.

⁶⁵ See TBOC §§ 5.054-5.063.

⁶⁶ TRLPA § 1.03.

⁶⁷ TBOC §§ 5.055, 153.102 and the related Revisor's Report, *supra* note 12.

⁶⁸ TRPA § 3.08; TBOC §§ 1.002(48) and 152.801-152.805.

⁶⁹ TBOC § 3.104; TBCA art. 2.43; TNPCA art. 1396-2.21.

execution of their duties.⁷⁰ Further, it clarifies, as a default rule, that governing persons of domestic entities, other than limited partnerships, have the right to inspect the entity's books and records in connection with their duties.⁷¹

Additionally, the TBOC expands the permissible methods of holding required meetings to encompass the broad spectrum of technology now available by which such meetings may be conducted.⁷² Moreover, it adds safeguards that must be followed when using such technology to assure that only authorized persons are able to vote at such meetings.⁷³

(f) Construction. The TBOC incorporates the provisions of the Code Construction Act⁷⁴ to assist in its interpretation.⁷⁵ The Code Construction Act includes such useful aids as definitions of commonly used terms, basic rules of construction, the order of authority for conflicting statutes, and statutory savings provisions. The rules of the Code Construction Act are general in nature, and are intended to fill in any gaps left by the more specific rules of construction provided within the TBOC applicable to particular entity types.

(g) Transition Rules.⁷⁶ As previously stated, during the transition period between January 1, 2006 and January 1, 2010, entities which were formed in Texas prior to the TBOC's effective date but not opting in to TBOC governance continued to be governed by the old Texas statutes. During that period, they could continue to make filings with the Texas Secretary of State in the same manner as before the TBOC effective date, without any need to conform to the new filing requirements of the TBOC or adjust the nomenclature used.⁷⁷ However, limited liability partnerships were only entitled to continue following the registration requirements of the TRPA and TRLPA until their existing registrations expired,⁷⁸ at which point they must renew under the TBOC (although until January 1, 2010 they would continue to be substantively governed by the TRPA and TRLPA).

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

1. Classification. Under the IRC and the Treasury regulations promulgated thereunder, an unincorporated business entity may be classified as an "association" taxable as a corporation and subject to income taxes at the corporate level ranging from 15% to 35% of

⁷⁰ TBOC § 3.102. This default right previously existed for certain entities (*see, e.g.*, TBCA art. 2.41D and TNPCA art. 1396-2.28(B)), but not for partnerships or LLCs. *See* TBOC § 3.102 and the related Revisor's Report, *supra* note 12.

⁷¹ TBOC § 3.152 and the related Revisor's Report, *supra* note 12.

⁷² *See* TBOC § 6.002.

⁷³ TBOC § 6.002.

⁷⁴ TEX. GOV'T CODE ANN. § 311 (Vernon Supp. 2010).

⁷⁵ TBOC § 1.051.

⁷⁶ For more detailed rules governing the transition period, *see* TBOC Title 8.

⁷⁷ To illustrate, a corporation that was incorporated in Texas prior to January 1, 2006 could still amend its Articles of Incorporation by filing Articles of Amendment to its Articles of Incorporation, rather than a Certificate of Amendment until January 1, 2010. The Articles of Amendment would only need to conform to the current version of the TBCA until January 1, 2010.

⁷⁸ TBOC § 402.001(b).

taxable net income (absent a valid S-corporation status election) in addition to any taxation which may be imposed on the owner as a result of distributions from the business entity. Alternatively, the entity may be classified as a partnership, a non-taxable “flow-through” entity in which taxation is imposed only at the ownership level. Finally, if it is a single-owner LLC or LP, it may be disregarded as a separate entity for federal income tax purposes.⁷⁹

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

2. Check-the-Box Regulations. On December 18, 1996 the IRS issued Treasury Regulations §§ 301.7701-1, -2 and -3 (the “Check-the-Box Regulations”), which became effective January 1, 1997 and completely replaced the former classification regulations.⁸⁰ Entities now have the assurance of either partnership or corporate classification under a set of default rules or the ability to make an election to obtain the desired classification.⁸¹ Although the four factor technical analysis of the IRS’ former classification regulations (“Former Classification Regulations”) has been completely replaced, the IRS still requires certain prerequisites to be fulfilled prior to qualifying under the default rules or making a valid election:⁸²

(a) Eligible Entities. Initially, the entity must be a “business entity” that is separate from its owners for federal income tax purposes. A business entity is defined, in part, as any entity recognized for tax purposes that is not classified as a trust under Treas. Reg. § 301.7701-4 or otherwise subject to special treatment under the IRC, e.g., real estate mortgage investment conduits (“REMICs”).⁸³ The Check-the-Box Regulations do not provide a test for determining when a separate entity exists. Rather, the Check-the-Box Regulations merely state that a separate entity may be created by a joint venture or other contractual arrangement if the participants carry on a trade or business and divide the resulting profits.⁸⁴ Additionally, to be eligible for partnership classification, the business entity must not be automatically classified as a corporation under the Check-the-Box Regulations (e.g., domestic incorporated entities, life

⁷⁹ Rev. Rul. 2004-77, 2004-2 C.B. 119 (July 29, 2004) (“If an eligible entity has two members under local law, but one of the members of the eligible entity is, for federal tax purposes, disregarded as an entity separate from the other member of the eligible entity, then the eligible entity cannot be classified as a partnership and is either disregarded as an entity separate from its owner or an association taxable as a corporation”).

⁸⁰ T.D. 8697, 1997-1 C.B. 215.

⁸¹ Treas. Reg. § 301.7701-3(a) (as amended in 2006).

⁸² *Id.*

⁸³ *Id.* §§ 301.7701-2(a), 301.7701-4.

⁸⁴ *Id.* § 301.7701-1(a)(2).

insurance companies and most entities whose interests are publicly traded).⁸⁵ Among the entities that the Check-the-Box Regulations automatically classify as corporations are over 85 specific types of foreign business entities.⁸⁶ A business entity that meets the foregoing requirements is an “eligible entity” that need not make an election if the entity meets the requirements of the default rules.⁸⁷

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

(c) The Election Rules. An eligible entity that desires to obtain a classification other than under the default classification rules, or desires to change its classification, may file an election with the IRS on Form 8832 (Entity Classification Election).⁸⁸ For example, an election will be necessary if a domestic LLC with two or more members qualifies as an eligible entity and the owners desire corporate classification rather than the default partnership classification. The Treasury Regulations require that each member of an entity, or any officer, manager or member of the entity who is authorized to make the election and who so represents under penalty of perjury, sign Form 8832.⁸⁹

(d) Existing Entities. Under the Check-the-Box Regulations, the classification of eligible entities in existence prior to the effective date of the regulations will be respected by the IRS for all periods prior to January 1, 1997 if (i) the entity had a reasonable basis⁹⁰ for its claimed classification, (ii) the entity and all of the entity’s members or partners recognized the federal income tax consequences of any change in the entity’s classification within the 60 months prior to January 1, 1997, and (iii) neither the entity nor any member had been notified in writing on or before May 8, 1996 that the entity’s classification was under examination by the IRS.⁹¹ Therefore, unless an existing eligible entity elected to change the classification claimed prior to January 1, 1997, the entity will be “grandfathered” and will not be required to make an election to protect its classification. However, the one exception to this rule

⁸⁵ *Id.* § 301.7701-2.

⁸⁶ Treas. Reg. § 301.7701-2(b)(8).

⁸⁷ *Id.* § 301.7701-3(a).

⁸⁸ *Id.* § 301.7701-3(c).

⁸⁹ *Id.* § 301.7701-3(g)(2).

⁹⁰ The term “reasonable basis” has the same meaning as under I.R.C. § 6662, which addresses the accuracy-related penalties. *See* I.R.C. § 6662 (West Supp. 2008). The “reasonable basis” standard is far from clear; however, it is significantly stronger than “not frivolous” and may be at least as high a standard as “more likely than not.” *See* American Bar Association Section of Taxation Committee on the Standards of Tax Practice, *Standards of Tax Practice Statement*, 54 TAX LAW. 185, 189 (2000).

⁹¹ Treas. Reg. § 301.7701-3(h)(2).

is when a single owner entity previously claimed to be classified as a partnership.⁹² The single owner entity will be disregarded as an entity separate from its owner and thus will be treated as a sole proprietorship, or a branch or division of the owner.⁹³ If an entity elects to change its classification, there can be severe adverse consequences and tax counsel should be consulted.

3. Former Classification Regulations. Prior to January 1, 1997, under former Treasury Regulation section 301.7701-2⁹⁴ (the “Former Classification Regulations”), an unincorporated organization would have been treated by the IRS as an “association” (taxable as a corporation) if the organization had more corporate characteristics than non-corporate characteristics. Thus, if an entity possessed more than two of the four corporate characteristics, it would have been classified as a corporation for purposes of federal income taxation and, if it had two or less of the corporate characteristics, it would be classified as a partnership. These four characteristics are still relevant today, for they may be embodied in existing partnership and LLC agreements and may be encountered in drafts of new documents based on old precedent for years to come. The following sections discuss the four corporate characteristics:

(a) Continuity of Life. An organization does not have continuity of life if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member would cause dissolution of the organization (hereinafter, “Dissolution Event”).⁹⁵ If the occurrence of a Dissolution Event causes a dissolution of the organization, continuity of life does not exist, even if the remaining members have the ability to opt, by unanimous or majority consent, to continue the business.⁹⁶ Some states (including Texas) allow the partners of a partnership or members of an LLC to provide in the partnership agreement or company agreement that the business will continue in the event of a Dissolution Event.⁹⁷ Despite the fact that such an agreement

⁹² *Id.* § 301.7701-3(b)(3).

⁹³ *Id.* § 301.7701-3(f)(2).

⁹⁴ Former Treas. Reg. § 301.7701-2 (1967) (codifying *Morrissey v. Commissioner*, 296 U.S. 344, 357–58 (1935)); see BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 2.02 (5th ed. 1987) (discussing the classification of associations as corporations for federal income tax purposes).

⁹⁵ Former Treas. Reg. § 301.7701-2(b). A general or limited partnership formed under a statute corresponding to the Uniform Partnership Act or the Uniform Limited Partnership Act was considered by the IRS to lack continuity of life under Former Treas. Reg. § 301.7701-2(b).

⁹⁶ Former Treas. Reg. § 301.7701-2(b). Until 1993, the Former Classification Regulations indicated that such a partnership would avoid continuity of life only if a Dissolution Event resulted in either automatic dissolution or dissolution unless *all* of the remaining partners agreed to continue the business. Thus, it was assumed that a partnership *would* have the corporate characteristic of continuity of life if an agreement of a *majority* of the remaining partners were sufficient to save the partnership from dissolution upon the occurrence of a Dissolution Event. This belief was reinforced by Private Letter Ruling 90-100-27, in which the IRS, considering an LLC’s tax status, ruled that “[b]ecause dissolution under the Act may be avoided by a majority vote of members, rather than unanimous agreement, L possesses the corporate characteristic of continuity of life.” I.R.S. Priv. Ltr. Rul. 90-10-027 (March 9, 1990). The IRS should have based its ruling on the Regulations governing the LLC instead of the statute under which the LLC was formed, regardless of whether a majority vote to continue the business was insufficient to preclude continuity of life. Ultimately, the Former Classification Regulations were amended effective June 14, 1993 to allow “a majority in interest,” rather than “all remaining members,” of a partnership to elect to continue the business after a Dissolution Event. See Rev. Rul. 93-91, 1983-2 C.B. 316; Rev. Proc. 95-10, 1995-1 I.R.B. 20 (confirming the applicability of this standard to LLCs).

⁹⁷ See, e.g., LLC Act §§ 3.02(9), 6.01(B); TBOC § 101.052.

constitutes the agreement of a majority of the members of the organization, the use of any prior agreement to continue the business, by eliminating the possibility of dissolution upon a Dissolution Event, may have created continuity of life and would have jeopardized the classification of the entity as a partnership for federal income tax purposes.⁹⁸ Because continuity of life is no longer relevant to determining whether an entity may be classified as a partnership for federal income tax purposes, attorneys should consider whether Dissolution Events are consistent with the business objectives of the parties and, if they are not, consider means for negating them in partnership and LLC agreements.

(b) Centralization of Management. For this corporate characteristic to be present, the exclusive and continuing power to make necessary management decisions must be concentrated in a managerial group (composed of less than all the members) that has the authority to act on behalf of the organization independently of its members.⁹⁹ The key to this characteristic is the group's ability to bind the entity in its role as a representative of the organization, as opposed to its role as an owner.

(c) Limited Liability. An organization has the corporate characteristic of limited liability if under local law no member is personally liable for the debts or obligations of the organization when the organization's assets are insufficient to satisfy such debts or obligations.¹⁰⁰ In the case of a limited partnership, the IRS deemed the entity to have limited liability where the general partner has no substantial assets (other than his interest in the partnership) that could be reached by creditors of the entity and the general partner is merely a "dummy" acting as agent of the limited partners.¹⁰¹ To negate such an IRS assertion under the Former Classification Regulations, tax lawyers advised that the general partner should have substantial assets that could be reached by creditors. The capitalization of the general partner is of reduced importance from a tax standpoint under the Check-the-Box Regulations.¹⁰²

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

⁹⁸ See I.R.S. Priv. Ltr. Rul. 90-30-013 (Apr. 25, 1990) (explaining "no right to continue the business of X upon a [Dissolution Event] is stated in the articles of organization apart from continuance of X's business upon the consent of all the remaining members. Therefore, if a member of X ceases to be a member of X for any reason, the continuity of X is not assured, because all remaining members must agree to continue the business. Consequently, X lacks the corporate characteristic of continuity of life."); see also I.R.S. Priv. Ltr. Rul. 90-29-019 (Apr. 19, 1990); I.R.S. Priv. Ltr. Rul. 89-37-010 (June 16, 1989); Former Treas. Reg. § 301.7701(b)(1) (explaining "[a]n organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization."). Arguably, if the members have a preexisting agreement providing that such Dissolution Events will not cause a dissolution, then the organization has continuity of life. It would appear that there must be some uncertainty about the continuation of the business at the time of the Dissolution Event in order to avoid a finding of continuity of life.

⁹⁹ Rev. Proc. 95-10, 1995-1 I.R.B. 20; Rev. Rul. 93-6, 1993-1 C.B. 229; see also BITTKER & EUSTICE, *supra* note 94, at § 2.02.

¹⁰⁰ Former Treas. Reg. § 301.7701-2(d)(1).

¹⁰¹ Former Treas. Reg. § 301.7701-2(d)(2).

¹⁰² In contrast to the Former Classification Regulations and Rev. Proc. 89-12, 1989-7, I.R.B. 22, the Check-the-Box Regulations do not focus on the capitalization of the general partner.

participate in the management of the organization.¹⁰³ Free transferability does not exist if, under local law, the transfer of a member's interest results in the dissolution of the old entity and the formation of a new entity.¹⁰⁴ Partnership and LLC agreements traditionally have contained provisions intended to negate free transferability by giving a general partner or manager the discretion to decide whether to approve a proposed transfer.¹⁰⁵ These provisions are no longer appropriate except to the extent necessary to achieve the party's business objectives or to facilitate compliance with securities laws.

E. Texas Entity Taxation.

1. Corporations and LLCs, but not Partnerships, Subject to Former Franchise Tax. Through December 31, 2006, corporations and LLCs were subject to the former version of the Texas franchise tax,¹⁰⁶ which was equal to the greater of (i) 0.25% of "taxable capital" (generally owners' equity) and (ii) 4.5% of "net taxable earned surplus." "Net taxable earned surplus" was computed by determining the entity's reportable federal taxable income and adding to that amount the compensation of officers and directors. The add-back was not required if (x) the corporation had not more than 35 shareholders or was an S-corporation for federal tax purposes with no more than 75 shareholders,¹⁰⁷ or (y) the LLC had not more than 35 members.¹⁰⁸ The result was apportioned to Texas based on the percentage of its gross receipts from Texas sources. Although labeled a "franchise tax," the tax on "net taxable earned surplus" was really in most case a 4.5% income tax levied at the entity level.

Limited and general partnerships (including the LLP) were not subject to the former franchise tax. The Texas Comptroller of Public Accounts ("Comptroller") had issued private letter rulings stating that it would honor the state law classification of an entity as a partnership, despite any Check-the-Box election by the partnership to be treated as a corporation for federal income tax purposes.¹⁰⁹

2. Franchise Tax Change Proposals. Efforts to reduce Texas' dependence on property taxes to fund the schools led the 1997 through 2005 Texas Legislatures to consider, but not adopt, proposed changes in the Texas tax system which would subject partnerships to the franchise tax.¹¹⁰ The 2005 Texas Legislature also proposed: (i) a payroll based tax; and (ii) an

¹⁰³ Former Treas. Reg. § 301.7701-2(e)(1); *see also* Act of May 9, 1961, 57th Leg., R.S., ch. 158, 1961 Tex. Gen. Laws 289; Act of May 17, 1979, 66th Leg., R.S., ch. 723, § 5, 1979 Tex. Gen. Laws 1782; Act of May 9, 1985, 69th Leg., R.S., ch. 159, § 76, 1985 Tex. Gen. Laws 692; Act of May 9, 1991, 72d Leg., R.S., ch. 901, §§ 83-85, 1991 Tex. Gen. Laws 3234-35; Act of May 31, 1993, 73d Leg., R.S., ch. 917, § 2, 1993 Tex. Gen. Laws 3912-13 (expired Jan. 1, 1999).

¹⁰⁴ Former Treas. Reg. § 301.7701-2(d)(2).

¹⁰⁵ In contrast to the Former Classification Regulations and Revenue Procedure 89-12, the Check-the-Box Regulations do not focus on the capitalization of the general partner.

¹⁰⁶ TEX. TAX CODE § 171.001 (Vernon 2002 & Supp. 2004).

¹⁰⁷ TEX. TAX CODE § 171.110(b) (Vernon 2002 & Supp. 2004).

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

¹⁰⁹ *See, e.g.*, Comptroller Taxpayer Response Letter Accession No. 9811328L (Nov. 30, 1998).

¹¹⁰ *See* Tex. H.B. 3146, 78th Leg., R.S. (2003), *available at* <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=78R&Bill=HB3146>. House Bill 3146 in

extension of the Texas franchise tax to foreign corporations earning Texas source income from Texas based partnerships. In 2006, property tax reform efforts were primarily motivated by the Texas Supreme Court's decision in *Neeley v. West Orange-Cove Consolidated Independent School District*.¹¹¹ The Court in *West Orange-Cove* held that the property tax rate cap then in effect of \$1.50 per \$1,000 of valuation violated Article VIII, Section 1-e of the Texas Constitution, which prohibits the imposition of a statewide property tax. The Court directed the Texas Legislature to cure the defect by June 1, 2006. In anticipation of a Supreme Court decision in *West Orange-Cove*, on November 4, 2005 Governor Rick Perry appointed a 24-member Texas Tax Reform Commission and former Comptroller John Sharp as its Chairman (the "Sharp Commission") to study and make recommendations on how to reform Texas' business tax structure and provide significant property tax relief and also to later address court-mandated changes in how Texas funds its schools. On November 21, 2005 (the day before the Supreme Court decision in *West Orange-Cove*), the Sharp Commission held the first of a series of public hearings at which various affected parties testified as to what should be changed. On March 29, 2006, the Sharp Commission released its report (the "Sharp Commission Report") which recommended that (1) the Legislature should cut school district property taxes for maintenance and operations substantially (with many districts setting rates at or near \$1.50 per \$100 of valuation, the Sharp Commission recommended that the property tax rate should be lowered to \$1 per \$100 and permanently re-capped at no more than \$1.30 per \$100 by the 2007 tax year and reductions for the 2006 tax year sufficient to comply with the Supreme Court's mandate to be provided immediately) and (2) the Legislature should reform the state's franchise tax by (a) broadening the base of businesses that pay into the system to include most entities whose owners are generally protected from the entities' liabilities, (b) cutting the franchise tax rate from 4.5% to 1%, (c) basing the franchise tax on a business' margin by allowing each

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

¹¹¹ 176 S.W.3d 746 (Tex. 2005).

business to choose between deducting either the cost of goods sold or employee or partner compensation (including health insurance, pensions and other benefits) from its total revenue, and (d) increasing the small-business exemption from \$150,000 to \$300,000 in total revenue and exempting sole proprietors and “non-corporate general partnerships.”¹¹² The Sharp Commission Report also recommended raising the tax on cigarettes by \$1 per pack.

3. Margin Tax. In a Special Session which convened on April 17, 2006 and adjourned *sine die* on May 15, 2006, the Texas Legislature passed House Bill 3 (“H.B. 3”).¹¹³ H.B. 3 amended Texas Tax Code Chapter 171¹¹⁴ to replace the current franchise tax on corporations and LLCs with a new and novel business entity tax called the “Margin Tax” herein. In the 2007 Legislative Session the Margin Tax provisions of the Texas Tax Code were amended by H.B. 3928.

In the 2009 Texas Legislative Session, only three bills that passed amended Chapter 171 of the Texas Tax Code. One of the bills clarified the method that banks may use to apportion income related to loans and securities to be consistent with prior Texas Comptroller policy.¹¹⁵ This change clarified that FASB 115 “trading securities” must be treated as inventory items and that the aggregate proceeds from trading shall be included in a lending institution’s apportionment formula. The second bill raised the small business threshold for Margin Tax payers from \$300,000 of gross revenue up to \$1,000,000 of gross revenue for the 2010 and 2011 tax years.¹¹⁶ The third bill¹¹⁷ allows “destination management companies” to exclude “payments

¹¹² A draft of the legislation proposed by the Sharp Commission can be found at http://www.governor.state.tx.us/priorities/tax_reform/TTRC_report/files/tax_reform_bill.pdf.

¹¹³ Tex. H.B. 3, 79th Leg., 3d C.S. (2006) (hereinafter H.B. 3); the text of H.B. 3 can be viewed in its entirety at the following link: <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=793&Bill=HB3>. See Ira A. Lipstet, *Franchise Tax Reformed: The New Margin Tax Including 2007 Legislative Changes and Final Comptroller Rules*, 42 TEX. J. BUS. L. 1 (2007).

¹¹⁴ Chapter 171 of the Texas Tax Code was modified and largely replaced by the provisions of H.B. 3. References in the following footnotes to the “Texas Tax Code” are references to Chapter 171 of the Texas Tax Code as amended in 2006 by H.B. 3 and in 2007 by H.B. 3928. H.B. 3928 by Rep. Jim Keffer, 80th Leg., R.S. (2007), available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=80R&Bill=HB3928>.

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

¹¹⁶ H.B. 4765 by Rep. Rene Oliveira (D-Brownsville), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB4765> (increased the small business exemption from the franchise tax from \$300,000 to \$1 million for 2010 and 2011 tax years, contingent on the passage of an increase in the smokeless tobacco tax; the increased exemption sunsets on December 31, 2011; thereafter, the exemption is reduced from \$1 million to \$600,000; the reduction was made contingent on the passage of an increase in the smokeless tobacco tax; HB 4765 is effective January 1, 2010); H.B. 2154 Rep. Al Edwards (D-Houston), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB2154> (provided the smokeless tobacco tax required by H.B. 4765).

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

(a) Who is Subject to Margin Tax. The Margin Tax is imposed on all businesses except (i) sole proprietorships, (ii) general partnerships “the direct ownership of which is entirely composed of natural persons,” and (iii) certain “passive” entities.¹¹⁸ Thus,

¹¹⁷ S.B. 636 by Sen. Kel Seliger (R-Amarillo), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=SB636>. The bill adds a new subsection 171.1011(g-6) to the Texas Tax Code.

¹¹⁸ Texas Tax Code § 171.0002 defines “taxable entity” as follows:

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

(b) “Taxable entity” does not include:

- (1) a sole proprietorship;
- (2) a general partnership:
 - (A) the direct ownership of which is entirely composed of natural persons; and
 - (B) the liability of which is not limited under a statute of this state or another state, including by registration as a limited liability partnership;
- (3) a passive entity as defined by Section 171.0003; or
- (4) an entity that is exempt from taxation under Subchapter B.

(c) “Taxable entity” does not include an entity that is:

- (1) a grantor trust as defined by Sections 671 and 7701(a)(30)(E), Internal Revenue Code, all of the grantors and beneficiaries of which are natural persons or charitable entities as described in Section 501(c)(3), Internal Revenue Code, excluding a trust taxable as a business entity pursuant to Treasury Regulation Section 301.7701-4(b);
- (2) an estate of a natural person as defined by Section 7701(a)(30)(D), Internal Revenue Code, excluding an estate taxable as a business entity pursuant to Treasury Regulation Section 301.7701-4(b);
- (3) an escrow;
- (4) a real estate investment trust (REIT) as defined by Section 856, Internal Revenue Code, and its “qualified REIT subsidiary” entities as defined by Section 856(i)(2), Internal Revenue Code, provided that:
 - (A) a REIT with any amount of its assets in direct holdings of real estate, other than real estate it occupies for business purposes, as opposed to holding interests in limited partnerships or other entities that directly hold the real estate, is a taxable entity; and
 - (B) a limited partnership or other entity that directly holds the real estate as described in Paragraph (A) is not exempt under this subdivision, without regard to whether a REIT holds an interest in it;

corporations, limited partnerships, certain general partnerships, LLPs, LLCs, business trusts and professional associations are subject to the Margin Tax.¹¹⁹ The Margin Tax is not imposed on sole proprietorships, general partnerships that are owned 100% by natural persons,¹²⁰ certain narrowly defined passive income entities¹²¹ (including certain real estate investment trusts (“REITs”)),¹²² grantor trusts,¹²³ estates of a natural person, an escrow,¹²⁴ or a REMIC.

(5) a real estate mortgage investment conduit (REMIC), as defined by Section 860D, Internal Revenue Code;

(6) a nonprofit self-insurance trust created under Chapter 2212, Insurance Code, or a predecessor statute;

(7) a trust qualified under Section 401(a), Internal Revenue Code; or

(8) a trust or other entity that is exempt under Section 501(c)(9), Internal Revenue Code.

(d) An entity that can file as a sole proprietorship for federal tax purposes is not a sole proprietorship for purposes of Subsection (b)(1) and is not exempt under that subsection if the entity is formed in a manner under the statutes of this state, another state, or a foreign country that limit the liability of the entity.

¹¹⁹ Texas Tax Code Ann. § 171.0002(a).

¹²⁰ Since an LLP is classified under both the TRPA and the TBOC as a species of general partnership, under a literal reading of H.B. 3 the Margin Tax would not have been applicable to an LLP composed solely of natural persons. Various statements by the Sharp Commission and the offices of the Governor and the Comptroller suggested that the Margin Tax was generally intended to apply to any entity that afforded limited liability to its owners, which would include the LLP. H.B. 3928 resolved this issue by amending Texas Tax Code § 171.0002 to expressly provide that an LLP is subject to the Margin Tax.

¹²¹ Texas Tax Code Ann. § 171.0003 defines “passive entity” as follows:

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

(1) the entity is a general or limited partnership or a trust, other than a business trust;

(2) during the period on which margin is based, the entity’s federal gross income consists of at least 90 percent of the following income:

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

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

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

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

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

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

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

(1) rent; or

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

(b) Passive Entities. Passive entities must have at least 90% of their gross income for federal income tax purposes¹²⁵ from partnership allocations from downstream non-controlled flow through entities, dividends, interest, royalties, or capital gains from the sale of (i) real estate,¹²⁶ (ii) securities or (iii) commodities. Real estate rentals, as well as other rent

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

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

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

- (1) the activities being carried on by the entity include one or more active operations that form a part of the process of earning income or profit; and
- (2) the entity performs active management and operational functions.

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

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

(e) For purposes of this section:

- (1) the ownership of a royalty interest or a nonoperating working interest in mineral rights does not constitute conduct of an active trade or business;
- (2) payment of compensation to employees or independent contractors for financial or legal services reasonably necessary for the operation of the entity does not constitute conduct of an active trade or business; and
- (3) holding a seat on the board of directors of an entity does not by itself constitute conduct of an active trade or business.

¹²² The REIT exclusion is limited to REITs that do not directly own property (other than the real estate that the REIT occupies for business purposes) and qualified REIT subsidiaries (which do not include partnerships). Tex. Tax Code Ann. § 171.0002(c)(4).

¹²³ An interpretative question under H.B. 3 is what types of “trusts” other than grantor trusts, might be considered to be a “legal entity” as that term is used in connection with the definition of “taxable entity.” The Texas Trust Code applies only to “express trusts.” An “express trust” is defined in the Texas Trust Code as “a fiduciary relationship” with respect to property which arises as a manifestation by the settlor of an intention to create the *relationship* and which subjects the person holding title to the property to equitable duties to deal with the property for the benefit of another person.” Recently, the Texas Supreme Court confirmed previous decisions that a trust is not an entity but a relationship. *See, e.g., Huie v. DeShazo*, 922 S.W.2d 920, 926 (Tex. 1996) (holding that “[t]he term ‘trust’ refers not to a separate legal entity but rather to the fiduciary relationship governing the trustee with respect to the trust property[,]” and that treating trust rather than trustee as attorney’s client “is inconsistent with the law of trusts”). There is at least a negative implication in the wording of H.B. 3, however, that trusts other than “grantor trusts” are taxable entities. Further, a trust is an entity for federal income tax purposes (when a trust applies for a taxpayer identification number, the name of the entity is the name of the trust – not the name of the trustee; the taxpayer name used on a trust’s Form 1041 is the trust’s name).

¹²⁴ Tex. Tax Code Ann. § 171.0002(c).

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

¹²⁶ There is some pending discussion of what definition of “real estate” will be used for this purpose. While the Texas Comptroller has long standing definitions for “real estate” under the sales tax chapters of the Texas Tax Code, there is some informal indication that the Internal Revenue Code’s definition of real estate is more appropriate for this purpose. *See, e.g., Treas. Reg. 1-897-1(b)(1).*

and income from mineral interests, are not passive income sources unless they are classified as “royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests.”¹²⁷ In addition, only non-business trusts, general partnerships and limited partnerships can qualify as passive entities. LLCs and S-corps cannot qualify as passive entities, even if 90% of their income is from qualifying passive sources.

A limited partnership that has income from real estate rents, as well as dividends and interest, may want to consider whether the entity could be split in two in order to isolate the passive income sources into an entity that will qualify as a tax exempt passive entity.¹²⁸

Comptroller Rule 3.582 mandates that an entity must be the type of entity that may qualify to be passive (i.e., a partnership or trust, and not an LLC) for the entire tax year at issue in order to qualify as passive for such year.¹²⁹ So for example, if an LLC with substantial real estate rents plans to convert to an LP for a year in which it will liquidate a real estate asset, achieve a major capital gain, and possibly qualify as a passive entity, the LLC will need to complete the conversion to an LP prior to January 1 of such year.

Passive entities are not part of combined groups, and the owners of passive entities are not allowed to exclude income allocations from the passive entity.¹³⁰ Rather, if the owners of a passive entity are otherwise “taxable entities,” they will have to re-test to determine their own passive status. The income the owners receive from such a downstream passive entity may qualify as passive source income,¹³¹ but the passive entity owner will still have to independently pass the 90% passive source test. Caution and care should be taken with respect to passive entity planning, and one rule of thumb is that passive entity status will not be of any benefit to the extent that there are intermediary taxable entities between a passive entity and its ultimate natural person owners.

¹²⁷ Tex. Tax Code Ann. § 171.0003(a)(2)(D); *see also* § 171.0003(b)(2) (passive income includes “income received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is [not] a member of an affiliated group and another member of that group is the operator under the same joint operating agreement”).

¹²⁸ H.B. 3 § 22 raises some question about whether or to what extent partnership divisions will be honored. For example, H.B. 3 § 22(f) provides that when a partnership is divided into two or more partnerships the resulting partnerships are treated as a “continuation of the prior partnership.” This does not apply to partnerships owned 50% or less by the partners of the former partnership. *See* H.B. 3 § 22.

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

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

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

(c) LLPs. In 2007 the Texas Legislature in H.B. 3928 “clarified” (or expanded) the scope of the Margin Tax to apply to LLPs.¹³² The Comptroller has determined that LLPs can qualify to be passive entities if they otherwise meet the 90% test for passive revenue.¹³³

(d) Prior Chapter 171 Exemptions. The Margin Tax preserves the exemptions previously available under the Texas franchise tax for “an entity which is not a corporation but that because of its activities, would qualify for a specific exemption ... if it were a corporation” to the extent it would qualify if it were a corporation.¹³⁴

(e) Small Business Phase-In. In the 2009 Legislative Session, the Tax Code was amended so that, for tax years 2010 and 2011, if a taxable entity¹³⁵ has total revenue of \$1 million or less, it is not required to pay any Texas franchise tax for that year.¹³⁶ After the 2010 and 2011 tax years, the small business exemption is reduced from \$1 million to \$600,000.¹³⁷ These threshold tax amounts do not function as a deduction. A business with gross revenue in excess of the applicable threshold amount calculates its tax liability on its entire gross receipts.

For tax years 2009 and prior, taxable entities¹³⁸ that have \$300,000 (with CPI adjustments for later years) or less in gross revenue in a year, or whose Margin Tax liability is less than \$1,000, are also exempt for that year.¹³⁹ For tax years 2009 and prior, taxable entities that have less than \$900,000 in gross revenue¹⁴⁰ in a year become subject to the Margin Tax on the following schedule:

¹³² H.B. 3928 § 2 (2007) amended TEX. TAX CODE ANN. § 171.0002(a) to add “limited liability partnership” to the statutory definition of “taxable entity.”

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

¹³⁴ See, e.g., TEX. TAX CODE ANN. § 171.088.

¹³⁵ A taxable entity includes a combined group for this \$1 million threshold. 34 T.A.C. 3.581(b)(13).

¹³⁶ In addition there would be a staggered phase in of the margin tax for taxpayers with annual revenues greater than \$600,000 and less than \$900,000.

¹³⁷ H.B. 4765 by Rep. Rene Oliveira (D-Brownsville), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB4765> (increased the small business exemption from the franchise tax from \$300,000 to \$1 million for 2010 and 2011 tax years, contingent on the passage of an increase in the smokeless tobacco tax; the increased exemption sunsets on December 31, 2011; thereafter, the exemption is reduced from \$1 million to \$600,000 and the reduction was made contingent on the passage of an increase in the smokeless tobacco tax; HB 4765 is effective January 1, 2010); H.B. 2154 Rep. Al Edwards (D-Houston), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB2154> (provided the smokeless tobacco tax required by H.B. 4765, which is intended to raise new revenue by increasing tobacco taxes to offset some of the fiscal impact of H.B. 4765).

¹³⁸ Combined groups are treated as a single taxable entity for purposes of this \$300,000 threshold. 34 T.A.C. § 3.581(b)(13).

¹³⁹ *Id.* § 171.0002(d)(2).

¹⁴⁰ *Id.* § 171.0021.

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

(f) Basic Calculation. In a nutshell, the calculation of the Margin Tax is based on a taxable entity’s (or unitary group’s) gross receipts after deductions for either (x) compensation or (y) cost of goods sold (“COGS”). An affiliated group must choose one type of deduction to apply to the entire group. The “tax base” is apportioned to Texas using a single-factor gross receipts apportionment formula with no throwback rule – Texas gross receipts divided by aggregate gross receipts. The tax rate applied to the Texas portion of the tax base is 1% for all taxpayers except a narrowly defined group of retail and wholesale businesses which pay a 0.5% rate. There is a safety net so that the “tax base” for the Margin Tax may not exceed 70% of a business’s total revenues.¹⁴¹ However, it is possible for an entity to owe Margin Tax in any given year even if it is reporting a loss for federal income tax purposes and has a negative cash flow.

Entities would pay the Margin Tax on a “unitary combined basis” (i.e., affiliated groups of entities would in effect be required to pay taxes on a consolidated basis). Thus, the internal partnership structure described below under the heading “6. Internal Partnerships Will Not Work Under Margin Tax” would no longer work as described.¹⁴²

(g) Gross Revenue Less (x) Compensation or (y) Cost of Goods Sold. For purposes of the Margin Tax, a taxable entity’s total revenue is generally total income as reported on IRS Form 1120 (for corporate entities),¹⁴³ or IRS Form 1065 (for partnerships and other pass-through entities),¹⁴⁴ plus dividends, interest, gross rents and royalties, and net capital gain income,¹⁴⁵ minus bad debts, certain foreign items, and income from related entities to the extent already included in the margin tax base.¹⁴⁶

(h) Gross Revenue. H.B. 3 includes a very short and specific list of “flow through” items which are excluded from gross receipts: (A) flow-through funds that are mandated by law or fiduciary duty to be distributed to other entities (such as sales and other

¹⁴¹ See *id.* § 171.101.

¹⁴² See *infra* note 215 and related text.

¹⁴³ *Id.* § 171.1011(c)(1).

¹⁴⁴ *Id.* § 171.1011(c)(2).

¹⁴⁵ *Id.* § 171.1011(c)(1)(A).

¹⁴⁶ *Id.* § 171.1011(c)(1)(B).

taxes collected from a third party and remitted to a taxing authority);¹⁴⁷ (B) the following flow-through funds that are required by contract to be distributed to other entities: (i) sales commissions paid to non-employees (including split-fee real estate commissions);¹⁴⁸ (ii) subcontracting payments for “services, labor, or materials in connection with the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of the boundaries of real property”;¹⁴⁹ and (iii) law firms may exclude the amounts they are obligated to pay over to clients and referring attorneys, matter specific expenses, and pro-bono out-of-pocket expenses not to exceed \$500 per case;¹⁵⁰ (C) the federal tax basis of securities and loans underwritten or sold;¹⁵¹ (D) lending institutions may exclude loan principal repayment proceeds;¹⁵² (E) dividends and interest received from federal obligations;¹⁵³ (F) reimbursements received by a “management company”¹⁵⁴ for specified costs incurred in its conduct of the active trade or business of a managed entity, including wages and compensation; and (G) payments received by a staff leasing services company from a client company for wages,

¹⁴⁷ *Id.* § 171.1011(f).

¹⁴⁸ *Id.* § 171.1011(g)(1).

¹⁴⁹ *Id.* § 171.1011(g)(3). Payments to subcontractors (apart from very limited express exclusions) are not excludable from gross receipts for Margin Tax calculations. Thus, if a client specifically engaged an accounting firm in Texas to hire other accounting firms and pay for tax filings in other states or countries and include the amount in the Texas accountant’s bill as a reimbursable expense, the expense reimbursement would be included in the Texas accounting firm’s gross receipts. The consequence is the Texas firms will increasingly ask their clients to pay significant out of pocket expenses directly.

¹⁵⁰ Texas Tax Code § 171.1011(g-3) allows legal service providers to exclude flow-through receipts as follows:

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

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

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

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

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

¹⁵¹ Tex. Tax Code §§ 171.1011(g)(2) and 171.1011(g-2).

¹⁵² *Id.* § 171.1011(g-1).

¹⁵³ *Id.* § 171.1011(m). “Federal obligations” are defined in Texas Tax Code § 171.1011(p)(1) to include stocks and other direct obligations of, and obligations unconditionally guaranteed by, the United States government and United States government agencies.

¹⁵⁴ *Id.* § 171.1011(m)(1). “Management company” is defined in Texas Tax Code § 171.0001(11) as any limited liability entity that conducts all or part of the active trade or business of another entity in exchange for a management fee and reimbursement of specified costs.

payroll taxes on those wages, employee benefits, and workers' compensation benefits for the assigned employees of the client company.¹⁵⁵

Health care providers¹⁵⁶ may generally exclude payments received under the Medicaid, Medicare, Children's Health Insurance Program ("CHIP"), workers' compensation, the TRICARE military health system, the Indigent Health Care and Treatment Act, as well as the actual costs of "uncompensated care."¹⁵⁷ Health care institutions¹⁵⁸ may exclude 50%¹⁵⁹ of the public reimbursement program revenues described above. Rulemaking by the Comptroller will be important with respect to these exclusions, because there are currently no means by which to trace Medicare funds to the actual service providers.

Any taxable entity may exclude revenues received from oil or gas produced during dates certified by the Comptroller from (1) an oil well designated by the Railroad Commission of Texas or similar authority of another state whose production averages less than 10 barrels a day over a 90-day period; and (2) a gas well designated by the Railroad Commission of Texas or similar authority of another state whose production averages less than 250 mcf a day over a 90-day period.¹⁶⁰ The Comptroller is required to certify dates during which the monthly average closing price of West Texas Intermediate crude oil is below \$40 per barrel and the average closing price of gas is below \$5 per MMBtu, as recorded on the New York Mercantile Exchange (NYMEX).¹⁶¹

(i) The Compensation Deduction. For purposes of the Margin Tax, "compensation" includes "wages and cash compensation" as reported on the Medicare wages and tips box of IRS Form W-2. It also includes "net distributive income" from partnerships, limited liability companies, and S Corporations to natural persons,¹⁶² plus stock awards and stock options as well as workers compensation benefits, health care, and retirement to the extent deductible for federal income tax purposes.¹⁶³ The deduction for wages and cash compensation may not exceed \$300,000 plus benefits that are deductible for federal income tax purposes for any single person.¹⁶⁴ Compensation apparently does not include social security or Medicare

¹⁵⁵ "Staff leasing services company" for these purposes has the meaning set forth in § 91.001 of the Texas Labor Code. TEX. LAB. CODE ANN. § 91.001 (Vernon 2010).

¹⁵⁶ "Health care providers" are defined in Texas Tax Code § 171.1011(p)(3) as "a taxable entity that participates in the Medicaid program, Medicare program, Children's Health Insurance Program (CHIP), state workers' compensation program, or TRICARE military health system as a provider of health care services."

¹⁵⁷ Tex. Tax Code § 171.1011(n).

¹⁵⁸ *Id.* § 171.1011(p)(2). "Health care institutions" are defined to include ambulatory surgical centers; assisted living facilities licensed under Chapter 247 of the Health and Safety Code; emergency medical service providers; home and community support services agencies; hospices; hospitals; hospital systems; certain intermediate care facilities for mentally retarded persons; birthing centers; nursing homes; end stage renal disease facilities; or pharmacies.

¹⁵⁹ *Id.* § 171.1011(o).

¹⁶⁰ *Id.* § 171.1011(r).

¹⁶¹ *Id.* § 171.1011(s).

¹⁶² *Id.* § 171.1013(a)(1) & (2).

¹⁶³ *Id.* § 171.1013(a)(3).

¹⁶⁴ *Id.* § 171.1013(c).

contributions, and such amounts apparently are not otherwise deductible for Margin Tax purposes.

(j) The Cost of “Goods” Sold Deduction. Under the Margin Tax, “goods” means real or tangible personal property sold in the ordinary course of business;¹⁶⁵ the term does not include provision of services. As a result, most service businesses (e.g., accounting, law and engineering firms) will not have a cost of goods sold and are relegated to sole reliance on the compensation deduction.

The term “cost of goods sold” is defined to include the direct costs of acquiring or producing goods, including labor costs, processing, assembling, packaging, inbound transportation, utilities, storage, control storage licensing and franchising costs, and production taxes.¹⁶⁶ Certain indirect costs for production facilities, land and equipment, such as depreciation, depletion, intangible drilling and dry hole costs, geological and geophysical costs, amortization, renting, leasing, repair, maintenance, research, and design are also included.¹⁶⁷ The “cost of goods sold” definition does not include selling costs, advertising, distribution and outbound transportation costs, interest or financing costs, income taxes or franchise taxes.¹⁶⁸ Up to 4% of administrative and overhead expenses may be included in “cost of goods sold” to the extent they are allocable to the costs of acquiring or producing goods.¹⁶⁹ The “cost of goods sold” must be capitalized to the extent required by I.R.C. § 263A.¹⁷⁰

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

Regular annual Margin Tax returns are due on May 15¹⁷¹ of each year, and are based on financial data from the previous calendar year. The first Margin Tax returns were originally due on May 15, 2008, but on April 22, 2008 the Comptroller extended that date for 30 days in recognition of the complexity of the Margin Tax and the newness of enhanced electronic reporting methods.¹⁷² The Margin Tax returns are based on financial data for the preceding calendar year.

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

¹⁶⁵ *Id.* § 171.1012(a)(1).

¹⁶⁶ *Id.* § 171.1012(c).

¹⁶⁷ *Id.* § 171.1012(c) and (d).

¹⁶⁸ *Id.* § 171.1012(e).

¹⁶⁹ *Id.* § 171.1012(f).

¹⁷⁰ *Id.* § 171.1011(g).

¹⁷¹ *Id.* § 171.151(c).

¹⁷² See Tex. H.B. 3, § 22; Texas Comptroller of Public Accounts press release issued April 22, 2008, available at <http://www.window.state.tx.us/news2008/080422-ftaxextension.html>.

on a unitary and combined basis. An affiliated group of entities in a “unitary business”¹⁷³ must file a combined return including all taxable entities within the group.¹⁷⁴ The unitary group includes all affiliates¹⁷⁵ with a common owner (i.e., greater than 50% owned),¹⁷⁶ and the group includes entities with no nexus in Texas.¹⁷⁷

(m) Combined Reporting. The Margin Tax statute literally applies its combined reporting standard of greater than 50% ownership to one or more “common owner or owners.”¹⁷⁸ The application of this standard proved unworkable, and the Comptroller’s Rule 3.590¹⁷⁹ now limits the application of the combined reporting requirement to entities with greater than 50% ownership or control held directly or indirectly by a single owner. The only attribution rule applies to interests owned or controlled by a husband and wife.¹⁸⁰

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

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

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

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

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

¹⁷³ Texas Tax Code § 171.0001(17) defines a “unitary business” as “a single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts.”

¹⁷⁴ *Id.* § 171.1014.

¹⁷⁵ Section 171.0001(1) of the Texas Tax Code defines an “affiliated group” as “a group of one or more entities in which a *controlling interest* is owned by a common owner or owners, *either corporate or noncorporate*, or by one of more of the member entities.” [*emphasis added*]

¹⁷⁶ *Id.* § 171.0001(8).

¹⁷⁷ *See id.* § 171.1014(c).

¹⁷⁸ *Id.* § 171.0001(1).

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

¹⁸⁰ *Id.* § 3.590 (b)(4)(E).

Limited Liability Company C. Corporation A owns a controlling interest in Partnership B and a 100% controlling interest in Limited Liability Company C.¹⁸¹

The Comptroller's Rule 3.590 defines "controlling interest" for determining the combined reporting standard for a corporation as, "either more than 50%, owned directly or indirectly, of the total combined voting power of all classes of stock of the corporation, or more than 50% owned directly or indirectly, of the beneficial ownership interest in the voting stock of the corporation."¹⁸² This test is clearly based on control. In contrast, with respect to a partnership or trust, Comptroller Rule 3.590 defines controlling interest as, "more than 50%, owned, directly or indirectly, of the capital, profits, or beneficial interest in the partnership, association, trust, or other entity."¹⁸³ The controlling interest standard for partnerships and trusts appears to be more focused on economic or beneficial ownership rather than control. The Comptroller Rule 3.590 goes on to state that with respect to a limited liability company, controlling interest means "either more than 50%, owned directly or indirectly, of the total membership interest of the limited liability company or more than 50%, owned directly or indirectly, of the beneficial ownership interest in the membership interest of the limited liability company."¹⁸⁴

One issue raised by Comptroller Rule 3.590 is which party to a trust agreement (settlor, trustee, or beneficiary) should be considered to hold the "beneficial interest" for purposes of the controlling interest standard. One might conclude under state law that the "beneficiary" holds the "beneficial interest." But, one must consider that in other contexts the term beneficial interest refers to control rather than economic ownership.¹⁸⁵ The Comptroller may well be inclined to take the position that "controlling interest" should be determined by control rather than mere economic ownership.

The combined group does not include entities with 80% or more of their property and payroll outside the United States.¹⁸⁶ Passive entities or exempt entities are not part of the group.¹⁸⁷

¹⁸¹ *Id.* § 3.590.

¹⁸² 34 T.A.C. § 3.590(b)(4)(A)(i).

¹⁸³ 34 T.A.C. § 3.590(b)(4)(A)(ii).

¹⁸⁴ 34 T.A.C. § 3.590(b)(4)(A)(iii).

¹⁸⁵ *See* Rule 13d-3(a) promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended, which provides as follows:

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

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

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

¹⁸⁶ Tex. Tax Code § 171.1014(a).

¹⁸⁷ 34 T.A.C. § 3.590(b)(2)(B) & (F).

The affiliated group is a single taxable entity for purposes of filing the Margin Tax return, and the combined return is designed to be the sum of the returns of the separate affiliates. The group must make an election to choose either the (i) cost of goods sold deduction; or (ii) the compensation deduction for all of its members.¹⁸⁸ In order to avoid double taxation the combined group may exclude items of total revenue received from a member of the group to the extent such revenue is already in the tax base of an upper tier group member.¹⁸⁹

(n) Apportionment. The Margin Tax is apportioned using a single-factor gross receipt formula (Texas gross receipts divided by aggregate gross receipts).¹⁹⁰ Receipts that are excluded from the tax base must also be excluded from gross receipts for apportionment purposes.¹⁹¹

Texas gross receipts include receipts from the sale of tangible personal property delivered or shipped to a buyer in this state, services performed in this state (regardless of customer location), the use of a patent, copyright, trademark, franchise, or license in this state, sale of real property in this state (including royalties from minerals) and other business done in this state.¹⁹² Only Texas gross receipts from those entities within the group which have nexus in Texas are included in the calculation of Texas receipts (this is sometimes referred to as the “Joyce” rule).¹⁹³ Sales to states in which the seller is not subject to an income tax are not deemed to be a Texas receipt (i.e., no throwback rule).¹⁹⁴

Aggregate gross receipts include the gross receipts (as described above) of each taxable entity in the combined group without regard to whether an individual entity has nexus with Texas.¹⁹⁵ If a taxable entity sells an investment or capital asset, the taxable entity’s gross receipts from its entire business for taxable margin includes only the net gain from the sale.¹⁹⁶

(o) Credits / NOLs. Comptroller Rule 3.594 (effective January 1, 2008) describes the limited ability of a taxpayer to utilize its net business operating loss carryforwards (“NOLs”) as a credit against the Texas margin tax.¹⁹⁷ One initial qualification is that any business losses upon which NOLs are based must have been used to offset any positive amount of earned surplus even in years when no tax was due.¹⁹⁸ In addition, taxpayers must submit a notice of intent to preserve the right to claim the temporary credit for business loss carryforwards with the first report due from a taxable entity after January 1, 2008, on a form

¹⁸⁸ *Id.* § 171.1014(d).

¹⁸⁹ *Id.* § 171.1014(c)(3).

¹⁹⁰ *Id.* § 171.106(a).

¹⁹¹ *Id.* § 171.1055(a).

¹⁹² *Id.* § 171.103(a).

¹⁹³ *Id.* § 171.103(b).

¹⁹⁴ *See* deletion from former TEX. TAX CODE ANN. § 171.103(a)(1) (amended 2006).

¹⁹⁵ *Id.* § 171.105(c).

¹⁹⁶ *Id.* § 171.105(b).

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

¹⁹⁸ *Id.*

prescribed by the Comptroller.¹⁹⁹ A taxable entity may only claim the credit if the entity was subject to franchise tax on May 1, 2006.²⁰⁰ The of the right to claim the NOL credit may not be transferred to another entity and changes to the membership of a combined group can prejudice the right to utilize the NOL credit.²⁰¹

“The election to claim the credit shall be made on each report originally due on or after January 1, 2008 and before September 1, 2027.”²⁰² If a taxpayer is eligible to use its NOLs as a Margin Tax credit, then for report years 2008–2017, the credit is the business loss carryforward amount x 2.25% x 4.5%.²⁰³ For report years 2018–2027: the credit for the business loss carryforward amount x 7.75% x 4.5%.²⁰⁴

(p) Administration and Enforcement. The Comptroller has rulemaking authority with respect to the Margin Tax and has prepared a worksheet illustrating the calculation of taxable margin on a separate entity basis.²⁰⁵ The former Comptroller, Carole Keeton Strayhorn, requested an Attorney General’s Opinion on whether the new margin tax safely avoids classification as an income tax that could be in violation of the Bullock amendment in the Texas Constitution.²⁰⁶

(q) Effect of Margin Tax on Choice of Entity Decisions. The enactment of the Margin Tax changes the calculus for entity selections, but not necessarily the result. The LLC has become more attractive for all business that are not likely to ever qualify as exempt “passive entities” because an LLC can elect to be taxed as a corporation or partnership for federal income tax purposes. However, the uncertainties as to an LLC’s treatment for self-employment purposes can restrict its desirability in some situations.²⁰⁷

4. Constitutionality of Margin Tax. Proponents of the Margin Tax claim that it is not an income tax because its name and deduction scheme differ from the income tax imposed by the IRC, although revenue, cost of goods sold and other computations would be based on amounts from specified lines in a federal income tax return, and it is imposed at the entity rather than the individual level. On August 3, 2006, however, the Financial Accounting Standards Board (“FASB”) found that the Margin Tax is an income tax for the purposes of financial statements prepared in accordance with generally accepted accounting principles for financial reporting in the U.S. (“GAAP”).²⁰⁸ Others also consider the Margin Tax to be an income tax, particularly in the case of a partnership providing professional services (e.g.,

¹⁹⁹ *Id.*

²⁰⁰ *Id.*

²⁰¹ *Id.*

²⁰² *Id.*

²⁰³ *Id.*

²⁰⁴ *Id.*

²⁰⁵ The Comptroller’s Margin Tax calculation worksheet is called “Franchise Tax Online Calculator” on the Comptroller’s website and may be found at <http://www.window.state.tx.us/taxinfo/taxforms/HB3Calc.pdf>.

²⁰⁶ *See infra* notes 208-213 and related text.

²⁰⁷ *See infra* notes 562-574 and related text.

²⁰⁸ *See infra* note 214 and related text.

accounting, engineering, law or medical), and refer to Texas Constitution article 8, section 24(a) (often referred to as the “Bullock Amendment”),²⁰⁹ which provides:

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

Former Comptroller Strayhorn has written that portions of H.B. 3 are unconstitutional: “Taxing income from partnerships is strictly prohibited by the Texas Constitution, and I believe when this portion of H.B. 3 is challenged in court, the State will lose.”²¹⁰ In a letter to the Attorney General of Texas requesting a formal opinion²¹¹ whether H.B. 3 requires voter approval under the Bullock Amendment, Comptroller Strayhorn wrote:²¹²

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

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

²⁰⁹ See Nikki Laing, *An Income Tax by Any Other Name is Still an Income Tax: The Constitutionality of the Texas “Margin” Tax as Applied to Partnerships and Other Unincorporated Associations*, 62 Baylor L. Rev. 1 (2010).

²¹⁰ Letter from Carole Keeton Strayhorn, Texas Comptroller of Public Accounts, to Rick Perry, Texas Governor (May 2, 2006), <http://www.cpa.state.tx.us/news/60502taxplan.pdf>.

²¹¹ Letter from Barry McBee, First Assistant Attorney General, to Deirdre Delisi, the Chief of Staff of Texas Governor Rick Perry (April 17, 2006) (on file with author) (stating that, “although a court may disagree,” the Margin Tax would not be subject to the Bullock Amendment because it is an entity level tax). The Comptroller’s request did not view the First Assistant Attorney General’s letter as an Attorney General opinion.

²¹² Letter from Carole Keeton Strayhorn, Texas Comptroller of Public Accounts, to Greg Abbott, Texas Attorney General (April 21, 2006) (on file with author).

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

* * *

This provision means that if the tax is determined by deducting from gross income any items of expense that are not specifically and directly related to transactions that created the income, it is an income tax. And, if it is an income tax, it is within the Bullock Amendment. Proposed Section 171.1012 (relating to the cost of goods sold deduction) and 171.1013 (relating to the compensation deduction) clearly include indirect and overhead costs of production and/or compensation that make the margin tax an income tax under this preexisting Texas definition found in Chapter 141, thereby invoking the Bullock Amendment.

* * *

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

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

the tax is directly on an entity is irrelevant if the only inquiry is whether there is ultimately a tax levied on “a person’s share” of some distribution.

* * *

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

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

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

As former Comptroller Strayhorn contended, the Bullock Amendment’s language encompasses an income tax on a partnership interest attributable to a natural person, whether imposed at the partnership or individual level, by its reference to “a person’s share of partnership and unincorporated association income.” This plain language makes no distinction between general partnerships, limited partnerships and limited liability partnerships, and applies even if the partnership is viewed as a separate legal entity.²¹³

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

5. Classification of Margin Tax Under GAAP. The Margin Tax is classified as an income tax in financial statements prepared in accordance with GAAP.²¹⁴ The minutes of

²¹³ See *Bishop v. District of Columbia*, 401 A.2d 955 (D.C. 1979), in which the imposition of the District of Columbia tax on unincorporated businesses at the partnership level was challenged by partners in District of Columbia law firms who were residents of surrounding states on the basis that it was actually a prohibited tax on the personal incomes of non-residents under the District of Columbia Home Rule Act, D.C. CODE ANN. § 1-206.02(a)(5), which prohibited a tax on the personal income of non-residents; the District of Columbia Court of Appeals held that “as to the characterization of the tax, it is fundamental that the nature and effect of the tax, not its label, determine if it is an income tax or not” and concluded that “since the tax is on unincorporated business, [it] is therefore in reality a tax on the associates or partners who run the business.”

²¹⁴ See Peggy Fikac, ‘Income tax’ is a loaded label for business levy - Perry opponents get fired up after accounting board calls it just that, *HoustonChronicle.com* -- <http://www.HoustonChronicle.com> | Section: Houston & Texas (August 10, 2006), <http://search.chron.com/chronicle/archiveSearch.do> (Type “Peggy Fikac” in the Author search box, then select date range of “August 10, 2006 to August 10, 2006”): “A board that sets national accounting standards stirred up the Texas governor’s race by saying the state’s new business tax is an income tax for reporting purposes. The decision by the Financial Accounting Standards Board embraced a label rejected by backers, including Republican Gov. Rick Perry, who championed the expanded business tax to lower local school property taxes. The designation gives fresh fodder to Perry

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

6. Internal Partnerships Will Not Work Under Margin Tax. Many Texas based corporations (whether or not incorporated in Texas) have utilized internal limited partnerships to isolate liabilities and reduce franchise taxes. Because the Texas franchise/income tax prior to the effectiveness of the Margin Tax was based upon federal taxable income (computed on a separate company basis, for there has been no consolidation for Texas franchise tax purposes), the corporate partner was subject to franchise taxes to the extent that its distributive share of the partnership’s income (whether or not distributed) was Texas-sourced.²¹⁵ If the limited partnership were structured such that the Texas parent was a 1% general partner and the 99% limited partner was incorporated in a state without an income tax (assume Nevada) and did not otherwise do business or pay franchise taxes in Texas (the ownership of a limited partner interest in a limited partnership doing business in Texas did not alone require the Nevada corporate limited partner to qualify in Texas as a foreign corporation or to pay Texas franchise taxes on its distributive share of the partnership’s income), the income attributable to the 99% limited partnership interest would not be subject to the Texas franchise/income tax. If the Nevada subsidiary subsequently dividended its income from the limited partnership to its Texas parent, then that dividend income would not be subjected to the Texas franchise/income tax because either the dividend was deducted in arriving at federal taxable income or it was a non-Texas receipt for franchise tax purposes. The foregoing is a simplification of a common internal limited partnership structure; the actual analysis, of course, was very fact specific and there were a number of structure variations available depending upon the objectives and the source of the income. Since the Margin Tax applies on a unitary and combined basis, the use of internal partnerships has become less effective as an alternative for reducing Texas entity level taxes.

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

²¹⁵ TEX. TAX CODE ANN. § 171.1032(c) (Vernon 2002 & Supp. 2004); Tex. S.B. 1125, 77th Leg., R.S. (2001).

7. Conversions. Though largely irrelevant under the Margin Tax, transforming a corporate entity into a limited partnership structure previously was an expensive and time consuming procedure for reducing Texas franchise taxes because it required actual asset conveyances and liability assumptions, multiple entities (typically including a Delaware or Nevada entity that must avoid nexus with Texas), and consents of lenders, lessors and others. A simpler “conversion” method evolved utilizing the Check-the-Box Regulations and the conversion procedures in the TBCA, the TRLPA and the TRPA.²¹⁶ The conversion method required converting an existing corporate entity subject to Texas franchise tax to a Texas limited partnership or LLP. The converted entity then filed a Check-the-Box election to continue to be classified as a corporation for federal income tax purposes. For federal income tax purposes, the conversion should qualify as a nontaxable “F” reorganization. Thus, the entity ceased to be subject to Texas franchise tax when the conversion became effective, but continued to be treated as the same corporate entity for federal income tax purposes. The conversion method was suitable primarily for closely held corporations.

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

Revenue Procedure 99-51, released by the IRS in December 1999 and reconfirmed by the IRS in Revenue Procedure 2009-3 issued in January 2009,²¹⁷ added an additional note of caution to the practice of using Texas’ conversion statutes to convert an existing corporation (with a valid S-corporation election but subject to Texas franchise taxes pre-conversion) into a limited partnership (with a Check-the Box election to be treated as a corporation for federal tax purposes but not subject to Texas franchise taxes post-conversion). The issue was whether the converted entity’s prior S-corporation election remains valid after its metamorphosis into a state law limited partnership due to the IRC’s requirement that an electing S-corporation may have only one class of stock. In at least one private letter ruling issued by the IRS prior to the publication of Revenue Procedure 99-51, the IRS sanctioned an S-corporation’s conversion under state law to a limited partnership and acquiesced in continued S-corporation election treatment where the taxpayer represented that general and limited partners had identical rights under the partnership agreement to distributions and liquidating proceeds.²¹⁸ However, in Revenue Procedure 99-51 the IRS stated that (i) the IRS will no longer rule on the single class of stock requirement in the limited partnership context until it studies the matter extensively and issues further published administrative guidance and (ii) the IRS will treat any request for an advance ruling on whether a state law limited partnership is eligible to elect S-corporation status as a request for a ruling on whether the entity has a single class of stock. Failure to continue a valid S-corporation election for a state law corporation converting to a state law limited partnership taxed as a corporation for federal tax purposes would be treated for tax purposes as a termination of the S election, which is effective as of the end of the day preceding the date of conversion. Until the IRS no-ruling policy is superseded, practitioners dealing with the

²¹⁶ See *infra* notes 230-233 and related text.

²¹⁷ Rev. Proc. 99-51, 1999-52 I.R.B. 761 (December 27, 1999); Rev. Proc. 2009-3, 2009-1 I.R.B. 107 (January 5, 2009).

²¹⁸ See, e.g., I.R.S. Priv. Ltr. Rul. 99-42-009 (July 16, 1999).

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

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

F. Business Combinations and Conversions.

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

(a) Merger. Texas law allows corporations, LLCs and partnerships to merge with each other (e.g., a limited partnership can merge into a corporation).²¹⁹ Detailed provisions appearing in the TBOC and its predecessor statutes provide the mechanics of adopting a plan of merger, obtaining owner approval, filing with the Secretary of State, and protecting creditors.

(b) Share Exchange. A business combination may be effected by a transfer of shares or other ownership interests in which either (i) all of the owners agree to the sale or exchange of their interests or (ii) there is a statutory share or interest exchange pursuant to a plan of exchange approved by the vote of the owners, which may be less than unanimous but is binding on all, pursuant to statute or the entity documents.²²⁰ The TBOC and its respective predecessor entity statutes – the TBCA, the LLC Act, the TRLPA and the TRPA – each have provisions providing the mechanics of adopting a plan of exchange, obtaining owner approval and filing with the Secretary of State.²²¹

(c) Asset Sale. A sale or exchange of all or substantially all of the assets of an entity may require approval of the owners, depending on the nature of the transaction, the entity’s organization documents and applicable state law.²²² In most states, shareholder approval of an asset sale has historically been required when a corporation is selling all or substantially all of its assets. The Delaware courts have used both “qualitative” and “quantitative” tests in interpreting the phrase “substantially all,” as it is used in Section 271 of

²¹⁹ TBCA art. 5.01, § A; LLC Act § 10.01, § A; TRLPA § 2.11; TRPA § 9.02; TBOC § 10.001.

²²⁰ TBCA art. 5.02 § A; LLC Act §§ 10.01, 10.06; TRLPA § 2.11; TRPA § 9.03; TBOC § 10.051.

²²¹ TBCA art. 5.02 § A; LLC Act §§ 10.01, 10.06; TRLPA § 2.11; TRPA § 9.03; TBOC §§ 10.151-10.153.

²²² See TBCA arts. 5.09 and 5.10; TBOC § 10.251. See also Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation - Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 287-288 (Winter 2001); Byron F. Egan and Amanda M. French, *1987 Amendments to the Texas Business Corporation Act and Other Texas Corporation Laws*, 25 Bull. of Section on Corp., Banking & Bus. L. 1, 11-12 (No. 1, Sept. 1987).

the Delaware General Corporation Law (“DGCL”), which requires stockholder approval for a corporation to “sell, lease or exchange all or substantially all of its property and assets.”²²³

Difficulties in determining when a shareholder vote is required in Delaware led Texas to adopt a bright line test. TBCA articles 5.09 and 5.10 provide, in essence, that shareholder approval is required under Texas law only if it is contemplated that the

²²³

See Gimbel v. The Signal Companies, Inc., 316 A.2d 599 (Del. Ch. 1974) (assets representing 41% of net worth but only 15% of gross revenues held not to be “substantially all”); *Katz v. Bregman*, 431 A.2d 1274 (Del. Ch. 1981) (51% of total assets, generating approximately 45% of net sales, held to be “substantially all”); and *Thorpe v. CERBCO, Inc.*, 676 A.2d 436 (Del. 1996) (sale of subsidiary with 68% of assets, which was primary income generator, held to be “substantially all”; court noted that seller would be left with only one operating subsidiary, which was marginally profitable). *See also Hollinger Inc. v. Hollinger International, Inc.*, 858 A.2d 342 (Del. Ch. 2004), *appeal denied*, 871 A.2d 1128 (Del. 2004), in which (A) the sale of assets by a subsidiary with approval of its parent corporation (its stockholder), but not the stockholders of the parent, was alleged by the largest stockholder of the parent to contravene DGCL § 271; (B) without reaching a conclusion, the Chancery Court commented in dicta that “[w]hen an asset sale by the wholly owned subsidiary is to be consummated by a contract in which the parent entirely guarantees the performance of the selling subsidiary that is disposing of all of its assets and in which the parent is liable for any breach of warranty by the subsidiary, the direct act of the parent’s board can, without any appreciable stretch, be viewed as selling assets of the parent itself”; and (C) examining the consolidated economics of the subsidiary level sale, the Chancery Court held (1) that “substantially all” of the assets should be literally read, commenting that “[a] fair and succinct equivalent to the term ‘substantially all’ would be ‘essentially everything’”, notwithstanding past decisions that have looked at sales of assets around the 50% level, (2) that the principal inquiry was whether the assets sold were “quantitatively vital to the operations of” seller (the business sold represented 57.4% of parent’s consolidated EBITDA, 49% of its revenues, 35.7% of the book value of its assets, and 57% of its asset values based on bids for the two principal units of the parent), (3) that the parent had a remaining substantial profitable business after the sale (the Chancery Court wrote: “if the portion of the business not sold constitutes a substantial, viable, ongoing component of the corporation, the sale is not subject to Section 271”), and (4) that the “qualitative” test of *Gimbel* focuses on “factors such as the cash-flow generating value of assets” rather than subjective factors such as whether ownership of the business would enable its managers to have dinner with the Queen. *See Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 Bus. Law. 843, 855-58 (2005); BALOTTI AND FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS*, section 10.2 (3d ed. Supp. 2008). To address the uncertainties raised by dicta in Vice Chancellor Strine’s opinion in *Hollinger*, DGCL § 271 was amended effective August 1, 2005 to add a new subsection (c) which provides as follows:

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

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

corporation will cease to conduct any business following the sale of assets.²²⁴ Under TBCA article 5.10, a sale of all or substantially all of a corporation's property and assets must be approved by the shareholders (and shareholders who vote against the sale can perfect appraisal rights). TBCA article 5.09(A) provides an exception to the shareholder approval requirement if the sale is "in the usual and regular course of the business of the corporation," and a 1987 amendment added section B to article 5.09 providing that a sale is

in the usual and regular course of business if, [after the sale,] the corporation shall, directly or indirectly, either continue to engage in one or more businesses or apply a portion of the consideration received in connection with the transaction to the conduct of a business in which it engages following the transaction.²²⁵

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

The Texas partnership statutes do not contain any analogue to TBCA articles 5.09 and 5.10 and the parallel TBOC provisions applicable to corporations. They leave any such requirement to the partnership agreement or another contract among the owners of the entity.²²⁶ The Texas LLC Statutes reach a similar result, but under the TBOC it would be necessary to affirmatively provide that no owner vote is required to approve a sale of all or substantially all of the assets of the LLC.²²⁷

²²⁴ See Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation --Texas versus Delaware: Is it Now Time to Rethink Traditional Notions?*, 54 SMU L. REV. 249, 287-290 (Winter 2001).

²²⁵ In *Rudisill v. Arnold White & Durkee, P.C.*, 148 S.W.3d 556 (Tex. App.—Houston [14th Dist.] 2004, no pet.), the 1987 amendment to art. 5.09 was applied literally. The *Rudisill* case arose out of the combination of Arnold White & Durkee, P.C. ("AWD") with another law firm, Howrey & Simon ("HS"). The combination agreement provided that all of AWD's assets other than those specifically excluded (three vacation condominiums, two insurance policies and several auto leases) were to be transferred to HS in exchange for a partnership interest in HS, which subsequently changed its name to Howrey Simon Arnold & White, LLP ("HSAW"). In addition, AWD shareholders were eligible individually to become partners in HSAW by signing its partnership agreement, which most of them did.

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

²²⁶ See TBOC § 153.152.

²²⁷ TBOC § 1.002(32) defines "fundamental business transaction" to include a "sale of all or substantially all of the entity's assets" and TBOC § 101.356 requires a member vote to approve any fundamental business

An important reason for structuring an acquisition as an asset transaction is the desire on the part of a buyer to limit its responsibility for liabilities of the seller, particularly unknown or contingent liabilities. Unlike a stock purchase or statutory combination, where the acquired corporation retains all of its liabilities and obligations, known and unknown, the buyer in an asset purchase has an opportunity to determine which liabilities of the seller it will contractually assume. In certain other jurisdictions, the purchase of an entire business where the shareholders of the seller become shareholders of the buyer can cause a sale of assets to be treated as a common law “*de facto merger*,” which would result in the buyer becoming responsible as a matter of law for seller liabilities which the buyer did not contractually assume.²²⁸

Texas has legislatively repealed the *de facto merger* doctrine in TBCA article 5.10B, which provides in relevant part that “[a] disposition of any, all, or substantially all, of the property and assets of a corporation . . . (1) is not considered to be a merger or conversion pursuant to this Act or otherwise; and (2) except as otherwise expressly provided by another statute, does not make the acquiring corporation, foreign corporation, or other entity responsible or liable for any liability or obligation of the selling corporation that the acquiring corporation, foreign corporation, or other entity did not expressly assume.”²²⁹ TBOC section 10.254 carries forward TBCA article 5.10B and makes it applicable to all domestic entities.

2. Conversions.

(a) General. Texas law allows corporations, LLCs and partnerships to convert from one form of entity into another without going through a transfer of assets or merger.²³⁰ A conversion is not a combination of entities; rather, it is only a change in the statutory form and nature of an existing entity. Additionally, a conversion involves only one entity and does not involve any change in the ownership of that entity, although it may change the rights of the owners. The TBOC and its source Texas entity statutes each have provisions relating to the mechanics of adopting a plan of conversion, obtaining owner approval, filing with

transaction, although TBOC § 101.052 would allow the parties to include in the company agreement provisions that trump this TBOC requirement.

²²⁸ See *Knapp v. North American Rockwell Corp.*, 506 F.2d 361 (3d Cir. 1974); *Philadelphia Electric Co. v. Hercules, Inc.*, 762 F.2d 303 (3d Cir. 1985); *SmithKline Beecham Corp. v. Rohm and Haas Corp.*, 89 F.3d 154 (3d Cir. 1996); *Cargo Partner AG v. Albatrans Inc.*, 352 F.3d 41 (2d Cir. 2003).

²²⁹ In *C.M. Asfahl Agency v. Tensor, Inc.*, 135 S.W.3d 768, 780-81 (Tex.App.—Houston [1st Dist.] 2004), a Texas Court of Civil Appeals, quoting TBCA art. 5.10(B)(2) and citing two other Texas cases, wrote: “This transaction was an asset transfer, as opposed to a stock transfer, and thus governed by Texas law authorizing a successor to acquire the assets of a corporation without incurring any of the grantor corporation’s liabilities unless the successor expressly assumes those liabilities. [citations omitted] Even if the Agency’s sales and marketing agreements with the Tensor parties purported to bind their ‘successors and assigns,’ therefore, the agreements could not contravene the protections that article 5.10(B)(2) afforded Allied Signal in acquiring the assets of the Tensor parties unless Allied Signal expressly agreed to be bound by Tensor parties’ agreements with the Agency.” See Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation --Texas versus Delaware: Is it Now Time to Rethink Traditional Notions*, 54 SMU Law Review 249, 287-290 (Winter 2001).

²³⁰ TBCA Part Five; TBOC Chapter 10, Subchapter C; cf. ABA Committee on Corporate Laws, *Changes in the Model Business Corporation Act Relating to Domestication and Conversion – Final Adoption*, 58 Bus. Law 219 (Nov. 2002).

the Secretary of State, and protecting creditors. Those Texas statutes and the federal income tax consequences of conversions are summarized below.

(b) Texas Statutes. Under the conversion provisions of Texas law,²³¹ a Texas corporation may convert into another corporation or other entity if (i) the conversion is approved by its shareholders in the same manner as a merger in which the corporation is not the surviving entity would be approved; (ii) the conversion is consistent with the laws under which the resulting entity is to be governed; (iii) shareholders will have a comparable interest in the resulting entity unless a shareholder exercises his statutory dissenter's rights or otherwise agrees; (iv) no shareholder will become personally liable for the obligations of the resulting entity without his consent; and (v) the resulting entity is a new entity formed as a result of the conversion rather than an existing entity (which would be a merger).²³² Partnerships, limited partnerships, and LLCs are afforded comparable rights.²³³

²³¹ TBCA arts. 5.17, 5.18, 5.19 and 5.20; TBOC §§ 10.101-10.151, 10.154-10.203.

²³² TBOC § 10.101. Under TBOC § 10.106, when a conversion takes effect upon the filing of a certificate of conversion with the Secretary of State after following the above procedures:

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

Under the TBOC a converting entity may elect to continue its existence in its current organizational form and jurisdiction of formation in connection with its conversion under TBOC Chapter 10.²³⁴ This election, which is intended to afford foreign entities a means to do business in the U.S. while avoiding adverse foreign tax consequences, is only available to a domestic entity of one organizational form that is converting into a non-U.S. entity of the same organizational form or a non-U.S. entity of one organizational form converting into a domestic entity of the same organizational form. The permitted election must be adopted and approved as part of the plan of conversion for the converting entity and permitted by, or not prohibited by or inconsistent with, the laws of the applicable non-U.S. jurisdiction.²³⁵

(c) Federal Income Tax Consequences. As in the case of organizational choice of entity determinations and business combinations, a conversion transaction should not be undertaken without a thorough analysis of the federal and state income tax consequences of the conversion. The following sections provide a brief summary of some of the federal income tax consequences of certain conversion transactions.²³⁶

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- (8) if the converted entity is one not governed by the TBOC, then it is considered (a) to have appointed the Texas Secretary of State as its registered agent for purposes of enforcing any obligations or dissenters' rights and (b) to have agreed to promptly pay the dissenting members or owners of the converting entity any amounts owed under the TBOC.

See also TBCA art. 5.20.

²³³ *See* TBOC § 10.101. The comparable provisions for such entities governed by pre-TBOC law are found for LLCs at LLC Act §§ 10.08-10.11, for limited partnerships at TRLPA § 2.15, and for general partnerships at TRPA §§ 9.01, 9.05 and 9.06.

²³⁴ TBOC § 10.1025 as added in the 2009 Legislative Session by S.B. 1442 §§ 15-18. In a conversion and continuance transaction under new TBOC § 10.109, the converting entity continues to exist both in its current organizational form and jurisdiction of formation and in the same organizational form in the new jurisdiction of formation, and as a single entity subject to the laws of both jurisdictions. The property interests, liabilities and obligations of the entity remain unchanged. For a conversion and continuance transaction, the certificate of conversion must be titled a "certificate of conversion and continuance" and must include a statement certifying that the converting entity is electing to continue its existence in its current organizational form and jurisdiction of formation. *See infra* [Appendix D](#).

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

²³⁵ Even though the converting entity continues to exist in the non-U.S. jurisdiction (as well as in Texas), the entity would not be required to qualify to do business as a foreign entity under TBOC Chapter 9 (Foreign Entities) after its conversion and continuance. TBOC § 10.1025 as added in the 2009 Legislative Session by S.B. 1442 §§ 15-18. *See infra* [Appendix D](#).

²³⁶ *See* Monte A. Jackel and Glen E. Dance, *Selected Federal Income Tax Aspects of Changing the Tax Status of Business Entities*, 3 PLI/Tax Strategies 255 (1997).

(1) Conversions of Entities Classified as Partnerships. There generally should be no federal income tax consequences arising from the conversion of an entity classified as a domestic partnership for federal income tax purposes (e.g., general partnerships, LLPs, limited partnerships and LLCs) into another entity classified as a domestic partnership for federal income tax purposes, provided that the owners' capital and profit interests and shares of entity liabilities do not change as a result of the conversion and the entity's business and assets remain substantially unchanged.²³⁷ These transactions are viewed as tax-free contributions under Section 721 of the IRC that do not cause the existing entity to terminate under Section 708, and do not cause the taxable year of the existing entity to close with respect to any or all of the partners or members. A new taxpayer identification number is not required. Careful attention should be paid to determining the partners' or members' correct share of the entity's liabilities before and after the conversion because a decrease in a partner's or member's share of those liabilities that exceeds the partner's or member's adjusted basis in its interest will result in recognition of gain.

The conversion of an entity classified as a partnership to an entity that is ignored for federal income tax purposes will occur if such entity only has a single member. For example, if one member of a two member LLC purchases the other member's interest, the partnership is deemed to make a liquidating distribution of all of its assets to the members, with the purchasing member treated as acquiring the assets distributed to the selling member. However, the selling member is treated as selling a partnership interest.²³⁸ Partnership liquidations generally do not result in recognition of gain by the partners except to the extent that the amount of cash (marketable securities are in certain cases treated as cash) actually or constructively received by a partner exceeds the partner's adjusted basis in his partnership interest.²³⁹ Note that distributions of property contributed to the partnership within seven years of the date of the deemed distribution may result in gain recognition pursuant to I.R.C. §§ 704(c)(1)(B) and 737.²⁴⁰

Conversion of an entity classified as a partnership into a corporation will generally be analyzed as a liquidating transaction with respect to the partnership and an incorporation transaction with respect to the corporation, either of which can result in recognition of gain by the owners of the converted entity.²⁴¹ Nevertheless, with careful planning, most conversions of this type can be accomplished without recognition of gain.²⁴²

(2) Conversions of Entities Classified as Corporations. Conversion of an entity classified as a corporation into an entity classified as a partnership or an entity ignored for federal income tax purposes will generally be treated as a taxable liquidating transaction with respect to the corporation and, in the case of conversion to a partnership entity, a

²³⁷ See e.g., Rev. Rul. 95-37, 1995-17 I.R.B.10; Rev. Rul. 86-101, 1986-2 C.B. 94; Rev. Rul. 84-52, 1984-1 C.B. 157.

²³⁸ Rev. Rul. 99-6, 1999-1 C.B. 432.

²³⁹ See I.R.C. § 731 (1997); I.R.C. § 736 (1993); I.R.C. § 751(b) (2004); Treas. Reg. § 301.7701-3(g) (2006).

²⁴⁰ See I.R.C. § 704(c)(1)(B) (2004); I.R.C. § 737 (1997).

²⁴¹ See, e.g., I.R.C. § 751(b) (2004); I.R.C. § 351 (2005).

²⁴² See Rev. Rul. 84-111, 1984-2 C.B. 88; Treas. Reg. § 301.7701-3(g) (2006).

contribution transaction with respect to the partnership entity.²⁴³ A corporation cannot be converted into an entity classified as a partnership or sole proprietorship in a tax free transaction. In the case of a C-corporation (other than one that is owned 80% or more by another corporation) the liquidation potentially may be subject to tax at both the corporate and shareholder levels. The corporation will recognize gain or loss equal to the difference between the fair market value of each tangible and intangible asset of the corporation and the corporation's adjusted basis in each respective asset.²⁴⁴ The shareholders will recognize gain or loss equal to the difference between the fair market value of the assets deemed distributed to them and their adjusted basis in the corporation's shares.²⁴⁵ Contrary to "common wisdom" that an S-corporation is taxed like a partnership, the same taxable liquidation rules apply to an S-corporation and its shareholders except that the corporate level gain realized by the S-corporation on the deemed liquidation generally flows through to the individual returns of the shareholders thereby increasing their adjusted bases in their stock and eliminating or decreasing the amount of shareholder level gain.²⁴⁶ In order to comply with the single-class-of-stock requirement, careful tax analysis should be undertaken when converting a corporation with an otherwise valid pre-conversion S-corporation election into partnership form electing post-conversion Check-the-Box treatment as a corporation.

(d) Effect on State Licenses. The Texas Attorney General has issued an opinion to the effect that "[w]hen a corporation converts to another type of business entity in accordance with the TBCA, as a general rule a state license held by the converting corporation continues to be held by the new business entity . . . subject to the particular statutory requirements or regulations of the specific state entity that issued the license."²⁴⁷

G. Use of Equity Interests to Compensate Service Providers. A corporation may compensate service providers using employee stock ownership plans ("ESOPs"), restricted stock, non-qualified stock options and incentive stock options; however, incentive stock options and ESOPs are not available in other forms of organization. The grant of equity interests or options to acquire equity interests to service providers in an entity taxed as a partnership creates a number of tax uncertainties.²⁴⁸

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

²⁴³ Treas. Reg. § 301.7701-3(g)(1)(ii), (iii).

²⁴⁴ I.R.C. § 336 (1988).

²⁴⁵ I.R.C. § 331(a) (1982).

²⁴⁶ I.R.C. § 1371(a) (2007); *see also* I.R.C. § 1363(a) (2007); *cf.* I.R.C. § 1374 (1989) (imposing a tax on built-in gains).

²⁴⁷ Op. Tex. Att'y Gen. No. JC-0126 (1999).

²⁴⁸ *See* William H. Hornberger and James R. Griffin, Stock Options and Equity Compensation, Address at the 47th Annual Texas CPA Tax Institute (Nov. 14-16, 2000), *available at* <http://www.jw.com/site/jsp/publicationinfo.jsp?id=56>.

II. CORPORATIONS.

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

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

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

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

Prior to January 1, 2006, Texas business corporations were organized under, and many are still governed by, the TBCA,²⁴⁹ which was amended in 1997 by S.B. 555,²⁵⁰ in 2003 by H.B. 1165, in 2005 by H.B. 1507 and in 2007 by H.B. 1737. However, corporations formed after January 1, 2006 are organized under and governed by the TBOC. For entities formed before that date, only the ones voluntarily opting into the TBOC, or converting to a Texas entity on or after January 1, 2006, were governed by the TBOC until January 1, 2010; from and after January 1, 2010, all Texas corporations are governed by the TBOC.²⁵¹

The TBOC provides that the TBOC provisions applicable to corporations (TBOC Titles 1 and 2) may be officially and collectively known as “Texas Corporation Law.”²⁵² However, because until 2010 some Texas for-profit corporations were governed by the TBCA and others by the TBOC, and because the substantive principles under both statutes are generally the same, the term “Tex. Corp. Stats.” is used herein to refer to the TBOC and the TBCA (as supplemented by the TMCLA) collectively, and the particular differences between the TBCA and the TBOC are referenced as appropriate.

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

1. **Taxation of C-Corporations.** C-corporations are separately taxable entities under the IRC. Thus, C-corporation earnings are subject to double taxation--first at the corporate

²⁴⁹ TBCA arts. 1.01 *et. seq.*

²⁵⁰ Tex. S.B. 555, 75th Leg., R.S. (1997).

²⁵¹ All foreign entities which initially register to do business in Texas after January 1, 2006 are subject to the TBOC, regardless when formed. TBOC § 402.001(a)(13).

²⁵² TBOC § 1.008(b).

level and again at the shareholder level upon distribution of dividends. Like the personal income tax, corporate tax rates vary depending on the level of income generated.

The taxable income of a C-corporation is subject to federal income tax at graduated rates ranging from 15% to 35%.²⁵³ The tax rate schedule for a C-corporation is as follows:²⁵⁴

If taxable income is:			
Over--	But not over--	Tax is:	Of the amount over--
\$0	\$50,000	15%	-0-
\$50,000	\$75,000	\$7,500 + 25%	\$50,000
\$75,000	\$100,000	\$13,750 + 34%	\$75,000
\$100,000	\$335,000	\$22,250 + 39% ²⁵⁵	\$100,000
\$335,000	\$10,000,000	\$113,900 + 34%	\$335,000
\$10,000,000	\$15,000,000	\$3,400,000 + 35%	\$10,000,000
\$15,000,000	\$18,333,333	\$5,150,000 + 38% ²⁵⁶	\$15,000,000
\$18,333,333	--	35%	-0-

Under the IRC, the capital gains of a corporation are taxed at the same rates as ordinary income.²⁵⁷

A C-corporation's shareholders must pay individual income taxes on any corporate profits that are distributed to them as dividends. A corporation may reduce its taxable income by paying salaries to its officers, directors or employees, which may help to minimize the effects of double taxation; however, unreasonable compensation may be recharacterized by the IRS as a constructive dividend, which is not deductible by the corporation and is also taxed as income to the officer, director or employee.²⁵⁸ There can also be corporate level taxes on excessive accumulations of earnings.

Because a C-corporation is a separately taxable entity, there is no flow-through of income, deductions (including intangible drilling costs and depletion allowances), NOLs or capital losses to a C-corporation's shareholders, although a C-corporation's shareholders are not

²⁵³ I.R.C. §§ 11(a), 11(b).

²⁵⁴ I.R.C. § 11(a).

²⁵⁵ The tax rate for a C corporation with taxable income in excess of \$100,000 is increased by the lesser of (i) 5% of such excess, or (ii) \$11,750. I.R.C. §§ 11(a), 11(b). This essentially means that an additional 5% of tax is imposed on taxable income between \$100,000 and \$335,000.

²⁵⁶ The tax rate for corporations with taxable income in excess of \$15,000,000 is increased by the lesser of (i) 3% of such excess, or (ii) \$100,000. I.R.C. §§ 11(a), 11(b). This essentially means that an additional 3% of tax is imposed on taxable income between \$15,000,000 and \$18,333,333.

²⁵⁷ See I.R.C. § 1201(a).

²⁵⁸ See *Pediatric Surgical Associates, P.C. v. Commissioner of Internal Revenue*, T.C. Memo 2001-81 (2001), in which the Tax Court disallowed claimed deductions for salaries paid to shareholder surgeons because it found that the salaries exceeded reasonable allowances for services actually rendered and were disguised nondeductible dividends.

subject to self-employment tax on distributions they receive. Additionally, a C-corporation can carry forward unused losses and credits, subject to specified limitations. If a C-corporation distributes appreciated assets to its shareholders, it will recognize a taxable gain. Furthermore, a C-corporation will generally recognize gain or loss on its liquidation (except for certain liquidations into a parent corporation),²⁵⁹ and a shareholder will recognize taxable gain or loss on his or her interest in the corporation upon the corporation's liquidation or the shareholder's disposition thereof. However, both S- and C-corporations may be parties to a tax-free reorganization in which neither the corporation nor its shareholders are subject to taxation.

2. Taxation of S-Corporations.

(a) Effect of S-Corporation Status. S-corporation status is achieved by an eligible C-corporation making an election to be so treated. All shareholders, including their spouses if their stock is community property, must consent to such election. Generally, the result of electing S-corporation status is that no corporate level tax is imposed on the corporation's income. Instead, corporate level income is treated as having been received by the shareholders, whether or not such income was actually distributed, and is taxed at the shareholder level. An S-corporation that was previously a C-corporation is subject to a corporate level tax (i) if it realizes a gain on the disposition of assets that were appreciated (i.e., the fair market value exceeded the tax basis) on the date the S election became effective and the disposition occurs within 10 years of that date²⁶⁰ and (ii) on its excess net passive income (subject to certain limits and adjustments) if it has subchapter C earnings and profits and more than 25% of its gross receipts for the year is passive investment income.²⁶¹

A shareholder's deduction for S-corporation losses is limited to the sum of the amount of the shareholder's adjusted basis in his stock and in the corporation's indebtedness to him.²⁶² To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year.²⁶³

(b) Eligibility for S-Corporation Status. To be eligible for S-corporation status, a corporation must (i) be a domestic corporation (i.e., organized under the laws of a state of the United States),²⁶⁴ (ii) have no more than 100 shareholders (for this purpose, stock owned by a husband and wife is treated as owned by one shareholder and all family members can elect to be treated as one shareholder),²⁶⁵ (iii) have no more than one class of stock²⁶⁶ and (iv) have no shareholders other than individuals who are residents or citizens of the U.S. and certain trusts, estates or exempt organizations (e.g., qualified employee benefit plans and I.R.C. § 501(c)(3) organizations).²⁶⁷ S-corporations may have a C-corporation as a

²⁵⁹ See I.R.C. § 336 (1998); I.R.C. § 337 (1988).

²⁶⁰ I.R.C. § 1374 (1989); Treas. Reg. § 1.1374-1 (2005).

²⁶¹ I.R.C. § 1374 (1989).

²⁶² I.R.C. § 1366(d)(1) (2007); I.R.C. § 1367(b)(2)(A) (2007).

²⁶³ I.R.C. § 1366(d)(2)(A) (2007).

²⁶⁴ I.R.C. § 1361(b)(1); I.R.C. § 1361(c).

²⁶⁵ I.R.C. § 1361(b)(1)(A) (2005) (as amended by The American Jobs Creation Act of 2004).

²⁶⁶ I.R.C. § 1361(b)(1)(D) (2005); see *supra* notes 216-218 and related text.

²⁶⁷ I.R.C. §§ 1361(b)(1)(B) and (C) and 1361(c)(6) (2005).

subsidiary (even if the S-corporation owns 80% or more of the C-corporation). Additionally, an S-corporation may now own a qualified subchapter S subsidiary (“QSSS”). A QSSS includes any domestic corporation that qualifies as an S-corporation and is owned 100% by an S-corporation that elects to treat its subsidiary as a QSSS.²⁶⁸ A QSSS is not treated as a corporation separate from the parent S-corporation; and all of the assets, liabilities, and items of income, deduction and credit are treated as though they belong to the parent S-corporation. For purposes of the requirement that an S-corporation have only one class of stock, indebtedness may be treated as a second class of stock unless it meets the requirements of the safe harbor rule for “straight debt”, the definition of which was expanded under the Small Business Job Protection Act of 1996. Certain options may also constitute a prohibited second class of stock. In order for the election of S-corporation status to be effective, the election must be made by all shareholders of the corporation.

(c) Termination of S-Corporation Status. Once an S-corporation election has been made, the election continues in effect until (i) it is voluntarily terminated by holders of more than one-half of the outstanding shares, (ii) the corporation ceases to meet the eligibility requirements specified above, or (iii) the corporation has subchapter C earnings and profits at the close of three consecutive taxable years and has gross receipts for each of such taxable years more than 25% of which are passive investment income.²⁶⁹

(d) Liquidation or Transfer of Interest. An S-corporation and its shareholders are treated in a manner similar to the way a C-corporation and its individual shareholders are treated when a shareholder disposes of its interest or the S-corporation is liquidated (except no double tax in most cases) or is a party to a nontaxable reorganization.²⁷⁰

3. Contributions of Appreciated Property. Owners of an S- or a C-corporation will generally recognize a taxable gain on appreciated property contributed to the corporation in exchange for shares in the corporation, unless the owners who contribute property will control 80% of the voting power and 80% of the total shares of the corporation immediately after the transfer.²⁷¹

4. Texas Entity Taxes. Effective for tax years beginning on or after January 1, 2007, the Margin Tax replaces the Texas franchise tax and is applicable to all corporations.²⁷² As discussed in more detail in Part I(E)(3) above, the tax is generally 1% of a statutorily defined gross receipts calculation, less either: (i) compensation or (ii) cost of goods sold.²⁷³

²⁶⁸ Paul G. Klug and Jay Nathanson, *Small Business Job Protection Act of 1996 Increases the Attractiveness of S Corporations*, 53 J. MO. B. 219, 221 (1997).

²⁶⁹ I.R.C. § 1362(d)(1)-(3) (2005).

²⁷⁰ See BITTKER & EUSTICE, *supra* note 94, at § 6.04.

²⁷¹ I.R.C. § 351(a) (2005); I.R.C. § 358(a) (2002); I.R.C. § 362(a) (2007); I.R.C. § 368(c) (1999).

²⁷² See *supra* notes 113-207 and related text.

²⁷³ Tex. Tax Code Ann. § 171.001 (Vernon 2010). See *supra* note 141 and related text.

5. Self-Employment Tax. Shareholders of an S-corporation are generally not subject to self-employment tax on their share of the net earnings of trade or business income of the S-corporation if reasonable compensation is paid to the shareholders active in the business.²⁷⁴

C. Owner Liability Issues. Limited liability is one of the most important advantages of doing business as a corporation. In corporate law, it is fundamental that shareholders, officers, and directors are ordinarily protected from personal liability arising from the activities of the corporation.²⁷⁵ This insulation from personal liability is said to be the natural consequence of the incorporation process, and is supported by the theory or “fiction” that incorporation results in the creation of an “entity” separate and distinct from the individual shareholders.²⁷⁶ While this general rule of nonliability is given great deference by the courts, there are circumstances under which personal liability may be imposed on the shareholders, officers, or directors of a corporation.

Generally, shareholders of a corporation will not be personally liable for debts and obligations of the corporation in excess of the shareholder’s investment in the corporation. In exceptional situations, a court will “pierce the corporate veil” or “disregard the corporate entity” to find a shareholder personally liable for the activities of the corporation. In *Castleberry v. Branscum*,²⁷⁷ the Texas Supreme Court enumerated circumstances under which the corporate entity may be disregarded, including, among others, (1) when the corporate fiction is used as a means of perpetrating fraud, (2) where a corporation is organized and operated as a mere tool or business conduit (the “alter ego”) of another corporation (or person), (3) where the corporate fiction is resorted to as a means of evading an existing legal obligation, (4) where the corporate fiction is used to circumvent a statute, and (5) where the corporate fiction is relied upon as a protection of crime or to justify wrong. TBCA article 2.21 was subsequently amended to overrule *Castleberry* and define the circumstances under which a court may pierce the corporate veil in contract cases.²⁷⁸

²⁷⁴ Rev. Rul. 59-221, 1959-1 C.B. 225; see also Priv. Ltr. Rul. 87-16-060 (Jan. 21, 1987) (ruling that S-corporation shareholders do not conduct the corporation’s business); Burgess J. W. Raby and William L. Raby, *Attempting to Avoid FICA and Self-Employment Tax*, 93 TAX NOTES 803, 803–06 (2001).

²⁷⁵ *Willis v. Donnelly*, 199 S.W.3d 262, 271 (Tex. 2006) (“A bedrock principle of corporate law is that an individual can incorporate a business and thereby normally shield himself from personal liability for the corporation’s contractual obligations.”); see Elizabeth S. Miller, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 TEX. J. OF BUS. L. 405, 406-416 (Fall 2009).

²⁷⁶ *Delaney v. Fid. Lease Ltd.*, 517 S.W.2d 420, 423 (Tex. Civ. App.—El Paso 1974), *aff’d in part and rev’d in part on other grounds*, 526 S.W.2d 543 (Tex. 1975); *Sutton v. Reagan & Gee*, 405 S.W.2d 828 (Tex. Civ. App.—San Antonio 1966, writ ref’d n.r.e.).

²⁷⁷ *Castleberry v. Branscum*, 721 S.W.2d 270, 272 (Tex. 1986).

²⁷⁸ *Castleberry* was cited by the Texas Supreme Court in *In re Smith*, 192 S.W.3d 564, 568-69 (Tex. 2006), which held that the *alter ego theory* was relevant in a post-judgment proceeding for determining a defendant’s net worth for the purposes of determining the amount of security required to suspend enforcement of a judgment (under Texas law the security required may not exceed the lesser of 50% of the judgment debtor’s net worth or \$25 million):

Because “[a]lter ego applies when there is such unity between corporation and individual that the separateness of the corporation has ceased,” *Castleberry v. Branscum*, 721

Under TBCA article 2.21, as amended, as well as the parallel provision in TBOC section 21.223, no shareholder, or affiliate of the shareholder or the corporation, may be held liable for (i) any contractual obligation of the corporation on the basis that the shareholder or affiliate is or was the alter ego of the corporation or on the basis of actual or constructive fraud, a sham to perpetuate a fraud or a similar theory, unless it is shown that the shareholder used the corporation for the purpose of perpetrating, and did perpetrate, an actual fraud, primarily for the personal benefit of the shareholder or affiliate or (ii) any obligation (whether contractual, tort or other) on the basis that the corporation failed to observe any corporate formality (e.g., maintaining separate offices and employees, keeping separate books, holding regular meetings of shareholders and board of directors, keeping written minutes of such meetings, etc.).²⁷⁹ Several Texas cases have confirmed that TBCA article 2.21 is the exclusive means for piercing the corporate veil of a Texas corporation for the types of cases referenced and that actual fraud is a prerequisite thereunder.²⁸⁰

S.W.2d 270, 272 (Tex.1986), an alter ego finding is relevant to the determination of the judgment debtor's net worth. * * *

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

²⁷⁹ TBCA art. 2.21 (emphasis added). Some courts continue to ignore TBCA art. 2.21, perhaps because the litigants fail to bring it to the attention of the court, and cite *Castleberry* as authority. See, e.g., *Cementos de Chihuahua, S.A. de C.V. v. Intermodal Sales Corporation*, 162 S.W.3d 581, 586-87 (Tex. App.—El Paso 2005, no pet.).

²⁸⁰ *S. Union Co. v. City of Edinburg*, 129 S.W.3d 74 (Tex. 2003) (the Texas Supreme Court repudiated the single business enterprise doctrine, and held that “[s]ince 1993 . . . section A of Article 2.21 is the exclusive means for imposing liability on a corporation for the obligations of another corporation in which it holds shares,” actual fraud is required to be plead and proved in a veil piercing case based on a contract claim); *Menetti v. Chavers*, 974 S.W.2d 168, 174 (Tex. App.—San Antonio 1998) (the Court of Appeals reversed a judgment against defendant shareholders of a construction company in a faulty home construction case, holding that “the trial court erred in finding the [defendants] individually liable for the acts of their corporation[,] because there was legally insufficient evidence to show actual fraud,” and that, following the 1996 amendments to the TBCA, “the actual fraud requirement should be applied, by analogy, to tort claims, especially those arising from contractual obligations”); *Signal Peak Enterprises of Texas, Inc. v. Bettina*, 138 S.W.3d 915, 925 (Tex. App.—Dallas 2004) (the court applied a two-step approach, first relying on *Castleberry* to establish that the corporation in question was merely the alter ego of its controlling shareholder, then finding that the defendant's conduct did not constitute actual fraud as required by TBCA art. 2.21: “Once alter ego is found to exist, the plaintiff must then show that the person on whom liability is sought to be imposed caused the corporation to be used for the purpose of perpetrating, and perpetrated an actual fraud on the obligee for the direct benefit of the person on whom liability is sought to be imposed.”); *Country Village Homes, Inc. v. Patterson*, 236 S.W.3d 413, 430 (Tex. App.—Houston [1st Dist.] 2007) (in a judgment later vacated by agreement, the court was willing to treat both the single business enterprise theory and the alter ego theory as viable paths to disregarding the corporate entity; the court then recognized that, after *Southern Union*, TBCA art. 2.21 controls all veil-piercing claims, and “that a finding of actual fraud is required in order to prove a theory of Single Business Enterprise”); and *Rutherford v. Atwood*, 2003 WL 22053687 (Tex. App.—Houston [1st Dist.] 2003) (the court (citing both *Menetti v. Chavers*, *supra*, and *Farr v. Sun World Sav. Ass'n*, 810 S.W.2d 294 (Tex. App.—El Paso 1991))

On November 14, 2008, *Castleberry* was explained and further limited by the Texas Supreme Court in *SSP Partners and Metro Novelties, Inc. v. Gladstrong Investments (USA) Corp.*²⁸¹ As a result of the Texas Supreme Court’s holding and teachings in *SSP*, *Castleberry* is no longer an authoritative statement of the Texas veil piercing common law. *SSP* was a products liability case in which a five-year-old boy was killed in a house fire started by a disposable butane lighter with a defective child-resistant mechanism sold by the defendant. In *SSP*, the Texas Supreme Court held that corporations cannot be held liable for each other’s tort obligations merely because they are part of a single business enterprise.²⁸² *SSP* rejects the single

held that not only was a showing of actual fraud required in order to pierce the corporate veil, but that the fraud must (i) “relate to the transaction at issue” and (ii) be primarily for the defendant’s direct personal benefit).

²⁸¹ 275 S.W.3d 444, 2008 WL 4891733 (Tex. 2008).

²⁸² In explaining and limiting *Castleberry*, the Supreme Court in *SSP* wrote:

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

Creation of affiliated corporations to limit liability while pursuing common goals lies firmly within the law and is commonplace. We have never held corporations liable for each other’s obligations merely because of centralized control, mutual purposes, and shared finances. There must also be evidence of abuse, or as we said in *Castleberry*, injustice and inequity. By “injustice” and “inequity” we do not mean a subjective perception of unfairness by an individual judge or juror; rather, these words are used in *Castleberry* as shorthand references for the kinds of abuse, specifically identified, that the corporate structure should not shield - fraud, evasion of existing obligations, circumvention of statutes, monopolization, criminal conduct, and the like. Such abuse is necessary before disregarding the existence of a corporation as a separate entity. Any other rule would seriously compromise what we have called a “bedrock principle of corporate law” that a legitimate purpose for forming a corporation is to limit individual liability for the corporation’s obligations.

* * *

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

* * *

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

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

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

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

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

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

D. Management. The corporation form of business entity allows for an efficient and flexible management structure. The traditional management structure of a corporation is centralized.²⁸³ Shareholders elect directors, who are given the power to manage the affairs of the corporation generally, as well as to formulate policies and objectives.²⁸⁴ Shareholders retain the power to vote on certain major matters.²⁸⁵ Directors appoint officers, who are delegated the

the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law, 31 BULL. OF BUS. L. SEC. OF THE ST. B. OF TEX. 1, 2, 19, 22 (June 1994).

²⁸³ Douglas K. Moll, *Shareholder Oppression & Reasonable Expectations: Of Change, Gifts, and Inheritances in Close Corporation Disputes*, 86 MINN. L. REV. 717, 724 (2002).

²⁸⁴ *Capital Bank v. Am. Eyewear, Inc.*, 597 S.W.2d 17, 20 (Tex. App.—Dallas 1980, no writ) (declaring that “the authority to manage a corporation’s affairs is vested in its board of directors.”). A Certificate of Formation may grant corporate directors different voting rights, whether or not elected by separate classes or series of shares. TBOC § 21.406(a) as amended in the 2009 Legislative Session by S.B. 1442 § 36. *See infra* Appendix D.

²⁸⁵ TBCA art. 2.28 and TBOC § 21.358 provide that the general requirement for a quorum of shareholders at a meeting of shareholders will be the holders of a majority of the outstanding shares entitled to vote at the meeting. This requirement may be increased or decreased to as few as one-third of the holders of the outstanding shares if so provided in the articles of incorporation or certificate of formation. Once there is a quorum of shareholders at a meeting of shareholders, there is a quorum for all matters to be acted upon at that meeting. Electronic meetings of shareholders are permitted by TBCA art. 2.24 if authorized in the articles of incorporation or bylaws. TBOC § 6.002 permits electronic meetings, subject to an entity’s governing documents.

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

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

In corporations formed prior to September 1, 2003, unless expressly prohibited by the articles of incorporation, shareholders have the right to cumulate their votes in the election of directors if they notify the corporation at least one day before the meeting of their intent to do so; for corporations formed on or after

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

Most corporate statutes, including the TBCA, the TBOC and the Delaware General Corporation Law (the "DGCL"), also provide for "close corporations" which may be managed by the shareholders directly.²⁸⁶ A Texas corporation elects "close corporation" status by including a provision to such effect in its articles of incorporation or certificate of formation, and may provide in such document or in a shareholder agreement, which can be similar to a partnership agreement, that management will be by a board of directors or by the shareholders.²⁸⁷ Under the Tex. Corp. Stats., any Texas corporation (except a corporation whose shares are publicly traded) may modify how the corporation is to be managed and operated, in much the same way as a close corporation, by an agreement set forth in (1) the certificate of formation or the bylaws approved by all of the shareholders or (2) a written agreement signed by all of the shareholders.²⁸⁸ Thus, the management structure of corporations is generally flexible enough to

September 1, 2003 and for those formed earlier but voluntarily opting in to the TBOC, shareholders do not have the right to cumulative voting unless the articles of incorporation or certificate of formation expressly grants that right. TBCA art. 2.29D; TBOC §§ 21.360, 21.362.

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

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

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

²⁸⁶ See J. Leon Lebowitz, *Texas Close Corporation Law*, 44 TEX. B.J. 51 (1981); Robert W. Hamilton, *Corporations and Partnerships*, 36 SW. L.J. 227, 228-34 (1982).

²⁸⁷ TBCA arts. 12.11, 12.13, 12.31; TBOC §§ 3.008, 21.703, 21.713.

²⁸⁸ TBCA art. 2.30-1 and TBOC § 21.101 in effect extend close corporation flexibility to all corporations that are not publicly traded by authorizing shareholders' agreements that modify and override the mandatory provisions of the TBCA or the TBOC relating to operations and corporate governance. The agreement must be set forth in either (i) the articles of incorporation or bylaws and approved by all shareholders or (ii) in an agreement signed by all shareholders and made known to the corporation. TBCA art. 2.30-1(B)(1); TBOC § 21.101(b). The agreement is not required to be filed with the Secretary of State unless it is part of the articles of incorporation. TBCA arts. 2.30-1(B), 3.03; TBOC §§ 21.101(b), 4.002. An agreement so adopted may:

- (1) restrict the discretion or powers of the board of directors;
- (2) eliminate the board of directors and permit management of the business and affairs of the corporation by its shareholders, or in whole or in part by one or more of its shareholders, or by one or more persons not shareholders;
- (3) establish the natural persons who shall be the directors or officers of the corporation, their term of office or manner of selection or removal, or terms or conditions of employment of any director, officer, or other employee of the corporation, regardless of the length of employment;

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

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

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

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

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

E. Fiduciary Duties.

1. General. Directors of a corporation owe fiduciary duties of care, loyalty and obedience to the corporation.²⁸⁹ The duty of care requires directors to exercise the degree of care that an ordinarily prudent person would exercise under similar circumstances.²⁹⁰ The duty of loyalty dictates that a director must act in good faith and must not allow personal business interests to prevail over the interests of the corporation.²⁹¹ In general, a director will not be permitted to derive a personal profit or advantage at the expense of the corporation and must act solely with an eye to the best interest of the corporation, unhampered by any pecuniary interest of his own.²⁹² The duty of obedience requires directors to obey the law and the articles of incorporation.²⁹³ Controlling shareholders owe a fiduciary duty to the minority shareholders to deal fairly with them.²⁹⁴

2. Business Judgment Rule. The business judgment rule provides a degree of protection to decisions made by corporate directors. Under the business judgment rule, directors are presumed to have satisfied their fiduciary duties in making a business decision.²⁹⁵ Under Delaware law, for the business judgment rule to apply, a decision must be made by disinterested directors who act in good faith after reasonable investigation and who honestly and reasonably believe that the decision will reasonably benefit the corporation.²⁹⁶ Under Texas law, the business judgment rule appears to be more favorable to directors than under Delaware law, since

²⁸⁹ *Gearhart Industries, Inc. v. Smith Intern. Inc.*, 741 F.2d 707 (5th Cir. 1984); see Byron F. Egan, *Fiduciary Duty Issues in M&A Transactions*, available at <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1166>; Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation - Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 259-270 (Winter 2001).

²⁹⁰ *Gearhart*, 741 F.2d at 720.

²⁹¹ *Id.* at 719 (holding that the good faith of a director will be determined by whether the director acted with an intent to confer a benefit to the corporation); *Lyondell Chemical Company v. Ryan*, _____ A.2d _____, WL 1024764 (Del. 2009); *Stone v. Ritter*, 911 A.2d 362 (Del. 2006); see *Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 578 (Tex. 1963) (holding that whether there exists a personal interest by the director will be a question of fact; cf. Lyman Johnson, *After Enron: Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27 (2003)).

²⁹² See *A. Copeland Enters., Inc. v. Guste*, 706 F. Supp. 1283, 1291 (W.D. Tex. 1989); *Milam v. Cooper Co.*, 258 S.W.2d 953, 956 (Tex. Civ. App.—Waco 1953, writ ref'd n.r.e.); see also TBCA art. 2.35-1(A) and TBOC § 21.418 (validating director transactions if (1) disinterested directors, after disclosure, approve the transaction; (2) shareholders of the corporation, after disclosure, approve the transaction; or (3) the transaction is otherwise fair); cf. *In re Mi-Lor Corp.*, 348 F.3d 294, 303 (1st Cir. 2003) (holding that a duty of full disclosure is imposed on directors in cases of self dealing). See generally John T. Kendrick, Jr., *The Interested Director in Texas*, 21 Sw. L.J. 794 (1967).

²⁹³ *Gearhart*, 741 F.2d at 719.

²⁹⁴ See *In re Pure Res., Inc.*, 808 A.2d 421, 433 (Del. Ch. 2002).

²⁹⁵ See *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986).

²⁹⁶ *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985). See Byron F. Egan, *Fiduciary Duty Issues in M&A Transactions*, available at <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1166>; Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation - Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 263-270 (Winter 2001).

directors' actions are presumed to be valid if no conflict of interest exists and the action is not *ultra vires* or tainted by fraud.²⁹⁷

3. Overcoming Business Judgment Rule. The business judgment rule is only a presumption that protects directors from liability arising out of business decisions made for the corporation. If the presumption created by the business judgment rule is overcome or shown not to apply, then the burden shifts to the director to justify the fairness of the transaction to the corporation.²⁹⁸

4. Corporate Opportunities Renunciation. Generally the duty of loyalty prohibits a director from usurping business opportunities that otherwise might be pursued by the corporation.²⁹⁹ Both Texas and Delaware law permit a corporation to renounce any interest in business opportunities presented to the corporation or one or more of its officers, directors or shareholders in its certificate of formation or by action of its board of directors.³⁰⁰ While this allows a corporation to specifically forgo individual corporate opportunities or classes of opportunities, the type of judicial scrutiny applied to the decision to make any such renunciation of corporate opportunities will generally be governed by a traditional common law fiduciary duty analysis.³⁰¹

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

DGCL § 144 provides that a contract between a director and the director's corporation will not be voidable due to the director's interest if (i) the transaction or contract is approved in good faith by a majority of the disinterested directors after the material facts as to the relationship or interest and as to the transaction or contract are disclosed or known to the directors, (ii) the transaction or contract is approved in good faith by shareholders after the material facts as to the relationship or interest and as to the transaction or contract is disclosed or known to the shareholders, or (iii) the transaction or contract is fair to the corporation as of the

²⁹⁷ See *Gearhart*, 741 F.2d at 719-21; Byron F. Egan and Curtis W. Huff, *supra*, 54 SMU L. Rev. at 260-263.

²⁹⁸ *Gearhart*, 741 F.2d at 720.

²⁹⁹ The basic framework of the corporate opportunity doctrine was laid down by the Delaware Supreme Court in *Guth v. Loft, Inc.*, as follows:

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

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

³⁰⁰ TBCA art. 2.02(20), TBOC § 2.101(21); DGCL § 122(17).

³⁰¹ R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* § 2.1 (2d ed. 1997); see generally *id.* at § 4.36.

time it is authorized, approved, or ratified by the directors or shareholders of the corporation.³⁰² In *Fliegler v. Lawrence*, however, the Delaware Supreme Court held that where the votes of directors, qua stockholders, were necessary to garner stockholder approval of a transaction in which the directors were interested, the taint of director self-interest was not removed, and the transaction or contract may still be set aside and liability imposed on a director if the transaction is not fair to the corporation.³⁰³ The question remains, however, whether approval by a majority of disinterested stockholders will, pursuant to DGCL § 144(a)(2), cure any invalidity of director actions and, by virtue of the stockholder ratification, eliminate any director liability for losses from such actions.³⁰⁴

In 1985, Texas followed Delaware's lead in the area of interested director transactions and adopted TBCA article 2.35-1,³⁰⁵ the predecessor to TBOC § 21.418. In general, these Texas Corporate Statutes provide that a transaction between a corporation and one or more of its directors or officers will not be voidable solely by reason of that relationship if the transaction is approved by shareholders or disinterested directors after disclosure of the interest, or if the transaction is otherwise fair.³⁰⁶ Because TBCA art. 2.35-1, as initially enacted, was essentially identical to DGCL § 144, some uncertainty on the scope of TBCA art. 2.35-1 arose because of *Fliegler's* interpretation of DGCL § 144. This imposition of a fairness gloss on the Texas statute rendered the effect of the safe harbor provisions in TBCA article 2.35-1 uncertain.

In 1997, TBCA article 2.35-1 was amended to address the ambiguity created by *Fliegler* and to clarify that contracts and transactions between a corporation and its directors and officers or in which a director or officer has a financial interest are valid notwithstanding that interest as long as any one of the following are met: (i) the disinterested directors of the corporation approve the transaction after disclosure of the interest, (ii) the shareholders of the corporation approve the transaction after disclosure of the interest or (iii) the transaction is fair.³⁰⁷ TBOC § 21.418 mirrors these clarifications.³⁰⁸ Under the Texas Corporate Statutes, if

³⁰² DGCL § 144(a).

³⁰³ *Fliegler v. Lawrence*, 361 A.2d 218, 222 (Del. 1976).

³⁰⁴ *See Michelson v. Duncan*, 407 A.2d 211, 219 (Del. 1979). In *Gantler v. Stephens*, 965 A.2d 695, 2009 WL 188828 (Del. 2009), the Delaware Supreme Court found that stockholder approval of a going private stock reclassification proposal did not effectively ratify or cleanse the transaction for two reasons:

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

* * *

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

³⁰⁵ TBOC § 21.418; TBCA art. 2.35-1.

³⁰⁶ *Id.*; TBOC § 21.418; *see Landon v. S & H Marketing Group, Inc.*, 82 S.W.3d 666 (Tex. App.—Eastland 2002).

³⁰⁷ TBCA art. 2.35-1.

any one of these conditions is met, the contract will be considered valid notwithstanding the fact that the director or officer has an interest in the transaction.³⁰⁹ These provisions rely heavily on the statutory definitions of “disinterested” contained in TBCA art. 1.02 and TBOC § 1.003. Under these definitions, a director will be considered “disinterested” if the director is not a party to the contract or transaction or does not otherwise have a material financial interest in the outcome of the contract.³¹⁰

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

6. Limitation of Director Liability. Both the DGCL and the Texas Corporate Statutes allow corporations to provide limitations on (or partial elimination of) director liability in relation to the duty of care in their certificates of incorporation.³¹¹ DGCL § 102(b)(7) in effect permits a corporation to include a provision in its certificate of incorporation limiting or eliminating a director’s personal liability for monetary damages for breaches of the duty of care.³¹² The liability of directors may not be so limited or eliminated, however, in connection with breaches of the duty of loyalty, the failure to act in good faith, intentional misconduct, knowing violations of law, obtaining improper personal benefits, or paying dividends or

³⁰⁸ TBOC § 21.418(b), as amended in the 2009 Legislative Session by S.B. 1442 § 37, provides that an interested director may participate in the board authorization of the transaction in which the director has an interest or sign a unanimous written consent of the directors approving it. *See infra* Appendix D.

³⁰⁹ *Id.* art. 2.35-1(A); TBOC § 21.418(b).

³¹⁰ *Id.*

³¹¹ DGCL § 102(b)(7) reads as follows:

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* * *

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

* * *

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

³¹² DGCL § 102(b)(7).

approving stock repurchases in violation of DGCL § 174.³¹³ Delaware courts have routinely enforced DGCL § 102(b)(7) provisions and held that, pursuant to such provisions, directors cannot be held monetarily liable for damages caused by alleged breaches of the fiduciary duty of care.³¹⁴

The Texas Corporate Statutes contain provisions which are comparable to DGCL § 102(b)(7), and permit a corporation to include a provision in its charter limiting or eliminating a director's personal liability for monetary damages for breaches of the duty of care.³¹⁵ Like the DGCL, the Texas Corporate Statutes do not authorize the limitation of liability of an officer or a director acting in the capacity of an officer.³¹⁶

³¹³ DGCL § 102(b)(7); *see also Zirn v. VLI Corp.*, 621 A.2d 773, 783 (Del. 1993) (DGCL § 102(b)(7) provision in corporation's certificate did not shield directors from liability where disclosure claims involving breach of the duty of loyalty were asserted).

³¹⁴ A DGCL § 102(b)(7) provision does not operate to defeat the validity of a plaintiff's claim on the merits, rather it operates to defeat a plaintiff's ability to recover monetary damages. *Emerald Partners v. Berlin*, 787 A.2d 85, 92 (Del. 2000). In determining when a DGCL § 102(b)(7) provision should be evaluated by the Court of Chancery to determine whether it exculpates defendant directors, the Delaware Supreme Court recently distinguished between cases invoking the business judgment presumption and those invoking entire fairness review (these standards of review are discussed below). *Id.* at 92-3. The Court determined that if a stockholder complaint unambiguously asserts solely a claim for breach of the duty of care, then the complaint may be dismissed by invocation of a DGCL § 102(b)(7) provision. *Id.* at 92. The Court held, however, that "when entire fairness is the applicable standard of judicial review, a determination that the director defendants are exculpated from paying monetary damages can be made only *after the basis* for their liability has been decided." *Id.* at 94. In such a circumstance, defendant directors can avoid personal liability for paying monetary damages only if they establish that their failure to withstand an entire fairness analysis was exclusively attributable to a violation of the duty of care. *Id.* at 98.

³¹⁵ The Texas analogue to DGCL § 102(b)(7) is TBOC § 7.001, which provides in relevant part:

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

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

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

TMCLA art. 1302-7.06 provides substantially the same.

³¹⁶ *See* TBOC § 7.001(b) ("The certificate of formation . . . may provide that a governing person of the organization is not liable, or is liable only to the extent provided by the certificate of formation or similar instrument, to the organization or its owners or members for monetary damages for an act or omission by the person *in the person's capacity as a governing person.*" (emphasis added)). *See also* TMCLA § 1302-7.06B. A corporate officer is an agent of the corporation. *Joseph Greenspon's Sons Iron & Steel Co. v. Pecos Valley Gas Co.*, 156 A. 350 (Del. Ch. 1931); *Hollaway v. Skinner*, 898 S.W.2d 793, 795 (Tex. 1995). If an officer commits a tort while acting for the corporation, under the law of agency, the officer is liable

F. Ability to Raise Capital. The corporation provides as much financing flexibility as any type of business entity. Corporations are given the authority in their statutes and governing documents to use any number of various devices to raise capital.³¹⁷ Different classes and series of common stock and preferred stock may be utilized to accommodate the desires of various types of investors.³¹⁸ Equity can be raised at the base level by common stock and at levels ranking above the common stock by preferred stocks.³¹⁹ Equity can be leveraged through many types of borrowings and financing devices, including stock options, warrants, and other forms of securities. In addition, convertible debt interests may be utilized. The different levels of a capital structure may include a differentiation in the voting rights assigned to equity holders, which may even be distributed differently among classes of common stock or even denied as to specified classes of common stock.

A Texas corporation may issue shares for such consideration, not less than the par value thereof, approved by its board of directors.³²⁰ Shares may be issued for cash, promissory notes, services performed or a contract for services to be performed, securities of the corporation or another entity, any tangible or intangible benefit to the corporation, or any property of any kind or nature.³²¹ When the consideration is a note or future services, the corporation may issue the shares into escrow, or may provide that the shares may not be transferred or entitled to receive distributions, until the note is paid or the services performed.³²²

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

1. **Restrictions on Transfer of Shares.** Shareholders of a closely-held corporation often desire to prohibit the transfer of shares to persons who are not family members or are not employees of the corporation. To be enforceable, these restrictions on transfer must be reasonable under state law. In any event, an absolute restriction on transfer would be unreasonable and therefore void.³²³ The Tex. Corp. Stats. provide that, among other restrictions, rights of first refusal and limitations on transfer necessary to maintain S-corporation status or other tax advantages are reasonable restrictions on transfer.³²⁴ They also specify certain procedures that must be followed to assure the enforceability of the share transfer restrictions, such as the placement of a restrictive legend on stock certificates and the maintenance of a copy of the document containing the transfer restrictions at the corporation's principal place of

personally for his actions. See Dana M. Muir and Cindy A. Schipani, *The Intersection of State Corporation Law and Employee Compensation Programs: Is it Curtains for Veil Piercing?*, 1996 U. Ill. L. Rev. 1059, 1078-1079 (1996); cf. *Centurion Planning Corporation, Inc. v. Seabrook Venture II*, 176 S.W.3d 498, 509 (Tex. App.—Houston [1st Dist.]2004). The corporation may also be liable under *respondeat superior*.

³¹⁷ ROBERT W. HAMILTON, CORPORATIONS 356 (7th ed. 2001).

³¹⁸ See *id.* at 357–59.

³¹⁹ See *id.*; TBOC §§ 21.152-21.157.

³²⁰ TBOC §§ 21.175 and 21.161.

³²¹ TBOC § 21.159.

³²² TBOC § 21.157(c) as added in the 2009 Legislative Session by S.B. 1442 § 30. See *infra* Appendix D.

³²³ See TBCA art. 2.22(C); see also TBOC § 21.213.

³²⁴ TBCA arts. 2.22(D), (H); TBOC § 21.211.

business or registered office.³²⁵ Since shares in a closely-held business typically lack an established trading market, those shares may be nontransferable as a practical matter. If the owners of the business enterprise desire to conduct an initial public offering for its shares, the corporate form of entity is the best option except in certain limited circumstances.

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

3. Beneficial Owners. The Tex. Corp. Stats. contemplate that a corporation directly communicates and deals with only a record or registered holder of its shares.³²⁶ It is typical, however, for publicly held shares to be held by a nominee or through securities depositories (i.e., in “street name”), so that the ultimate owner of the shares is not the record or registered holder. The TBOC was amended in the 2009 Legislative Session to provide that a corporation, if it desires, may recognize the beneficial owner as the “shareholder” and may communicate and deal directly with the beneficial owner instead of the record or registered holder.³²⁷ The extent of this recognition is at the corporation’s discretion: it may recognize the beneficial owner for all purposes or only for certain purposes, such as giving notice of shareholders’ meetings or paying dividends. The procedure for recognition is also subject to the corporation’s discretion, except that it must include the nominee’s filing with the corporation of a statement identifying, and providing other relevant information regarding, the beneficial owner. A beneficial owner’s decision to follow the procedure to become recognized as the “shareholder” is also subject to his or her discretion.

The TBOC was further amended in the 2009 Legislative Session to permit a beneficial owner of an ownership interest that is entitled to dissenters’ rights to file a petition for appraisal.³²⁸ An ownership interest is entitled to dissenters’ rights only if the record or registered owner has taken the steps in Subchapter H of TBOC Chapter 10 to perfect those rights, and a petition for appraisal may be filed only if the dissenting record or registered owner and the entity responsible for satisfying the obligations to dissenters have not agreed on the fair market value of the ownership interest. If the dissenting record or registered owner is the trustee of a voting trust or other nominee holder of the ownership interest for a beneficial owner, then the beneficial owner, as the person with the direct economic interest in the ownership interest entitled to dissenters’ rights, may pursue the dissenters’ rights by petitioning a court for appraisal. The nominee holder of the ownership interest then need not serve as plaintiff in the appraisal action.

³²⁵ TBCA arts. 2.22(B), (C); TBOC §§ 21.210, 21.213.

³²⁶ TBOC § 21.201.

³²⁷ TBOC § 21.201(b)-(d) as added in the 2009 Legislative Session by S.B. 1442 § 33. *See infra* [Appendix D.](#)]

³²⁸ TBOC § 10.154(c) and TBOC § 10.361(g) as added in the 2009 Legislative Session by S.B. 1442 §§ 18 and 19. *See infra* [Appendix D.](#)

4. **No Bearer Shares.** Certificates for shares in a Texas corporation may not be registered in bearer form.³²⁹ Bearer form certificates have no registered owners and have been criticized by federal and other law enforcement agencies as a means to avoid disclosure of actual ownership of entities in order to prevent discovery of the persons responsible for illegal activities by the culpable entity. The prohibition on bearer shares does not affect ownership interest certificates held by nominees.

H. Continuity of Life. Corporations frequently have perpetual existence, either by default under the TBOC or by a provision in a corporation's articles of incorporation under older Texas law.³³⁰ Since a corporation is treated as a separate entity with continuity of life, events such as death or bankruptcy of an owner have no effect on the legal structure of a corporation—at least absent a specific shareholder agreement attaching consequences and procedures for certain events. Even in bankruptcy, a shareholder continues to be a shareholder of the bankrupt entity. Shares can be passed down to heirs. In contrast, under some existing non-Texas partnership laws, particularly less modern ones, a partnership is not an entity separate from its partners and a deceased partner's estate may have to be probated in each state where the partnership owns property. Expenses and the hassle of multiple probate proceedings are avoided in a corporation because corporate shares are personal property subject to probate only in the deceased shareholder's state of domicile.

Under the pre-TBOC business entity rules, with respect to other types of entities, the problems associated with a finite lifetime or unanticipated dissolution could be solved in many cases in the drafting of the entity's constituent documents. However, under the TBOC, *all* domestic entities exist perpetually unless otherwise provided in its governing documents.³³¹ Thus, the perpetual existence of a corporation is not an advantage to be given much weight in determining the type of business entity to utilize, particularly since the TBOC governs all newly-formed entities.

I. Formation. The formation of a corporation requires certain legal formalities and the preparation of certain documents. Under the TBCA, articles of incorporation had to be prepared and filed with the Secretary of State, along with the payment of a \$300 filing fee.³³² Under the TBOC, a certificate of formation is the proper filing document.³³³ The certificate of formation (hereinafter referred to as the "corporation's governing document") establishes the initial board of directors and capital structure of the corporation, and designates a registered agent and office for service of process in Texas.³³⁴ After the Secretary of State officially

³²⁹ TBOC § 3.202 (f) as added in the 2009 Legislative Session by S.B. 1442 § 3. Also TBOC § 21.163(a)(4) was amended in the 2009 Legislative Session by S.B. 1442 § 31 to eliminate the ability of a corporation to issue scrip in bearer form. *See infra* [Appendix D](#).

³³⁰ TBOC § 3.003; TBCA art. 3.02(A) provides that the articles of incorporation shall set forth: "(2) The period of duration, which may be perpetual."

³³¹ TBOC § 3.003.

³³² TBCA arts. 3.02 and 3.03.

³³³ TBOC §§ 3.001, 4.001. The filing fee for a for-profit corporation remains \$300 under the Code. TBOC § 4.152(1).

³³⁴ TBOC § 3.005(a)(5). Under TBOC § 5.201(b), a registered agent in Texas must be a resident individual or business registered or authorized to do business in the state. A registered agent must consent to serve as such before being designated or appointed in a filing with the Secretary of State of Texas after January 1,

acknowledges the filing of the corporation's certificate of formation,³³⁵ there should be an organizational meeting of the initial board of directors named in the corporation's governing document (at the call of a majority of the directors) for the purposes of adopting bylaws, electing officers and transacting such other business as may come before the meeting.³³⁶ The bylaws may contain any provisions for the regulation and management of the affairs of the corporation not inconsistent with law or the corporation's certificate of formation.³³⁷ Although the initial bylaws of a corporation are ordinarily in writing and adopted by the directors at the organization meeting of the board, the shareholders may amend, repeal or adopt the bylaws, unless the corporation's governing document or a bylaw adopted by the shareholders provides otherwise.³³⁸ In the absence of a contrary provision in the corporation's governing document, the TBCA or the

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

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

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

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

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

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

³³⁵ TBOC § 4.002. Under pre-TBOC law, the Secretary of State would issue a Certificate of Incorporation once a corporation properly filed its Articles of Incorporation.

³³⁶ TBCA art. 3.06; TBOC § 21.059.

³³⁷ TBCA art. 2.33A; TBOC § 21.057.

³³⁸ TBCA art. 2.23; TBOC § 21.058.

TBOC, bylaws may be adopted or amended orally or by acts evidenced by a uniform course of proceeding or usage and acquiescence.³³⁹

J. Operations in Other Jurisdictions. When a corporation does business outside of its state of incorporation, it may be required to qualify to do business as a foreign corporation in the other states in which it does business under statutory provisions comparable to TBCA Part Eight and TBOC Chapter 9 and subject to taxation by those states. Over the years, there has evolved a substantial body of law for analyzing these questions.³⁴⁰

K. Business Combinations; Conversions. The Tex. Corp. Stats. now allow corporations, LLCs and partnerships to merge with each other (e.g., a limited partnership can merge into a corporation) and to convert from one form of entity to another without going through a merger or transfer of assets.³⁴¹ Both the TBOC and the older entity statutes each have provisions relating to the mechanics of the adoption of a plan of merger or conversion, owner approval, filings with the Secretary of State, and the protection of creditors.

Under the conversion provisions of the Tex. Corp. Stats.,³⁴² a Texas corporation may convert into another corporation or other entity if (a) the conversion is approved by its shareholders in the same manner as a merger where the corporation is not the surviving entity, (b) the conversion is consistent with the laws under which the resulting entity is to be governed, (c) shareholders will have a comparable interest in the resulting entity, unless the shareholder exercises his dissenters' rights under the Tex. Corp. Stats. or he otherwise agrees, (d) no shareholder will become personally liable for the obligations of the resulting entity without his consent, and (e) the resulting entity is a new entity formed as a result of the conversion rather than an existing entity (which would be a merger).

The Tex. Corp. Stats. require shareholder approval of the sale of all or substantially all of the assets of the corporation in certain circumstances.³⁴³

L. Anti-Takeover. TBCA Part Thirteen and TBOC Chapter 21, Subchapter M deal with business combinations involving public companies where there is a change of control after which there are minority shareholders by imposing a special voting requirement for business

³³⁹ *Keating v. K-C-K Corporation*, 383 S.W.2d 69 (Tex. Civ. App.—Houston 1964, no writ).

³⁴⁰ *See* CT Corporation, *What Constitutes Doing Business* (2008). In the 2009 Legislative Session S.B. 1442 § 14 added a new subdivision (15) to TBOC § 9.251 (Activities Not Constituting Transacting Business in This State) to provide that mere ownership of real or personal property in Texas, without more, will not constitute transaction of business in Texas for the purposes of the requirement to register to do business under TBOC Chapter 9. For example, the ownership by a limited partner of a partnership interest in a limited partnership doing business in Texas, without more, will not require the limited partner to register to transact business in Texas. This amendment would not affect (i) the payment of taxes under the Tax Code, including the Margin Tax, or (ii) the long-arm jurisdiction statute which allows Texas courts to obtain personal jurisdiction over out-of-state entities or having sufficient minimum contacts with Texas. *See infra* [Appendix D](#).

³⁴¹ *See* TBCA Part Five; TBOC Chapter 10.

³⁴² TBCA arts. 5.17, 5.18, 5.19 and 5.20. Comparable provisions are found for LLCs at LLC Act §§ 10.08-10.11, for limited partnerships at TRLPA § 2.15, and for general partnerships at TRPA §§ 9.01, 9.05 and 9.06. The TBOC contains substantially similar provisions, all consolidated in Chapter 10, Subchapter C.

³⁴³ *See supra* notes 224-225 and related text.

combinations and other transactions involving a new controlling shareholder.³⁴⁴ These anti-takeover provisions (i) apply only to an “issuing public corporation”³⁴⁵ and (ii) prohibit a “business combination”³⁴⁶ (which includes a merger, share exchange, sale of assets, reclassification, conversion or other transaction between the issuing public corporation and any “affiliated shareholder”³⁴⁷) for three years after the affiliated shareholder became such unless (iii) the “business combination” is approved by the holders of not less than two-thirds of the voting shares not beneficially owned by the affiliated shareholder at a meeting of shareholders held not less than six months after the affiliated shareholder became such or, prior to the affiliated shareholder becoming such, the board of directors approved either the business combination or the affiliated shareholder’s acquisition of the shares that made him an affiliated shareholder.³⁴⁸ Tex. Corp. Stats. also confirm that a director, in discharging his duties, may consider the long-term, as well as the short-term, interests of the corporation and its shareholders.³⁴⁹

III. GENERAL PARTNERSHIP.

A. General. Texas law will only recognize an association or organization as being a “partnership” if it was created under (1) the TBOC, (2) the TRPA, (3) the older Texas Uniform Partnership Act (“TUPA”),³⁵⁰ (4) the Texas Revised Limited Partnership Act (“TRLPA”)³⁵¹ or (5) under a statute of another jurisdiction which is comparable to any of the Texas statutes referred to in (1), (2), (3), or (4) above.³⁵² If an association is created under a law other than those listed, then it is not a partnership. A “partnership” is defined as an association of two or more persons to carry on a business for profit, whether they intend to create a partnership and whether they call their association a partnership, a joint venture or other name.³⁵³ The definition

³⁴⁴ TBCA arts. 13.01-13.08; TBOC §§ 21.601-21.610. State corporation statutes intended to restrain some of the abuses associated with hostile takeovers were validated by the United States Supreme Court in *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987). See *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 505-09 (7th Cir. 1989), *cert. denied*, 493 U.S. 955 (1989) (upholding Wisconsin’s 3-year moratorium statute); Byron F. Egan and Bradley L. Whitlock, *State Shareholder Protection Statutes*, Address at the University of Texas 11th Annual Conference on Securities Regulation and Business Law Problems (Mar. 10, 1989).

³⁴⁵ “Issuing public corporation” is defined as a Texas corporation that has 100 or more shareholders of record, has a class of voting shares registered under the Securities Exchange Act of 1934, or has a class of voting shares qualified for trading on a national market system. TBCA arts. 13.02(A)(6), 13.03; TBOC §§ 21.601(1), 21.606. These TBCA and TBOC provisions do not apply to corporations that are organized under the laws of another state, but that have a substantial nexus to Texas, because such a “foreign application” provision might jeopardize the constitutionality thereof. See, e.g., *Tyson Foods, Inc. v. McReynolds*, 700 F. Supp. 906, 910-14 (M.D. Tenn. 1988); *TLX Acquisition Corp. v. Telex Corp.*, 679 F. Supp. 1022, 1029-30 (W.D. Okla. 1987).

³⁴⁶ TBCA art. 13.02(A)(4); TBOC § 21.604.

³⁴⁷ “Affiliated shareholder” is defined as a shareholder beneficially owning 20% or more of the corporation’s voting shares and certain of its related persons. TBCA art. 13.02(A)(2); TBOC § 21.602.

³⁴⁸ TBCA art. 13.03 is based on DGCL § 203. See also TBOC § 21.606.

³⁴⁹ TBCA art. 13.06; TBOC § 21.401(b).

³⁵⁰ See statutes cites *supra* note 1.

³⁵¹ Tex. Rev. Civ. Stat. Ann. art. 6132a-1 (Vernon Supp. 2010).

³⁵² TRPA § 2.02; TBOC § 152.051(c).

³⁵³ TRLPA § 6(a)(1); TRPA § 2.02(a); TBOC § 152.051(b).

of a partnership is crucial in litigation in which a person is arguing that he is not a partner and that the general partner disadvantages (e.g., individual, and joint and several liability, for the obligations of the partnership) should not be imposed upon him.

The TBOC now governs all Texas general partnerships.³⁵⁴ Within the TBOC, Chapter 152 is specifically applicable to general partnerships, though many of the general provisions in Title 1 and Title 4, Chapters 151 and 154, will also apply. The TBOC provides that such provisions may be collectively known as “Texas General Partnership Law.”³⁵⁵ Texas general partnerships formed on or after January 1, 2006 had to be governed by the TBOC, and those formed before January 1, 2006 could voluntarily opt in to TBOC governance between January 1, 2006 and January 1, 2010.³⁵⁶ Until January 1, 2010 (at which time *all* partnerships became subject to the TBOC),³⁵⁷ Texas general partnerships which were formed prior to January 1, 2006 and did not opt into the TBOC were governed by the TRPA.³⁵⁸ Because until 2010 some general partnerships were governed by the TRPA and others by the TBOC and because the substantive principles under both statutes are generally the same, the term “Tex. GP Stats.” is used herein to refer to the TBOC and the TRPA collectively, and the particular differences between the TRPA and the TBOC are referenced as appropriate.

1. Definition of “Person”. Any person may be a partner unless the person lacks capacity apart from the Tex. GP Stats. Under TRPA, a “person” is defined to include “individual[s], corporation[s], business trust[s], estate[s], trust[s], custodian[s], trustee[s], executor[s], administrator[s], nominee[s], partnership[s of any sort], association[s], limited liability compan[ies], government[s], governmental subdivision[s], governmental agenc[ies, etc.] . . . and any other legal or commercial entity.”³⁵⁹ The definition of “person” under the new TBOC comes from the Government Code,³⁶⁰ which provides that “[p]erson” includes corporation, organization, government or governmental subdivision or agency, business trust, estate, trust, partnership, association, and any other legal entity.”³⁶¹

2. Factors Indicating Partnership. Under the Tex. GP Stats., the following factors indicate that persons have created a partnership:³⁶²

- Receipt or right to receive a share of profits;

³⁵⁴ TBOC §§ 402.001 and 402.005.

³⁵⁵ TBOC § 1.008(f).

³⁵⁶ TBOC §§ 402.001 and 402.003.

³⁵⁷ TBOC § 402.005.

³⁵⁸ TRPA § 11.03(c). Prior to January 1, 1999, some entities were still governed by the Texas Uniform Partnership Act. *See* TRPA § 11.03(a); Steven M. Cooper, *The Texas Revised Partnership Act and the Texas Uniform Partnership Act: Some Significant Differences*, 57 Tex. B. J. 828 (Sept. 1994).

³⁵⁹ TRPA § 1.01(14).

³⁶⁰ *See* TEX. GOV'T CODE ANN. § 311.002 (Vernon 2010) (regarding application of the Government Code to construction of other Texas laws).

³⁶¹ TEX. GOV'T CODE ANN. § 311.005.

³⁶² TRPA § 2.03(a); TBOC § 152.052(a); John C. Ale & Buck McKinney, *Stumbling into Partnerships: How Bands, Business Owners and Strategic Allies Find Themselves in Inadvertent Partnerships*, 43 TEX. J. OF BUS. L. 465 (Fall 2009).

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

3. Factors Not Indicative of Partnership. Conversely, under Tex. GP Stats., the following circumstances do not individually indicate that a person is a partner in a business:³⁶³

- The right to receive or share in profits as (a) debt repayment, (b) wages or compensation as an employee or independent contractor, (c) payment of rent, (d) payment to a former partner, surviving spouse or representative of a deceased or disabled partner, (e) a transferee of a partnership interest, (f) payment of interest or (g) payment of the consideration for the sale of a business;
- Co-ownership of property whether in the form of joint tenancy, tenancy in common, tenancy by the entireties, joint property, community property or part ownership, whether combined with sharing of profits from the property;
- Sharing or having the right to share gross revenues regardless of whether the persons sharing gross revenues have a common or joint interest in the property from which they are derived; or
- Ownership of mineral property under a joint operating agreement.³⁶⁴

³⁶³ TRPA § 2.03(b); TBOC § 152.052(b).

³⁶⁴ The statement in TRPA § 2.03(b)(4) and TBOC § 152.052(b)(4) that “ownership of mineral property under a joint operating agreement” is not a circumstance evidencing a partnership among the co-owners is included to negate the possibility that a joint operating arrangement constitutes a “mining partnership” and to give effect to the typical operating agreement provision stating that the parties do not intend to create, and are not creating, a mining or other partnership. The law of mining partnerships is ably summarized in Cullen M. Godfrey, *Mining Partnerships: Liability Based on Joint Ownership and Operations in Texas*, XXXVII Landman 35-48 (No. 6 Nov.-Dec. 1993), which states:

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

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

* * *

4. Oral Partnerships. A written partnership agreement is not required to form a partnership: “An oral agreement of partnership is valid in Texas and need not set a specific date for termination within one year. What matters for the purpose of statute of frauds is that the partnership can be performed within a year.”³⁶⁵

5. Joint Venture. The definition of a partnership under Tex. GP Stats. includes a “joint venture” or any other named association that satisfies the definition of “partnership.”³⁶⁶ A joint venture is often thought of as a limited purpose partnership, although a joint venture may be organized as a corporation, limited partnership, LLP or LLC.³⁶⁷ A joint venture may also be no more than a contractual relationship such as a contractual revenue-sharing arrangement, a lease, a creditor/debtor relationship or some other relationship not constituting an entity. A risk to the contractual relationship structure is that a court will impose general partnership duties or liabilities on the venturers if their relationship is found to constitute “an association of two or more persons to operate a business as co-owners for a profit” (the

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

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

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

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

³⁶⁵ *Wilson v. Vaught*, 355 B.R. 600, S.D. Tex. 2006 (citing *Niday v. Niday*, 643 S.W.2d 919 (Tex. 1982)); see Steven A. Waters and Peter Christofferson, *Partnerships*, 61 SMU L. Rev. 995, 999 n.37 (2008):

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

³⁶⁶ TRPA § 2.02; TBOC § 152.051(b).

³⁶⁷ See Alan R. Bromberg and Larry E. Ribstein, *Bromberg & Ribstein on Partnership*, § 2.06 (Aspen Publishers 2003).

traditional definition of a partnership) regardless of how the venturers characterize and document their relationship.³⁶⁸

Because a joint venture may be a type of partnership and loss sharing is not necessary to form a partnership, the Tex. GP Stats. effectively overrule cases in the line represented by *Coastal Plains Development Corp. v. Micrea, Inc.*³⁶⁹ They also resolve old questions about whether an agreement to share losses was necessary to create a partnership by providing that it is unnecessary.³⁷⁰

B. Taxation.

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

2. Joint Venture/Tax Implications. A joint venture is commonly thought of as a limited duration general partnership formed for a specific business activity.³⁷¹ Unless the venturers elect otherwise, it is treated for federal income tax purposes like a general partnership in that the entity pays no tax; rather, its income or loss is allocated to the joint venturers.³⁷²

³⁶⁸ In *Dernick Resources, Inc. v. David Wilstein, et al*, ___ S.W.3d ___, 2009 WL 5174171 (Tex.App.-Hous. [1st Dist.] Dec. 31, 2009), which involved an oil and gas drilling and production arrangement pursuant to a contract that was called a “joint venture agreement,” the Court in an opinion by Justice Evelyn Keyes held that the joint venture agreement created a fiduciary relationship that imposed a fiduciary duty of full and fair disclosure on the managing venturer as it held title to the venture’s properties in its name and had a power of attorney to dispose of the properties, and explained:

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

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

³⁶⁹ See *Coastal Plains Dev. Corp. v. Micrea, Inc.*, 572 S.W.2d 285, 287–88 (Tex. 1978).

³⁷⁰ TRPA § 2.03(c); TBOC § 152.052(c).

³⁷¹ See, e.g., *Tompkins v. Comm’r*, 97 F.2d 396 (4th Cir. 1938); *United States v. U.S. Nat’l Bank of Portland, Or.*, 239 F.2d 475, 475-80 (9th Cir. 1956).

³⁷² I.R.C. § 7701(a)(2) (2006).

3. Contributions of Appreciated Property. As a general rule, a transfer of appreciated property in exchange for an interest in a general partnership will not result in any gain or loss being recognized by the transferor, the partnership or any of the other partners of the partnership.³⁷³ The tax basis of the transferor in his partnership interest and of the partnership in the transferred property is the basis the transferor had in the transferred property at the time of the transfer.³⁷⁴ Under certain circumstances, a partner's contribution of property may result in a net reduction in liability to that partner in excess of the partner's tax basis in the contributed property. In such a situation, the partner will recognize a gain to the extent of such excess. In addition, certain contributions can be treated as "disguised sales" of all or a portion of the contributed property by the partner to the partnership if the partner receives cash or other property (in addition to a partnership interest) in connection with the transfer.

4. Texas Entity Taxes. A general partnership was not obligated to pay Texas franchise taxes before January 1, 2007.³⁷⁵

The Margin Tax is not applicable to a general partnership (other than an LLP) if all of its partners are individuals.³⁷⁶ The Margin Tax is imposed on a general partnership which has a business entity as a partner.³⁷⁷

5. Self-Employment Tax. Partners of a general partnership generally will be subject to self-employment tax on their share of the net earnings of trade or business income of the partnership and any guaranteed payments for personal services.³⁷⁸

C. Owner Liability Issues. Under Tex. GP Stats.,³⁷⁹ and typically under common law, a general partnership as an entity is liable for loss or injury to a person, as well as for a penalty caused by or incurred as a result of a wrongful act or omission of any of its partners acting either in the ordinary course of the business of the partnership or with authority of the partnership. Generally, except as provided for an LLP (which is hereinafter discussed), all partners of a general partnership are jointly and severally liable for all debts and obligations of the partnership unless otherwise agreed by a claimant or otherwise provided by law.³⁸⁰ Provisions in a partnership agreement that serve to allocate liability among the partners are generally ineffective against third-party creditors.³⁸¹ A partner who is, however, forced to pay

³⁷³ I.R.C. § 721(a) (1997). *But see* Treas. Reg. § 1.707-3 (2003) (discussing disguised sales).

³⁷⁴ I.R.C. § 722 (1984); I.R.C. § 723 (1984).

³⁷⁵ TEX. TAX CODE ANN. § 17.001(a)(1) (Vernon 2002 & Supp. 2004). *But see supra* notes 80-93 and related text.

³⁷⁶ *See supra* notes 113-207 and related text and *infra* note 778 and related text.

³⁷⁷ *Id.*

³⁷⁸ I.R.C. § 1402(a) (2004).

³⁷⁹ TRPA § 3.03; TBOC § 152.303.

³⁸⁰ TRPA § 3.04; TBOC § 152.304.

³⁸¹ J. CARY BARTON, TEXAS PRACTICE GUIDE: BUSINESS ENTITIES § 20.205 (2003); *see Fincher v. B & D Air Conditioning & Heating Co.*, 816 S.W.2d 509, 512 (Tex. App.—Houston [1st Dist.] 1991, writ denied).

more than his allocable share of a particular liability should have a right of contribution under Tex. GP Stats. from the partnership or the other partners who did not pay their allocable share.³⁸²

A person admitted as a new partner into an existing general partnership in Texas does not have personal liability for an obligation of the partnership that arose before his admission if the obligation relates to an action taken or omission occurring prior to his admission or if the obligation arises before or after his admission under a contract or commitment entered into before his admission.³⁸³

A general partner who withdraws from the partnership in violation of the partnership agreement is liable to the partnership and the other partners for damages caused by the wrongful withdrawal.³⁸⁴ A withdrawn general partner may also be liable for actions committed by the partnership while he was a partner, including malpractice, even though the action was not adjudicated to be wrongful until after the partner withdrew from the firm.³⁸⁵

In a change from old Texas law, a creditor under current Tex. GP Stats. must exhaust partnership assets before collecting a partnership debt from an individual partner on his or her joint and several liability, except in limited circumstances.³⁸⁶ Previously, a creditor could obtain a judgment enforceable against an individual partner's assets without suing the partnership.³⁸⁷ Generally, Tex. GP Stats. require that there be a judgment against the partnership and that the individual partner has been served in that action; however, a judgment against a partnership is not automatically a judgment against its partners.³⁸⁸

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

D. Management. Partners have wide latitude to provide in the partnership agreement how the partnership is to be managed. Unless the partnership agreement provides otherwise, each partner has an equal right to participate in the management of the business.³⁸⁹ In

³⁸² TRPA §§ 4.01(c), 8.06(c); TBOC §§ 152.203(d), 152.708.

³⁸³ TRPA § 3.07; TBOC § 152.304(b).

³⁸⁴ TRPA § 6.02(c).

³⁸⁵ *In re Keck, Mahin & Cate*, 274 B.R. 740, 745–47 (Bankr. N.D. Ill. 2002). In *Keck*, the court explained:

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

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

³⁸⁶ TRPA § 3.05; TBOC § 152.306.

³⁸⁷ *See* statutes cited *supra* note 1.

³⁸⁸ TRPA § 3.05(c); TBOC § 152.306(a).

³⁸⁹ TRPA § 4.01(d); TBOC § 152.203(a).

such a situation, management of the partnership is decentralized. Often, however, partners will designate a managing partner or partners who will have the authority to manage the business of the partnership, creating a more centralized management structure. Since a partner is an agent of the partnership, he or she may bind the partnership in the ordinary course of its business unless the partner has no authority to so act and the third party with whom the partner is dealing has knowledge that the partner has no authority to so act.³⁹⁰ In the event that a partner exceeds his or her authority to act, the other partners may have a cause of action against such partner for breach of the partnership agreement, although this does not alter the fact that the partnership may be bound by the acts of the partner that exceeded his or her authority.³⁹¹

E. Fiduciary Duties.

1. General. Under Tex. GP Stats., a partner owes duties of loyalty and care to the partnership, the other partners, and the heirs, legatees or personal representatives of a deceased partner to the extent of their respective partnership interests.³⁹² These duties are fiduciary in nature although not so labeled.³⁹³

2. Loyalty. The duty of loyalty requires a general partner to place the interests of the partnership ahead of his own interests.³⁹⁴ It requires a partner to account to the partnership for any partnership asset received or used by the partner and prohibits a partner from competing with the partnership or dealing with the partnership in an adverse manner. The following fact patterns may evidence a breach of the fiduciary duty of loyalty in the general partnership context on the part of general partners, creating liability to the partnership or the other partners:

- Self-dealing or profiting from dealing with the partnership in ways not contemplated by the partnership agreement;
- Appropriation of partnership opportunities;

³⁹⁰ TRPA § 3.02; TBOC §§ 152.301, 152.302.

³⁹¹ TRPA § 4.05; TBOC §§ 152.210, 152.302.

³⁹² TRPA § 4.04; TBOC § 152.204.

³⁹³ See *Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193, 199–200 (Tex. 2002) (asserting that since the court historically has held that partners owe certain fiduciary duties to other partners, it did not have to consider the impact of the TRPA on such duties); Erin Larkin, *What's in a Word? The Effect on Partners' Duties after Removal of the Term "Fiduciary" in the Texas Revised Partnership Act*, 59 Baylor L. Rev. 895 (2007).

³⁹⁴ *Meinhard v. Salmon*, 249 N.Y. 458, 463-64, 164 N.E. 545, 546 (1928), in which Justice Cardozo wrote:

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

- Refusal to distribute profits to other members of the partnership;
- Diversion of an asset of the partnership for a non-intended use;
- Failure to disclose plans and conflicts to partners; and
- A general lack of candor with partners.³⁹⁵

3. Care. The duty of care requires a partner to act as an ordinarily prudent person would act under similar circumstances.³⁹⁶ A partner is presumed to satisfy the duty of care if the partner acts on an informed basis, in good faith and in a manner the partner reasonably believes to be in the best interest of the partnership.³⁹⁷

4. Candor. In addition to the duties of loyalty and care, a partner owes his co-partners a fiduciary duty of candor, sometimes referred to as a duty of disclosure.³⁹⁸

5. Liability. A partner is liable to the partnership and the other partners for violation of a statutory duty that results in harm to the partnership or the other partners and for a breach of the partnership agreement.³⁹⁹ Tex. GP Stats. provide that a partner, in that capacity, is not a trustee and is not held to the same standards as a trustee,⁴⁰⁰ which represents a change from cases under TUPA.⁴⁰¹ A managing partner stands in a higher fiduciary relationship to other partners than partners typically occupy.⁴⁰²

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

³⁹⁵ See TRPA § 4.04(b); TBOC § 152.205; *Bromberg & Ribstein*, *supra* note 367, at § 6.07.

³⁹⁶ TRPA § 4.04(c); TBOC § 152.206(a).

³⁹⁷ TRPA §§ 4.04(c), (d); TBOC §§ 152.204(b), 152.206(c).

³⁹⁸ *Bromberg & Ribstein*, *supra* note 367, at §§ 6.05(c) and 6.06.

³⁹⁹ TRPA § 4.05; TBOC § 152.210.

⁴⁰⁰ TRPA § 4.04(f); TBOC § 152.204(d).

⁴⁰¹ See *Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.) (holding that a managing partner owes his co-partners the highest fiduciary duty recognized in the law).

⁴⁰² See, e.g., *Hughes v. St. David's Support Corp.*, 944 S.W.2d 423 (Tex. App.—Austin 1997, writ denied); *Conrad v. Judson*, 465 S.W.2d 819, 828 (Tex. Civ. App.—Dallas 1971, writ ref'd n.r.e.); *Huffington*, 532 S.W.2d at 579; see also *Brazosport Bank of Tex. v. Oak Park Townhouses*, 837 S.W.2d 652, 659 (Tex. App.—Houston [14th Dist.] 1992), *rev'd on other grounds*, 851 S.W.2d 189 (Tex. 1993) (noting that a fiduciary relationship exists between general partners, as well as between general and limited partners); *Crenshaw*, 611 S.W.2d at 890.

obligation of good faith, although the agreement may within reason determine the standards by which the performance of the obligation is to be measured.⁴⁰³

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

G. Transferability of Ownership Interests.

1. Generally. A partnership interest is transferable by a partner, but a partner's right to participate in the management of the partnership may not be assigned without the consent of the other partners.⁴⁰⁴ Texas law differentiates between a transfer of a partner's partnership interest and the admission of a successor as a general partner. A transferee is neither able to participate in management nor liable as a partner solely because of a transfer unless and until he becomes a partner, but such transferee is entitled to receive, to the extent transferred, distributions to which the transferor would otherwise be entitled.⁴⁰⁵ A transfer of a partnership interest is not considered an event of withdrawal; therefore, transfer alone will not cause the winding up of the partnership business.⁴⁰⁶ The partnership agreement will often contain a provision prohibiting a partner from assigning his economic rights associated with the partnership interest. Unless otherwise specified by the partnership agreement, all of the partners must consent to the substitution of a new partner.⁴⁰⁷ General partnership interests may be evidenced by transferable certificates, but ordinarily no such certificates are issued.⁴⁰⁸

2. Partnership Interests as Securities. Under the Securities Act of 1933, the Securities Exchange Act of 1934, and most state blue sky laws, the term "security" is defined to include an "investment contract."⁴⁰⁹ Neither federal securities act defines a partnership interest, whether general or limited, as a "security." However, by overwhelming precedent, limited partnership interests are considered investment contracts for purposes of the securities laws.⁴¹⁰ The question of whether a general partnership interest is a security requires a case-by-case analysis. A general partner interest may be a security when the venture, although a general partnership *de jure*, functions *de facto* as a limited partnership (i.e., certain partners do not

⁴⁰³ TRPA § 1.03(b); TBOC § 152.002; *see infra* notes 428-429 and related text.

⁴⁰⁴ *See* TRPA § 5.03; TBOC §§ 152.401, 152.402(3).

⁴⁰⁵ *See* TRPA §§ 5.02, 5.03 and 5.04; TBOC §§ 152.402(3), 152.404(a), (c).

⁴⁰⁶ TRPA § 5.03(a); TBOC §§ 152.402(1), (2).

⁴⁰⁷ TRPA § 4.01(g); TBOC § 152.201.

⁴⁰⁸ TRPA § 5.02(b); TBOC § 3.201.

⁴⁰⁹ Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2000); Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (2000).

⁴¹⁰ *See S.E.C. v. Murphy*, 626 F.2d 633, 640 (9th Cir. 1980) (concluding that shares in LPs fall within the definition of "securities," as investors had no managerial role); *Stowell v. Ted S. Finkel Inv. Servs., Inc.*, 489 F. Supp. 1209, 1220 (S.D. Fla. 1980), *aff'd*, 64 F.2d 323 (5th Cir. 1981) (stating that the issue is whether the limited partnership interest meets the test of an investment contract).

actively participate in management and rely primarily on the efforts of others to produce profits). In *Williamson v. Tucker*,⁴¹¹ the court stated that a general partnership or joint venture interest may be categorized as a security if the investor can show that:

(1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.⁴¹²

While quoting from the *Williamson* case, the *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.* court further stated that when a “partnership agreement allocates powers to the general partners that are specific and unambiguous, and when those powers are sufficient to allow the general partners to exercise ultimate control, as a majority, over the partnership and its business, then the presumption that the general partnership is not a security can only be rebutted by evidence that it is not possible for the partners to exercise those powers.”⁴¹³ The results should not be affected by the fact that some of the general partners may have remained passive⁴¹⁴ or that the general partnership had made an LLP election.⁴¹⁵

H. Continuity of Life. Under Tex. GP Stats., a partnership will continue after the withdrawal of a partner or an event requiring a winding up of the business of the partnership until the winding up of the partnership has been completed.⁴¹⁶ The statutes provide for “events of withdrawal” and “events of winding up.”⁴¹⁷ Upon the occurrence of an event of withdrawal, the business of the partnership is not required to be wound up.⁴¹⁸ An event of withdrawal occurs (i) upon the occurrence of events specified in the partnership agreement, (ii) when the partnership receives notice of a partner’s election to withdraw, (iii) upon the expulsion of a partner by partner vote or judicial decree in statutorily specified circumstances, or (iv) upon the death or bankruptcy of a partner, among other events.⁴¹⁹ Except for the partner’s right to withdraw, the statutory events of withdrawal may be modified by the partnership agreement,⁴²⁰ and in view of the Check-the-Box Regulations, modification has become appropriate and common. Although a partner may withdraw from the partnership at any time, the withdrawal may subject the withdrawing partner to liability and various penalties if he or she violates the

⁴¹¹ *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir. 1981) *cert. denied*, 454 U.S. 897 (1981).

⁴¹² *But cf.*, *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236 (4th Cir. 1988).

⁴¹³ *Id.* at 241.

⁴¹⁴ *Id.*

⁴¹⁵ *Cf. Securities and Exchange Commission v. Merchant Capital, LLC*, 400 F.Supp.2d 1336 (N.D. Ga. 2005).

⁴¹⁶ TRPA §§ 2.06(a), 8.02; TBOC §§ 152.502, 152.701.

⁴¹⁷ TRPA §§ 1.01(6), (7); 6.01(b), 8.01; TBOC §§ 11.051, 11.057, 152.501(b).

⁴¹⁸ TRPA § 2.06(a), TBOC § 152.502.

⁴¹⁹ TRPA § 6.01; TBOC § 152.501(b).

⁴²⁰ TRPA § 1.03; TBOC § 152.002.

partnership agreement or the withdrawal is otherwise wrongful.⁴²¹ Unless the partnership agreement provides otherwise,⁴²² the interest of a withdrawing partner (except for a partner who wrongfully withdraws) must be redeemed by the partnership at fair market value.⁴²³ An event of winding up occurs when, among other things, a majority in interest of the partners elect to wind up the partnership if the partnership does not have a specified duration, the term of the partnership expires, the partnership agreement calls for a winding up in a particular situation or all or substantially all of the assets of the partnership are sold outside the ordinary course of its business.⁴²⁴

I. Formation. A general partnership can be one of the simplest, least expensive business entities to form because the existence of a partnership does not depend on the existence or filing of any particular document, but rather depends on the existence of an association of two or more persons carrying on, as co-owners, a business for profit.⁴²⁵ The factors discussed in Part III.A. are used to determine whether or not a general partnership exists.⁴²⁶ Thus, it is not necessary that any written partnership agreement exists or that any significant expenses be incurred in the formation of a partnership.⁴²⁷ Most of the time, however, partners will wish to have their relationship governed by a partnership agreement rather than rely on the default statutory provisions, and partnership agreements can be very complex.

Under Tex. GP Stats., a partnership agreement, which does not have to be in writing, governs the relations of the partners and the relations between the partners and the partnership; to the extent the partnership agreement does not otherwise provide, Tex. GP Stats. govern those relationships.⁴²⁸ The partnership agreement, however, may not (i) unreasonably restrict a partner's statutory rights of access to books and records, (ii) eliminate the duty of loyalty, although the agreement may within reason identify specific types of activities that do not violate the duty of loyalty, (iii) eliminate the duty of care, although the agreement may within reason determine the standard by which the performance of the obligation is to be measured, (iv) eliminate the obligation of good faith, although the agreement may within reason determine the standard by which the performance of the obligation is to be measured, (v) vary the power to withdraw as a partner, except to require the notice be in writing, or (vi) vary certain other requirements.⁴²⁹ Public policy limitations in some cases may limit the extent to which a partnership agreement may effectively reduce the fiduciary duties of a partner.

⁴²¹ TRPA § 6.02; TBOC § 152.503.

⁴²² TRPA § 1.03; TBOC § 152.002.

⁴²³ TRPA § 7.01; TBOC §§ 152.601-152.602. In the case of a partner who wrongfully withdraws, the redemption price is the lesser of fair market value or liquidation value. TRPA § 7.01; TBOC §§ 152.601-152.602.

⁴²⁴ TRPA § 8.01; TBOC §§ 11.051, 11.057.

⁴²⁵ TRPA § 2.02(a); TBOC § 152.051.

⁴²⁶ TRPA § 2.03(a); TBOC § 152.052(a); *see supra* notes 362-364 and related text.

⁴²⁷ *See Pappas v. Gounaris*, 301 S.W.2d 249, 254 (Tex. Civ. App.—Galveston 1957, writ ref'd n.r.e.).

⁴²⁸ TRPA § 1.03(a); TBOC § 152.002(a).

⁴²⁹ TRPA § 1.03(b); TBOC § 152.002(b).

Unless the partnership agreement specifically provides otherwise, profits and losses of a general partnership are shared per capita and *not* in accordance with capital contributions or capital accounts.⁴³⁰

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

J. Operations in Other Jurisdictions. A general partnership generally does not qualify to do business as a foreign general partnership under the laws of other states, although the partnership may have to file tax returns and the partners may be subject to taxation in the other states in which the partnership does business.⁴³¹

K. Business Combinations. Texas law now authorizes a partnership to merge with a corporation, LLC or another partnership, as well as to convert from one form of entity into another without going through a merger or transfer of assets.⁴³² Article IX of the TRPA and chapter 10 of the TBOC include provisions relating to the mechanics of adopting a plan of merger or conversion, obtaining owner approval, filing with the Secretary of State and protecting creditors.⁴³³

IV. LIMITED PARTNERSHIP.

A. General. A “limited partnership” is a partnership formed by two or more persons, with one or more general partners and one or more limited partners.⁴³⁴ Limited partnerships are statutorily authorized entities. Most states have adopted some form of the Uniform Limited Partnership Act or the Revised Uniform Limited Partnership Act to govern the rights, duties and liabilities of limited partnerships organized under such statutes. In Texas, all domestic limited partnerships are now governed by the TBOC.⁴³⁵ Like other entities formed under Texas law, limited partnerships formed on or after January 1, 2006 are governed by the TBOC,⁴³⁶ and those formed prior to January 1, 2006 which did not voluntarily opt into the TBOC continued to be governed by the TRLPA until January 1, 2010.⁴³⁷ Because from January 1, 2006 until January 1, 2010 some limited partnerships were governed by the TRLPA and others by the TBOC and because the substantive principles under both statutes are generally the same,

⁴³⁰ See TRPA § 4.01(b); TBOC § 152.202(c).

⁴³¹ Cf. TRPA § 9.05(a) (acknowledging that the laws of other states apply to a partnership looking to be bound by that jurisdiction’s law as a domestic partnership); see TBOC § 10.101(d).

⁴³² TRPA §§ 9.01-9.06; TBOC Chapter 10.

⁴³³ *Id.*; TBOC §§ 10.001-10.009; 10.101-10.151; 10.154-10.201.

⁴³⁴ TRLPA § 1.02(6); TBOC § 1.002(50).

⁴³⁵ The TBOC provisions relating to limited partnerships are Title 1 and Chapters 151, 153, and 154, as well as certain provisions of Chapter 152. Such provisions may officially and collectively be referred to as “Texas Limited Partnership Law.” TBOC § 1.008(g).

⁴³⁶ TBOC § 401.001.

⁴³⁷ TBOC § 402.005; TRLPA § 13.10.

the term “Tex. LP Stats.” is used herein to refer to the TBOC and the TRPA collectively, and the particular differences between the TRLPA and the TBOC are referenced as appropriate.

B. Taxation.

1. Federal Income Taxation. Unless the partners elect otherwise, a domestic limited partnership should ordinarily be treated as a partnership for federal income tax purposes under the Check-the-Box Regulations so long as it has two or more partners.⁴³⁸

2. Contributions of Appreciated Property. With respect to contributions of appreciated property, the same rule applies to limited partnerships as applies to general partnerships: ordinarily, a transfer of appreciated property in exchange for an interest in a limited partnership will not result in any gain or loss being recognized by the transferor, the partnership or any of the other partners of the partnership.⁴³⁹ The tax basis of the transferor in his partnership interest, and of the partnership in the transferred property, is the basis the transferor had in the transferred property at the time of the transfer.⁴⁴⁰ Under certain circumstances, a partner’s contribution of property may result in a net reduction in liability⁴⁴¹ to that partner in excess of the partner’s tax basis in the contributed property. In such a situation, the partner will recognize a gain to the extent of such excess.⁴⁴² In addition, certain contributions can be treated as “disguised sales” of all or a portion of the contributed property by the partner to the partnership if the partner receives cash or other property (in addition to a partnership interest) in connection with the transfer.

3. Texas Entity Taxes. A limited partnership was not subject to the Texas franchise tax before January 1, 2007.⁴⁴³

Effective for tax years beginning on or after January 1, 2007, the Margin Tax replaces the Texas franchise tax and is imposed on limited partnerships.⁴⁴⁴

4. Self-Employment Tax. A limited partner’s share of income of the limited partnership (other than a guaranteed payment for services) is generally not subject to the self-employment tax.⁴⁴⁵ Guaranteed payments made to a limited partner by the partnership for services rendered and the general partner’s share of the net earnings of trade or business income of a limited partnership generally will be subject to self-employment tax. On January 13, 1997, the IRS issued proposed regulations under IRC § 1402 that would define “limited partner” for employment tax purposes as follows, irrespective of the partner’s status under state law, as follows:

⁴³⁸ See Treas. Reg. § 301.7701-2(c)(1) (as amended in 2003).

⁴³⁹ I.R.C. § 721(a) (1997). *But see* Treas. Reg. § 1.707-3 (1992) (discussing disguised sales).

⁴⁴⁰ I.R.C. § 722 (1986); I.R.C. § 723 (1986).

⁴⁴¹ I.R.C. § 752 (1986).

⁴⁴² I.R.C. § 731 (1997).

⁴⁴³ See TEX. TAX CODE ANN. § 171.001 (Vernon 2002 & Supp. 2004).

⁴⁴⁴ See *supra* notes 113-207 and related text.

⁴⁴⁵ I.R.C. § 1402(a)(13) (2007); see Robert G. Fishman, *Self-Employment Tax, Family Limited Partnerships and the Partnership Anti-Abuse Regulations*, 74 Taxes 689 (No. 11, Nov. 1996).

Generally, an individual will be treated as a limited partner under the proposed regulations unless the individual (1) has personal liability (as defined in § 301.7701-3(b)(2)(ii) of the Procedure and Administration Regulations) for the debts of or claims against the partnership by reason of being a partner; (2) has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or, (3) participates in the partnership's trade or business for more than 500 hours during the taxable year. If, however, substantially all of the activities of a partnership involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides services as part of that trade or business will not be considered a limited partner.⁴⁴⁶

The proposed regulations would also allow an individual who fails the test for limited partner status to bifurcate the partnership interest into two classes, one of which could qualify for exclusion from employment taxes if it were demonstrably related to invested capital rather than services.⁴⁴⁷

The Taxpayer Relief Act of 1997 prohibited the IRS from issuing any temporary or final regulations relating to the definition of a limited partner for employment tax purposes that would be effective before July 1, 1998.⁴⁴⁸ The legislative history indicates that Congress wants the IRS to withdraw the controversial proposed regulation discussed above, which would impose a tax on limited partners.⁴⁴⁹ A “sense of the Senate” resolution in the Senate amendment expressed dissatisfaction with the proposed regulation, noting that Congress, not the Treasury or the IRS, should determine the law governing self-employment income for limited partners.⁴⁵⁰

C. Owner Liability Issues. A general partner of a limited partnership has the same unlimited liability as does a partner of a general partnership.⁴⁵¹ The Tex. LP Stats. authorize a limited partnership to register as an LLP by complying with the LLP provisions of TRPA or TBOC discussed below, whereupon the general partner would be liable for the debts or obligations of the limited partnership only to the extent provided in TRPA section 3.08(a) or TBOC section 152.801 and the limited partnership would be an “LLL.P.”⁴⁵²

⁴⁴⁶ Definition of Limited Partner for Self-Employment Tax Purposes, Prop. Treas. Reg. 1.1402(a)-2(h), 62 Fed. Reg. 1702-01 (Jan. 13, 1997).

⁴⁴⁷ *Id.*

⁴⁴⁸ Taxpayer Relief Act of 1997, Pub. L. 105-34, 111 Stat. 788 (1997) (enacted).

⁴⁴⁹ Taxpayer Relief Act of 1997, H.R. 2014, 105th Cong. § 734 (1997) (enacted).

⁴⁵⁰ S. 949, 105th Cong. § 734 (1997).

⁴⁵¹ See TRLPA §§ 4.01(d), 4.03(a); TBOC § 153.152. See *KAO Holdings, L.P. v. Young*, 214 S.W.3d 504 (Tex. App.—Houston [14th Dist.] 2006), in which a court held that “in a suit against a partnership (general or limited), citation may be served on any general partner of the partnership” and, quoting TRLPA § 3.05(c), “a judgment may be entered against a [general] partner who has been served with process in a suit against a partnership” even though the general partner was neither named or served individually in the lawsuit.

⁴⁵² TRPA § 3.08(e); TRLPA § 2.14; TBOC §§ 152.805, 153.351, 153.353. See *infra* notes 793-799 and related text.

By contrast, a limited partner’s liability for debts of or claims against the partnership is limited to the limited partner’s capital contribution to the partnership (plus any additional amounts agreed to be contributed).⁴⁵³ Veil piercing is inapplicable to Texas limited partnerships.⁴⁵⁴ A limited partner may lose this limited liability, however, if he or she participates in the management of partnership business.⁴⁵⁵ The safe harbor provisions of Tex. LP Stats. specify activities that will not subject a limited partner to unlimited liability, such as consulting with and advising a general partner, acting as a contractor for or an agent or employee of the limited partnership or of a general partner, proposing, approving or disapproving certain specified matters related to the partnership business or the winding up of the partnership business or guaranteeing specific obligations of the limited partnership.⁴⁵⁶

Even if the limited partner’s activities exceed the safe harbors, the limited partner will only have unlimited liability to those third parties dealing with the limited partnership who have actual knowledge of the limited partner’s participation and control and who reasonably believe that the limited partner is a general partner based on the limited partner’s conduct.⁴⁵⁷ Under the TRLPA, though not under the TBOC, a limited partner who knowingly permits his name to be used in the name of the partnership will be liable to creditors who extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner.⁴⁵⁸ A corporation can serve as the general partner of a limited partnership, although the ordinary grounds for piercing the corporate veil (e.g. if the corporate general partner is not sufficiently

⁴⁵³ See TRLPA § 3.03; TBOC § 153.102. The Texas LP Stats. provide that the limitation on a limited partner’s liability is not affected by the forfeiture of a limited partnership’s right to transact business in Texas because of its failure to file reports with the Secretary of State or by any resulting cancellation of its Certificate of Formation or foreign registration by the Secretary of State. TBOC §§ 153.309(c) and 153.311(d); TRLPA §§ 13.06(d) and 13.08(b). See S.B. 1442 §§ 54 and 55 and *infra* Appendix D. See Elizabeth S. Miller, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 TEX. J. OF BUS. L. 405, 426-435 (Fall 2009).

⁴⁵⁴ See *Asshauer v. Wells Fargo Foothill*, 263 S.W.3d 468, 474 (Tex. App.—Dallas 2008). As such, TBCA art. 2.21 and TBOC § 21.223 make no mention of limited partners; neither the TRLPA nor the TBOC makes any effort to incorporate TBCA art. 2.21 or TBOC § 21.223 by reference; and neither the TRLPA nor the TBOC includes any provision limiting the applicability of veil piercing or alter ego theory to cases involving actual fraud. But these omissions are certainly not reflective of a legislative intent to give less protection to limited partners than to shareholders of a Texas corporation. Rather, they reflect the Legislature’s understanding that veil piercing is so clearly inapplicable to limited partnerships that to duplicate or incorporate the language of TBCA art. 2.21 would be unnecessary and inappropriate. In *Asshauer v. Wells Fargo Foothill*, veil piercing was not allowed to hold a limited partner personally liable for a partnership liability, even though the limited partnership agreement gave broad approval rights to the defendant limited partner, which was also a mezzanine lender. In so holding, the court wrote that in order to conclude that the partnership entities should be ignored, allowing the limited partner/lender to be sued directly, simply because the limited partnerships were set up to perpetuate a fraud, they “would be required to ignore the rules of limited partnerships as set out in Texas Revised Limited Partnership Act [§ 3.03(a)] . . . [which does not provide] an exception for a limited partner to sue another limited partner or the limited partnership where the entities are allegedly part of a fraudulent scheme.” TRLPA § 3.03(a) is the analogue to LLC Act § 4.03A.

⁴⁵⁵ *Id.*

⁴⁵⁶ TRLPA § 3.03(b); TBOC § 153.103.

⁴⁵⁷ TRLPA § 3.03(a); TBOC § 153.102(b).

⁴⁵⁸ TRLPA § 3.03(d); Revisor’s Note to TBOC § 153.102.

capitalized in light of known and contingent liabilities) may be applied to hold the shareholders of such a corporate general partner liable in certain factual contexts.⁴⁵⁹

D. Distributions. A limited partnership may not make a distribution to a partner if, immediately after giving effect to the distribution, the liabilities of the limited partnership, other than liabilities to partners with respect to their partnership interests and liabilities for which the recourse of creditors is limited to specified property of the partnership, exceed the fair value of the partnership assets.⁴⁶⁰ This limitation on distributions does not apply to payments for reasonable compensation for present or past services or reasonable payments made in the ordinary course of business pursuant to a bona fide retirement plan or other benefits program.⁴⁶¹

E. Management. Control of a limited partnership is vested in the general partner or partners, who have all the rights and powers of a partner in a general partnership.⁴⁶² Therefore, management of a limited partnership tends to be centralized in the general partner or partners, although safe harbor provisions in most modern limited partnership statutes give limited partners greater latitude in certain matters of management of the limited partnership than was given previously.⁴⁶³ Under Tex. LP Stats., the partnership agreement may provide for multiple classes or groups of limited partners having various rights or duties, including voting rights.⁴⁶⁴ A limited partnership may have elected or appointed officers.⁴⁶⁵

F. Fiduciary Duties. Case law has adopted fiduciary standards for general partners of limited partnerships mirroring the unbending fiduciary standards espoused in general partnership cases.⁴⁶⁶ Because of their control over partnership affairs, general partners may be

⁴⁵⁹ See *Grierson v. Parker Energy Partners 1984-I*, 737 S.W.2d 375, 377–78 (Tex. App.—Houston [14th Dist.] 1987, no writ) (stating that in tortious activity, the corporate veil of a corporate general partner need not be pierced in order to impose liability, thus implying the veil may be pierced in other circumstances).

⁴⁶⁰ TBOC § 153.210(a).

⁴⁶¹ TBOC § 153.210(b) as added in the 2009 Legislative Session by S.B. 1442 § 52. See *infra* [Appendix D](#).

⁴⁶² TRLPA § 4.03(a); TBOC § 153.152.

⁴⁶³ TRLPA § 3.03; TBOC §§ 153.102, 153.103.

⁴⁶⁴ TRLPA § 3.02; TBOC § 154.101.

⁴⁶⁵ TBOC § 101.004, as amended in the 2009 Legislative Session by S.B. 1442 § 46. See *infra* [Appendix D](#).

⁴⁶⁶ See *Hughes v. St. David's Support Corp.*, 944 S.W.2d 423, 425–26 (Tex. App.—Austin 1997, writ denied) (holding that “in a limited partnership, the general partner stands in the same fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of a trust.”); *McLendon v. McLendon*, 862 S.W.2d 662, 676 (Tex. App.—Dallas 1993, writ denied) (holding that “in a limited partnership, the general partner acting in complete control stands in the same fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of a trust.”); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.); *Watson v. Limited Partners of WCKT, Ltd.*, 570 S.W.2d 179, 182 (Tex. Civ. App.—Austin 1978, writ ref'd n.r.e.); Robert W. Hamilton, *Corporate General Partners of Limited Partnerships*, 1 J. SMALL & EMERGING BUS. L. 73, 73 (1997) (stating that “[g]eneral partners are personally liable for all partnership obligations, including breaches of fiduciary duties owed to the limited partners.”); see also *Huffington v. Upchurch*, 532 S.W.2d 576 (Tex. 1976); *Johnson v. Peckham*, 120 S.W.2d 786 (Tex. 1938); *Kunz v. Huddleston*, 546 S.W.2d 685 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

subjected to an even higher fiduciary standard with respect to limited partners.⁴⁶⁷ Those in control of the general partner have been held to the same high standards.⁴⁶⁸

Since a general partner in a limited partnership has the powers, duties and liabilities of a partner in a general partnership unless applicable law or the partnership agreement provides otherwise, a general partner in a limited partnership has the duties of care and loyalty set forth in TRPA section 4.04 and TBOC section 152.204, which basically codify those duties without giving them the “fiduciary” appellation.⁴⁶⁹ Since Tex. LP Stats. provide that a general partner’s conduct is not to be measured by trustee standards, it may no longer be appropriate to measure general partner conduct in terms of trustee fiduciary standards.⁴⁷⁰ Courts, however, continue to refer to the trustee standard.⁴⁷¹

A general partner owes the duties of care and loyalty to the partnership and the other partners.⁴⁷² The Tex. LP Stats. define the duty of care as requiring a partner to act in the conduct and winding up of the partnership business with the care of an ordinarily prudent person under similar circumstances.⁴⁷³ An error in judgment does not by itself constitute a breach of the duty of care.⁴⁷⁴ Further, a general partner is presumed to satisfy the duty of care if the partner acts on an informed basis, in good faith and in a manner the partner reasonably believes to be in the best interest of the partnership.⁴⁷⁵ These provisions draw on the corporate business judgment rule in articulating the duty of care. Nevertheless, Texas law does not specify whether the standard of care is one of simple or gross negligence. The sparse case law in this area (pre-dating the TRPA) indicates that a general partner will not be held liable for mere negligent mismanagement.⁴⁷⁶

In Texas, the duty of loyalty is defined as including⁴⁷⁷:

⁴⁶⁷ In *Palmer v. Fuqua*, 641 F.2d 1146, 1155 (5th Cir. 1981), the Fifth Circuit noted that under Texas law a general partner having exclusive power and authority to control and manage the limited partnership “owe[s] the limited partners an even greater duty than is normally imposed [upon general partners].”

⁴⁶⁸ See *In re Bennett*, 989 F.2d 779, 790 (5th Cir. 1993) (explaining that when a partner is in complete control of the partnership, the partner owes the highest level of fiduciary duty); *In re USA Cafes, L.P. Litigation*, 600 A.2d 43 (Del. Ch. 1991) (in holding that directors of corporate general partner of limited partnership owe fiduciary duties to the partnership and its limited partners, the court wrote: “those affiliates of a general partner who exercise control over the partnership’s property may find themselves owing fiduciary duties to both the partnership and its limited partners”).

⁴⁶⁹ TRPLPA §§ 4.03(b), 13.03; TBOC §§ 153.003, 153.152. See Erin Larkin, *What’s in a Word? The Effect on Partners’ Duties after Removal of the Term “Fiduciary” in the Texas Revised Partnership Act*, 59 Baylor L. Rev. 895 (2007).

⁴⁷⁰ TRPA § 4.04(f); TBOC § 152.204(d).

⁴⁷¹ See *McBeth v. Carpenter*, 2009 WL 922071 (C.A.5 (Tex.)); *Hughes v. St. David’s Support Corp.*, 944 S.W.2d 423, 425-26 (Tex. App.—Austin 1997, writ denied).

⁴⁷² TRPA § 4.04(a); TBOC § 152.204(a).

⁴⁷³ TRPA § 4.04(c); TBOC § 152.206(a).

⁴⁷⁴ TRPA § 4.04(c); TBOC § 152.206(a).

⁴⁷⁵ TRPA § 4.04(c)-(d); TBOC §§ 152.204(b), 152.206.

⁴⁷⁶ See *Ferguson v. Williams*, 670 S.W.2d 327, 331 (Tex. App.—Austin 1984, writ ref’d n.r.e.).

⁴⁷⁷ TRPA § 4.04(b); TBOC § 152.205.

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

These provisions mirror the common areas traditionally encompassed by the duty of loyalty (e.g., self-dealing, conflicts of interest and usurpation of partnership opportunity).⁴⁷⁸ To temper some of the broader expressions of partner duties in older Texas case law and permit a balancing analysis as in the corporate cases, Texas law specifically states that a partner does not breach a duty merely because his conduct furthers his own interest and that the trustee standard should not be used to test general partner conduct.⁴⁷⁹ It does, however, impose on a general partner in a limited partnership the obligation to discharge any duty, and exercise any rights or powers, in conducting or winding up partnership business in good faith and in a manner that the partner reasonably believes to be in the best interest of the partnership.⁴⁸⁰

Under the TBOC *limited* partners, as limited partners, generally do not owe fiduciary duties to the partnership or to other partners.⁴⁸¹ Previously, a literal reading of the TRPA and TRLPA suggested that limited partners owed such duties by virtue of the linkage of TRPA to TRLPA under TRLPA section 13.03(a).⁴⁸² That literal interpretation of the statutes, however, was contrary to the general concept that limited partners are merely passive investors and thus should not be subjected to liability for their actions as limited partners. Further, even before the TBOC was enacted there was some case law to the effect that limited partners do not have fiduciary duties.⁴⁸³ Pre TBOC, an exception was made to this general rule in the case where a limited partner actually had or exercised control in management matters (e.g., because of control

⁴⁷⁸ Under Texas law, persons engaged in a partnership owe to one another one of the highest duties recognized in law—the duty to deal with one another with the utmost good faith and most scrupulous honesty. *See Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976); *Smith v. Bolin*, 271 S.W.2d 93, 96 (Tex. 1954); *Johnson v. J. Hiram Moore, Ltd.*, 763 S.W.2d 496 (Tex. App.—Austin 1988, writ denied); *see also Brazosport Bank of Tex. v. Oak Park Townhouses*, 837 S.W.2d 652, 659 (Tex. App.—Houston [14th Dist.] 1992, writ granted), *rev'd on other grounds*, 851 S.W.2d 189 (Tex. 1993); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.).

⁴⁷⁹ TRPA § 4.04(e)-(f); TBOC § 152.204(c)-(d).

⁴⁸⁰ TRPA § 4.04(d); TBOC § 152.204(b).

⁴⁸¹ TBOC §§ 153.003(b) (“The powers and duties of a limited partner shall not be governed by a provision of Chapter 152 [the TBOC Chapter dealing with general partnerships] that would be inconsistent with the nature and role of a limited partner as contemplated by this chapter [153]”) and 153.003(c) (“A limited partner shall not have any obligation or duty of a general partner solely by reason of being a limited partner”).

⁴⁸² TRLPA § 13.03(a) provides: “In any case not provided by [TRLPA], the applicable statute governing partnerships that are not limited partnerships [TRPA] and the rules of law and equity, including the law merchant, govern.”

⁴⁸³ *See, e.g., In re Villa West Assocs.*, 146 F.3d 798, 806 (10th Cir. 1998); *In re Kids Creek Partners, L.P.*, 212 B.R. 898, 937 (Bankr. N.D. Ill. 1997).

of the general partner, contractual veto powers over partnership actions or service as an agent of the partnership).⁴⁸⁴ In such situations, the limited partner’s conduct could be judged by fiduciary principles.⁴⁸⁵

The Tex. LP Stats. state in part that except as provided in various statutory provisions or the partnership agreement, a general partner of a limited partnership “has the liabilities of a partner in a partnership without limited partners to the partnership and to the other partners.”⁴⁸⁶ This language indicates that the partnership agreement may modify the internal liabilities of a general partner, but it is not clear whether it is an authorization without express limits or whether it would link to Texas general partnership statutes that prohibit elimination of duties and set a “manifestly unreasonable” floor for contractual variation.⁴⁸⁷

⁴⁸⁴ *McBeth v. Carpenter*, 2009 WL 922071 (C.A.5 (Tex.)) (limited partnerships controlled by the same individual who controlled the general partner, and whose individual conduct was held to violate his fiduciary duties to the limited partners, were held to have fiduciary duties to the other limited partners).

⁴⁸⁵ *See RJ Assocs., Inc. v. Health Payors’ Org. Ltd. P’ship, HPA, Inc.*, No. 16873, 1999 WL 550350, at *10 (Del. Ch. July 16, 1999) (unpublished mem. op.) (suggesting that, unless a partnership agreement provides to the contrary, any limited partner owes fiduciary duties to the partnership); *KE Prop. Mgmt. Inc. v. 275 Madison Mgmt. Inc.*, Civ. A. No. 12683, 1993 WL 285900, at *4 (Del. Ch. July 27, 1993) (unpublished mem. op.). Limited partners who function as officers or managers of a limited partnership are typically considered agents of the limited partnership, and as agents to owe fiduciary duties, including the duty of loyalty, to the limited partnership and its other partners. *See* American Law Institute, *Restatement of the Law of Agency* 2nd (1958) §§ 13 (“An agent is a fiduciary with respect to matters within the scope of his agency”), 387 (“Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency”), 393 (“Unless otherwise agreed, an agent is subject to a duty not to compete with the principal concerning the subject matter of his agency”), 394 (“Unless otherwise agreed, an agent is subject to a duty not to act or to agree to act during the period of his agency for persons whose interests conflict with those of the principal in matters in which the agent is employed”), and 395 (“Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge”); *see also Daniel v. Falcon Interest Realty Corp.*, 190 S.W.3d 177 (Tex. App.—Houston [1st Dist.] 2005, no pet. hist).

⁴⁸⁶ TRLPA § 4.03(b); TBOC § 153.152(a). Note, this language should *not* be mistaken as an authorization for partnership agreements to alter partner liabilities to third parties. *See infra* notes 722-820 and related text regarding the LLP provisions in TRPA and the TBOC which permit a general partnership to significantly limit the individual liability of its partners for certain acts of other partners by the partnership making a specified filing with the Secretary of State.

The implied contractual duty of good faith and fair dealing is likely a duty of a general partner, in addition to the general partner’s fiduciary duties. *See Dunagan v. Watson*, 204 S.W. 3d 30 (Tex. App. Ft. Worth 2006); RESTATEMENT (SECOND) OF CONTRACTS § 205 (“every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement”). This contractual duty of good faith and fair dealing is to be contrasted with the fiduciary duty of good faith, which is a component of the common law fiduciary duty of loyalty. *See also infra* note 622.

⁴⁸⁷ *See* TRPA § 1.03(b); TBOC § 152.002(b). One additional point applies to limited partnerships that continue to be governed by the TRLPA. When originally drafted, it was the intent of the Partnership Law Committee of the Business Law Section of the State Bar of Texas that the TRLPA be subject to variation by agreement *only* if expressly permitted by the TRLPA; otherwise, the parties were *not* free to agree to provisions in the partnership agreement that differed from those contained in the TRLPA. TRLPA § 4.03

Delaware expressly allows the limitation or elimination of partner fiduciary duties in the partnership agreement.⁴⁸⁸ Although limitations on fiduciary duty in a partnership agreement may

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

"Partnership agreement" is defined to be either a written *or oral* agreement of the partners concerning the affairs of the partnership and the conduct of its business. See TRLPA § 1.02(10); TBOC § 151.001(5) (emphasis added).

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

⁴⁸⁸ Section 17-1101(b)-(f) of the Delaware Revised Limited Partnership Act ("*DRLPA*"), DEL. CODE ANN. tit. 6, § 17-1101(b)-(f) (Supp. 2009), provides as follows:

(b) The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.

(c) It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.

(d) To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

(e) Unless otherwise provided in a partnership agreement, a partner or other person shall not be liable to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement for breach of fiduciary duty for the partner's or other person's good faith reliance on the provisions of the partnership agreement.

(f) A partnership agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement; provided, that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

DEL. CODE ANN. tit. 6, § 17-1101(b)-(f) (Supp. 2009); see RESTATEMENT (SECOND) OF CONTRACTS § 205 ("every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement"). This contractual duty of good faith and fair dealing is to be contrasted with the fiduciary duty of good faith, which is a component of the common law fiduciary duty of loyalty. See *Stone v. Ritter*, 911 A.2d 362 (Del. 2006) and Byron F. Egan, *Fiduciary Duty Issues in M&A Transactions* at 13-27, available at <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1166>.

See Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 25 (2007), in which Delaware Supreme Court Chief Justice Steele argues that parties forming limited partnerships and companies should be free to adopt or reject

be respected by courts when they are expressly set forth in the four corners of the partnership agreement, “a topic as important as this should not be addressed coyly.”⁴⁸⁹

some or all of the fiduciary duties recognized at common law in the context of corporations, that courts should look to the parties’ agreement and apply a contractual analysis, rather than analogizing to traditional notions of corporate governance, in limited partnership and LLC fiduciary duty cases, and that Delaware courts should analyze limited partnership fiduciary duty cases as follows:

The courts’ approach should be, first, to examine the agreement to determine if the act complained of is legally authorized by statute or by the terms of the agreement itself. If so, a court should then proceed to inquire whether the implementation of the lawful act requires equity to intervene and craft a remedy? At this point, the court should look to the agreement to determine the extent to which it establishes the duties and liabilities of the parties, i.e., their bargained for, negotiated, contractual relationship. Is the agreement silent about traditional fiduciary duties, but creates a fiduciary relationship consistent with those duties thus allowing the court to imply them by default? Does the agreement expand, restrict, or eliminate one or more of the traditional fiduciary duties? Is the contract language creating those duties and liabilities so inconsistent with common law fiduciary duty principles that it can be concluded that the parties consciously modified them in a discernible way? If so, which duties and in what respect were they modified? Finally, without regard to traditional overlays of scrutiny under the common law of corporate governance, has a party breached its implied covenant of good faith and fair dealing?

See infra note 622 regarding Chief Justice Steele’s views in respect of fiduciary duties in the LLC context.

⁴⁸⁹ *Miller v. American Real Estate Partners, L.P.*, No. CIV.A.16788, 2001 WL 1045643, at *8 (Del. Ch. Sept. 6, 2001) (unpublished mem. op.). In *Miller*, the general partner contended that the partnership agreement eliminated any default fiduciary duty of loyalty owed by the general partner to the limited partners in section 6.13(d) of the partnership agreement, which read as follows:

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

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

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

* * *

Once again, therefore, this court faces a situation where an agreement which does not expressly preclude the application of default principles of fiduciary is argued to

Unlike DRLPA, under the Tex. LP Stats., the duties of care and loyalty and the obligation of good faith may not be eliminated by the partnership agreement, but the statute leaves room for some modification by contract.⁴⁹⁰ For example, the partnership agreement may not eliminate the

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

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

* * *

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

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

⁴⁹⁰ TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b), 4.04; TBOC §§ 152.002(b); 153.003(a).

duty of care, but may determine the standards by which the performance of the obligation is to be measured, if the standards are not “manifestly unreasonable.”⁴⁹¹ In one case decided prior to the passage of the TRPA and the TBOC, the court stated that, when the parties bargain on equal terms, a fiduciary may contract for the limitation of liability, though public policy would preclude limitation of liability for self-dealing, bad faith, intentional adverse acts, and reckless indifference with respect to the interest of the beneficiary.⁴⁹²

With respect to a partner’s duty of loyalty, Tex. LP Stats. provide that the partnership agreement may not eliminate the duty of loyalty, but may identify specific types or categories of activities that do not violate the duty of loyalty, again if not “manifestly unreasonable.”⁴⁹³ The level of specificity required of provisions in the partnership agreement limiting duties pursuant to Tex. LP Stats. is unknown. In fact, it may depend upon the circumstances, such as the sophistication and relative bargaining power of the parties, the scope of the activities of the partnership, etc.

Tex. LP Stats. provide that the obligation of good faith may not be eliminated by the partnership agreement, but the agreement may determine the standards by which the performance is to be measured if not “manifestly unreasonable.”⁴⁹⁴ Again the parameters of this provision are not readily apparent and probably will depend, at least in part, on the circumstances of any particular case.

Texas law requires a limited partnership to keep in its registered office, and make available to the partners for copying and inspection, certain minimum books and records of the partnership.⁴⁹⁵ This mandate provides a statutory mechanism by which a partner may obtain the documents specified therein, but should not be viewed as in any way limiting a general partner’s broader fiduciary duty of candor regarding partnership affairs as developed in case law and as provided in Tex. LP Stats.⁴⁹⁶

G. Indemnification. A limited partnership is required to indemnify a general partner who is “wholly successful on the merits or otherwise” unless indemnification is limited or prohibited by a written partnership agreement.⁴⁹⁷ A limited partnership is prohibited from indemnifying a general partner who is found liable to the limited partners or the partnership or for an improper personal benefit if the liability arose out of willful or intentional misconduct.⁴⁹⁸ A limited partnership is permitted, if provided in a written partnership agreement, to indemnify a general partner who is determined to meet certain standards. These standards require that the general partner conducted himself in good faith, reasonably believed the conduct was in the best interest of the partnership (if the conduct was in an official capacity) or that the conduct was not

⁴⁹¹ TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b)(3), 4.04; TBOC § 152.002(b)(3).

⁴⁹² *Grider v. Boston Co., Inc.*, 773 S.W.2d 338, 343 (Tex. App.—Dallas 1989, writ denied).

⁴⁹³ TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b)(2), 4.04; TBOC §§ 152.002(b)(2), 153.003(a).

⁴⁹⁴ TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b)(4), 4.04; TBOC §§ 152.002(b)(4), 153.003(a).

⁴⁹⁵ TRLPA § 1.07; TBOC §§ 153.551, 153.552.

⁴⁹⁶ See TRPA § 4.03; TBOC §§ 153.551, 153.552.

⁴⁹⁷ TRLPA §§ 11.08, 11.21; TBOC §§ 8.003, 8.051.

⁴⁹⁸ TRLPA §§ 11.03, 11.05; TBOC § 8.102(b).

opposed to the partnership's best interest (in cases of conduct outside the general partner's official capacity), and, in the case of a criminal proceeding, had no reasonable cause to believe the conduct was unlawful.⁴⁹⁹ If a general partner is not liable for willful or intentional misconduct, but is found liable to the limited partners or partnership for improper benefit, permissible indemnification is limited to reasonable expenses.⁵⁰⁰ General partners may only be indemnified to the extent consistent with the statute.⁵⁰¹ Limited partners, employees and agents who are not also general partners may be indemnified to the same extent as general partners and to such further extent, consistent with law, as may be provided by the partnership agreement, general or specific action of the general partner, by contract, or as permitted or required by common law.⁵⁰² Insurance providing coverage for unindemnifiable areas is expressly permitted.⁵⁰³

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

Under Tex. LP Stats., contributions to a limited partnership by either a general or a limited partner may consist of any tangible or intangible benefit to the limited partnership or other property of any kind or nature, including cash, a promissory note, services performed, a contract for services to be performed, other interests in or securities of the limited partnership, or interests or securities of any other limited partnership, domestic or foreign, or other entity.⁵⁰⁴ However, a conditional contribution obligation, including a contribution payable upon a discretionary call prior to the time the call occurs, may not be enforced until all conditions have been satisfied or waived.⁵⁰⁵

Although a general partner is personally liable for all of the debts and obligations of the limited partnership,⁵⁰⁶ if provided in a written partnership agreement, (i) a person may be admitted as a general partner in a limited partnership, including as the sole general partner, and acquire a partnership interest in the limited partnership without (x) making a contribution to the limited partnership or (y) assuming an obligation to make a contribution to the limited partnership; and (ii) a person may be admitted as a general partner in a limited partnership, including as the sole general partner, without acquiring a partnership interest in the limited partnership.⁵⁰⁷

⁴⁹⁹ TRLPA § 11.02; TBOC § 8.101(a).

⁵⁰⁰ TRLPA §§ 11.03, 11.05; TBOC § 8.102(b).

⁵⁰¹ TRLPA § 11.13; TBOC § 8.004.

⁵⁰² TRLPA §§ 11.15, 11.17; TBOC § 8.105.

⁵⁰³ TRLPA § 11.18; TBOC § 8.151.

⁵⁰⁴ TRLPA § 5.01; TBOC § 153.201.

⁵⁰⁵ TRLPA § 5.02(d); TBOC § 153.202.

⁵⁰⁶ TRLPA §§ 4.01(d), 4.03(b); TBOC § 153.152.

⁵⁰⁷ TRLPA § 4.01(c); TBOC § 153.151(c), (d).

Absent a contrary provision in the written partnership agreement, profits and losses of a limited partnership are to be allocated in accordance with the partnership interests reflected in the records that the partnership is required to maintain under Tex. LP Stats., or in the absence of such records, in proportion to capital accounts.⁵⁰⁸ Additionally, absent a different provision in the written partnership agreement, distributions representing a return of capital are to be made in accordance with the relative agreed value of capital contributions made by each partner, and other distributions are made in proportion to the allocation of profits.⁵⁰⁹

I. Transferability of Ownership Interests. Unless otherwise provided by the limited partnership agreement, a partnership interest is assignable in whole or in part and will not require winding up a limited partnership.⁵¹⁰ The assignment of the partnership interest will not, however, entitle the assignee to become, or to exercise the rights or powers of, a partner unless the partnership agreement provides otherwise.⁵¹¹ Instead, the assignment will entitle the assignee to an allocation of income, gain, loss, deductions, credits or similar items and to receive distributions to which the assignor was entitled.⁵¹² If a general partner assigns all of his or her rights as a general partner, a majority in interest of the limited partners may terminate the assigning general partner's status as a general partner.⁵¹³ Until an assignee of a partnership interest becomes a partner, the assignee has no liability as a partner solely by reason of the assignment.⁵¹⁴

J. Continuity of Life. Although a limited partnership does not have an unlimited life to the same extent as a corporation, the death or withdrawal of a limited partner or the assignment of the limited partner interest to a third party will not affect the continuity of existence of the limited partnership unless the partners agree otherwise or unless no limited partners remain.⁵¹⁵ A limited partnership is dissolved under TRLPA, or required to commence winding up under the TBOC, upon the first to occur of the following events: (i) any event specified in the partnership agreement as causing dissolution, or the winding up or termination of, the partnership, (ii) all of the partners of the limited partnership agreeing in writing to dissolve the limited partnership, (iii) an event of withdrawal of a general partner under Tex. LP Stats. (i.e., death, removal, voluntary withdrawal and, unless otherwise provided in the partnership agreement, bankruptcy of a general partner)⁵¹⁶ absent certain circumstances⁵¹⁷ or (iv)

⁵⁰⁸ See TRLPA § 5.03; TBOC § 153.206.

⁵⁰⁹ See TRLPA § 5.04; TBOC § 153.208.

⁵¹⁰ TRLPA § 7.02; TBOC § 153.251.

⁵¹¹ TRLPA § 7.02(a)(2); TBOC § 153.251(b)(2).

⁵¹² TRLPA § 7.02(a)(3); TBOC § 153.251(b)(3).

⁵¹³ TRLPA § 7.02(a)(4); TBOC § 153.252(b).

⁵¹⁴ TRLPA § 7.02(b); TBOC § 153.254(a).

⁵¹⁵ TRLPA §§ 8.01, 8.02; TBOC §§ 11.051, 11.058.

⁵¹⁶ TRLPA § 4.02; TBOC § 153.155.

⁵¹⁷ Under TRLPA § 6.02 and TBOC § 153.155(b) a general partner has a right to withdraw which cannot be eliminated by the partnership agreement, although the partnership may prohibit withdrawal and violation thereof can result in the general partner being liable for damages. TRLPA § 6.03 and TBOC § 153.110 provide that a limited partner may withdraw in accordance with the partnership agreement; previously a limited partner could withdraw on six months notice if the partnership agreement were silent on limited partner withdrawal. Under TBOC § 11.058(b), as amended in 2007 by H.B. 1737, a winding up of a limited

a court of competent jurisdiction dissolving the partnership because (a) the economic purpose of the partnership is likely to be unreasonably frustrated, (b) a partner has engaged in conduct relating to the partnership that makes it not reasonably practicable to carry on the business in the partnership with that partner, or (c) it is not reasonably practicable to carry on the business of the limited partnership in conformity with the partnership agreement.⁵¹⁸

If the limited partnership is terminated or dissolved, the limited partnership's affairs must be wound up as soon as reasonably practicable unless it is reconstituted or the partnership agreement provides otherwise.⁵¹⁹ However, upon the withdrawal of a general partner (unless the limited partnership agreement otherwise provides),⁵²⁰ the limited partnership may continue its business without being wound up if (i) at least one general partner remains and the partnership agreement permits the business of the limited partnership to be carried on by the remaining general partner or partners or (ii) all (or a lesser percentage stated in the partnership agreement) remaining partners agree in writing to continue the business of the limited partnership within a specified period after the occurrence of the dissolution event and agree to the appointment, if necessary, of one or more new general partners.⁵²¹

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

K. Formation. The cost of forming a limited partnership is usually greater than that of forming a general partnership. A certificate of formation containing (1) the name of the entity, (2) a statement that it is a limited partnership, (3) the name and address of each general partner; (4) the address of the registered office and the name and address of the registered agent for service of process; and (5) the address of the principal office where books and records are to be kept, must be filed with the Secretary of State.⁵²² Additionally, a filing fee of \$750 must be paid upon filing the certificate of formation.⁵²³

partnership is not required by the TBOC if the limited partnership agreement provides that withdrawal of the general partner does not require winding up of the limited partnership.

⁵¹⁸ TRLPA § 8.02; TBOC §§ 11.051, 11.314.

⁵¹⁹ TRLPA § 8.04; TBOC § 11.052.

⁵²⁰ TRLPA § 8.01(3); TBOC §§ 11.051(4), 11.058(b).

⁵²¹ TRLPA § 8.01; TBOC §§ 11.051(4), 11.058(2), 11.152(a), 153.501(b). Under the TRLPA, such agreement must be made within ninety days; under the TBOC, it must be made within a year. TBOC § 153.501 and Revisor's Note thereto. The partnership agreement may also provide for continuation of the partnership after dissolution for reasons in addition to an event of withdrawal in respect of a general partner.

⁵²² TBOC §§ 3.001, 3.005, 3.011. Limited partnerships formed prior to January 1, 2006 were required to file a certificate of limited partnership instead, though with substantially similar requirements for the contents. See TRLPA § 2.01; see also *Arkoma Basin Exploration Co. v. FMF Assocs.1990-A, Ltd.*, 118 S.W.3d 445, 455 (Tex. App.—Dallas 2003, no pet.); *Garrett v. Koepke*, 569 S.W.2d 568,569 (Tex. Civ. App.—Dallas 1978,

The Tex. LP Stats. contain a number of default provisions that govern the limited partnership in the absence of any relevant provisions in the partnership agreement. Except as provided in the Tex. LP Stats., the partners generally have the freedom to contract around these default provisions and to provide for the rights and obligations of the partners in the partnership agreement.⁵²⁴ Since the default provisions of the Tex. LP Stats. to an extent reflect the requirements of the Former Classification Regulations, attorneys drafting limited partnership agreements should now consider whether the business expectations of the partners require negation of some of the default provisions, particularly in the context of dissolution.

The Tex. LP Stats. assume the existence of a limited partnership agreement, but allow the agreement to be either written or oral.⁵²⁵ An oral limited partnership agreement is subject to the statute of frauds.⁵²⁶

The name of the limited partnership must contain the word “limited,” the phrase “limited partnership,” or an abbreviation of either.⁵²⁷

Unless the partnership agreement provides otherwise, unanimity is required to amend a limited partnership agreement.⁵²⁸ Since it may be difficult to get unanimity, it may be appropriate to provide that amendments may be made with the approval of a simple majority or supermajority of the partners. If this type of provision is included, it is important to specify whether the requisite approval is based on sharing ratios, capital account balances, or some other factor or is merely per capita. Also, even if a majority vote is sufficient for most amendments, certain amendments (e.g., those that disproportionately affect a particular partner or group of partners or increases the capital commitment of partners) require a different approval (e.g., the approval of the affected partner or group of partners (or some percentage of that group of partners)). If the amendment provisions are purposefully drafted to give less than all of the partners the right to make amendments that disproportionately affect a particular partner or group of partners, it may be wise to expressly specify in the partnership agreement, to the extent permitted by the Tex. LP Stats., the ability of the general partners to act inconsistently with the fiduciary duties normally required of them.

L. Operations in Other Jurisdictions. Multistate operations of limited partnerships have been prevalent for a sufficient period for most states to have limited partnership statutes

writ ref'd n.r.e.); *Brewer v. Tehuacana Venture, Ltd.*, 737 S.W.2d 349, 352 (Tex. App.—Houston [14th Dist.] 1987, no writ).

⁵²³ TBOC § 4.155(1). The fee is the same as it was under the TRLPA. See TRLPA §§ 2.01(a), 12.01(1).

⁵²⁴ See TRPA § 1.03; TBOC §§ 152.002, 153.003.

⁵²⁵ TRLPA § 1.02(10); TBOC § 151.001(5).

⁵²⁶ An oral agreement which is not to be performed within one year from the date of making of the agreement is barred by the statute of frauds. TEX. BUS. & COM. CODE ANN. § 26.01(b)(6) (Vernon Supp. 2010). See *Chacko v. Mathew*, 2008 WL 2390486 (Tex.App.-Hous. (14 Dist.)).

⁵²⁷ TBOC § 5.055(a). The TBOC has eliminated the TRLPA limitations on using a limited partner's name in the name of the partnership, as well as the requirement that the necessary words or letters designating a limited partnership be at the end of the entity's name. See Revisor's Note to TBOC § 5.055. Under TRLPA § 1.03, an entity's name had to contain the words “Limited Partnership,” “Limited,” or the abbreviation “L.P.,” “LP” (no periods) or “Ltd.” as the last words or letters of its name.

⁵²⁸ TRPA § 4.01(i); TBOC § 152.208.

which contain provisions for the qualification of foreign limited partnerships to do business as such so that the limited liability of the limited partners will be recognized under local law.⁵²⁹ To qualify to do business as a foreign limited partnership in most states, the limited partnership must file with the state's secretary of state evidence of its existence and an application that generally includes *inter alia* information regarding its jurisdiction and state of organization, its registered office and agent for service of process in the state (and providing that in the event that there is at any relevant time no duly designated agent for service of process in the state, then appointing the state's secretary of state as agent for service of process), the names and addresses of its general partners, the business it proposes to pursue in the state and the address of its principal office.

In New York there is now an additional requirement that within 120 days after the filing of its application for authority, the foreign limited partnership must publish once each week for six successive weeks in one daily and one weekly newspaper (each being designated by the county clerk in the county where the partnership is located) generally the same information required to be filed with the New York Department of State and must file a proof of publication with the New York Department of State. Failure to file such proof of publication will result in automatic suspension of the entity's right to transact business in New York.⁵³⁰

M. Business Combinations. Under Texas law, a limited partnership may merge with a corporation, LLC or another partnership and convert from a limited partnership into another form of entity without effecting a merger or transfer of assets.⁵³¹ The Tex. LP Stats. have provisions relating to the mechanics of adopting a plan of merger or conversion, obtaining owner approval, filing with the Secretary of State, and protecting creditors.

The Tex. LP Stats. do not contain any analogue to TBCA articles 5.09 and 5.10 and the parallel TBOC provisions which require shareholder approval of sales of all or substantially all of a corporation's assets in certain circumstances.⁵³² Requirements for limited partner approval of an asset transaction are left to the limited partnership agreement if the partners wish to provide such requirements.

⁵²⁹ See TRLPA article 9; *see generally* TBOC title 1, chapter 9.

⁵³⁰ N.Y. REV. LIMITED PARTNERSHIP ACT § 121-902 (McKinney Supp. 2006). N.Y. REV. LIMITED PARTNERSHIP ACT § 121-201 (McKinney Supp. 2006) contains similar publication requirements for newly formed domestic limited partnerships.

⁵³¹ TRLPA §§ 2.11, 2.15; TBOC §10.001. In order for a limited partnership to participate in a conversion, consolidation, or merger, the partnership agreement *must* authorize such action and the process for its approval. See TRLPA §§ 2.11(a)(1), 2.11(a)(2), 2.11(d)(1)(F), 2.15(a)(1); TBOC § 10.009(f). Therefore, it is important to include such a provision. Failure to include the provision will mean that, if such a transaction is desired, the partnership agreement will first need to be amended to permit it. To the extent the merger also results in amendments to the partnership agreement, the provisions relating to amendments will also need to be followed, so it would be prudent to coordinate the vote needed for conversions, consolidations, and mergers with the vote needed for amendments.

⁵³² See *supra* notes 224-225 and related text regarding the requirements of TBCA arts. 5.09 and 5.10 and the parallel TBOC provisions.

V. LIMITED LIABILITY COMPANY.

A. **General.** LLCs formed under Texas law are now governed by Title 3 and pertinent provisions of Title 1 of the TBOC.⁵³³ Because until January 1, 2010 some LLCs were governed by the LLC Act⁵³⁴ and others by the TBOC and because the substantive principles under both statutes are generally the same, the term “Tex. LLC Stats.” is used herein to refer to the TBOC and the LLC Act collectively, and the particular differences between the LLC Act and the TBOC are referenced as appropriate. Texas was the fourth state to adopt an LLC statute and now every state has adopted an LLC statute.⁵³⁵

“The allure of the [LLC] is its unique ability to bring together in a single business organization the best features of all other business forms - properly structured, its owners obtain both a corporate-styled liability shield and the pass-through tax benefits of a partnership.”⁵³⁶ All equity holders of an LLC have the limited liability of corporate shareholders even if they participate in the business of the LLC. Thus the Tex. LLC Stats. contemplate that LLCs will be organized with features that resemble corresponding features of corporations.

Under the Check-the-Box Regulations, a domestic LLC with two or more Members typically would be treated for federal income tax purposes as a partnership.⁵³⁷ An LLC is subject to Texas Margin Tax.⁵³⁸

An underlying premise of the Tex. LLC Stats. is that the LLC is based in large part upon a contract between its Members, similar to a partnership agreement. As a result, fundamental principles of freedom of contract imply that the owners of an LLC have maximum freedom to determine the internal structure and operation of the LLC. Thus the Tex. LLC Stats. would be classified as “flexible” LLC statutes.⁵³⁹ This freedom of contract, however, could have resulted

⁵³³ TBOC §§ 401.001, 402.003. The TBOC provisions applicable to LLCs may be officially and collectively referred to as “Texas Limited Liability Company Law.” TBOC § 1.008(e).

⁵³⁴ The Texas Limited Liability Company Act, as amended, is found at TEX. REV. CIV. STAT. ANN. art. 1528n (Vernon Supp. 2010) (hereinafter “LLC Act”). The operational provisions of the LLC Act are modeled after the TBCA, the TMCLA, and TRLPA. *Summary of Business Organizations Bill (HB 278)*, 28 BULL. OF BUS. L. SEC. OF THE ST. B. OF TEX. 2, 31-41 (June 1991) [hereinafter “*1991 Bill Analysis Summary*”]; TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon Supp. 2010); TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon 2003 & Supp. 2004); TEX. REV. CIV. STAT. ANN. art. 6132a-1, arts. 1-13 (Vernon Supp. 2010).

⁵³⁵ See Charles W. Murdock, *Limited Liability Companies in the Decade of the 1990s: Legislative and Case Law Developments and Their Implications for the Future*, 56 Bus. Law 499, 502 (2001).

⁵³⁶ *PB Real Estate, Inc. v. DEM Properties*, 719 A.2d 73, 74 (Conn. App. Ct. 1998); see Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006*, XV FORDHAM J. CORP. & FIN. L. 459 (2010)

⁵³⁷ See *supra* notes 80-93 and related text.

⁵³⁸ See *supra* notes 113-207 and related text. The LLC is not subject to a franchise tax in Delaware or most other states. See Bruce P. Ely & Christopher R. Grissom, *State Taxation of LLCs and LLPs: An Update*, 1 BUS. ENTITIES 24 (Mar./Apr. 1999).

⁵³⁹ See Robert B. Keatinge, *New Gang in Town - Limited Liability Companies: An Introduction*, 4 BUS. L. TODAY 5 (Mar./Apr. 1995).

in the inadvertent loss of partnership classification for federal income tax purposes under the Former Classification Regulations.⁵⁴⁰

The Tex. LLC Stats. in many cases provide “default” provisions⁵⁴¹ designed to reflect the common expectations of persons engaged in business under the Former Classification Regulations, and to permit those expectations to be met in the event that the LLC’s organizational documents do not include a provision specifically dealing with an issue. These default provisions, however, may result in restrictions on the LLC that are not necessary under the Check-the-Box Regulations and may unnecessarily change the intended business deal.⁵⁴² Examples of provisions that were often included in an LLC structure because of the Former Classification Regulations, and which are not required by either the Tex. LLC Stats. or the Check-the-Box Regulations, include:

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

B. Taxation.

1. Check the Box Regulations. Domestic LLCs that have two or more Members ordinarily will be classified as partnerships for federal income tax purposes unless the LLC makes an election to be classified as an association taxable as a corporation.⁵⁴³ A single Member LLC will be disregarded as an entity separate from its owner under the Check-the-Box Regulations unless the LLC elects to be taxed as a corporation.⁵⁴⁴

2. Other Tax Issues Relating to LLCs.

(a) Texas Entity Taxes. An LLC with gross receipts of \$150,000 or more was subject to the Texas franchise tax until January 1, 2007.⁵⁴⁵ As a result, an LLC was subject to a franchise tax equal to the greater of (1) 0.25% of its “net taxable capital,” which equals its Members’ contributions and surplus, and (2) 4.5% of its “net taxable earned

⁵⁴⁰ See Robert F. Gray *et al.*, *Corporations*, 45 Sw.L.J. 1525, 1537 (1992).

⁵⁴¹ See HOUSE COMM. ON BUS. & INDUS., BILL ANALYSIS, Tex. H.B. 1239, 73d Leg., R.S. (1993) at 1 [hereinafter 1993 LLC Bill Analysis].

⁵⁴² See William D. Bagley, *The IRS Steps Back - Entity Classification Rules are Relaxed*, 6 BUS. L. TODAY 41 (1997).

⁵⁴³ Treas. Reg. § 301.7701-3(b)(i) (as amended in 2003).

⁵⁴⁴ Treas. Reg. § 301.7701-3(b)(ii).

⁵⁴⁵ TEX. TAX CODE ANN. §§ 171.001, 171.002(d) (Vernon 2002 & Supp. 2004).

surplus.”⁵⁴⁶ Unless the LLC had more than one Member but did not have more than 35 Members, the “net taxable earned surplus” of an LLC was based on the entity’s reportable federal taxable income with the compensation of officers and Managers being added back plus certain other adjustments and with the amount being apportionable to Texas based on the percentage of the LLC’s gross receipts from Texas sources.⁵⁴⁷ An LLC with fewer than 35 Members could eliminate its Texas franchise tax based on “net taxable earned surplus” with Member compensation, subject to limits on unreasonable compensation.⁵⁴⁸ Texas administrative regulations provided that a single Member LLC could not deduct compensation paid to the Member in computing “net taxable earned surplus.”⁵⁴⁹ Such an LLC could, however, deduct compensation paid to officers or managers other than a Member-Manager.

Effective for tax years beginning on or after January 1, 2007, the Margin Tax replaces the Texas franchise tax and is imposed on LLCs.⁵⁵⁰

In each other state in which an LLC does business it will be necessary to ascertain the franchise and income tax treatment of foreign LLCs doing business therein. Since most state income tax regimes are based on the federal adjusted gross income, an LLC treated as a partnership for federal income tax purposes should be treated as such for state income tax purposes in the absence of a specific state statute.⁵⁵¹

(b) Flexible Statute. In Revenue Ruling 88-76, a Wyoming LLC was held to lack continuity of life and free transferability of interest, because the Wyoming LLC *statute* requires the unanimous vote of *all* remaining Members to continue the LLC upon a Dissolution Event, and the consent of *all* LLC Members for any transferee of an interest to participate in the management of the LLC or to become a Member.⁵⁵² The Wyoming LLC statute was considered a “bullet proof statute” because an LLC formed thereunder would always lack these two corporate characteristics important under the Former Classification Regulations.⁵⁵³ By contrast, the Tex. LLC Stats. are considered “flexible” statutes because they allow the Members to vary the Regulations or Company Agreement to allow greater organizational flexibility (thus, creating the possibility that an LLC organized thereunder would be taxable as an “association” rather than a partnership under the Former Classification Regulations).⁵⁵⁴

(c) One Member LLC. The Tex. LLC Stats. permit formation of a one-Member LLC, the status of which is now certain under the Check-the-Box Regulations.⁵⁵⁵

⁵⁴⁶ *Id.* § 171.002(a).

⁵⁴⁷ See Brandon Janes and Steven D. Moore, *The New Texas Franchise Tax*, TEX. B.J., Nov. 1991, at 1108.

⁵⁴⁸ TEX. TAX CODE ANN. § 171.110(a)(1).

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

⁵⁵⁰ See *supra* notes 113-207 and related text.

⁵⁵¹ David G. Dietze, *The Limited Liability Company: Latest Strategy and Developments*, 6 No. 1 INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR, Jan. 1992, at 7.

⁵⁵² Rev. Rul. 88-76, 1988-2 C.B. 360, *obsoleted* by Rev. Rul. 98-37, 1998-2 C.B. 133.

⁵⁵³ Rev. Rul. 88-76, WYO. STAT. ANN. §§ 17-15-101–17-15-147 (Michie 2003).

⁵⁵⁴ LLC Act §§ 3.02(A), 6.01(B); TBOC § 101.052.

⁵⁵⁵ Treas. Reg. § 301.7701-2(a), (c)(2) (as amended in 2003).

As previously stated, for federal income tax purposes, a single Member domestic LLC will be disregarded as an entity separate from its owner unless it elects to be taxed as a corporation.⁵⁵⁶ Many state LLC statutes do not authorize single Member LLCs.⁵⁵⁷

(d) Contributions of Appreciated Property. As a general rule, a transfer of appreciated property in exchange for an interest in an LLC classified as a partnership will not result in any recognizable gain or loss for the transferor, the LLC or any other Member of the LLC.⁵⁵⁸ The tax basis of the transferor in the LLC interest thereof and of the LLC in the transferred property is the basis the transferor had in the transferred property at the time of the transfer.⁵⁵⁹ Under certain circumstances, a Member's contribution of property may result in a net reduction in liability⁵⁶⁰ to that Member in excess of the Member's tax basis in the contributed property. In such a situation, the Member will recognize a gain to the extent of such excess.⁵⁶¹ In addition, certain contributions can be treated as "disguised sales" of all or a portion of the contributed property by the member to the LLC if the member receives cash or other property (in addition to an LLC interest) in connection with the transfer.

(e) Self-Employment Tax. Individuals are subject to a self-employment tax on self-employment income.⁵⁶² The tax rate aggregates up to 15.3% and consists of (i) a 12.40% social security equivalent tax on self-employment income up to a 2010 contribution base of \$106,800 (adjusted annually for inflation), plus (ii) a 2.9% Medicare tax on all self-employment income (there is no ceiling).⁵⁶³ An individual's wage income is applied against the contribution base.⁵⁶⁴ Self-employment income generally means an individual's net earnings from the individual's trade or business.⁵⁶⁵ An individual's self-employment income

⁵⁵⁶ In I.R.S. Priv. Ltr. Rul. 2001-18023 (Jan. 31, 2001), the issue was the application of § 1031 of the IRC (dealing with tax-free like-kind property exchanges) to a transaction in which an individual conveyed qualifying real property to the sole member of an LLC for the membership interest of a single member LLC (which is a disregarded business entity for federal tax purposes). The conveyance of the real property to the taxpayer would be subject to a real estate transfer fee under state law, but the transfer of an ownership interest in an LLC to the taxpayer would not be subject to the transfer fee. To avoid incurring a liability for the local real estate transfer fees incident to the transfer of the real property by the LLC, the taxpayer was proposing to simply acquire the LLC from its single member. The IRS ruled that, because the LLC is a single member LLC and will, therefore, be disregarded as an entity separate from its owner, the receipt of the ownership of the LLC by the taxpayer is treated as the receipt by the taxpayer of the real property owned by the LLC. Accordingly, the taxpayer's receipt of the sole membership interest in the LLC which owns the real property would be treated as the receipt of real property directly by the taxpayer for purposes of qualifying the receipt of the real property for non-recognition of gain under § 1031. The ruling applies only to the extent the property held by the LLC at the time it is transferred to the taxpayer is property of a like kind to the real property held for use by the taxpayer in his trade or business or for investment (not like kind property held by the LLC would be taxable to the taxpayer as boot).

⁵⁵⁷ See Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 7 (1995).

⁵⁵⁸ I.R.C. § 721(a). *But see* 26 C.F.R. § 1.707-3 (2003) (discussing disguised sales).

⁵⁵⁹ I.R.C. §§ 722, 723.

⁵⁶⁰ I.R.C. § 752.

⁵⁶¹ I.R.C. § 731.

⁵⁶² See I.R.C. § 1401; SSA Pub. No. 05-10022 (2009), available at <http://www.ssa.gov/pubs/10022.pdf>.

⁵⁶³ I.R.C. § 1401.

⁵⁶⁴ *Id.*

⁵⁶⁵ I.R.C. § 1402(a).

includes his distributive share of the trade or business income from a partnership of which he is a partner (including an LLC classified as a partnership for federal income tax purposes), *subject to* the exception that a limited partner's distributive share of income or loss from a limited partnership generally will not be included in his net income from self employment.⁵⁶⁶

In 1994, the IRS issued proposed regulations providing that an individual Member's share of income from a trade or business of the LLC is subject to self-employment tax (assuming the LLC is treated as a partnership for federal income tax purposes) unless (i) the Member is not a managing Member and (ii) the entity could have been formed as a limited partnership rather than an LLC in the same jurisdiction with the Member qualifying as a limited partner.⁵⁶⁷ Under such regulations, if the LLC did not have designated Managers with continuing and exclusive authority to manage the LLC, then all Members would be treated as Managers for this purpose.

On January 13, 1997 the IRS withdrew its 1994 proposed regulation dealing with employment taxes in the LLC context and proposed new regulations that would apply to all entities (including LLCs) classified as partnerships under the Check-the-Box Regulations.⁵⁶⁸ The IRS said that it was proposing a "functional" approach that would define "limited partner" for federal tax purposes, irrespective of the state law classification, because of the proliferation of new business entities such as the LLC as well as the evolution of state limited partnership statutes.⁵⁶⁹ Under the proposed regulations:

Generally, an individual will be treated as a limited partner under the proposed regulations unless the individual (1) has personal liability (as defined in section 301.7701-3(b)(2)(ii) of the Procedure and Administration Regulations) for the debts of or claims against the partnership by reason of being a partner; (2) has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or, (3) participates in the partnership's trade or business for more than 500 hours during the taxable year. If, however, substantially all of the activities of a partnership involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides services as part of that trade or business will not be considered a limited partner.⁵⁷⁰

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

⁵⁶⁶ I.R.C. § 1402.

⁵⁶⁷ See 26 C.F.R. § 1.1402(a)-18, 59 Fed. Reg. 67,253-01 (proposed Dec. 29, 1994).

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

⁵⁶⁹ See *id.*

⁵⁷⁰ *Id.*

employment tax on distributions if the LLC is treated as an association taxable as a corporation for Federal tax purposes.

The Taxpayer Relief Act of 1997 prohibited the IRS from issuing any temporary or final regulations relating to the definition of a limited partner for employment tax purposes that would be effective before July 1, 1998.⁵⁷¹ The legislative history indicates that Congress wants the IRS to withdraw the controversial proposed regulation discussed above, which would impose a tax on limited partners.⁵⁷² A “sense of the Senate” resolution in the Senate amendment expressed dissatisfaction with the proposed regulation, noting that Congress, not the Treasury or the IRS, should determine the law governing self-employment income for limited partners.⁵⁷³ Congress may again consider ways to rationalize the self-employment tax treatment of LLCs, partnerships and S-corporations.⁵⁷⁴

C. Members; Managers. The owners of an LLC are called “Members,”⁵⁷⁵ and are analogous to shareholders in a corporation or limited partners of a limited partnership.⁵⁷⁶ 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.⁵⁷⁷ Under the Tex. LLC Stats., however, an LLC may be structured so that management shall be by the Members as in the case of a close corporation or a general partnership,⁵⁷⁸ and in that case the Members would be analogous to general partners in a general or limited partnership but without personal liability.⁵⁷⁹ For an LLC to be taxed as a partnership it must have at least two Members, although Texas law would permit an LLC to have only one Member; a single Member LLC is not treated as a separate entity for federal tax purposes under the Check-the-Box Regulations unless it elects to be taxed as a corporation (i.e., a single Member LLC may be taxed as a sole proprietorship or corporation, but not as a partnership).⁵⁸⁰

⁵⁷¹ H.R. CONF. REP. NO. 105-220, at 765 (1997).

⁵⁷² *Id.*

⁵⁷³ *Id.* In a letter to the Chairman of the House Ways and Means Committee dated July 6, 1999, the American Bar Association Tax Section commented on the uncertainty of the law in this area, recommending that the IRC be amended to provide that the income of an entity taxable as a partnership (including an LLC) that is attributable to capital is not subject to self-employment tax, but suggested that, if legislation is not forthcoming, the best immediately available approach is that contained in the 1997 proposed regulations. Paul A. Sax, *ABA Tax Section Suggests Legislative Fix for LLC Self-Help Employment Tax*, TAX NOTES TODAY, July 13, 1999, 1999 TNT 133-23, available at <http://www.taxanalysts.com>.

⁵⁷⁴ See “*Options to Improve Tax Compliance and Reform Tax Expenditures*” prepared by the Staff of the Joint Committee on Taxation (January 27, 2005).

⁵⁷⁵ LLC Act § 4.01; TBOC §§ 1.002(53), 101.101, 101.102.

⁵⁷⁶ 1991 Bill Analysis Summary at 41.

⁵⁷⁷ See LLC Act § 2.13; TBOC § 101.302; 1991 Bill Analysis Summary at 41.

⁵⁷⁸ LLC Act § 2.12; TBOC §§ 1.002(35), 101.251.

⁵⁷⁹ 1991 Bill Analysis Summary at 41.

⁵⁸⁰ See *supra* notes 80-93 and related text and notes 555-557 and related text. In 1993, Article 4.01(A) of the LLC Act was amended to expressly provide that an LLC “may have one or more members.” Tex. H.B. 1239, 73d Leg., R.S. (1993). See also TBOC § 101.101.

Under the Tex. LLC Stats., any “person” may become a Member or Manager.⁵⁸¹ Because of the broad construction given to “person” by the Tex. LLC Stats., any individual, corporation, partnership, LLC or other person may become a Member or Manager.⁵⁸² Thus, it is possible to have an LLC with a corporation as the sole Manager just as it is possible to have a limited partnership with a sole corporate general partner.

D. Purposes and Powers. Under Texas law, an LLC may generally be formed to conduct any lawful business, subject to limitations of other statutes which regulate particular businesses.⁵⁸³ It has all of the powers of a Texas corporation or limited partnership, subject to any restrictions imposed by statute or its governing documents.⁵⁸⁴

E. Formation. An LLC is formed when one or more persons file a certificate of formation with the Texas Secretary of State along with a \$300 filing fee.⁵⁸⁵ 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

⁵⁸¹ LLC Act § 4.01C; TBOC § 101.102(a).

⁵⁸² “Person” is defined in LLC Act § 1.02(4) as follows:

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

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

⁵⁸³ LLC Act § 2.01 provides as follows:

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

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

LLC Act § 2.01 provides that a limited liability company “may engage in any lawful business.” The term “business,” as defined in LLC Act § 1.02.A(6), means every “trade and occupation or profession.” Based on the foregoing, a limited liability company governed by the LLC Act possibly could not be used for a nonprofit purpose. However, under the TBOC, an LLC’s purpose “may be stated to be or include any lawful purpose for [an LLC].” TBOC § 3.005(3). Such broad language would seem to negate the prior profit versus nonprofit ambiguity. *See also* TBOC § 2.001 (providing “A domestic entity has any lawful purpose or purposes, unless otherwise provided by this code.”).

⁵⁸⁴ Governing documents, as used here, includes an LLC’s Articles of Organization, Certificate of Formation, Regulations, or Company Agreement. LLC Act § 2.02; *see* TBOC § 101.402.

⁵⁸⁵ TBOC §§ 3.001, 4.152(1), 4.154. Prior to January 1, 2006, an LLC was formed by filing articles of organization with the Secretary of State, which were similar to a certificate of limited partnership under TRLPA and articles of incorporation under the TBCA. *See* LLC Act §§ 3.01, 9.01.

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.⁵⁸⁶ 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.⁵⁸⁷ An LLC may also be formed pursuant to a plan of conversion or merger, in which case the certificate of formation must be filed with the certificate of conversion or merger, but need not be filed separately. In such case the LLC's formation takes effect on the effectiveness of the plan.⁵⁸⁸

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.⁵⁸⁹ 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.⁵⁹⁰ Prior to accepting a certificate of formation for filing, the Secretary of State reviews its LLC, limited partnership and corporation records to determine whether the LLC's proposed name is impermissibly close to that of an existing filing entity.⁵⁹¹

The Tex. LLC Stats. provide that, except as otherwise provided in an LLC's certificate of formation or Company Agreement, the affirmative vote, approval, or consent of all Members is required to amend its certificate of formation.⁵⁹² Any such amendment must include a statement that it was approved in accordance with the proper provisions of governing laws,⁵⁹³ or for entities governed by the LLC Act, alternately as provided in the articles of organization or Regulations, along with the date of approval.⁵⁹⁴

LLC Act section 2.23G provides that if the LLC has not received any capital and has not otherwise commenced business, the articles of organization may be amended by and the LLC may be dissolved by (a) a majority of the Managers, if there are no Members, or (b) a majority of the Members, if there are no Managers. The TBOC does not contain such an express provision, but simply grants broad leeway for an LLC's Company Agreement (equivalent to the "Regulations" under the LLC Act) to govern such matters.⁵⁹⁵

⁵⁸⁶ TBOC §§ 3.005, 3.010, 3.014.

⁵⁸⁷ TBOC §§ 4.051, 4.052.

⁵⁸⁸ TBOC § 3.006(b).

⁵⁸⁹ TBOC § 5.056. However, LLCs formed prior to September 1, 1993 in compliance with the laws then in existence need not change their names to comply with the current provisions. TBOC § 5.056(b).

⁵⁹⁰ TBOC § 5.053.

⁵⁹¹ *Id.*

⁵⁹² LLC Act § 2.23H; TBOC §§ 101.356(d), 101.051, 101.052. For LLCs that continue to be governed by the LLC Act, the pertinent documents are referred to as the articles of organization and the Regulations.

⁵⁹³ LLC Act § 3.06(3); TBOC § 3.053(4).

⁵⁹⁴ LLC Act § 3.06(3).

⁵⁹⁵ *See* TBOC §§ 101.051, 101.052.

F. Company Agreement. Most of the provisions relating to the organization and management of an LLC and the terms governing its securities are to be contained in the LLC's company agreement ("Company Agreement"), which will typically contain provisions similar to those in limited partnership agreements and corporate bylaws.⁵⁹⁶ A Company Agreement is the same as the document referred to as the "Regulations" for LLCs governed by the LLC Act. A Company Agreement may be oral or in writing,⁵⁹⁷ but an oral Company Agreement is subject to the statute of frauds.⁵⁹⁸ The complexity of the matters typically addressed in a Company Agreement make it rare and inadvisable to have an oral Company Agreement.

Under the TBOC, the Company Agreement controls the majority of LLC governance matters and generally trumps the default TBOC provisions relating to LLCs, but certain provisions of the Tex. LLC Stats. may not be waived or modified by Regulations or Company Agreement.⁵⁹⁹ For example, the TBOC provides that the Company Agreement or certificate of

⁵⁹⁶ LLC Act § 2.09A; TBOC § 101.052; Joint Task Force of the Committee on LLCs, Partnerships and Unincorporated Entities and the Committee on Taxation, ABA Section of Business Law, *Model Real Estate Development Operating Agreement with Commentary*, 63 Bus. Law. 385 (February 2008).

⁵⁹⁷ TBOC § 101.001(1); DLLCA § 18-101(7).

⁵⁹⁸ An oral agreement which is not to be performed within one year from the date of making of the agreement is barred by the statute of frauds. TEX. BUS. & COM. CODE ANN. § 26.01(b)(6) (Vernon Supp. 2010). To be enforceable, an agreement to make contributions of cash or property to an LLC must be in writing and signed by the person making the promise. TBOC § 101.151. Likewise, profits and losses are to be allocated, and distributions made, according to the written agreed value of contributions found in the LLC's company records. TBOC §§ 101.501, 101.201, 101.203. *See Olson v. Halvorsen*, 2008 WL 4661831 (Del. Ch. 2008) (Delaware statute of frauds, which provides "an agreement 'that is not to be performed within the space of one year from the making thereof' must be reduced to writing and signed by the party against which the agreement is to be enforced," applies to a Delaware LLC agreement; noting that "the statute of frauds does not apply to any contract which may, by any possibility, be performed within a year," the court observed that few oral LLC agreements would contain terms that could not possibly be performed within one year and thus ordinarily the statute of frauds would not limit the enforcement of oral LLC agreements; nevertheless, in the case before it, the court held that the earnout provision at issue violated the statute of frauds because it could not be performed within a year and none of the exceptions to the statute of frauds was applicable).

⁵⁹⁹ TBOC §§ 101.052 and 101.054 provide as follows:

Sec. 101.052. COMPANY AGREEMENT. (a) Except as provided by Section 101.054, the company agreement of a limited liability company governs:

(1) the relations among members, managers, and officers of the company, assignees of membership interests in the company, and the company itself; and

(2) other internal affairs of the company.

(b) To the extent that the company agreement of a limited liability company does not otherwise provide, this title and the provisions of Title 1 applicable to a limited liability company govern the internal affairs of the company.

(c) Except as provided by Section 101.054, a provision of this title or Title 1 that is applicable to a limited liability company may be waived or modified in the company agreement of a limited liability company.

(d) The company agreement may contain any provisions for the regulation and management of the affairs of the limited liability company not inconsistent with law or the certificate of formation.

Sec. 101.054. WAIVER OR MODIFICATION OF CERTAIN STATUTORY PROVISIONS PROHIBITED; EXCEPTIONS. (a) Except as provided by this section, the following provisions may not be waived or modified in the company agreement of a limited liability company:

(1) this section;

(2) Section 101.101(b)[Members Required], 101.151 [Requirements for Enforceable Promise [to make contribution]], 101.206 [Prohibited Distribution; Duty to Return], 101.501 [Supplemental Records Required for Limited Liability Companies], or 101.502 [Right to Examine Records and Certain Other Information];

(3) Chapter 1 [Definitions and Other General Provisions], if the provision is used to interpret a provision or define a word or phrase contained in a section listed in this subsection;

(4) Chapter 2 [Purposes and Power of Domestic Entity], except that Section 2.104(c)(2) [Power to Make Guaranties], 2.104(c)(3) [Power to Make Guaranties], or 2.113 [Limitation on Powers] may be waived or modified in the company agreement;

(5) Chapter 3 [Formation and Governance], except that Subchapters C [Governing Persons and Officers] and E [Certificates Representing Ownership Interest] may be waived or modified in the company agreement; or

(6) Chapter 4 [Filings], 5 [Names of Entities; Registered Agents and Registered Offices], 7 [Liability], 10 [Mergers, Interest Exchanges, Conversions, and Sales of Assets], 11 [Winding Up and Termination of Domestic Entity], or 12 [Administrative Powers], other than Section 11.056 [Supplemental Provisions for Limited Liability Company].

(b) A provision listed in Subsection (a) may be waived or modified in the company agreement if the provision that is waived or modified authorizes the limited liability company to waive or modify the provision in the company's governing documents.

(c) A provision listed in Subsection (a) may be modified in the company agreement if the provision that is modified specifies:

(1) the person or group of persons entitled to approve a modification;

or

(2) the vote or other method by which a modification is required to be approved.

(d) A provision in this title or in that part of Title 1 [General Provisions] applicable to a limited liability company that grants a right to a person, other than a member, manager, officer, or assignee of a membership interest in a limited liability company, may be waived or modified in the company agreement of the company only if the person consents to the waiver or modification.

Although TBOC § 101.054 expressly states which provisions *cannot* be modified, its predecessor, the LLC Act, only expressly states which provisions *can* be modified. As the Revisor's Note to TBOC § 101.052 explains:

Because of the reversal of the prior assumption that each provision of the [LLC Act] was mandatory (unless expressly qualified) to the new assumption in Sections 101.052 and 101.054 [of the TBOC] that most provisions of the code governing limited liability companies may be waived or modified, a number of the provisions of Title 3 are now stated in such a way that the new provision appears to be the converse of the corresponding provision under the Texas Limited Liability Company Act.

formation may only be amended by unanimous member consent,⁶⁰⁰ but if either document provides otherwise (such as for amendment by manager consent), then it may be amended pursuant to its own terms.⁶⁰¹ The only statutory provisions not subject to contrary agreement are enumerated in TBOC section 101.054.⁶⁰² While the structure and wording of the TBOC relating to these matters differs from the source LLC Act, the rule has not substantively changed.⁶⁰³

Although the Company Agreement will ordinarily contain the capital account and other financial and tax provisions found in a typical limited partnership agreement,⁶⁰⁴ the Tex. LLC Stats. do not require that the Company Agreement ever be approved by the Members or be filed with the Secretary of State or otherwise made a public record. Nevertheless it may be desirable for the Members to approve the Company Agreement and agree to be contractually bound thereby.⁶⁰⁵ The Members' express agreement to be contractually bound by the Company Agreement should facilitate enforcement thereof and their treatment as a "partnership agreement" for federal income tax purposes.⁶⁰⁶

⁶⁰⁰ TBOC §§ 101.053, 101.356(d).

⁶⁰¹ See TBOC §§ 101.052, 101.054.

⁶⁰² See *supra* note 599.

⁶⁰³ See Revisor's Note to TBOC § 101.052; LLC Act §§ 2.09B, 2.23H. With respect to LLCs that continue to be governed by the LLC Act, the default provision in LLC Act § 2.23D provides that the affirmative vote, approval, or consent of a majority of all the Members is required to approve any merger or interest exchange, dissolution or any act which would make it impossible to carry on the ordinary business of the LLC. The LLC Act default provisions would require unanimous approval of the Members to amend the Articles (LLC Act § 2.23H), issue additional membership interests (LLC Act § 4.01B-1, as amended by H.B. 1637 effective September 1, 2003) or take action beyond the stated purposes of the LLC (LLC Act § 2.02B). The general default voting provision is in LLC Act § 2.23C-1, which provides that Members or Managers may take action at a meeting or without a meeting in any manner permitted by the Articles, the Regulations or the LLC Act and that, unless otherwise provided by the Articles or the Regulations, an action is effective if it is taken by (1) an affirmative vote of those persons having not fewer than the minimum number of votes that would be necessary to take the action at a meeting at which all Members or Managers, as the case may be, entitled to vote on the action were present and voted; or (2) consent of each Member of the LLC, which may be established by (a) the Member's failure to object to the action in a timely manner, if the Member has full knowledge of the action, (b) consent to the action in writing signed by the Member, or (c) any other means reasonably evidencing consent. Thus, when drafting the Regulations, it is important to override these provisions if they do not properly reflect the desires of the parties. Also, Paragraph F of LLC Act § 2.23 provides, as the default rule, that a majority is defined to be determined on a per-capita basis and not, for instance, by capital contributions or sharing ratios; since this may or may not be appropriate, it is critical that the Regulations properly set forth the appropriate standard for determining what constitutes a majority.

⁶⁰⁴ It is critical that the Company Agreement accurately reflect the business deal of the parties. Absent a different provision therein, profits and losses of an LLC are to be allocated, and all distributions, whether a return of capital or otherwise, are to be made in accordance with the relative agreed value of capital contributions made by each member reflected in the records that the LLC is required to maintain under the Tex. LLC Stats. LLC Act §§ 2.22, 5.01-1, 5.03; TBOC §§ 3.151, 101.203, 101.501.

⁶⁰⁵ The agreement to be contractually bound could be through signing the Company Agreement directly or indirectly through a subscription agreement or power of attorney.

⁶⁰⁶ Philip M. Kinkaid, *Drafting Limited Liability Company Regulations and Articles: Sample Documents*, Address at The University of Texas School of Law Sponsored Conference on Current Issues in Partnerships, Limited Liability Companies, and Registered Limited Liability Partnerships (Jan. 23-24, 1992).

In some other states, the agreement which is referred to in Texas as the Company Agreement is referred to as “operating agreement” or the “LLC agreement.”⁶⁰⁷

G. Management. The business and affairs of an LLC with Managers are managed under the direction of its Managers, who can function as a board of directors and may designate officers and other agents to act on behalf of the LLC.⁶⁰⁸ 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.⁶⁰⁹ 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.⁶¹⁰ Thus an LLC could be organized to be run without Managers, as in the case of a close corporation, or it could be structured so that the day to day operations are run by Managers but Member approval is required for significant actions as in the case of many joint ventures and closely held corporations.

The Company Agreement should specify who has the authority to obligate the LLC contractually or to empower others to do so. It should dictate the way in which the Managers or Members, whichever is authorized to manage the LLC, are to manage the LLC’s business and affairs.⁶¹¹ The Tex. LLC Stats. provide that the following are agents of an LLC: (1) any officer or other agent who is vested with actual or apparent authority; (2) each Manager (to the extent that management of the LLC is vested in that Manager); and (3) each Member (to the extent that management of the LLC has been reserved to that Member).⁶¹² Texas law also provides that an act (including the execution of an instrument in the name of the LLC) for the purpose of apparently carrying on in the usual way the business of the LLC by any of the persons named in LLC Act section 2.21C or TBOC section 101.254(a) binds the LLC unless (1) the person so acting lacks authority to act for the LLC and (2) the third party with whom the LLC is dealing is aware of the actor’s lack of authority.⁶¹³ 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.

⁶⁰⁷ See, e.g., OHIO REV. CODE ANN. § 1705.01(J) (West 2003) (“operating agreement”); DEL. CODE ANN. tit. 6, § 18-101(7) (2009) (“limited liability company agreement”).

⁶⁰⁸ LLC Act §§ 2.12, 2.21; TBOC §§ 101.251-101.253.

⁶⁰⁹ LLC Act §§ 2.12, 1.02(4); TBOC § 101.302; TEX. GOV’T CODE § 311.005(2).

⁶¹⁰ LLC Act § 2.12; see TBOC § 101.251.

⁶¹¹ TBOC § 101.252. Along the same lines, LLC Act § 2.21B provides that all officers, agents, Managers and Members of an LLC, as among themselves and the LLC, have such authority in the management of the LLC as may be provided in its Regulations or as may be determined by resolution of the Managers or, to the extent to which management is reserved to them, the Members.

⁶¹² LLC Act § 2.21C; TBOC §§ 1.002(35), (37), 101.254(a).

⁶¹³ LLC Act § 2.21D; TBOC § 101.254(b).

Members and Managers acting on behalf of an LLC should disclose that they are acting on behalf of the entity and that it is an LLC. Under common law agency principles, an agent can be personally liable on a contract made for an undisclosed or unnamed principal.⁶¹⁴

The Tex. LLC Stats. contain no requirements as to the terms of Managers, but allow the Company Agreement to provide for specified terms of Managers and annual or other regularly scheduled meetings of Members.⁶¹⁵ If the Company Agreement is silent as to the terms of Managers, the default provision is retention of the Managers. Tex. LLC Stats. allow any number of classes of Managers, and contains no requirement that such classes either be equal or nearly equal in number or be elected in strict rotation at successive annual meetings of Members.⁶¹⁶

H. Fiduciary Duties. The Tex. LLC Stats. do not address specifically whether Manager or Member fiduciary duties exist or attempt to define them,⁶¹⁷ but implicitly recognize that they may exist in statutory provisions which permit them to be expanded or restricted in the Company Agreement.⁶¹⁸ The duty of Managers in a Manager-managed LLC and Members in a Member-managed LLC to the LLC is generally assumed to be fiduciary in nature, measured by reference to the fiduciary duties of corporate directors. By analogy to corporate directors, Managers would have the duties of obedience, care and loyalty and should have the benefit of the business judgment rule.⁶¹⁹ 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.⁶²⁰

⁶¹⁴ See *Water, Waste & Land, Inc. v. Lanham*, 955 P.2d 997, 1001 (Colo. 1998).

⁶¹⁵ See TBOC § 101.303.

⁶¹⁶ See LLC Act § 2.14; TBOC § 101.307.

⁶¹⁷ See Elizabeth M. McGeever, *Hazardous Duty? The Role of the Fiduciary in Noncorporate Structures*, 4 BUS. L. TODAY 51, 53 (Mar.–Apr.1995); Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 401 (1992) (noting that LLC statutes usually do not specify fiduciary duties of Members or Managers).

⁶¹⁸ LLC Act § 2.20B provides that the Regulations may expand or reduce fiduciary duties as follows:

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

Similarly, TBOC § 101.401 provides:

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

⁶¹⁹ See *supra* notes 289-298 and related text.

⁶²⁰ *Suntech Processing Sys., L.L.C. v. Sun Communications, Inc.*, No. 05-99-00213-CV, 2000 WL 1780236, at *6 (Tex. App.—Dallas Dec. 5, 2000, pet. denied) (not designated for publication). In *Suntech*, a minority Member of a Texas LLC claimed that the controlling Member owed a fiduciary duty as a matter of law in connection with the winding up of operations and distribution of assets. *Id.* at *5. The court pointed out that the Regulations expressly provided for a duty of loyalty to the LLC rather than between the Members,

The Tex. LLC Stats. allow LLC Company Agreements to expand or restrict the duties (including fiduciary duties) and liabilities of Members, Managers, officers and other persons to the LLC or to Members or Managers of the LLC.⁶²¹ This provision of Texas law was designed, in the same vein as the Delaware Limited Liability Company Act (the “DLLCA”) from which it drew inspiration, to allow LLCs the flexibility to address fiduciary duties through contract principles.⁶²² Unlike the DLLCA which allows an LLC agreement to eliminate fiduciary duties,⁶²³ the Tex. LLC Stats. only permit an LLC Company agreement to “restrict” duties.⁶²⁴

and, noting the absence of Texas case law on fiduciary duties of LLC Members and looking to case law regarding fiduciary duties of shareholders of a closely held corporation, held that there was no fiduciary relationship between the Members as a matter of law. *Id.* at *1.

⁶²¹ See LLC Act § 2.20B; TBOC § 101.401. Prior to the effectiveness of S.B. 555 on September 1, 1997, LLC Act § 8.12 had incorporated by reference the limitation of liability afforded to corporate directors under TMCLA 1302-7.06 and thereby allowed the limitation of Manager liability by a provision in the Articles (now, the Certificate of Formation) to the extent permitted for a director under TMCLA 1302-7.06. S.B. 555 deleted such incorporation by reference of TMCLA 1302-7.06 in favor of the broader authorization now in LLC Act § 2.20B.

⁶²² DEL. CODE ANN. tit. 6, § 18-1101(a)-(f) (2009). The Delaware Limited Liability Company Act aggressively adopts a “contractarian approach” (i.e., the bargains of the parties manifested in LLC agreements are to be respected and rarely trumped by statute or common law) and does not have any provision which itself creates or negates Member or Manager fiduciary duties, but instead allows modification of fiduciary duties by an LLC agreement as follows:

18-1101 CONSTRUCTION AND APPLICATION OF CHAPTER AND LIMITED LIABILITY COMPANY AGREEMENT.

(a) The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.

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

(c) To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member’s or manager’s or other person’s duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

(d) Unless otherwise provided in a limited liability company agreement, a member or manager or other person shall not be liable to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement for breach of fiduciary duty for the member’s or manager’s or other person’s good faith reliance on the provisions of the limited liability company agreement.

(e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

(f) Unless the context otherwise requires, as used herein, the singular shall include the plural and the plural may refer to only the singular. The use of any gender shall be applicable to all genders. The captions contained herein are for purposes of convenience only and shall not control or affect the construction of this chapter.

See RESTATEMENT (SECOND) OF CONTRACTS and related Comment which provide:

§ 205. Duty of Good Faith and Fair Dealing

Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.

Comment:

a. Meanings of “good faith.” Good faith is defined in Uniform Commercial Code § 1-201(19) as “honesty in fact in the conduct or transaction concerned.” “In the case of a merchant” Uniform Commercial Code § 2-103(1)(b) provides that good faith means “honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.” The phrase “good faith” is used in a variety of contexts, and its meaning varies somewhat with the context. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving “bad faith” because they violate community standards of decency, fairness or reasonableness. The appropriate remedy for a breach of the duty of good faith also varies with the circumstances.

b. Good faith purchase. In many situations a good faith purchaser of property for value can acquire better rights in the property than his transferor had. See, e.g., § 342. In this context “good faith” focuses on the honesty of the purchaser, as distinguished from his care or negligence. Particularly in the law of negotiable instruments inquiry may be limited to “good faith” under what has been called “the rule of the pure heart and the empty head.” When diligence or inquiry is a condition of the purchaser’s right, it is said that good faith is not enough. This focus on honesty is appropriate to cases of good faith purchase; it is less so in cases of good faith performance.

c. Good faith in negotiation. This Section, like Uniform Commercial Code § 1-203, does not deal with good faith in the formation of a contract. Bad faith in negotiation, although not within the scope of this Section, may be subject to sanctions. Particular forms of bad faith in bargaining are the subjects of rules as to capacity to contract, mutual assent and consideration and of rules as to invalidating causes such as fraud and duress. See, for example, §§ 90 and 208. Moreover, remedies for bad faith in the absence of agreement are found in the law of torts or restitution. For examples of a statutory duty to bargain in good faith, see, e.g., National Labor Relations Act § 8(d) and the federal Truth in Lending Act. In cases of negotiation for modification of an existing contractual relationship, the rule stated in this Section may overlap with more specific rules requiring negotiation in good faith. See §§ 73, 89; Uniform Commercial Code § 2-209 and Comment.

d. Good faith performance. Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party’s performance.

e. Good faith in enforcement. The obligation of good faith and fair dealing extends to the assertion, settlement and litigation of contract claims and defenses. See,

e.g., §§ 73, 89. The obligation is violated by dishonest conduct such as conjuring up a pretended dispute, asserting an interpretation contrary to one's own understanding, or falsification of facts. It also extends to dealing which is candid but unfair, such as taking advantage of the necessitous circumstances of the other party to extort a modification of a contract for the sale of goods without legitimate commercial reason. See Uniform Commercial Code § 2-209, Comment 2. Other types of violation have been recognized in judicial decisions: harassing demands for assurances of performance, rejection of performance for unstated reasons, willful failure to mitigate damages, and abuse of a power to determine compliance or to terminate the contract. For a statutory duty of good faith in termination, see the federal Automobile Dealer's Day in Court Act, 15 U.S.C. §§ 1221-25 (1976).

In *Kuroda v. SPJS Holdings, L.L.C.*, CA No. 4030-CC (Del. Ch. April 15, 2009), a dispute among members of an LLC, the Chancellor dismissed plaintiff's allegations that the defendant members had breached the implied covenant of good faith and fair dealing by failing to pay him monies due, disparagements and threats because plaintiff had "failed to articulate a contractual benefit he was denied as a result of defendants' breach of an implied provision in the contract," and explained:

The implied covenant of good faith and fair dealing inheres in every contract and "requires 'a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits' of the bargain." The implied covenant cannot be invoked to override the express terms of the contract. Moreover, rather than constituting a free floating duty imposed on a contracting party, the implied covenant can only be used conservatively "to ensure the parties' 'reasonable expectations' are fulfilled." Thus, to state a claim for breach of the implied covenant, Kuroda "must allege a specific implied contractual obligation, a breach of that obligation by the defendant, and resulting damage to the plaintiff." General allegations of bad faith conduct are not sufficient. Rather, the plaintiff must allege a specific implied contractual obligation and allege how the violation of that obligation denied the plaintiff the fruits of the contract. Consistent with its narrow purpose, the implied covenant is only rarely invoked successfully.

This contractual duty of good faith and fair dealing is to be contrasted with the fiduciary duty of good faith, which is a component of the common law fiduciary duty of loyalty. See *Stone v. Ritter*, 911 A.2d 362 (Del. 2006) and Byron F. Egan, *Fiduciary Duty Issues in M&A Transactions* at 13-27, available at <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1166>. DLLCA §§ 18-1101(a)-(f) are counterparts of, and virtually identical to, §§ 17-1101(a)-(f) of the Delaware Revised Limited Partnership Act. See DEL. CODE ANN. tit. 6, § 17-1101 (2009). Thus, Delaware cases regarding contractual limitation of partner fiduciary duties should be helpful in the LLC context.

See Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 25 (2007), in which Delaware Supreme Court Chief Justice Steele argues that parties forming limited liability companies should be free to adopt or reject some or all of the fiduciary duties recognized at common law, that courts should look to the parties' agreement and apply a contractual analysis, rather than analogizing to traditional notions of corporate governance, in LLC fiduciary duty cases, and that:

Delaware's Limited Liability Company Act does not specify the duties owed by a member or manager. It does, however, like the Limited Partnership Act, provide for a default position "to the extent, at law or in equity" limited liability companies have "duties (including fiduciary duties)." These duties, in turn, "may be expanded or restricted or eliminated" in the agreement, provided that the "agreement may not eliminate the implied contractual covenant of good faith and fair dealing."

The same issues and considerations that arise in limited partnerships arise in governance disputes in limited liability companies. There is an assumed default to traditional corporate governance fiduciary duties where the agreement is silent, or at least not inconsistent with the common law fiduciary duties. Lack of clarity in the agreements on

this point may confuse the court and cause it to focus improperly when addressing the conduct complained of in a derivative action or in an action to interpret, apply, or enforce the terms of the limited liability company agreement. Predictably, but not necessarily correctly, Delaware courts will gravitate toward a focus on the parties' status relationship and not their contractual relationship in the search for a legal and equitable resolution of a dispute unless the agreement explicitly compels the court to look to its terms and not to the common law fiduciary gloss.

See supra note 488 and related text regarding Chief Justice Steele's views in respect of fiduciary duties in the limited partnership context.

In *Fisk Ventures, LLC v. Segal*, 2008 WL 1961156 (Del. Ch. 2008), Delaware Chancellor William Chandler wrote that LLCs are creatures of contract and that a prerequisite to any breach of contract analysis is to determine if there is a *duty* in the document that has been breached. The Chancellor quoted in footnote 34 Chief Justice Steele's article entitled *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 Del. J. Corp. L. 1, 4 (2007) ("Courts should recognize the parties' freedom of choice exercised by contract and should not superimpose an overlay of common law fiduciary duties..."), and found no provision in the LLC Agreement at issue that: "create[d] a code of conduct for all members; on the contrary, most of those sections expressly claim to limit or waive liability." The Chancellor wrote:

There is no basis in the language of the LLC Agreement for Segal's contention that all members were bound by a code of conduct, but, even if there were, this Court could not enforce such a code because there is no limit whatsoever to its applicability".

In addressing the breach of fiduciary duty claims asserted by plaintiff, the Chancellor focused on Delaware LLC Act § 18-1101(c) which allows for the complete elimination of all fiduciary duties in an LLC agreement. The Court then read the subject LLC Agreement to eliminate fiduciary duties because it flatly stated that:

No Member shall have any duty to any Member of the Company except as expressly set forth herein or in other written agreements. No Member, Representative, or Officer of the Company shall be liable to the Company or to any Member for any loss or damage sustained by the Company or to any Member, unless the loss or damage shall have been the result of gross negligence, fraud or intentional misconduct by the Member, Representative, or Officer in question....

Because the foregoing LLC Agreement exception for gross negligence, fraud or intentional misconduct did not create a fiduciary duty and the LLC Agreement did not otherwise expressly articulate fiduciary obligations, the foregoing LLC Agreement provision was held to be sufficient to eliminate defendant's fiduciary duties.

The Chancellor considered and disposed of plaintiff's "implied covenant of good faith and fair dealing" claim as follows:

Every contract contains an implied covenant of good faith and fair dealing that "requires a 'party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits' of the bargain." Although occasionally described in broad terms, the implied covenant is not a panacea for the disgruntled litigant. In fact, it is clear that "a court cannot and should not use the implied covenant of good faith and fair dealing to fill a gap in a contract with an implied term unless it is clear from the contract that the parties would have agreed to that term had they thought to negotiate the matter." Only rarely invoked successfully, the implied covenant of good faith and fair dealing protects the spirit of what was *actually bargained and negotiated for* in the contract. Moreover, because the implied covenant is, by definition, *implied*, and because it protects the *spirit* of the agreement rather than the form, it cannot be invoked where the contract itself expressly covers the subject at issue.

Here, Segal argues that Fisk, Rose and Freund breached the implied covenant of good faith and fair dealing by frustrating or blocking the financing opportunities proposed by Segal. However, neither the LLC Agreement nor any other contract endowed him with the right to unilaterally decide what fundraising or financing opportunities the Company should pursue, and his argument is “another in a long line of cases in which a plaintiff has tried, unsuccessfully, to argue that the implied covenant grants [him] a substantive right that [he] did not extract during negotiation.” Moreover, the LLC Agreement *does* address the subject of financing, and its specifically requires the approval of 75% of the Board. Implicit in such a requirement is the right of the Class B Board representatives to disapprove of and therefore block Segal’s proposals. As this Court has previously noted, “[t]he mere exercise of one’s contractual rights, without more, cannot constitute ... a breach [of the implied covenant of good faith and fair dealing].” Negotiating forcefully and within the bounds of rights granted by the LLC agreement does not translate to a breach of the implied covenant on the part of the Class B members.

In Texas a common-law duty of good faith and fair dealing does not exist in all contractual relationships. *Blackmon-Dunda v. Mary Kay, Inc.*, 2009 WL 866214 (Tex.App.-Dallas). Rather, the duty arises only when a contract creates or governs a special relationship between the parties. *Subaru of Am. v. David McDavid Nissan*, 84 S.W.3d 212, 225 (Tex. 2002). A “special relationship” has been recognized where there is unequal bargaining power between the parties and a risk exists that one of the parties may take advantage of the other based upon the imbalance of power, e.g., insurer-insured (*see Arnold v. Nat’l County Mut. Fire Ins. Co.*, 725 S.W.2d 165, 167 (Tex.1987)). The elements which make a relationship special are absent in the relationship between an employer and an employee. *See City of Midland v. O’Bryant*, 18 S.W.3d 209, 215 (Tex. 2000). While there are no reported Texas cases as to whether a contractual duty of good faith and fair dealing exists between Members in an LLC, or between Managers and Members in a Texas LLC, it is likely that the duty of good faith and fair dealing exists in those LLC relationships, just as fiduciary duties likely exist, except in each case to the extent that the duty has been restricted by contract as permitted by the Tex. LLC Stats. *See supra* notes 486 and 618.

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DLLCA § 18-1101(e) provides:

(e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

DLLCA § 18-1101(e) was followed in *In re Heritage Organization, LLC*, 2008 WL 5215688 (Bankr. N.D. Tex. Dec. 12, 2008), which involved a bankruptcy trustee’s breach of fiduciary duty claims against former officers of a bankrupt Delaware LLC which had an LLC agreement that eliminated fiduciary duties in the following sweeping language:

The Manager shall not be required to exercise any particular standard of care, nor shall he owe any fiduciary duties to the Company or the other Members. Such excluded duties include, by way of example, not limitation, any duty of care, duty of loyalty, duty of reasonableness, duty to exercise proper business judgment, duty to make business opportunities available to the company, and any other duty which is typically imposed upon corporate officers and directors, general partners or trustees. The Manager shall not be held personally liable for any harm to the Company or the other Members resulting from any acts or omissions attributed to him. Such acts or omissions may include, by way of example but not limitation, any act of negligence, gross negligence, recklessness, or intentional misconduct.

Faced with this broad clause, the bankruptcy court in *Heritage* held that the defendants had no fiduciary duties to breach, and thus rejected the trustee’s breach of fiduciary duty claim. *Cf. Kahn v. Portnoy*, CA

Although the Tex. LLC Stats., unlike their Delaware counterpart, do not include provisions that expressly emphasize the principles of freedom of contract and enforceability of LLC Company Agreements that expand, restrict or eliminate liability for breach of fiduciary duties, the legislative history and scope of LLC Act section 2.20B, the precursor to TBOC section 101.401, indicate that there may be more latitude to exculpate Managers and Members for conduct that would otherwise breach a fiduciary duty under the Tex. LLC Stats. than under provisions of the TBOC and the TBCA relating specifically to corporations. Provisions in Company Agreements purporting to limit fiduciary duties need to be explicit and conspicuous as coyness can lead to unenforceability.⁶²⁵ A provision which purports to limit fiduciary duties in the LLC context “to the maximum extent permitted by the laws in effect at the effective date of this Company Agreement, as such Agreement may be amended from time to time” probably is not adequate.

While courts may be tempted to find contractual limitations on fiduciary duties ambiguous in particular situations where it appears that the provision is allowing a fiduciary to get away with something egregious, they should generally recognize the ability of LLCs to

No. 3515-CC (Del. Ch. December 11, 2008) (under freedom of contract principles, fiduciary duties held to be defined, but not eliminated, by LLC agreement).

⁶²⁴ See *supra* note 618 and related text

⁶²⁵ *Solar Cells, Inc. v. True N. Partners, LLC*, No. CIV.A.19477, 2002 WL 749163, at *4 (Del. Ch. Apr. 25, 2002). In *Solar Cells*, Chancellor Chandler enjoined the merger of an LLC with an affiliate of the controlling owner on the basis of the Delaware “entire fairness” doctrine notwithstanding an operating agreement section providing in relevant part as follows:

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

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

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

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

contractually limit fiduciary duties. In *McConnell v. Hunt Sports Enterprises*,⁶²⁶ the court stated that Members (of what was apparently a Member-managed LLC) are generally in a fiduciary relationship and would ordinarily be prohibited from competing with the LLC. The court, however, recognized the validity of a provision in the Ohio LLC's operating agreement (the equivalent of a Texas LLC's Company Agreement) providing:

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

The Ohio court in *McConnell* found that this provision clearly and unambiguously permitted a Member to compete against the LLC to obtain a hockey franchise sought by the LLC.⁶²⁷ The court noted the trial court's finding that the competing Members had not engaged in willful misconduct, misrepresentation or concealment.⁶²⁸

Persons who control Members can be held responsible for fiduciary duty breaches of the Members.⁶²⁹ A legal claim exists in some jurisdictions for aiding and abetting a breach of fiduciary duty, whether arising under statute, contract, common law or otherwise.⁶³⁰

⁶²⁶ 725 N.E.2d 1193 (Ohio App. 1999).

⁶²⁷ *Id.* at 1215.

⁶²⁸ *Id.* at 1214. *But see Dragt v. Dragt/DeTray, LLC*, 161 P.3d 473 (Wash. App. 2007) (holding that non-managing members of a Washington LLC do not owe fiduciary duties to other members unless fiduciary duties are imposed under the operating agreement).

⁶²⁹ In *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, 2009 WL 1124451 (Del.Ch.), Delaware Vice Chancellor Strine wrote that "in the absence of a contrary provision in the LLC agreement, the manager of an LLC owes the traditional fiduciary duties of loyalty and care to the members of the LLC," and held that LLC agreement provisions that "Members shall have the same duties and obligations to each other that members of a limited liability company formed under the Delaware Act have to each other" and "except for any duties imposed by this Agreement . . . each Member shall owe no duty of any kind towards the Company or the other Members in performing its duties and exercising its rights hereunder or otherwise" had the effect of leaving in place the traditional Delaware common law fiduciary duties. The Vice Chancellor then summarized those duties as follows in footnote 33:

The Delaware LLC Act is silent on what fiduciary duties members of an LLC owe each other, leaving the matter to be developed by the common law. The LLC cases have generally, in the absence of provisions in the LLC agreement explicitly disclaiming the applicability of default principles of fiduciary duty, treated LLC members as owing each other the traditional fiduciary duties that directors owe a corporation. Moreover, when addressing an LLC case and lacking authority interpreting the LLC Act, this court often looks for help by analogy to the law of limited partnerships. In the limited partnership context, it has been established that "[a]bsent a contrary provision in the partnership agreement, the general partner of a Delaware limited partnership owes the traditional fiduciary duties of loyalty and care to the Partnership and its partners." (Citations omitted)

The court then held the owner and manager of the LLC personally liable for the fiduciary duty breaches of the LLC's managing member.

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

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

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

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

(iii) The transaction is fair to the LLC as of the time it is authorized, approved or ratified by the Managers or Members.⁶³¹

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.⁶³²

I. Indemnification. Under the Tex. LLC Stats., an LLC may indemnify any of its Members, Managers, officers or other persons subject only to such standards and restrictions, if any, as may be set forth in the LLC's certificate of formation or Company Agreement.⁶³³ The restrictions on indemnification applicable to regular corporations are not applicable to LLCs.⁶³⁴ This approach is similar to the approach taken under Delaware law, but could be subject to

⁶³⁰ *Fitzgerald v. Cantor*, No. CIV.A.16297-NC, 1999 WL 182573, at *1 (Del. Ch. Mar. 25, 1999) (holding that the elements of a claim for aiding and abetting a breach of fiduciary duty are: (1) the existence of a fiduciary relationship; (2) the fiduciary breached its duty; (3) a defendant, who is not a fiduciary, knowingly participated in a breach; and (4) damaged to the plaintiff resulted from the concerted action of the fiduciary and the non-fiduciary.

⁶³¹ LLC Act § 2.17; TBOC § 101.255 as amended in the 2009 Legislative Session by S.B. 1442 § 44. *See infra* Appendix D.

⁶³² *Id.*; *see* TRPA § 4.04; *see also* TBOC § 152.204.

⁶³³ LLC Act § 2.20A; TBOC § 101.402.

⁶³⁴ *See generally* Chapter 8 of the TBOC, specifically § 8.002(a).

public policy limitations.⁶³⁵ In any event, this change increases the importance of having long form indemnification because a “to maximum extent permitted by law” provision may encompass things neither the drafter nor the client foresaw, which could lead courts to read in public policy limits or find the provision void for vagueness. The indemnification provisions should specify who is entitled to be indemnified for what and under what circumstances, which requires both thought and careful drafting.

J. Capital Contributions. The contribution of a Member may consist of any tangible or intangible benefit to the LLC or other property of any kind or nature, including a promissory note, services performed, a contract for services to be performed or other interests in or securities or other obligations of any other LLC or other entity.⁶³⁶ The Company Agreement ordinarily would contain provisions relative to capital accounts and the allocation of profits and losses comparable to those in a limited partnership agreement.

K. Allocation of Profits and Losses; Distributions. Allocations of profits and losses, and distributions of cash or other assets, of an LLC are made to the Members in the manner provided by the Company Agreement.⁶³⁷ If the Company Agreement does not otherwise provide, allocations and distributions are made on the basis of the agreed value of the contributions made by each Member.⁶³⁸ A Member is not entitled to receive distributions from an LLC prior to its winding up unless specified in the Company Agreement if the LLC is governed by the TBOC.⁶³⁹ 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.⁶⁴⁰ A Member who receives a distribution that is not permitted under the preceding sentence has no liability to return the distribution under the LLC Act unless the Member knew that the distribution was prohibited.⁶⁴¹ The limitations on distributions by an LLC

⁶³⁵ Cf. DEL. CODE ANN. tit. 6, § 18-108 (1999 & Supp. 2002) (providing that an LLC may, and shall have the power to, indemnify and hold harmless Members, Managers, and other persons from and against any and all claims).

⁶³⁶ LLC Act § 5.01; TBOC § 1.002(9). LLC Act § 5.02 and TBOC §§ 101.052 and 101.151 provide that written obligations to make contributions are enforceable, except to the extent otherwise provided in the Articles or Regulations (or Certificate of Formation or Company Agreement, as appropriate), and LLC Act § 4.07 and TBOC § 101.111(b) provide that an obligation to make a contribution will survive the assignment of the membership interest. LLC Act § 5.02 and TBOC § 101.156 provide that a conditional obligation to make a contribution to an LLC, which includes contributions payable upon a discretionary call prior to the time the call occurs, must be in writing and signed by the Member, and may not be enforced unless the conditions of the obligation have been satisfied or waived.

⁶³⁷ LLC Act §§ 5.02-1, 5.03; TBOC §§ 101.052, 101.201. A new Subchapter M was added to TBOC Chapter 101 in the 2009 Legislative Session by S.B. 1442 § 45 to permit LLCs to establish series of members, managers, membership interests or assets to which different assets and liabilities may be allocated. Through appropriate provisions in the Company Agreement and Certificate of Formation, the assets of one series could be isolated from the liabilities attributable to a different series. See *infra* [Appendix D](#).

⁶³⁸ LLC Act §§ 5.02-1, 5.03; TBOC §§ 101.052, 101.201.

⁶³⁹ TBOC § 101.204 provides this as a new default rule, subject to contrary agreement under § 101.052. The older LLC Act, however, simply provides that Members are entitled to pre-winding up distributions in accordance with the Articles of Incorporation. LLC Act § 5.04.

⁶⁴⁰ LLC Act § 5.09A; TBOC § 101.206.

⁶⁴¹ LLC Act § 5.09B; TBOC § 101.206(d).

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.⁶⁴²

L. Owner Limited Liability Issues. The Tex. LLC Stats. provide that, except as provided in the Company Agreement, a Member or Manager is not liable to third parties for the debts, obligations or liabilities of an LLC, although Members are liable for the amount of any contributions they agreed in writing to make.⁶⁴³ Members may participate in the management of

⁶⁴² TBOC § 101.206(f) as amended in 2009 Legislative Session by S.B. 1442 § 41. *See infra* Appendix D.

⁶⁴³ LLC Act §§ 4.03, 5.02A; TBOC §§ 101.114; 101.151. LLC Act § 4.03 provides as follows:

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

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

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

(emphasis added)

TBOC § 101.114 provides for substantially the same protection of Members and Managers as LLC Act § 4.03A. *See infra* notes 821-847 and related text regarding uncertainties as to the extent to which this statutory limitation of liability will be recognized in other states.

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

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

(emphasis added)

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

In the 2009 Legislative Session, S.B. 1773 by Sen. Troy Fraser, *available at* <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=81R&Bill=SB1773>, would have provided that the limits on corporate veil piercing in TBCA art. 2.21 and TBOC Chapter 21 are applicable to LLCs.

the LLC without forfeiting this liability shield,⁶⁴⁴ but may be liable for their own torts.⁶⁴⁵ Since the LLC Act deals expressly with the liability of Members and Managers for LLC obligations, the principles of “piercing the corporate veil” should not apply to LLCs in Texas, although this issue is not settled.⁶⁴⁶ Alter ego veil piercing principles similar to those applicable to Delaware

S.B. 1773 passed the Senate without opposition, but died in the House as it was not reached on the last House Calendar when the 2007 Legislative session adjourned *sine die*. The fate of S.B. 1773 was shared by over 200 bills that were on the last House Calendar behind S.B. 362, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=81R&Bill=SB362>, which would have required a voter to present an acceptable form of photo identification at the polling place before being allowed to vote. See Robert T. Garrett and Terrence Stutz, *House’s early exit led to chaotic end*, Dallas Morning News, June 3, 2009, at 6A.

⁶⁴⁴ The LLC Act does not contain any provision comparable to TRLPA § 3.03 or TBOC § 153.102, which make a limited partner liable for partnership obligations under certain circumstances if “the limited partner participates in the control of the business.”

⁶⁴⁵ Even though corporate veil piercing theories should not be applicable to Texas LLCs, parties dealing with an LLC are not without remedies against those responsible for the actions of the entity in appropriate situations. In contract situations, persons dealing with an LLC can condition their doing business with the LLC on (i) an LLC including in its Regulations or Operating Agreement provisions for the personal liability of Members or Managers in specified circumstances or (ii) Members or Managers personally guaranteeing obligations of the LLC. In the tort context, a Member or Manager individually may be a direct tortfeasor and liable under traditional tort law theories for his own conduct. See *Walker v. Anderson*, 232 S.W.3d 899 (Tex. App.—Dallas 2007); *Shapolsky v. Brewton*, 56 S.W.3d 120, 133 (Tex. App.—Houston [14th Dist.] 2001, pet. denied); *Weber v. U.S. Sterling Sec., Inc.*, 924 A.2d 816 (Conn. 2007) (holding that liability protection of managers and members under the Delaware LLC statute does not protect members or managers from direct liability for their own torts). In addition, Texas and federal fraudulent transfer laws provide protection to entity creditors where insiders have improperly transacted business with an entity which is insolvent or would be rendered insolvent thereby. See 11 U.S.C. §548 (2008); TEX. BUS. & COM. CODE ANN. §§24.001-013 (Vernon 2010); Byron F. Egan and H. Laurence Tafe, III, *Private Company Acquisitions*, 120–122, prepared for the Penn State Law and City Bar Center, New York City Bar, Fifth Annual Institute on Corporate, Securities, and Related Aspects of Mergers and Acquisitions on September 26, 2008, and available at: <http://www.jw.com/site/jsp/publicationsinfo.jsp?id=1021>.

⁶⁴⁶ Despite the clear legislative intent to the contrary, some lower court opinions in Texas have suggested that veil-piercing concepts from corporation law are applicable to LLCs. But they have done so only in narrow circumstances, have acknowledged that a mere absence of corporate formalities is not sufficient to support veil piercing, and have consistently recognized the applicability of TBCA art. 2.21 to LLC veil-piercing cases. See Elizabeth S. Miller, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 TEX. J. OF BUS. L. 405, 416-426 (Fall 2009).

In *Pinebrook Props., Ltd. v. Brookhaven Lake Prop. Owners Ass’n*, 77 S.W.3d 487, 500 (Tex. App.—Texarkana 2002), a complicated real estate use and maintenance case, the Texarkana Court of Appeals assumed that corporate veil piercing rules must be applicable to an LLC because the LLC is a limited liability entity. The court cited *Castleberry*, even though *Castleberry* was decided five years before the enactment of the LLC Act, made no reference to the LLC (or any entity other than a business corporation) and had been repudiated by the Legislature in amendments to TBCA art. 2.21A. The Texarkana court did conclude that failure to comply with corporate formalities is no longer a relevant factor in the veil-piercing context and cited TBCA art. 2.21 as the relevant governing authority.

McCarthy v. Wani Venture, A.S., 251 S.W.3d 573 (Tex. App.—Houston [1st Dist] 2007) held that corporate veil piercing principles apply to Texas LLCs notwithstanding the wording of LLC Act § 4.03(a) that “[e]xcept and to the extent the regulations specifically provide otherwise, a member or manager is not liable for the debts, obligations or liabilities of a limited liability company, including under a judgment, decree, or order of a court.” The court in *McCarthy* acknowledged that the LLC Act does not address whether the “corporate veil” of a LLC may be pierced, but cited *Pinebrook* and several cases from other jurisdictions to support its

conclusion that veil piercing principles are applicable to LLCs under the LLC Act. *Id.* at 590. The court failed to incorporate into its analysis the clear legislative intent embodied in LLC Act § 4.03—namely, that the corporate veil piercing principles should not be applicable to LLCs and that LLCs were intended to be free from the uncertainties created by *Castleberry*. Nonetheless, *McCarthy* still recognizes that actual fraud is necessary to pierce the veil of an LLC, and that TBCA art. 2.21 is still the applicable standard. The jury instructions in *McCarthy* required that, in order to hold the defendant shareholders directly liable, the jury would have to find that defendants caused the LLC “to be used to perpetrate a fraud and did perpetrate an actual fraud . . . primarily for [their] own personal benefit.” In fact, no Texas court has ever applied corporate veil piercing principles to an LLC without also applying the restrictions of TBCA art. 2.21.

In a non-Texas case, *Taurus IP, LLC v. DaimlerChrysler Corp.*, 534 F.Supp. 2d 849 (W.D. Wis. 2008), the court, relying on *Castleberry*, does hold the non-owner Manager of a Texas LLC individually liable by employing a novel interpretation of TBCA art. 2.21. According to the *Taurus* court, TBCA art. 2.21 “limits alter ego liability only for shareholders, owners, subscribers and affiliates, not directors, officers, managers or members.” *Id.* at 871. The court eventually sidesteps the limits of TBCA art. 2.21 by asserting that the non-owner manager was never a shareholder or owner of the LLC, simply a Manager. In declaring this statutory exemption to veil-piercing liability inapplicable to Managers, the court ignores the fact that veil-piercing liability itself is inapplicable to Managers (much as it is inapplicable to officers and directors), and engages in an alter ego analysis that is entirely defective. But more problematic than the *Taurus* court’s apparent application of veil piercing to non-owner Managers is the court’s belief that because “Members” were not specifically included in the protections of TBCA art. 2.21, it was the Texas Legislature’s intent to give Members of an LLC even *less* protection from individual liability than shareholders of a Texas corporation. This is simply not the case. As discussed above, Members were not mentioned in TBCA art. 2.21 because it was never envisioned by the Legislature or the Bar Committee that veil piercing would be applied to Members of an LLC; had this been anticipated, LLC Act § 4.03 would have been drafted to mirror TBCA art. 2.21. (This also explains the absence of a reference to TBCA art. 2.21 in LLC Act § 8.12, which incorporates a few technical sections of the TBCA into the LLC Act: No reference was included because it was believed that veil-piercing would not be applied to LLCs.)

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

Although not the intent of the Legislature and inconsistent with the clear wording of LLC Act § 4.03A, it is at least understandable that some courts would apply veil piercing to Texas LLCs. But to apply this corporate law theory to LLCs without also applying the limitations of TBCA art. 2.21 is inconsistent—not only with the express intent of the Bar Committee and the Legislature—but with the holdings of every single Texas court that has addressed the issue. The Texas Supreme Court’s decision in *SSP* (*see supra* note 281 and related text) makes this even clearer: by extending TBCA art. 2.21 to cases grounded purely in tort law, the Texas Supreme Court has acknowledged the Legislature’s intent that TBCA art. 2.21 be the law of the land.

Texas has its own body of precedent in the corporate context with respect to piercing the corporate veil, and if the Texas Supreme Court were to determine to look to corporate precedent in determining whether to respect the limitation of liability provided by the LLC Act, the Texas court would not necessarily consider the same factors as the courts in the reported cases from other jurisdictions. In *Gearhart Industries, Inc. v. Smith International*, 741 F.2d 707, 719 n.4 (5th Cir. 1984), the Fifth Circuit sharply criticized the parties’ failure to cite Texas jurisprudence:

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

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.⁶⁴⁷ Some state LLC statutes expressly deal with the veil piercing issue by providing that the LLC veil will be pierced to the same extent as the corporate veil⁶⁴⁸ or that the Members will have the same liabilities as corporate shareholders.⁶⁴⁹

M. Nature and Classes of Membership Interests. A membership interest in an LLC is personal property.⁶⁵⁰ It does not confer upon the Member any interest in specific LLC property.⁶⁵¹ A membership interest may be evidenced by a certificate if the Company Agreement so provides.⁶⁵²

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.⁶⁵³ The Company

If the Texas Supreme Court were to sanction veil piercing concepts to hold Members or Managers of an LLC liable for LLC obligations, the Supreme Court should also apply the public policy inherent in TBCA art. 2.21 and make actual fraud a requirement for veil piercing.

There have been a number of cases in other jurisdictions in which courts have applied corporate veil piercing theories to LLCs. *See, e.g., N. Tankers (Cyprus) Ltd. v. Backstrom*, 967 F. Supp. 1391, 1402 (D. Conn. 1997); *Hollowell v. Orleans Reg'l. Hosp.*, No. CIV.A.95-4029, 1998 WL 283298, at *9 (E.D. La. May 29, 1998); *In re Multimedia Communications Group Wireless Assoc.*, 212 B.R. 1006 (Bankr. M.D. Fla. 1997); *Marina, LLC v. Burton*, No. CA 97-1013, 1998 WL 240364, at *7 (Ark. App. May 6, 1998); *Ditty v. CheckRite, Ltd.*, 973 F. Supp. 1320, 1336 (D. Utah 1997). In *Ditty*, a case examining a Utah limitation of Member liability statute similar to LLC Act § 4.03, the court wrote: “While there is little case law discussing veil piercing theories outside the corporate context, most commentators assume that the doctrine applies to limited liability companies.” *Ditty*, 973 F. Supp. at 1336. The court then proceeded to uphold the limited liability of the sole Member, officer and director for the LLC, noting that the fact that defendant “played an active role in the firm’s business is, at best, only marginally probative of the factors considered when determining whether to pierce the corporate veil.” *Id.* In the court’s view, the significant factors in determining whether to pierce the entity are “undercapitalization of a close corporation; failure to observe corporate formalities; siphoning of corporate funds by the dominant shareholder; nonfunctioning of other officers and directors; and the use of the corporation as a facade for operations of the dominant shareholder.” *Id.* Texas has its own body of precedent in the corporate context with respect to piercing the corporate veil and, if a Texas court were to determine to look to corporate precedent in determining whether to respect the limitation of liability provided by the LLC Act, would not necessarily consider the same factors as the courts in the reported cases from other jurisdictions. *See generally* Elizabeth S. Miller, *Cases Involving Limited Liability Companies and Registered Limited Liability Partnerships*, PUBOGRAM, A.B.A. SEC. OF BUS. L. COMMITTEE ON PARTNERSHIPS AND UNINCORPORATED BUS. ORG., Vol. XXIV, No. 3, at 19; Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 8-9 (Nov. 1995).

⁶⁴⁷ *NetJets Aviation, Inc. v. LHC Communications, LLC*, 537 F.3d 168, 176 (2d Cir. 2008); *Heritage Organization, LLC*, 2008 WL 5215688 (Bankr. N.D. Tex. Dec. 12, 2008).

⁶⁴⁸ *See* COLO. REV. STAT. 7-80-107 (1998); MINN. STAT. ANN. 322B.303.2 (1995 & Supp. 1998); N.D. CENT. CODE §§ 10-32-29.3, 44-22-09 (2001); WASH. REV. CODE ANN. § 25.15.060 (West Supp. 2003).

⁶⁴⁹ *See* W. VA. CODE § 31-B-3-303(b) (2003).

⁶⁵⁰ LLC Act § 4.04; TBOC § 101.106.

⁶⁵¹ LLC Act § 4.04; TBOC § 101.106.

⁶⁵² LLC Act § 4.05B; TBOC § 3.201(e).

⁶⁵³ LLC Act § 4.02; TBOC § 101.104.

Agreement could provide for different classes of Members, each authorized to elect a specified number or percentage of the Managers.⁶⁵⁴ The Tex. LLC Stats. generally allow even more flexibility in structuring classes of Members than is available under Texas law in structuring classes of corporate stock.⁶⁵⁵

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.⁶⁵⁶ The offer and sale

⁶⁵⁴ See LLC Act § 2.13; TBOC § 101.104.

⁶⁵⁵ See 1993 LLC Bill Analysis at 2; see also TBOC §§ 21.152, 101.104.

⁶⁵⁶ The Securities Act of 1933, 15 U.S.C.A. 77a, et seq. (1997) (the “1933 Act”), in § 77b(a)(1) defines the term “security” to include:

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

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

Since *Howey*, however, the Supreme Court has endorsed relaxation of the requirement that an investor rely only on others’ efforts, by omitting the word “solely” from its restatements of the *Howey* test. And neither our court nor our sister circuits have required that an investor like *Robinson* expect profits “solely” from the efforts of others. Requiring investors to rely wholly on the efforts of others would exclude from the protection of the securities laws any agreement that involved even slight efforts from investors themselves. It would also exclude any agreement that offered investors control in theory, but denied it to them in fact. Agreements do not annul the securities laws by retaining nominal powers for investors unable to exercise them.

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

of an interest must either be registered under applicable federal and state securities laws⁶⁵⁷ or effected in a private⁶⁵⁸ or other transaction structured to be exempt from those requirements.⁶⁵⁹

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

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

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

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

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

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

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

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Section 5 of the 1933 Act provides that a registration statement must be in effect as to a non-exempt security before any means of transportation or communication in interstate commerce or of the mails may be used for the purpose of sale or delivery of such non-exempt security. The primary purpose of the 1933 Act is to provide a full disclosure of material information concerning public offerings of securities to investors. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976). The registration statement is the primary means for satisfying the full disclosure requirement. The 1933 Act (particularly §§ 5-7 and Schedule A) and Regulations C and S-K thereunder contain the general registration requirements. The Securities and Exchange Commission (“SEC”) has set forth a number of registration forms to be used under varying circumstances. Form S-1 is the basic form to be used by an issuer unless another form is specifically prescribed. There are basically three stages in the registration process: the pre-filing stage, the waiting period, and the post-effective stage. During the pre-filing stage, § 5(c) of the 1933 Act prohibits the use of interstate facilities (including telephones) or the mails to “offer to sell.” Further, § 5(a) prohibits sales or deliveries at any time before the “effective” date of the registration statement, which includes the pre-filing stage. The term sale is defined to include “every contract of sale or disposition of a security or interest in a security, for value.” During the waiting period, written offers are still prohibited, but oral offers are permitted. Since the registration statement is still not “effective,” sales or deliveries are still forbidden. During the post-effective stage, sales may be

made freely. A prospectus satisfying the requirements under the 1933 Act must accompany any interstate or mailed “delivery” of the security if the prospectus has not preceded the delivery. *See generally*, LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION ch. 2B (1988). Unlike the federal statute that seeks full disclosure, many of the state “blue sky” acts are based on a concept known as “merit regulation.” *Id.* at chs. 1B, 1C. Under these systems, the state securities administrator can prohibit a particular security from being offered in that state if the administrator determines that the terms of the offering are not “fair, just and equitable.” Most state acts do not define “fair, just and equitable.” In the Blue Sky Cases, the United States Supreme Court validated a number of state acts regulating securities on the basis that the acts neither violated the Fourteenth Amendment nor unduly burdened interstate commerce. *See Hall v. Geiger - Jones Co.*, 242 U.S. 539 (1917); *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559 (1917); *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917).

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Section 4(2) of the 1933 Act exempts from the registration requirements of the 1933 Act “transactions by an issuer not involving any public offering” – generally referred to as “private placements.” The U.S. Supreme Court has held that the § 4(2) exemption must be interpreted in light of the statutory purpose of the 1933 Act to “protect investors by promoting full disclosure of information thought necessary to informed investment decisions” and that its applicability “should turn on whether the particular class affected needs the protection of the Act.” *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119, 124-25 (1953). Subsequent court opinions have enumerated a number of more specific factors to be considered in determining whether a transaction involves a “public offering,” including the following:

- (a) the number of offerees (there is no number of offerees that always makes an offering either private or public; 25 to 35 is generally considered consistent with a private offering, but the sophistication of the offerees is more important; an offer to a single unqualified investor can defeat the exemption and an offering to a few hundred institutional investors can be exempt; note that the judicial focus is upon the number of persons to whom the securities are offered, not the number of actual purchasers);
- (b) offeree qualification (each offeree should be sophisticated and able to bear the economic risk of the investment; a close personal, family or employment relationship should also qualify an offeree);
- (c) manner of offering (the offer should be communicated directly to the prospective investors without the use of public advertising or solicitation);
- (d) availability of information (each investor should be provided or otherwise have access to information comparable to that contained in a registration statement filed under the 1933 Act; commonly investors are furnished a “private offering memorandum” describing the issuer and the proposed transaction in at least as much detail as would be found in a registration statement filed with the SEC for a public offering registered under the 1933 Act); and
- (e) absence of redistribution (the securities must come to rest in the hands of qualified purchasers and not be redistributed to the public; securities sold in a private placement generally may be replaced privately, freely sold by a person who is not an affiliate of the issuer in limited quantities to the public pursuant to SEC Rule 144, 17 C.F.R. 230.144 (2008), after a one-year holding period (if the issuer files reports with the SEC, the securities may be sold in limited quantities to the public pursuant to Rule 144 after a six-month holding period), or sold to the public pursuant to a registration statement filed and effective under the 1933 Act; the documentation of a private placement normally includes contractual restrictions on subsequent transfers of the securities purchased).

See 1933 Act Release No. 33-8869 (December 6, 2007); *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 900 (5th Cir. 1977); Carl W. Schneider, *The Statutory Law of Private Placements*, 14 REV. SEC. REG. 869, 870 (1981); ABA Comm. on Fed. Regulation of Sec., *Integration of Securities Offerings: Report of the Task Force on Integration*, 41 BUS. LAW. 595, 595 (1986); C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L. J. 1081, 1120-24 (1988).

SEC Regulation D (“Reg D”), 17 C.F.R. 230.501-506 (2007), became effective April 15, 1982 and is now the controlling SEC regulation for determining whether an offering of securities is exempt from registration under

Prior to September 1, 1995, an LLC membership interest represented by a certificate would ordinarily have been considered a “security” for the purposes of Chapter 8 of the Texas Business and Commerce Code as in effect prior to that date (“Pre 9/1/95 B&CC”).⁶⁶⁰ Such an interest would ordinarily have been considered a “certificated security” under Pre 9/1/95 B&CC section 8.102 because it would have been (a) represented by an instrument issued in bearer or registered form; (b) of a type dealt in as a medium for investment; and (c) a class or series of shares, participations, interests or obligations. Under Pre 9/1/95 B&CC, security interests in certificated LLC interests would have been perfected by possession, as in the case of corporate shares.⁶⁶¹ Security interests in membership interests which were not evidenced by an instrument would have been perfected by a financing statement filing under Pre 9/1/95 B&CC section 9.⁶⁶²

As of September 1, 1995, LLC membership interests are not “securities” governed by Chapter 8 of the Texas Business & Commerce Code, as amended by House Bill 3200 (“H.B. 3200” and “Post 9/1/95 B&CC”), unless the interests are dealt in or traded on securities exchanges or markets or unless the parties expressly agree to treat them as such.⁶⁶³ Under Post 9/1/95 B&CC Chapter 9, LLC membership interests should be classified as “general

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

⁶⁵⁹ Section 3(a)(11) of the 1933 Act exempts from the registration requirements of the 1933 Act “any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or if a corporation, incorporated by and doing business within, such State or Territory.” Consequently there are two principal conditions to the intrastate offering exemption: (a) that the entire issue of securities be offered and sold exclusively to, and come to rest in the hands of, residents of the state in question (an offer or sale to a single non-resident will render the exemption unavailable to the entire issue); and (b) the issuer be organized under the laws of and doing substantial business in the state. Rule 147 promulgated under the 1933 Act articulates specific standards for determining whether an offering is intrastate within the meaning of Section 3(a)(11).

⁶⁶⁰ Act of June 17, 1983, 68th Leg., R.S., ch. 442, § 1, 1983 Tex. Gen. Laws 2511, *amended by* Act of June 16, 1995, 74th Leg., R.S., ch. 962, § 1, sec. 8.102, 1995 Tex. Gen. Laws 4760, 4761.

⁶⁶¹ Pre 9/1/95 B&CC § 8.321.

⁶⁶² A membership interest not represented by an instrument would be a “general intangible” under Pre 9/1/95 B&CC § 9.106. A security interest therein would attach as provided in Pre 9/1/95 B&CC § 9.203 when the debtor has signed a proper security agreement, value has been given and the debtor has rights therein, and would be perfected by a financing statement filing under Pre 9/1/95 B&CC § 9.302.

⁶⁶³ Post 9/1/95 B&CC §§ 8.102, 8.103(c).

intangibles,” whether or not represented by a certificate, and security interests would be perfected by a financing statement filing.⁶⁶⁴

Under the Tex. LLC Stats., a judgment creditor of a Member may on application to a court of competent jurisdiction secure a “charging order” against the Member’s membership interest.⁶⁶⁵ In a “charging order” a court “charges” the membership interest such that any distributions thereon are made as directed by the court, but does not order foreclosure of the interest or compel any distributions. A charging order should not permit a judgment creditor of a Member to receive distributions on an interest subject to a prior perfected security interest.

N. Assignment of Membership Interests. Unless otherwise provided in an LLC’s Company Agreement, a Member’s interest in an LLC is assignable in whole or in part.⁶⁶⁶ 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.⁶⁶⁷ 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.⁶⁶⁸ 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.⁶⁶⁹ 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.⁶⁷⁰ Until an assignee is admitted as a Member, the assignee does not have liability as a Member solely as a result of the assignment.⁶⁷¹

⁶⁶⁴ Post 9/1/95 B&CC §§ 9.102(a)(42), 9.310. An LLC membership interest held in a securities account at a broker or dealer would be a “financial asset” and a “security entitlement” under Post 9/1/95 B&CC §§ 8.102(a)(17), 8.103(c) and 8.501(b)(1), and a security interest therein could be perfected by “control” or by filing under Post 9/1/95 B&CC §§ 9.106 and 9.115.

⁶⁶⁵ LLC Act § 4.06A, as amended in 2007 by H.B. 1737, provides:

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

See LLC Act § 7.03. TBOC § 101.112 provides substantially the same.

⁶⁶⁶ LLC Act § 4.05A; TBOC § 101.108.

⁶⁶⁷ *Id.*

⁶⁶⁸ LLC Act § 4.05A; TBOC § 101.109.

⁶⁶⁹ LLC Act § 4.05A; TBOC § 101.111.

⁶⁷⁰ LLC Act § 4.07A; TBOC §§ 101.109(b); 101.052. Under Tex. LLC Stats., an assignee who becomes a Member (i) has (to the extent assigned) the rights and powers, and is subject to the restrictions of, a Member under the Company Agreement and the Tex. LLC Stats., and (ii) becomes liable for the obligations of the assignor to make contributions known to him at the time he becomes a member or as provided in the Company Agreement, although the assignment does not release the assignor from his liabilities to the LLC. LLC Act § 4.07B; TBOC §§ 101.110; 101.111(b).

⁶⁷¹ LLC Act § 4.05C; TBOC § 101.109(c).

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.⁶⁷²

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

- (1) the expiration of the period (if any) fixed for its duration, which may be perpetual;⁶⁷³
- (2) any event specified in its certificate of formation or Company Agreement to cause dissolution, or to require the winding up or termination, of the LLC;⁶⁷⁴
- (3) the action of the Members to dissolve the LLC (in the absence of a specific provision in its certificate of formation or Company Agreement, the vote will be by a majority of the Members);⁶⁷⁵
- (4) the occurrence of any event that terminates the continued membership of the last remaining Member of the LLC, absent certain circumstances;⁶⁷⁶ or
- (5) entry of decree of judicial dissolution under the Tex. LLC Stats.⁶⁷⁷

⁶⁷² Tex. LLC Stats. provide that a membership interest is assignable unless otherwise provided by the Company Agreement. LLC Act § 4.05A; TBOC § 101.108(a). There is no statutory requirement of “reasonableness” with respect to LLC transfer restrictions as is found in TBCA art. 2.22 and TBOC §§ 21.211 and 21.213.

⁶⁷³ LLC Act §§ 3.02A(2), 6.01A(1); TBOC § 11.051(1); *see* 1993 LLC Bill Analysis at 4.

⁶⁷⁴ LLC Act § 6.01A(2); TBOC § 11.051(3).

⁶⁷⁵ LLC Act §§ 2.23D(2), 6.01A(3); TBOC §§ 11.051(2), 101.552. *See* 1993 LLC Bill Analysis at 5. Additionally, the TBOC provides that if there are no members, dissolution may occur upon the majority vote of the LLC’s managers. *See* TBOC § 101.552. This provision was intended to parallel the LLC Act provision which provided for dissolution upon the act of a majority of the Managers or Members named in the Articles, if no capital has been paid into the LLC and the LLC has not otherwise commenced business. LLC Act § 6.01A(4); *see* Revisor’s Note to TBOC § 101.552.

⁶⁷⁶ LLC Act § 6.01A(5), as amended by H.B. 1637 effective September 1, 2003; TBOC § 11.056. An LLC is not dissolved upon the termination of membership of the last remaining Member if the legal representative or successor of the last remaining Member agrees to continue the LLC and to become a Member as of the date of the termination of the last remaining Member’s membership in the LLC or designates another person who agrees to become a Member of the LLC as of the date of the termination. LLC Act § 6.01C as amended by H.B. 1637 effective September 1, 2003; TBOC § 11.056.

⁶⁷⁷ LLC Act §§ 6.01A(6), 6.02A; TBOC § 11.051(5). The availability of judicial dissolution may not be modified by Regulations or Company Agreement under either the LLC Act or the TBOC. TBOC § 101.054(a)(6) expressly states that judicial dissolution may not be modified or waived by Company Agreement, and LLC Act § 6.02 does not provide for modification or waiver in Regulations. Although TBOC § 101.054 expressly states which provisions *cannot* be modified, its predecessor, the LLC Act, only expressly states which provisions *can* be modified. As the Revisor’s Note to TBOC § 101.052 explains:

Because of the reversal of the prior assumption that each provision of the [LLC Act] was mandatory (unless expressly qualified) to the new assumption in Sections 101.052 and 101.054 [of the TBOC] that most provisions of the code governing limited liability companies may be waived or modified, a number of the provisions of Title 3 are now stated in such a way that the new provision appears to be the converse of the corresponding provision under the Texas Limited Liability Company Act.

However, an LLC may in many cases cancel the event that would otherwise require dissolution or termination and carry on its business. The procedures for doing so differ both by whether the LLC is governed by the TBOC or the LLC Act and by the type of event requiring dissolution. Unless otherwise provided in its Company Agreement, the TBOC requires a majority vote of all the LLC’s Members (or, if there are no Members, a majority vote of all its Managers) to revoke a voluntary winding up, or a unanimous vote of all of its Members to approve cancellation of an event that would otherwise require termination and winding up, other than a judicial decree.⁶⁷⁸ Under the LLC Act and the TBOC, revocation of a voluntary dissolution simply requires the written consent of all its members,⁶⁷⁹ while an election to continue following the expiration of a fixed period of duration for the LLC or the occurrence of events in the LLC’s governing documents requiring dissolution can only happen if there is at least one remaining member and all members vote to continue (unless a lesser percentage is specified in its certificate of formation or Company Agreement).⁶⁸⁰

The time frames for permissible elections to continue in business also differ by governing law and type of event of dissolution, and are all subject to restrictions in an LLC’s governing documents. Where the event of dissolution is the termination of the LLC’s period of duration, the TBOC allows three years for cancellation, whereas the LLC Act requires an election to cancel within 90 days of the expiration, and subject to the amendment within three years of the LLC’s formation document allowing for a longer duration.⁶⁸¹ For voluntary dissolutions, the LLC Act allows the LLC to cancel such dissolution within 120 days of the issuance of a certificate of dissolution, whereas the TBOC mandates that such election be made before the effective date of termination of the LLC’s existence.⁶⁸² For the occurrence of an event determined in the LLC’s governing documents to require automatic dissolution, the LLC Act requires any cancellation election to be made within 90 days of the event, subject to amendment of the LLC’s governing documents within three years to eliminate dissolution upon such event,

The Revisor’s Notes make no mention of any substantive change from the LLC Act to TBOC with respect to judicial dissolution, or the waivability thereof, because there was no substantive change. TBOC § 11.314—which is substantially similar to LLC Act § 6.02—is explicitly listed as being unwaivable under TBOC § 101.054. But under the LLC Act, all provisions are assumed mandatory unless it is explicitly stated that they are subject to variation by an LLC’s governing documents, and LLC Act § 6.02 contains no such qualification allowing modification or waiver of the right of judicial dissolution.

In contrast to the Texas LLC Stats. which do not permit the availability of judicial dissolution to be modified by Regulations or Company Agreement, the DLLCA permits an LLC agreement to waive judicial dissolution under DLLCA § 18-802. *R&R Capital, LLC v. Duck & Doe Run Valley Farms, LLC*, CA No. 3803-CC (Del. Ch. August 19, 2008) (LLC agreement could waive judicial dissolution under the DLLCA principle that LLCs “are creatures of contract, ‘designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved’”). Just as DLLCA § 18-1101(e) expressly states fiduciary duties may be eliminated by contract and the Tex. LLC Stats. do not so provide and do not allow that degree of contractual freedom to Texas LLCs, Texas differs from Delaware in that Texas LLCs do not have the power by Regulations or Company Agreement to eliminate the statutory right of judicial dissolution of a Texas LLC.

⁶⁷⁸ TBOC §§ 101.552.

⁶⁷⁹ LLC Act § 6.06A; TBOC § 101.552.

⁶⁸⁰ LLC Act § 6.01B; TBOC § 101.552.

⁶⁸¹ LLC Act § 6.01B; TBOC § 11.152(b).

⁶⁸² LLC Act § 6.06A; TBOC § 11.151.

while the TBOC allows one year to revoke such dissolution.⁶⁸³ For other circumstances requiring termination under the TBOC, LLCs are permitted one year to cancel the event of termination.⁶⁸⁴

Since (i) under the Check-the-Box Regulations continuity of life is not an issue in determining whether an LLC will be treated as a partnership for federal income tax purposes and (ii) there is considerable flexibility under the Tex. LLC Stats. in defining the circumstances in which an LLC is dissolved, the Certificate and Company Agreement should henceforth focus on dissolution from a business rather than a tax standpoint. The result in many cases will be that the LLC will not dissolve until the parties take affirmative action to cause dissolution.

Upon the dissolution of an LLC, its affairs must be wound up as soon as practicable by its Managers, or Members or other persons as provided in its Certificate or Company Agreement or by resolution of the Managers or Members.⁶⁸⁵ Before filing a certificate of termination with the Secretary of State,⁶⁸⁶ the LLC shall (i) cease to carry on its business, except as may be necessary for the winding up thereof, (ii) send written notice of its intention to dissolve to each of its known creditors and claimants,⁶⁸⁷ and (iii) collect its assets, discharge its obligations or make provision therefor and distribute the remaining assets to its Members.⁶⁸⁸ In the event a dissolving LLC's assets are not sufficient to discharge its obligations, the LLC is required to apply the assets as far as they will go to the just and equitable payment of its obligations.⁶⁸⁹ Upon the filing of a certificate of termination with the Secretary of State, the existence of the LLC terminates except for the purpose of suits and other proceedings by Members, Managers and other LLC representatives.⁶⁹⁰

P. Merger; Conversion. Part Ten of LLC Act and Chapter 10 of the TBOC contain merger provisions that allow an LLC to merge with one or more LLCs or “other entities” (i.e. any corporation, limited partnership, general partnership, joint venture, joint stock company, cooperative, association, bank, insurance company or other legal entity) to the extent that the laws or constituent documents of the other entity permit the merger.⁶⁹¹ The merger must be

⁶⁸³ LLC Act § 6.01B; TBOC § 11.152(a).

⁶⁸⁴ TBOC § 11.152(a).

⁶⁸⁵ LLC Act § 6.03A; TBOC § 101.551.

⁶⁸⁶ For entities still governed by the LLC Act, the proper filing document is articles of dissolution. *See* LLC Act § 6.07. For the required elements that must appear in a certificate of termination under the TBOC, see TBOC § 11.101.

⁶⁸⁷ Under § 6.05 of the LLC Act, notice must be sent by registered or certified mail. Under the new TBOC, notice must still be written, but can alternately be sent through a variety of technological means. *See* Revisor's Note to TBOC § 11.052.

⁶⁸⁸ LLC Act § 6.05; TBOC § 11.052.

⁶⁸⁹ LLC Act § 6.05(A)(3); TBOC § 11.053(b). The TBOC provides that such distribution may be delayed if continuing the business for a limited period will prevent unreasonable loss of the LLC property. *See* TBOC § 11.053(d).

⁶⁹⁰ LLC Act § 6.08(B); TBOC §§ 11.055, 11.102. Under the LLC Act, such existence terminates upon the issuance of a certificate of dissolution by the Secretary of State. LLC Act § 6.08B.

⁶⁹¹ However, the TBOC does impose restrictions on mergers involving nonprofit corporations. *See* TBOC § 10.010.

pursuant to a written plan of merger containing certain provisions,⁶⁹² and the entities involved must approve the merger by the vote required by their respective governing laws and organizational documents. Under Tex. LLC Stats., a merger is effective when the entities file an appropriate certificate of merger with the Secretary of State, unless the plan of merger provides for delayed effectiveness.⁶⁹³

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.⁶⁹⁴ The Tex. LLC Stats. grant broad authority for who can execute merger documents on a company's behalf.⁶⁹⁵ Their provisions on short form mergers are broadly drafted to allow their application to all types of entities that own, are owned by, or are under common ownership with a domestic limited liability company in the required percentage.⁶⁹⁶

The Tex. LLC Stats. also authorize an LLC to convert into another form of entity, or convert from another form of entity into an LLC, without going through a merger or transfer of assets, and has provisions relating to the mechanics of the adoption of a plan of conversion, owner approval, filings with the Secretary of State, and the protection of creditors.⁶⁹⁷

The Texas LLC Stats. allow the Company Agreement to provide whether, or to what extent, Member approval of sales of all or substantially all of the LLC's assets is required.⁶⁹⁸ 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.⁶⁹⁹

Q. TLLCA Relationship to TBCA and TMCLA. While LLCs governed by the TBOC need only look to the TBOC to ascertain applicable law, those LLCs still governed by the LLC Act are subject not only to that Act but also other pre-TBOC business entity statutes incorporated by reference thereto. The 1991 LLC Act section 8.12 provided that, to the extent that the LLC Act contains no provision with respect to one of the matters provided for in the TBCA and the TMCLA, such acts (as amended from time to time) will supplement the LLC Act to the extent not inconsistent with the LLC Act.⁷⁰⁰ In particular, TBCA article 2.02-1 and Part 5

⁶⁹² The LLC Act's requirements appear in its § 10.02. The TBOC's requirements are in its §§ 10.002 and 10.003.

⁶⁹³ LLC Act §§ 9.03, 10.03; TBOC § 10.007 and Revisor's Note thereto.

⁶⁹⁴ LLC Act § 10.01A; TBOC §§ 10.001, 101.356, 101.052.

⁶⁹⁵ LLC Act § 10.03A; TBOC §§ 10.001(b), 10.151(b).

⁶⁹⁶ See LLC Act § 10.05; TBOC § 10.006.

⁶⁹⁷ LLC Act §§ 10.08-10.09; TBOC §§ 10.101-10.105. Note, the TBOC permits LLCs still governed by the LLC Act to convert into another entity form to be governed by the TBOC. TBOC § 10.102.

⁶⁹⁸ See *supra* notes 224-225 and related text regarding the requirements of TBCA arts. 5.09 and 5.10 and the parallel TBOC provisions.

⁶⁹⁹ TBOC § 1.002(32) defines "fundamental business transaction" to include a "sale of all or substantially all of the entity's assets" and TBOC § 101.356 requires a member vote to approve any fundamental business transaction, although TBOC § 101.052 would allow the parties to include in the Company Agreement provisions that trump this TBOC requirement.

⁷⁰⁰ 1991 LLC Act § 8.12.

with respect to indemnification and mergers, respectively, and TMCLA article 7.06 with respect to the limitation of director liability (made applicable to Managers) were incorporated.⁷⁰¹

The 1991 LLC Act was left relatively short to provide maximum flexibility to parties to tailor their organizational structures to transactional needs. The references to the TBCA and TMCLA were inserted to allow established bodies of law under those statutes to serve as gap fillers in areas where the LLC Act, the Articles and the Company Agreement are silent. The concept of “piercing the corporate veil,” which developed under the TBCA, is inconsistent with the concept of limited liability for Members in the LLC Act and was not intended to be carried over.⁷⁰² The concepts of cumulative voting and preemptive rights, from TBCA articles 2.29D and 2.22-1 respectively, may have been incorporated into the 1991 LLC Act by LLC Act section 8.12, although this conclusion is not free from doubt.

The Bar Committee preparing the 1993 amendments to the LLC Act concluded that the 1991 LLC Act section 8.12 was overbroad and presented interpretive difficulties and revised LLC Act section 8.12 to designate the sections of the TBCA and the TMCLA incorporated by reference. As amended in 1993, 1997 and 2003, LLC Act section 8.12A provides that only the following TBCA articles apply to an LLC and its Members, Managers and officers:

- 2.07 (registered name)
- 2.08 (renewal of registered name)
- 4.14 (amendments of Articles, merger and dissolution pursuant to Federal bankruptcy laws)
- 5.14 (derivative suits)
- Part Seven (involuntary dissolution and receivership)

LLC Act section 8.12B provides that the following TMCLA articles apply to an LLC, its Members, Managers and officers:

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

TMCLA articles 2.03, 2.04, 2.09 and 2.09A were repealed by H.B. 1165 effective September 1, 2003, but LLC Act section 8.12B was not correspondingly amended.

TBCA concepts of cumulative voting and preemptive rights are not incorporated by reference into the LLC Act. Organizers desiring to provide those rights must expressly provide

⁷⁰¹ *Id.*

⁷⁰² *See* LLC Act § 4.03; *see also supra* notes 643-649 and related text.

them in the Articles or Company Agreement, although an express denial thereof in the Articles or Company Agreement still seems useful so that all parties will be aware of the result.

R. Foreign LLCs. The Tex. LLC Stats. provide a mechanism by which a limited liability company formed under the laws of another jurisdiction can qualify to do business in Texas as a foreign limited liability company (a “Foreign LLC”) and thereby achieve in Texas the limited liability afforded by the Tex. LLC Stats. to a domestic LLC.⁷⁰³ The LLC Act defines Foreign LLC broadly so that business trusts and other entities afforded limited liability under the laws under which they were organized, but which would not qualify for LLC status if formed in Texas, can still qualify to do business and achieve limited liability in Texas.⁷⁰⁴ However, under the TBOC, such specific provision was unnecessary, as such entities may register directly to transact business in Texas under TBOC Chapter 9 and be afforded the limited liability shield.⁷⁰⁵ A foreign entity comparable to a Texas LLC and doing business in Texas registers and thereby qualifies to do business in Texas by filing an application to do so with the Secretary of State.⁷⁰⁶ The analysis of whether a Foreign LLC is doing business in Texas so as to require qualification is the same as for a foreign corporation.⁷⁰⁷

The internal affairs of a Foreign LLC, including the personal liability of its Members for its obligations, are governed by the laws of its jurisdiction of organization.⁷⁰⁸ However, for matters affecting intrastate business in Texas, a Foreign LLC is subject to the same duties,

⁷⁰³ LLC Act Part Seven; TBOC chapter 101.

⁷⁰⁴ “Foreign limited liability company” is broadly defined in LLC Act § 1.02(9) as follows:

(9) “Foreign Limited Liability Company” means an entity formed under the laws of a jurisdiction other than this state (a) that is characterized as a limited liability company by such laws or (b) although not so characterized by such laws, that elects to procure a certificate of authority pursuant to Article 7.01 of this act, that is formed under laws which provide that some or all of the persons entitled to receive a distribution of the assets thereof upon the entity’s dissolution or otherwise or to exercise voting rights with respect to an interest in the entity shall not be liable for the debts, obligations or liabilities of the entity and which is not eligible to become authorized to do business in this state under any other statute.

⁷⁰⁵ See TBOC §§ 9.001 and 101.001 and the Revisor’s Notes thereto.

⁷⁰⁶ LLC Act §§ 7.01A, 7.05; TBOC §§ 9.001, 9.004.

⁷⁰⁷ LLC Act § 7.01B; TBCA art. 8.01B; TBOC § 9.251.

⁷⁰⁸ LLC Act § 7.02 provides in relevant part as follows with respect to a Foreign LLC that has procured a certificate of authority from the Secretary of State to transact business in Texas pursuant to LLC Act Part Seven:

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

The TBOC also provides for governance of a Foreign LLC’s internal affairs by the laws of its jurisdiction of organization. In fact, such governance is in the TBOC’s very definition of “foreign entity,” which states that the term “means an organization formed under, and the internal affairs of which are governed by, the laws of a jurisdiction other than this state.” TBOC § 1.002(28).

restrictions, and liabilities as a domestic LLC.⁷⁰⁹ The failure of a Foreign LLC to qualify to do business in Texas will not impair the limitation on liability of its Members or Managers, which gives specific effect to the applicability of the internal affairs doctrine relating to foreign entities in the case of a non-qualified Foreign LLC.⁷¹⁰

S. Professional LLCs. Tex. LLC Stats. expressly provide for the formation of a professional limited liability company (a “PLLC”) and specify the statutory requirements for such entities.⁷¹¹ The pertinent provisions of the LLC Act (a predecessor to the TBOC), including the definition of “professional service,” were based upon the Texas Professional Corporation Act (“TPCA”).⁷¹² Unlike the TPCA, however, physicians, surgeons and other doctors of medicine are not excluded from forming PLLCs under the Tex. LLC Stats.⁷¹³

A PLLC is required to contain in its name the words “Professional Limited Liability Company” or an abbreviation thereof.⁷¹⁴ Only a “professional individual”⁷¹⁵ or a “professional organization”⁷¹⁶ may be a governing person⁷¹⁷ of a PLLC.⁷¹⁸ The PLLC, but not the other individual Members, Managers or officers, is jointly and severally liable with a Member, Manager, officer, employee or agent rendering professional service for an error, omission, negligence, incompetence, or malfeasance on the part of the Member, Manager, officer, employee or agent when the Member, Manager, officer, employee or agent is rendering professional service in the course of employment for the PLLC.⁷¹⁹

⁷⁰⁹ LLC Act § 7.02A; TBOC § 9.203.

⁷¹⁰ LLC Act § 7.13B; TBOC § 9.051(c).

⁷¹¹ See Part Eleven of the LLC Act; see also TBOC chapters 301 and 304. The Texas Disciplinary Rules of Professional Conduct permit Texas lawyers to form a Texas LLC for the practice of law. Op. Tex. Ethics Comm’n No. 486 (1994). Most (but not all) states will also allow attorneys to practice in an LLC, at least so long as the client is on notice of dealing with a limited liability entity and each lawyer rendering services to a client remains fully accountable to the client. Lance Rogers, *Questions of Law and Ethics Face Firms Becoming LLPs, LLCs*, 12 ABA/BNA Law. Manual on Prof. Conduct 411 (No. 23, Dec. 11, 1996); see ABA Comm. on Ethics and Prof’l Responsibility, Formal Op. 96-401 (1996).

⁷¹² TEX. REV. CIV. STAT. ANN. art. 1528e, §3(a) (Vernon 2010).

⁷¹³ 1993 LLC Bill Analysis at 6; LLC Act § 11.01; TBOC §§ 301.003, 301.012.

⁷¹⁴ LLC Act § 11.02; TBOC § 5.059.

⁷¹⁵ The LLC Act defines “professional individual” to mean an individual who is licensed or otherwise authorized to render the same professional service as the PLLC, either within Texas or in any other jurisdiction. LLC Act § 11.01B(3); TBOC § 301.003(5).

⁷¹⁶ TBOC § 301.003(7). The LLC Act uses the alternate term “professional entity,” LLC Act § 11.01B(4), but either term indicates a person other than an individual that renders the same professional service as the PLLC, only through owners, members, employees, agents, and the like, each of whom is either a professional individual or professional organization or entity.

⁷¹⁷ “Governing person” is a new term of art in the TBOC, and refers to a person entitled to manage and direct an entity’s affairs under the TBOC and the entity’s governing documents. TBOC §§ 1.001(37), (35). In terms of the LLC Act, the governing person would be the same as the members, if member-managed, and the managers if manager-managed.

⁷¹⁸ LLC Act § 11.03A; TBOC §§ 301.007(a), 301.004(2).

⁷¹⁹ LLC Act § 11.05; TBOC § 301.010.

T. Diversity Jurisdiction. The cases are divided as to whether the citizenship of an LLC for federal diversity jurisdiction purposes should be determined by analogy to a partnership or a corporation. Where citizenship is determined in accordance with partnership precedent, an LLC is deemed a citizen of each state in which it has a Member.⁷²⁰ Where corporate precedent is applied, an LLC is a citizen of its state of incorporation and the state where its principal place of business is located.⁷²¹

VI. LIMITED LIABILITY PARTNERSHIP.⁷²²

A. General. An LLP is a general partnership in which the individual liability of partners for partnership obligations is substantially limited. This species of general partnership represents a dramatic innovation and was first authorized in 1991 by provisions (the “LLP Provisions”) added to the TUPA by Sections 83-85 of House Bill 278.⁷²³ The LLP Provisions were refined and carried forward as section 3.08 of the TRPA⁷²⁴ passed in 1993, and then were substantially expanded by S.B. 555 effective September 1, 1997.⁷²⁵

The LLP provisions appearing in the new TBOC⁷²⁶ took effect on January 1, 2006 and govern all LLPs formed on or after that date.⁷²⁷ The source LLP Provisions will govern LLPs formed before that date which do not voluntarily opt in to TBOC governance until their registrations expire, unless they are revoked or withdrawn prior to expiration.⁷²⁸ Registration renewal, however, will be governed by the TBOC.⁷²⁹ The LLP Provisions or TBOC LLP provisions, as each may be applicable to a particular LLP, will be hereinafter collectively referred to as “Tex. LLP Stats.,” with differences between the two noted as appropriate.

⁷²⁰ *International Flavors & Textures, LLC v. Gardner*, 966 F.Supp. 552 (W.D. Mich. 1997).

⁷²¹ *SMS Fin. II, L.L.C. v. Stewart*, 1996 WL 722080 (N.D. Tex. 1996); *Carlos v. Adamany*, 1996 WL 210019 (N.D. Ill. 1996).

⁷²² The discussion of LLPs herein, insofar as it relates to LLP’s under H.B. 278, is drawn in part from R. Dennis Anderson, Alan R. Bromberg, Byron F. Egan, Campbell A. Griffin, Larry L. Schoenbrun and Charles Szalkowski, *Registered Limited Liability Partnerships*, Vol. 28, No. 3 BULL. OF SEC. OF BUS. L. 1 (Jan. 1992); reprinted 55 TEX. B. J. 728 (July 1992).

⁷²³ Tex. H.B. 278, 72d Leg., R.S. (1991).

⁷²⁴ TRPA § 1.01 et seq.

⁷²⁵ Tex. S.B. 555, 75th Leg., R.S. (1997). Under TRPA § 11.03(b), TRPA § 3.08 governs all LLPs between January 1, 1994 and December 31, 2005 (regardless of when formed). Its coverage continues until December 31, 2009 for those LLPs formed prior to January 1, 2006 but not opting into the TBOC. However, an LLP formed before January 1, 1994 and governed by the TRPA is subject to TUPA for the purposes of determining liability for acts occurring prior to January 1, 1994. The TRPA phase-in provisions relating to LLPs deal only with the LLP Provisions in TRPA § 3.08. The other aspects of a partnership entity which is an LLP are governed by the remaining provisions of TRPA which have a different statutory phase-in. TRPA § 11.03 provides that, except for § 3.08, TRPA applies on and after January 1, 1994 to (i) new partnerships formed on and after that date and (ii) existing partnerships which elect to be governed by TRPA; and all partnerships will be governed by TRPA after January 1, 1999 (though again, subject to the phase in of the TBOC).

⁷²⁶ See TBOC Title 1 and §§ 152.801-152.805.

⁷²⁷ TBOC §§ 401.001, 402.003, 402.005.

⁷²⁸ TBOC § 402.001(b).

⁷²⁹ TBOC § 402.001(c).

B. Background. The LLP Provisions of TUPA originated in a separate bill, Senate Bill 302 (“S.B. 302”) (by Sen. John Montford). That bill was conceived as an alternate means for allowing professionals the limitation of liability already available to them under the Texas Professional Corporation Act.⁷³⁰ Although that statute allows professionals to limit their liability, the federal income tax consequences of joining and separating from professional corporations often made this avenue unavailable as a practical matter. The solution embodied in S.B. 302 was to amend TUPA to allow professionals to achieve through a new kind of partnership the same liability limitation already available in corporate form.⁷³¹ Thus, the proposed amendments to TUPA that were contained in S.B. 302 applied only to certain kinds of professional partners: physicians, surgeons, other doctors of medicine, architects, attorneys at law, certified public accountants, dentists, public accountants and veterinarians. S.B. 302 passed the Senate but encountered criticism in hearings before the House Business and Commerce Committee on grounds, among others, that the Bill was discriminatory against non-professional partnerships, that the Bill did not tell persons dealing with a partnership whether the partnership had the liability shield, and that the Bill did not require any substitute source of recovery for a person injured by partnership misconduct.⁷³² These criticisms led to the enlargement of the LLP Provisions to be applicable to all partnerships, and to the addition of the requirements of LLP registration, use of LLP status words or initials in the partnership name and maintenance by LLP’s of liability insurance. In this form, the LLP Provisions were added to H.B. 278 in the Senate, and the House concurred in H.B. 278 as so amended. With the adoption of TRPA in House Bill 273 (“H.B. 273”) in 1994 the LLP Provisions of TUPA were refined and carried over into TRPA.

The LLP Provisions originated as part of a liability limiting trend that has included (i) the LLC Act, (ii) amendments to the Texas Professional Corporation Act in 1989 and in H.B. 278, (iii) the passage of TRPA in H.B. 273, maintaining the LLP entity created by H.B. 278, (iv) the 1989 and 1993 amendments to TBCA article 2.21 to clarify non-liability of shareholders for corporate contractual obligations, (v) the passage of TRLPA in 1987, which allowed limited partners to engage in widely expanded activities without sacrificing their limited liability, and (vi) the 1987 enactment and subsequent amendment of TMCLA art. 1302-7.06 authorizing the limitation of liability of directors. These legislative changes were made during a period of increasing litigation against individuals for actions that they allegedly took, or failed to take, while serving as directors, officers or partners of a firm that failed or provided services to a firm that failed. This litigation often involved amounts that dwarfed the net worth of the individuals involved.

The LLP has spread beyond its Texas roots, and now every state has adopted an LLP statute. As the adoption of LLP statutes became more widespread, the LLP statutes of an increasing number of states protected partners from liabilities arising other than from the negligence, malpractice, wrongful acts or misconduct of other partners and employees.⁷³³ The

⁷³⁰ TEX. REV. CIV. STAT. ANN. art. 1528e (Vernon Supp. 2010).

⁷³¹ See Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065 (1995).

⁷³² See TEX. LAW. 7 (May 13, 1991); TEX. LAW. 1 (Oct. 21, 1991).

⁷³³ See, e.g., N.Y. Partnership Law § 26(b) (McKinney 1988 & Supp.); Hamilton, *Registered Limited Liability Partnerships: Present at Birth (Nearly)*, 66 U. COL. L. REV. 1065, 1097 (1995).

“full shield” LLP statutes of a number of states (including Colorado, Georgia, Idaho, Indiana, Maryland, Minnesota and New York) insulate a partner from personal liability for any debts, obligations or liabilities of, or chargeable to, the partnership, if such liability would exist solely by reason of their being partners, rendering professional services, or participating in the conduct of the business of the LLP, but do not protect a partner from liability arising from the partner’s own negligence, wrongful acts or misconduct, or from that of any person acting under his direct supervision and control.⁷³⁴

Although Texas was the first jurisdiction in the nation to permit the creation of limited liability partnerships, TRPA lagged behind other jurisdictions in providing partners of limited liability partnerships with protection from liabilities of the partnership. To address this deficiency, S.B. 555 amended TRPA section 3.08 to bring the Texas statute more in line with the laws of other jurisdictions relating to limited liability partnerships, in particular the liability of partners of a limited liability partnership for contractual obligations. TRPA section 3.08(a), as amended, provides that, except for liability for errors, omissions, negligence, incompetence or malfeasance committed by, or attributed to, a partner in a registered limited liability partnership, a partner will not be individually liable, directly or indirectly, by contribution, indemnity or otherwise, for the debts and obligations of the partnership incurred while the partnership is a registered limited liability partnership.⁷³⁵ The TBOC affords LLP partners the same protection, although the TBCA in referring to the LLP has dropped the “registered” in limited liability partnership and refers to an LLP as a limited liability partnership.⁷³⁶ This provision, however, does not apply to the liability of a partnership to pay its debts and obligations out of partnership property, the liability of a partner, if any, imposed by law or contract independently of the partner’s status as a partner, or the manner in which service of citation or other civil process may be served in an action against the partnership.

A new subsection (5) was added to TRPA section 3.08(a)⁷³⁷ to provide that in the case of a registered limited liability partnership, the limitations of liability provided in section 3.08(a) will prevail over other parts of TRPA regarding the liability of partners, their chargeability for the debts and obligations of the partnership and their obligations regarding contributions and indemnity.

The amendment to TRPA section 3.08 relating to limitation of liability of partners of a limited liability partnership did not impair the obligations under a contract existing before the effective date of S.B. 555.⁷³⁸ Thus, the partners of an LLP which was subject to a long-term lease entered into prior to September 1, 1997 remained personally liable for those lease obligations notwithstanding the amendment of TRPA section 3.08, although they would be

⁷³⁴ N.Y. Partnership Law § 26(c), (d) (McKinney 1988 & Supp.).

⁷³⁵ TRPA § 3.08.

⁷³⁶ TBOC §§ 1.002(48) and 152.801-152.805.

⁷³⁷ The TBOC’s parallel provision is in § 152.801(f).

⁷³⁸ S.B. 555 § 125(d) provides as follows:

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

shielded against contractual obligations created thereafter. Similarly, for organizations subject to the TBOC, the TBOC's provisions govern contracts the LLP enters on and after the first date the TBOC applies to the LLP, but prior law governs any contracts entered into under such old law.⁷³⁹

TRPA section 8.06 was amended by S.B. 555 to clarify that the obligations of a partner to make contributions to a partnership for the partner's negative balance in the partner's capital account and to satisfy obligations are subject to the limitations contained in TRPA sections 3.07 and 3.08 relating to LLPs and the liability of incoming partners. TBOC section 152.707 provides substantially the same.

C. Liability Shielded. Partners in a general partnership that is not an LLP are individually liable, jointly and severally, for all partnership obligations, including partnership liabilities arising from the misconduct of other partners, although under Texas law a creditor generally must first seek to satisfy the obligations out of partnership property.⁷⁴⁰ Although an LLP is a general partnership, the general partnership joint and several liability scheme is dramatically altered by the Tex. LLP Stats. when LLP status is attained.

1. **LLP Shield.** The essence of the Tex. LLP Stats. shield is to relieve a partner from individual liability for partnership obligations, except to the extent that they are attributable to the fault of the partner. The shield is set forth in TBOC section 152.801 as follows:

Sec. 152.801. Liability of Partner.

(a) Except as provided by Subsection (b) or the partnership agreement, a partner in a limited liability partnership is not personally liable to any person, including a partner, directly or indirectly, by contribution, indemnity, or otherwise, for a debt or obligation of the partnership incurred while the partnership is a limited liability partnership.⁷⁴¹

⁷³⁹ TBOC § 402.006.

⁷⁴⁰ TRPA § 3.05(a), (d), (e); TBOC § 152.306(b). See *Bromberg & Ribstein, supra* note 367, § 1.01 and ch. 5 for a general discussion of the liabilities of general partners.

⁷⁴¹ In *Evanston Insurance Company v. Dillard Department Stores, Inc. v. Chargois & Ernster*, ___ F.3d ___, 2010 WL 1212567 (No. 09-20261, 5th Cir. Jan. 15, 2010), the Fifth Circuit held that the partners in an LLP were personally liable for trademark infringement and business torts that occurred when the partnership was an LLP because the judgment creating the partnership "debt" was entered after the partnership dissolved and its LLP registration had expired. The facts of the case elucidate why the Fifth Circuit reached a result that appears inconsistent with both the intent and the wording of the Tex. LLP Stats. The two defendants formed a law partnership in 2002, registered it as an LLP and prosecuted lawsuits against plaintiff ("Dillard's"), alleging that Dillard's racially discriminated against its customers. In an attempt to solicit business, the firm developed a website which included a link using the "Dillard's" name and logo. Clicking this link took visitors to *dillardsalert.com*, a separate website documenting acts of alleged racial profiling by the department stores. Dillard's sued the firm for trademark infringement and various business torts. It sought damages and an injunction against CELLP's use of its trademark.

In 2004, while the litigation continued, the partners executed a separation agreement that provided for "dissolution" of the partnership, and the partnership's registration as an LLP was not renewed and expired. Notwithstanding these facts, the defunct LLP remained a party to the Dillard's litigation, no party was substituted on its behalf, and a final judgment was entered ordering the LLP to pay Dillard's \$143,500. Dillard's attempt to collect on the judgment did not succeed and ultimately it sued the two lawyers individually for the obligations of the partnership.

(b) A partner in a limited liability partnership is not personally liable for a debt or obligation of the partnership arising from an error, omission, negligence, incompetence, or malfeasance committed by another partner or representative of the partnership while the partnership is a limited liability partnership and in the course of the partnership business unless the first partner:

In affirming on other grounds the district court holding which had stated that the partners became personally liable because they did not wind up the business upon dissolution of the partnership and expiration of the LLP registration, the Fifth Circuit explained:

Appellants [the LLP partner defendants] argue that [TRPA] § 3.08(a)(1) insulates them from liability because CELLP's debt was incurred when the infringing website was created in June 2003, at which time CELLP was still a registered limited liability partnership. Dillard's, meanwhile, contends that the debt was incurred when the judgment was entered on November 2, 2004, at which time the erstwhile LLP had lost its liability-limiting attributes.

* * *

Although the terms "debt" and "incurred" are not defined by the TRPA, a plain reading of the statute's text supports Dillard's proffered interpretation. Neither partner was necessarily aware in June 2003 that displaying the Dillard's mark on the law firm website would ultimately lead to a partnership debt. The underlying conduct gave rise to the possibility of a future debt, but to say that a debt was "incurred" at that time unrealistically distorts the meaning of the word. After all, CELLP's conduct may have gone undetected, it may have been adjudged perfectly innocent, or Dillard's may have opted not to sue. Under any of those scenarios, no debt would ever have been incurred, let alone incurred in June 2003. It was only when the district court entered judgment against CELLP in November 2004 that a payable debt came into existence. It was then that CELLP incurred the debt within the meaning of the provision.

Moreover, the neighboring language of § 3.08(a)(2) demonstrates that the Texas legislature, when it so chooses, is capable of drafting a provision that focuses on the commission of events that lead to liability, rather than the fixing of consequent liability from those events. In that provision, the legislature insulated an LLP partner from personal liability "arising from errors, omissions, negligence, incompetence, or malfeasance committed" by another partner "while the partnership is a registered limited liability partnership." TRPA § 3.08(a)(2) (emphasis added). Thus, to decide whether the first partner's liability is limited for the second partner's malfeasance under § 3.08(a)(2), a court must look to when the second partner committed the malfeasance. Had the legislature intended to enact the same "when committed" approach for § 3.08(a)(1), it could have used the language from § 3.08(a)(2). [Citation omitted] It chose, however, to use different language, and created a regime in which partners could be held individually liable for debts and obligations incurred when the partnership was not a registered LLP [§ 3.08(a)(1)], but in which partners would not bear liability for one another's independent malfeasance committed while the LLP existed [§ 3.08(a)(2)].

Because CELLP's registration had expired, it was not a valid registered LLP at the time its debt was incurred. Therefore, § 3.08 does not foreclose individual liability and § 3.04's default rule operates to hold appellants personally liable for CELLP's debt.

See Elizabeth S. Miller, Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities, 43 TEX. J. OF BUS. L. 405, 435-445 (Fall 2009).

- (1) was supervising or directing the other partner or representative when the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative;
 - (2) was directly involved in the specific activity in which the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative; or
 - (3) had notice or knowledge of the error, omission, negligence, incompetence, or malfeasance by the other partner or representative at the time of the occurrence and then failed to take reasonable action to prevent or cure the error, omission, negligence, incompetence, or malfeasance.
- (c) Sections 2.101(1), 152.305, and 152.306 do not limit the effect of Subsection (a) in a limited liability partnership.
- (d) In this section, “representative” includes an agent, servant, or employee of a limited liability partnership.
- (e) Subsections (a) and (b) do not affect:
- (1) the liability of a partnership to pay its debts and obligations from partnership property;
 - (2) the liability of a partner, if any, imposed by law or contract independently of the partner’s status as a partner; or
 - (3) the manner in which service of citation or other civil process may be served in an action against a partnership.
- (f) This section controls over the other parts of this chapter and the other partnership provisions regarding the liability of partners of a limited liability partnership, the chargeability of the partners for the debts and obligations of the partnership, and the obligations of the partners regarding contributions and indemnity.⁷⁴²

2. Limits to LLP Shield. The Tex. LLP Stats. expressly do not relieve a partner for any liability imposed by law or contract independently of his status as a partner.⁷⁴³ In addition, there are three situations in which the statutes do not shield a partner from liability for a partnership obligation arising from the specified misconduct of a copartner or representative of the partnership:

⁷⁴² The provisions of TBOC § 152.801 are substantially the same as those found in TRPA § 3.08(a), except that TBOC § 152.801(a) was amended as follows in the 2009 Legislative Session by S.B. 1442 § 47 without a corresponding change being made to TRPA § 3.08(a):

SECTION 47. Subsection (a), Section 152.801, Business Organizations Code, is amended to read as follows:

(a) Except as provided by Subsection (b) or the partnership agreement, a partner in a limited liability partnership is not personally liable to any person, including a partner, directly or indirectly, by contribution, indemnity, or otherwise, for a debt or obligation of the partnership incurred while the partnership is a limited liability partnership.

⁷⁴³ TRPA § 3.08(a)(3)(B); TBOC § 152.801(e).

- (1) The miscreant copartner or representative is working under the supervision or direction of the partner.⁷⁴⁴
- (2) The partner is directly involved in the specific activity in which the copartner or representative commits the misconduct.⁷⁴⁵
- (3) The partner has “notice” or “knowledge” of the misconduct at the time of occurrence and fails to take reasonable steps to prevent the misconduct.⁷⁴⁶

All three situations involve fact questions as well as legal interpretations of the statutory language.

In situation (1), the supervision should be direct, or the direction should be specific, for the exception to apply. The language in situation (1) was not intended to deny the liability shield to someone (such as a managing or senior partner) who exercises indirect supervision over all partnership activity or over a particular segment of the partnership’s business or who generally directs other partners by establishing policies and procedures or by assigning responsibilities.

In situation (2), the direct involvement should relate to the particular aspect of the endeavor in which the misconduct occurred. The language in situation (2) was not intended to deny the liability shield to someone who was directly involved in one facet of a multifaceted matter (e.g., one involving several different areas of expertise) but did not participate in that facet of the matter that gave rise to the liability.

Neither exception (1) nor (2) should denude someone who had direct supervisory responsibility for, and therefore was directly involved in, a particular project but was not directly supervising the person who engaged in misconduct or directly involved in the aspect of the project in which the misconduct occurred.⁷⁴⁷ For example, an environmental lawyer who negligently rendered legal advice with respect to the environmental law aspects of a real property acquisition would not ordinarily be viewed as “working under the supervision or direction” of a real estate lawyer having overall responsibility for the acquisition (which means that exception (1) would not be applicable), and the real estate lawyer would not ordinarily be viewed as

⁷⁴⁴ TRPA § 3.08(a)(2); TBOC § 152.801(b)(1).

⁷⁴⁵ TRPA § 3.08(a)(2)(A); TBOC § 152.801(b)(2).

⁷⁴⁶ TRPA § 3.08(a)(2)(B); TBOC § 152.801(b)(3). Tex. LLP Stats. provide that a person has “notice” of a fact if such person (i) has actual knowledge of such fact, (ii) has received a communication of the fact, or (iii) reasonably should have concluded, from all facts known to such person at the time in question, that the fact exists. A person is treated as having received a communication of a fact if the fact is communicated to the person, the person’s place of business, or another place held out by the person as the place for receipt of communications. TRPA § 1.02; TBOC § 151.003.

⁷⁴⁷ *But see* Fortney, *Am I My Partner’s Keeper? Peer Review in Law Firms*, 66 U. COL. L. REV. 329, 331-32 (1995) (notes that in six “actions brought in connection with failed savings and loan associations, the government has alleged that *each law firm partner is personally liable for failing to monitor the conduct of other firm partners*. * * * In making such allegations the government has asserted that the failure to monitor claims are distinct from the vicarious liability claims,” for which the LLP shield was designed).

“involved in the specific activity” (i.e., advising with respect to environmental law) in which the misconduct occurred (which means that exception (2) would not apply).

3. Burden of Proof. The liability shield of the Tex. LLP Stats. is an affirmative defense, with the burden of proof on the partner claiming its benefit to show that the partnership is an LLP (i.e. that it complied at the relevant time(s) with the registration, name and insurance requirements). The burden would then shift to the plaintiff to prove that one or more of the three exceptions apply to remove the liability shield from particular partners.

4. LLP Status Does Not Affect Liability of Partnership. LLP status does not relieve a partnership itself from liability for misconduct of its partners or representatives or prevent its assets from being reached to satisfy partnership obligations.⁷⁴⁸ A partnership may still be sued as an entity in its common name under Rule 28 of the Texas Rules of Civil Procedure, with or without the partners.⁷⁴⁹ Citation or other process against a partnership may still be served on a partner under Section 17.022 of the Texas Civil Practice and Remedies Code, regardless of whether the partner is shielded from liability by the partnership’s LLP status.⁷⁵⁰

5. Shielded vs. Unshielded Obligations. The LLP shield only applies to the liability of partners for the covered partnership obligations incurred while the partnership is an LLP.⁷⁵¹ The partners remain jointly and severally liable for all other partnership obligations. A partnership at any time may have both shielded and unshielded obligations.

The Tex. LLP Stats. do not deal with the right of a partnership to pay unshielded obligations before paying shielded obligations or whether partner contributions may be earmarked to cover particular unshielded obligations. These matters are left to fiduciary principles and laws pertaining to creditors rights.

6. Contractual Obligations Incurred Prior to September 1, 1997. The amendment to TRPA section 3.08 making Texas a full shield state does not apply to contractual obligations incurred prior to the September 1, 1997 effective date of S.B. 555 by virtue of S.B. 555 section 125(d), which provides as follows:

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

Such obligations are similarly unshielded for partnerships governed by the TBOC.⁷⁵² Thus, the partners of an LLP which was subject to a long term lease entered into prior to September 1,

⁷⁴⁸ TRPA § 3.08(a)(3)(A) and TBOC § 152.801(e)(1) provide that the other Texas LLP provisions “do not affect . . . the liability of a partnership to pay its debts and obligations [out of] partnership property.”

⁷⁴⁹ TEX. R. CIV. P. 28.

⁷⁵⁰ TRPA § 3.08(a)(3)(C) (Vernon Supp. 2010).

⁷⁵¹ See *Elmer v. Santa Fe Properties, Inc.*, 2006 WL 3612359 (Tex. – San Antonio 2006, no pet. h.) (partner held liable for LLP lease obligations because it “was not a properly registered limited liability partnership when it incurred its lease obligations” because it did not have the required insurance at that time).

⁷⁵² TBOC § 402.006.

1997 remain personally liable for those lease obligations notwithstanding the amendment of TRPA section 3.08, although the same obligation incurred thereafter would be shielded unless the partners had agreed to be liable therefor.

7. Other State LLP Statutes. In the other states that have LLP statutes, the scope of liability from which an innocent partner in an LLP is protected varies from state to state. Some LLP statutes only protect partners from vicarious liability for tort-type liabilities (“*partial shield*”), while others provide a “*full shield*” of protection from both tort and contract liabilities of the partnership,⁷⁵³ perhaps in recognition that some malpractice claims could be pled in contract as well as in tort.⁷⁵⁴ Under most LLP statutes, including that of Delaware,⁷⁵⁵ a partner is liable not only for his own negligence, malpractice, wrongful act or misconduct, but also for that of someone under his direct supervision and control. The Maryland LLP statute preserves liability for a partner who is negligent in appointing, supervising or cooperating with the partner, employee or agent who was negligent or committed the wrongful act or omission.⁷⁵⁶ At least two states, Kentucky and Utah, have adopted LLP statutes providing that a partner is personally liable only for his own negligence, malpractice, wrongful acts and misconduct.⁷⁵⁷

D. Requirements for LLP Status. Each of the three requirements described below must be satisfied in order for the LLP shield to be in place in Texas. Creditors seeking to break the shield can be expected to require proof of satisfaction of each of the conditions and to challenge any noncompliance.

1. Name. The Tex. LLP Stats. require that an LLP must include in its name the words “limited liability partnership” or an abbreviation thereof.⁷⁵⁸

⁷⁵³ See Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 BUS. LAW. 101 (Nov. 1997), which contains a table of LLP Liability Shield Features (through October 31, 1997) showing those LLP statutes which are full shield or partial shield).

⁷⁵⁴ Miller, *Procedural and Conflict Laws Issues Arising In Connection With Multi-State Partnerships* (ABA BUS. L. SEC. 1996 Spring Meeting).

⁷⁵⁵ DEL. CODE ANN. tit. 6, § 1515 (1999 & Supp. 2005).

⁷⁵⁶ MD. CORP. & ASS’N. CODE ANN. § 9A-306(d)(1) (1999).

⁷⁵⁷ See KY. REV. STAT. ANN. § 362.220 (Michie 2002); UTAH CODE ANN. § 48-1-12(2) (2002).

⁷⁵⁸ TRPA § 3.08(c); TBOC § 5.063; TEX. ADMIN. CODE tit. 1, § 80.1(b) (2003). Under the TRPA, LLPs were officially called registered limited liability partnerships. The TRPA also imposed additional restrictions regarding an LLP’s name which have been omitted from the TBOC. See Revisor’s Notes to TBOC §§ 1.002(48) and 5.063. A firm with a written partnership agreement should amend the agreement to include the required words or letters as part of its name.

Compliance with the Texas name requirements by a law firm should not conflict with the misleading name prohibition in Rule 7.01 of Texas Disciplinary Rules of Professional Conduct, which provides in relevant part as follows:

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

2. Filing with the Secretary of State of Texas. LLPs are considered to be non-filing entities under the TBOC.⁷⁵⁹ Nonetheless, to achieve domestic LLP status, a partnership must file with the Secretary of State of Texas⁷⁶⁰ an application accompanied by a fee for each partner of \$200.⁷⁶¹ The application must (a) state the name of the partnership, the address of its principal office, the number of partners and the business in which the partnership engages, plus the federal tax identification number of the partnership,⁷⁶² and (b) be executed by a majority in interest⁷⁶³ of the partners or by one or more partners authorized by a majority in interest of the partners. The Tex. LLP Stats. do not require that an LLP filing with the Secretary of State have any express authorization in the partnership agreement, but changing the name to include the required words or abbreviation required by Tex. LLP Stats. would ordinarily require that the partnership agreement contemplate LLP status.⁷⁶⁴

If the required information is supplied in the application and the fee is paid, the LLP registration becomes effective upon filing.⁷⁶⁵ There is no requirement for the Secretary of State to issue a certificate. As evidence of the filing, the Secretary of State will return a file-stamped duplicate of the application. The Tex. LLP Stats. now permit electronic filings of LLP documents as soon as the Secretary of State's procedures will permit.⁷⁶⁶

Registration remains effective for a year,⁷⁶⁷ regardless of changes in the partnership, unless the registration is earlier withdrawn or revoked or unless renewed.⁷⁶⁸

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

⁷⁵⁹ See TBOC §§ 1.002(57), (34).

⁷⁶⁰ The rules of the Secretary of State dealing with LLP filings may be found at TEX. ADMIN. CODE tit. 1, §§ 80.1-80.7 (2003) as well as TRPA § 3.08(b) and TBOC § 152.802.

⁷⁶¹ The \$200 per partner fee for LLPs organizing under Texas law is based on the total partners in the firm, and not the number of partners in Texas, under TRPA § 3.08(b)(3) and TBOC § 4.158(1). For a foreign LLP, the fee is \$200 per partner in Texas, not to exceed \$750, under TRPA § 10.02(c) and TBOC § 4.158(1).

⁷⁶² The Secretary of State's form of application and the Tex. LLP Stats. require the tax identification number of the partnership as part of the application to provide more positive identification than the partnership name, which may change or may be similar to other names.

⁷⁶³ "Majority in interest" is defined in TRPA § 1.01(10), TRLPA § 1.02(7), and TBOC § 151.001(3) as more than 50% of the current interest in profits of the partnership. Although not required by the Secretary of State's form or the Tex. LLP Stats., it is prudent for an application to recite that it is signed by a majority in interest of the partners or by one or more partners authorized by a majority in interest of the partners.

⁷⁶⁴ In some states, electing LLP status requires unanimous partner approval or an amendment to the partnership agreement in accordance with the applicable partnership agreement provisions. See Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 BUS. LAW. 101, 114-115 (Nov. 1997).

⁷⁶⁵ TBOC § 4.051. The Secretary of State must register or renew as an LLP any partnership that submits a completed application with the required fee. See Tex. Admin. Code tit. 1, § 80.3 (2008); TBOC § 4.002.

⁷⁶⁶ TRPA § 3.08(b)(16); TBOC § 4.001(a)(2).

⁷⁶⁷ TRPA § 3.08(b)(5); TBOC § 152.802(e).

Because the registration is a notice filing and no listing of partners is required in the application, partnership changes due to withdrawals or to admissions of new partners do not require any refile with the Secretary of State until the next renewal filing.⁷⁶⁹ Caution suggests an amendment to the application if the partnership changes its name. LLPs should arrange their own reminders, since the Secretary of State is not obliged to send renewal notices.

3. Insurance or Financial Responsibility. The third requirement for LLP status under Tex. LLP Stats. is that the partnership must:

(1) carry at least \$100,000 of liability insurance of a kind that is designed to cover the kind of error, omission, negligence, incompetence, or malfeasance for which liability is limited by Section 152.801(b); or

(2) provide \$100,000 specifically designated and segregated for the satisfaction of judgments against the partnership for the kind of error, omission, negligence, incompetence, or malfeasance for which liability is limited by Section 152.801(b) by:

- (A) deposit of cash, bank certificates of deposit, or United States Treasury obligations in trust or bank escrow;
- (B) a bank letter of credit; or
- (C) insurance company bond.⁷⁷⁰

The requirement that the partnership “carry at least \$100,000 of liability insurance of a kind that is designed to cover the kind of error, omission, negligence, incompetence, or malfeasance for which liability is limited by” the Tex. LLP Stats. (and the option to provide \$100,000 of funds instead) is intended to provide some source of recovery as a substitute for the assets of partners who are shielded from liability by the Tex. LLP Stats. The \$100,000 figure is arbitrary and may or may not be greater than the partners’ individual assets otherwise available to partnership creditors. Nevertheless, the maintenance by the LLP of the required \$100,000 of insurance or segregated funds at the time a liability is incurred is a requirement for the liability to be shielded, and it is not sufficient that a partner individually maintains insurance in such amount.⁷⁷¹

⁷⁶⁸ TRPA §§ 3.08(b)(6), (7); TBOC § 152.802(e).

⁷⁶⁹ See TRLPA § 3.08(b)(4); TEX. ADMIN. CODE tit. 1, §§ 80.1, 80.4 (2008); see also TBOC § 152.802(d).

⁷⁷⁰ TBOC § 152.804(a). TRPA § 3.08(d)(1) provides substantially the same. The partnership should, of course, be a named insured. While a policy naming only the partners may suffice, caution suggests not relying on this approach.

⁷⁷¹ In *Elmer v. Santa Fe Properties, Inc.*, 2006 WL 3612359 (Tex. App.—San Antonio 2006), a partner of an LLP was held personally liable for the LLP’s obligations under a lease executed at a time when the LLP was not in compliance with the requirement of the applicable LLP Stats. that an LLP maintain liability insurance of at least \$100,000 “of a kind that is designed to cover the kinds of errors, omissions, negligence, incompetence, or malfeasance for which liability is limited by” the LLP Stats. It did not matter that (i) a judgment was first obtained against the partnership on pleadings alleging that the partnership was an LLP, (ii) the individual partner sued in the case had actually maintained errors and omissions coverage for himself individually (the Tex. LLP Stats. require that the insurance cover the partnership and covering an individual partner is not good enough—substantial compliance is not enough under the Tex. LLP Stats: strict compliance is required), and (iii) the liability at issue was a contract obligation rather than the kind of tort liability for which the statutorily required insurance would provide coverage. See Elizabeth S. Miller,

The \$100,000 requirement refers to the liability limit of the insurance, above any deductibles, retentions or similar arrangements; thus, deductibles, retentions and the like are permitted so long as the coverage would allow aggregate proceeds of at least \$100,000. The statute is not explicit about the effect on one claim of exhaustion of the policy limits by a prior claim. The intent is clear that exhaustion by one claim does not remove the liability shield for the same claim. If an LLP had the requisite insurance in place at the time the error or omission occurred, the insurance requirement should be satisfied even though subsequent events made the coverage unavailable to the aggrieved party. For example, if there were a number of lawsuits pending against an LLP at the time an error or omission occurred and judgments subsequently entered depleted the insurance available for the aggrieved party, the subsequent events should not retroactively deny the LLP shield to the partnership. Renewal or replacement of policies on their periodic expirations is probably enough to satisfy the insurance requirement of TRPA section 3.08(d) and TBOC section 152.804.

The insurance must be “designed to cover the kinds of” acts for which partner liability is shielded by Tex. LLP Stats.⁷⁷² The quoted phrase contains some flexibility; actual coverage of the misconduct that occurs is not an absolute necessity. The partner claiming the shield from liability, however, has the burden of proof that the insurance satisfied this statutory requirement.

Insurance coverage for particular conduct is not always available. TRPA section 3.08(d) and TBOC section 152.804(a) allow an LLP the option of providing \$100,000 in funds in lieu of obtaining insurance, but require one or the other. Proof of compliance with the insurance or financial responsibility requirements is on the partner claiming the liability shield of TBOC section 152.801 or TRPA section 3.08(a).⁷⁷³

The Tex. LLP Stats. provide that the LLP insurance requirements “shall not be admissible nor in any way made known to the jury in determining the issue(s) of liability for or extent of the debt or obligation or damages in question.”⁷⁷⁴ These provisions are intended to keep the existence of insurance from influencing a jury decision on liability or damages. Tex. LLP Stats. specifically state that if compliance with their insurance or fund provisions is disputed, “compliance must be determined separately from the trial or proceeding” to determine liability or damages.⁷⁷⁵

E. Taxation.

1. Federal Tax Classification. Since a domestic LLP must have two or more partners, it can be classified as a partnership for federal income tax purposes under the Check-the-Box Regulations.

Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities, 43 TEX. J. OF BUS. L. 405, 440 (Fall 2009).

⁷⁷² TRPA § 3.08(d)(1)(A); TBOC § 152.804(a)(1).

⁷⁷³ See TRPA § 3.08(d)(3); TBOC § 152.804(c).

⁷⁷⁴ TRPA § 3.08(d)(2); see also TBOC § 152.804(b).

⁷⁷⁵ TRPA § 3.08(d)(3); see also TBOC § 152.804(c).

2. Texas Entity Taxes. As a species of general partnership, an LLP was not subject to the Texas franchise tax.⁷⁷⁶

The Margin Tax is expressly imposed on LLPs.⁷⁷⁷ Although the LLP is a species of general partnership to which the Margin Tax is not generally applicable, the Margin Tax applies to all LLPs even if all of its partners are individuals.⁷⁷⁸

3. Self-Employment Tax. Partners in an LLP generally will be subject to self-employment tax on their share of the trade or business income of the LLP since an LLP is a species of general partnership and under state law different from a limited partnership.⁷⁷⁹

F. Other Issues.

1. Advertisement of LLP Status. Although not required by the Tex. LLP Stats., an LLP should include the LLP words or initials wherever the partnership's name is used, e.g., on directory listings, signs, letterheads, business cards and other documents that typically contain the name of the partnership. Although the LLP designation is part of the partnership's name and should be used as such, it is common and should be permissible for some partnership communications to be shorthanded and omit the designation. A rule of reason should apply in deciding how far a partnership should go in using the LLP designation. Thus, a partnership should, in answering the telephone, be able to use a shortened version of its name that does not refer to its LLP status and, when an existing partnership elects to become an LLP, it should have a reasonable period of time in which to implement the use of the LLP status words or symbols in printed matter and should be able to use up existing supplies of letterhead, etc.

There is no requirement, beyond the name change, that a partnership that becomes an LLP notify its customers, clients or patients of the partnership's new status. Further, there is no requirement that a partnership publish notice of its becoming an LLP comparable to the notice required of certain incorporations in other states.⁷⁸⁰

2. Assumed Name Certificate. Since an LLP is a species of general partnership, prior to House Bill ("H.B. 1239") which became effective September 1, 1993, an LLP was required to make filings under the Texas Assumed Business or Professional Name Act (the "Assumed Name Statute")⁷⁸¹ like any other general partnership. H.B. 1239 sections 1.29-1.31 amended the Assumed Name Statute so that LLPs, LLCs and limited partnerships are not deemed to be conducting business under an "assumed name," and do not have to make filings under the Assumed Name Statute if they conduct business in the same name as shown in their

⁷⁷⁶ TEX. TAX CODE ANN. § 171.001 (Vernon 2002 and Supp. 2004).

⁷⁷⁷ TEX. TAX CODE ANN. § 171.0002(a); H.B. 3928 § 2 (2007) (amended TEX. TAX CODE ANN. § 171.0002(a) to add "limited liability partnership" to the statutory definition of "taxable entity").

⁷⁷⁸ TEX. TAX CODE ANN. § 171.0002(a); H.B. 3928 § 2 (2007); *see supra* notes 113-213 and related text.

⁷⁷⁹ Burgess J. W. Raby & William L. Raby, *Partners, LLC Members, and SE Tax*, 87 Tax Notes 665, 668 (April 26, 2000).

⁷⁸⁰ The New York LLP statute requires publication of a notice once per week for six weeks upon creation of an LLP. N.Y. Partnership Law § 121-1500(a)(9) (McKinney Supp. 2004).

⁷⁸¹ TEX. BUS. & COM. CODE § 36.01ff (Vernon 2010).

documents on file in the office of the Secretary of State.⁷⁸² However, a general partnership which is not an LLP would have to file under the Assumed Name Statute if it conducted business under a name that does not include the surname or legal name of each general partner.⁷⁸³ If an LLP, LLC or limited partnership regularly conducts business under any other name (an “assumed name”), it would be required to file in the office of the county clerk of each county in which it maintains a business or professional premises a certificate setting forth the assumed name of the firm and the name and residence address of each general partner.⁷⁸⁴ Failure to comply with the filing requirements of the Assumed Name Statute should not affect the partnership’s LLP status but would subject the partnership to the penalties specified in the Assumed Name Statute.⁷⁸⁵ Although under the Assumed Name Statute it would be possible for an LLP to adopt an assumed name that did not include the LLP designation, failure to include the designation is inadvisable since it would frustrate the LLP Act requirement that the designation be in the firm name.

3. Time of Compliance. A partnership must be in compliance with the Tex. LLP Stats. requirements for an LLP at the time of misconduct giving rise to an obligation in order to raise the liability shield. Texas law explicitly states that the shielded partners are not liable for misconduct incurred while the partnership is a limited liability partnership.⁷⁸⁶

The liabilities of a general partnership that incorporates or becomes a limited partnership remain the individual liabilities of the former general partners notwithstanding the assumption of those liabilities by the new entity.⁷⁸⁷ Likewise, dissolution of a corporation or limited partnership does not result in the liability of its shareholders or limited partners for the entity’s obligations,⁷⁸⁸ and the result should be no different in the case of the dissolution of an LLP. Thus, for example, if an LLP were to dissolve, its partners should not lose the liability shield in an action brought during winding up for misconduct that occurred, or upon a contract made, before dissolution.

4. Effect on Pre-LLP Liabilities. An LLP is the same partnership that existed before it became an LLP.⁷⁸⁹ Since the Tex. LLP Stats. shield protects partners only against liabilities incurred while the partnership is an LLP, attainment of LLP status has no effect on pre-existing partnership liabilities. In *Medical Designs, Inc. v. Shannon, Gracey, Ratliff & Miller*,

⁷⁸² See also TEX. BUS. & COM. CODE §§ 71.001-71.203 as amended in the 2009 Legislative Session by S.B. 1442. See *infra* Appendix D.

⁷⁸³ TEX. BUS. & COM. CODE § 36.02(7) as amended in the 1993 Legislative Session by H.B. 1239.

⁷⁸⁴ TEX. BUS. & COM. CODE § 36.10 as amended in the 1993 Legislative Session by H.B. 1239.

⁷⁸⁵ TEX. BUS. & COM. CODE §§ 36.25 and 36.26.

⁷⁸⁶ TBOC § 152.801(a); see also TRPA § 3.08(a)(1). This result is buttressed by the Bar Committee Bill Analysis of H.B. 273 which at 14 states that TRPA § 3.08(a)(1) “clarifies that the partnership must be a registered limited liability partnership at the time of the errors and omissions for which partner liability is limited.”

⁷⁸⁷ TRPA § 3.08(a)(1); see also *Baca v. Weldon*, 230 S.W.2d 552 (Tex. Civ. App.—San Antonio, 1950, writ ref’d n.r.e.).

⁷⁸⁸ See *Hunter v. Fort Worth Capital Corp.*, 620 S.W.2d 547 (Tex. 1981); *Anderson v. Hodge Boats & Motors, Inc.*, 814 S.W.2d 894 (Tex. App.—Beaumont 1991).

⁷⁸⁹ See *Middlemist v. BDO Seidman, LLP*, 958 P.2d 486 (Colo. Ct. App. 1997); *Sasaki v. McKinnon*, 707 N.E. 2d 9 (Ohio Ct. App. 1997); and *Howard v. Klynveld Peat Marwick Goerdeler*, 977 F. Supp. 654 (S.D. N.Y. 1997).

L.L.P.,⁷⁹⁰ a law firm was sued for malpractice and obtained a summary judgment that was upheld on appeal on the basis that a “successor partnership” is *not liable* for the torts of a predecessor partnership, although the liabilities of the prior partners would remain their liabilities. The law firm defendant had, subsequent to the time the alleged malpractice occurred, merged and unmerged with another law firm, and the miscreant partner of the prior partnership was not associated with the defendant law firm. Under these facts the court of appeals wrote, “Texas does not recognize that successor partnerships are liable for the tortious conduct of predecessor partnerships.”⁷⁹¹ However, there is nothing in the court’s opinion suggesting that registration as an LLP is enough to make the partnership a different partnership.⁷⁹²

5. Limited Partnership as LLP. A limited partnership can become an LLP simply by complying with the applicable LLP provisions, in which case it would be a “LLL.P.”⁷⁹³ In addition, Tex. LLP Stats. provide that a limited partnership is an LLP as well as a limited partnership if it (i) registers as an LLP under the proper provisions,⁷⁹⁴ as permitted by its partnership agreement or with the consent of partners required to amend its partnership agreement to so permit, (ii) complies with the insurance or financial responsibility provisions of Tex. LLP Stats.,⁷⁹⁵ and (iii) contains in its name⁷⁹⁶ “limited liability partnership,” “limited liability limited partnership” or an abbreviation thereof.⁷⁹⁷

In an LLLP the general partners should have the same liability shield as partners in any other LLP. In a limited partnership, a limited partner is not liable to creditors unless (i) the limited partner participates in the control of the business and (ii) the creditor reasonably believed that the limited partner was a general partner.⁷⁹⁸ Under Tex. LLP Stats., a limited partner in an LLLP whose conduct would otherwise render it liable as a general partner has the benefit of the LLP shield.⁷⁹⁹

6. Indemnification and Contribution. The Tex. LLP Stats. eliminate the usual right of a partner who is held personally liable for a partnership obligation to obtain indemnification from the partnership or contribution from co-partners.⁸⁰⁰ It seems inconsistent with the Tex. LLP Stats. to allow a partner to recover, directly or indirectly, from copartners who are shielded from liability by the same statutes, absent a specific agreement of indemnification.

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

⁷⁹¹ *Id.* at 629.

⁷⁹² For an analysis of the *Shannon Gracey* case, see Elizabeth S. Miller, *The Advent of LLCs and LLPs in the Case Law: A Survey of Cases Dealing With Registered Limited Liability Partnerships and Limited Liability Companies* presented at symposium on Partnerships and LLCs - Important Case Law Developments 1998 at ABA Annual Meeting in Toronto, Ontario, Canada on August 4, 1998.

⁷⁹³ See TRPA § 3.08(e); TBOC §§ 152.805, 1.002(47).

⁷⁹⁴ TRPA § 3.08(b); TBOC § 152.802.

⁷⁹⁵ TRPA § 3.08(d); TBOC § 152.804.

⁷⁹⁶ TBOC § 5.055(b). The name requirements differ slightly for entities still governed by the TRLPA. See TRLPA § 2.14(a)(3).

⁷⁹⁷ TRLPA § 2.14; TBOC § 153.351.

⁷⁹⁸ TRLPA § 3.03; TBOC § 153.102.

⁷⁹⁹ TRLPA § 2.14(c); TBOC § 153.353.

⁸⁰⁰ TRPA § 3.08; TBOC § 152.801.

Indeed, TRPA section 3.08(a) and TBOC section 152.801 expressly provide that a partner is not individually liable “by contribution, indemnity, or otherwise” for partnership obligations except as otherwise provided. Quite apart from the Tex. LLP Stats., there is authority that a partner who commits malpractice cannot recover from his or her non-negligent copartners.⁸⁰¹ It would certainly be inconsistent with the Tex. LLP Stats. to let a plaintiff reach those co-partners through some theory of subrogation based on an alleged indemnification or contribution right of the misfeasant partner.

7. Inconsistent Partnership Agreement Provisions. A written or oral partnership agreement can modify or defeat the LLP liability shield. In cases where a partnership agreement sets forth partner indemnification or contribution obligations inconsistent with those described above,⁸⁰² a creditor could argue that the partnership agreement supersedes the shield afforded by the Tex. LLP Stats.⁸⁰³ Thus, if a miscreant partner is entitled to indemnification from the innocent partners in excess of the firm’s assets, then a creditor could claim the indemnification right has become an asset of the miscreant partner’s bankruptcy estate and the indemnification agreement could lead to a series of payments from the innocent partners, with each payment ultimately being for the benefit of creditors entitled to recover for the actions of the miscreant partner.⁸⁰⁴ The partnership could counter that compliance with the Tex. LLP Stats. amends or otherwise trumps any inconsistent partnership agreement provisions. Attorneys should exercise care to assure that the partnership agreement of an LLP does not contain indemnification or contribution provisions that would inadvertently frustrate the LLP purpose.

⁸⁰¹ See, e.g., *Flynn v. Reaves*, 218 S.E.2d 661 (Ga. App. 1975).

⁸⁰² Any LLP that intends by contract to require partners whose liabilities are shielded by the Tex. LLP Stats. to indemnify or contribute to partners whose liability is not shielded (due to their own misconduct) should be particularly sensitive to the “express negligence doctrine.” Under the “express negligence doctrine” as articulated by the Supreme Court of Texas, an indemnification agreement is not enforceable to indemnify a party from the consequences of its own negligence unless such intent is specifically stated in the agreement. See *Ethyl Corp. v. Daniel Constr. Co.*, 725 S.W.2d 705, 708 (Tex. 1987), wherein the Supreme Court held:

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

* * *

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

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

⁸⁰³ Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 Bus. Law. 101, 118-120 (Nov. 1997).

⁸⁰⁴ See Banoff, *Alphabet Soup: A Navigator’s Guide*, 4 BUS. L. TODAY 10, 12 (March/April 1995).

Since a partnership agreement may be written or oral,⁸⁰⁵ an LLP should have a written partnership agreement that provides that it may be amended only by a written amendment. Otherwise a creditor might argue that partner contributions to pay unshielded obligations (e.g., rent on a lease executed before September 1, 1997) constituted an amendment by conduct to the partnership agreement that dropped the LLP liability shield.⁸⁰⁶

8. Fiduciary Duties. Partners in an LLP are in a fiduciary relationship and owe each other fiduciary duties just as in any other partnership. In *Sterquell v. Archer*,⁸⁰⁷ the court wrote:

No one disputed that Archer, Sterquell, and Harris were partners. As such, they were involved in a fiduciary relationship which obligated each to act loyally towards one another and to fully disclose information affecting the partnership and their interests in same. [Citations omitted] So too were each prohibited from personally taking advantage of information unknown to the others but concerning partnership interests. *Id.* (each is a confidential agent of the other, each has a right to know all that the others know). Furthermore, in violating any of these fiduciary duties, the actor committed fraud. [Citations omitted]

9. Foreign LLP Qualification. A foreign LLP doing business in Texas⁸⁰⁸ may qualify to do business in Texas like a foreign LLC⁸⁰⁹ (the filing fee would be the lesser of

⁸⁰⁵ TRPA § 1.01(12); TBOC § 151.001(4).

⁸⁰⁶ Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 BUS. LAW. 101, 120 (Nov. 1997).

⁸⁰⁷ 1997 WL 20881, 6 (Tex. App.—Amarillo 1997, no writ) (not designated for publication).

⁸⁰⁸ Texas law does not define what constitutes “transacting business in Texas” for the purposes of the requirement of TBOC § 152.905 (and the substantially similar TRPA § 10.02(a)) that “[b]efore transacting business in this state, a foreign limited liability partnership must file an application for registration in accordance with this section and Chapters 4 and 9.” TBOC § 9.251, however, does contain the following non-exclusive list of activities not constituting transacting business in Texas:

Sec. 9.251. Activities Not Constituting Transacting Business In This State.

For purposes of this chapter, activities that do not constitute transaction of business in this state include:

- (1) maintaining or defending an action or suit or an administrative or arbitration proceeding, or effecting the settlement of:
 - (A) such an action, suit, or proceeding; or
 - (B) a claim or dispute to which the entity is a party;
- (2) holding a meeting of the entity’s managerial officials, owners, or members or carrying on another activity concerning the entity’s internal affairs;
- (3) maintaining a bank account;
- (4) maintaining an office or agency for:
 - (A) transferring, exchanging, or registering securities the entity issues; or

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- (B) appointing or maintaining a trustee or depositary related to the entity's securities;
 - (5) voting the interest of an entity the foreign entity has acquired;
 - (6) effecting a sale through an independent contractor;
 - (7) creating, as borrower or lender, or acquiring indebtedness or a mortgage or other security interest in real or personal property;
 - (8) securing or collecting a debt due the entity or enforcing a right in property that secures a debt due the entity;
 - (9) transacting business in interstate commerce;
 - (10) conducting an isolated transaction that:
 - (A) is completed within a period of 30 days; and
 - (B) is not in the course of a number of repeated, similar transactions;
 - (11) in a case that does not involve an activity that would constitute the transaction of business in this state if the activity were one of a foreign entity acting in its own right:
 - (A) exercising a power of executor or administrator of the estate of a nonresident decedent under ancillary letters issued by a court of this state; or
 - (B) exercising a power of a trustee under the will of a nonresident decedent, or under a trust created by one or more nonresidents of this state, or by one or more foreign entities;
 - (12) regarding a debt secured by a mortgage or lien on real or personal property in this state:
 - (A) acquiring the debt in a transaction outside this state or in interstate commerce;
 - (B) collecting or adjusting a principal or interest payment on the debt;
 - (C) enforcing or adjusting a right or property securing the debt;
 - (D) taking an action necessary to preserve and protect the interest of the mortgagee in the security; or
 - (E) engaging in any combination of transactions described by this subdivision;
 - (13) investing in or acquiring, in a transaction outside of this state, a royalty or other non-operating mineral interest; or
 - (14) the execution of a division order, contract of sale, or other instrument incidental to ownership of a non-operating mineral interest.

See also TBOC § 153.903. The TRPA provides substantially the same. TRPA § 10.04.

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See TRPA article X; TBOC Chapter 9 and §§ 152.901-152.914 and 402.001(e).

\$200 per resident partner⁸¹⁰ or \$750); however, the failure of the foreign LLP to qualify would not affect its LLP shield in Texas.⁸¹¹ Under the Tex. LLP Stats., the laws of the state under which a foreign LLP is formed will govern its organization and internal affairs and the liability of partners for obligations of the partnership.⁸¹²

Thus, under the Tex. LLP Stats., partners may choose the state law, and hence the liability shield, that they wish to apply to their relationship.⁸¹³ That choice should not be subject to the general limitation in the Tex. GP Stats. that the law chosen by the partners to govern binds only “if that state bears a reasonable relation to the partners or to the partnership business and affairs under principles that apply to a contract among the partners other than the partnership agreement.”⁸¹⁴

A determination of whether a foreign LLP must qualify to do business in any particular state must be made on a state by state basis. A number of states, such as Delaware,⁸¹⁵ do not require such qualification, but recognize that the law governing the internal affairs of a partnership also governs its liability to third parties. By contrast, New York and Maryland require foreign LLPs to qualify to do business in the state.⁸¹⁶

10. Bankruptcy. Section 723 of the Bankruptcy Code⁸¹⁷ addresses the personal liability of general partners for the debts of the partnership, granting the trustee a claim against “any general partner” for the full partnership deficiency owing to creditors to the extent that the partner would be personally liable for claims against the partnership. In recognition of uncertainty as to how this provision would be construed to apply with regard to LLPs which had

⁸¹⁰ The Secretary of State has adopted a regulation for determining whether a partner is in Texas for purposes of annual fee calculations. Texas Administrative Code title 1, § 80.2(f) provides as follows:

(f) *Partners in Texas.* For purposes of this section, a partner is considered to be in Texas if:

- (1) the partner is a resident of the state;
- (2) the partner is domiciled or located in the state;
- (3) the partner is licensed or otherwise legally authorized to perform the services of the partnership in this state; or
- (4) the partner, or a representative of the partnership working under the direct supervision or control of the partner, will be providing services or otherwise transacting the business of the partnership within the state for a period of more than 30 days.

⁸¹¹ TRPA § 10.03(c); TBOC §§ 9.051, 152.910.

⁸¹² The TBOC places governance by foreign law into the very definition of “foreign”: “‘Foreign’ means, with respect to an entity, that the entity is formed under, and the entity’s internal affairs are governed by, the laws of a jurisdiction other than this state.” TBOC § 1.002(27). *See also* TBOC § 1.103. TRPA § 10.01 similarly recognizes foreign governance of a foreign LLP’s internal affairs.

⁸¹³ TRPA § 10.01; TBOC §§ 1.101-1.105.

⁸¹⁴ TRPA § 1.05(a)(1). *See* TBOC § 1.002(43)(C)(i), providing substantively the same. *See also* TEX. BUS. & COM. CODE § 35.51.

⁸¹⁵ DEL. CODE ANN., tit. 6, §§ 1515, 1547 (1999 & Supp. 2002).

⁸¹⁶ N.Y. P’S HIP LAW § 121-1502 (McKinney Supp. 2006); MD. CODE ANN. CORPS. & ASS’NS § 9A-1101 (1999).

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

been authorized by a number of states since the advent of the 1978 Bankruptcy Code, the 1994 amendments to the Bankruptcy Code clarified that a partner of an LLP would only be liable in bankruptcy to the extent that the partner would be personally liable for a deficiency according to the LLP statute under which the partnership was formed.⁸¹⁸

11. Federal Diversity Jurisdiction. An LLP is a citizen of every state in which one of its partners resides for the purposes of Federal court diversity jurisdiction.⁸¹⁹ As a result, large accounting firms with offices in most states are likely beyond the reach of the diversity jurisdiction of the Federal courts.⁸²⁰

VII. EXTRATERRITORIAL RECOGNITION OF LLC AND LLP LIMITED LIABILITY.

A. General. Courts of other states should recognize the Texas statutory liability shield of LLCs and LLPs under the “internal affairs” doctrine, which treats the laws of the state of organization as governing the liability of members of business organizations, such as corporations and limited partnerships.⁸²¹ The principal case that did not follow this doctrine was a Texas case, which has been effectively overturned by H.B. 278.⁸²² The extent to which LLC or LLP status will be recognized in other jurisdictions absent a specific statute, however, remains a question for which there is little case-law precedent.⁸²³

B. Texas Statutes. The LLC Act states that it is the “intention of the legislature by the enactment of this Act that the legal existence of limited liability companies formed under this Act be recognized beyond the limits of this state and that, subject to any reasonable registration requirements, any such limited liability company transacting business outside this state shall be granted the protection of full faith and credit under Section 1 of Article IV of the Constitution of the United States.”⁸²⁴

⁸¹⁸ Congressional Record—House H 10767 (Oct. 4, 1994). This amendment to the Bankruptcy Code is attributable in large part to efforts of representatives of the Texas Business Law Foundation.

⁸¹⁹ *Reisman v. KPMG Peat Marwick LLP*, 965 F. Supp. 165 (D. Mass. 1997), relying on *Carden v. Arkoma Assoc.*, 494 U.S. 185 (1990).

⁸²⁰ The court in *Reisman* wrote that it was “particularly troubled that a Big Six accounting firm which operates offices within every state in the United States has effectively immunized itself from the reach of the diversity jurisdiction of the federal courts simply by organizing itself as a limited liability partnership rather than a corporation. Nevertheless, until Congress addresses the jurisdictional implications of this new class of business entities, this Court can reach no other result.”

⁸²¹ TBOC § 1.101-1.105; *cf.* Revised Uniform Limited Partnership Act § 9.01 adopted in many states and in this state as TRLPA § 9.01(a); TBCA art. 8.02; 59A Am. Jur. 2d Partnership § 30 (1987); 29 A.L.R. 2d 295 (1953). For a discussion of the history of TBCA art. 8.02, see R. Dennis Anderson and Harva R. Dockery, *Formalities of Corporate Operations*, Texas Corporations—Law and Practice § 31.05 (1986).

⁸²² *Means v. Limpia Royalties*, 115 S.W.2d 468 (Tex. Civ. App.—Ft. Worth 1938, writ dismissed).

⁸²³ See Herbert B. Chermiside, Jr., Annotation, *Modern Status of the Massachusetts or Business Trust*, 88 A.L.R. 3d 704 (1978) (“In some jurisdictions a Massachusetts or business trust has been treated as a partnership for some purposes.”).

⁸²⁴ LLC Act § 4.03B.

There is no comparable statement of legislative intention in the Tex. LLP Stats. However, they do provide that (1) a partnership's internal affairs are governed by the law of the state chosen by the partners if the law chosen bears a reasonable relationship to the partnership's business and affairs under applicable choice of law principles and (2) the law governing a partnership's internal affairs also governs the liability of its partners to third parties.⁸²⁵ Texas has thus codified the internal affairs doctrine recognized by the courts of other states, as discussed below.

C. Texas Cases. Texas appears to be the only state with a reported decision denying limited liability to owners of an unincorporated entity formed under another state's law because the forum state did not have such a statute.⁸²⁶ In *Means v. Limpia Royalties*,⁸²⁷ suit was brought in Texas by a purchaser of trust interests for rescission of the purchase because of misrepresentations by the defendant that holders of trust interests could not be liable for trust obligations. Limpia Royalties was an unincorporated association operating under a declaration of trust, was organized under the laws of Oklahoma and had its principal office in Oklahoma. In holding that the representations were materially misleading, the court wrote:

It is well settled in this state by a long line of decisions that a shareholder in an unincorporated or joint-stock association is liable to its creditor for debts of the association; his liability being that of a partner. 25 Tex. Jur. section 20, p. 202, and authorities there cited.

The fact that, under the laws of the state of Oklahoma and under the provisions of the declaration of trust, a shareholder in the Limpia Royalties could not be held liable for the debts or obligations of the association would not operate to extend the same immunity from liability growing out of transactions by the association in the state of Texas, since, as is well said in the opinion in *Ayub v. Automobile Mortgage Company*, 252 S.W. 287, 290 [(Tex. Civ. App.—El Paso 1923, writ granted) *rev'd. Auto. Mortgage Co. v. Ayub*, 266 S.W. 134 (Tex. Comm'n. App. 1924)]. “The established public policy of the forum is supreme, and will not be relaxed upon the ground of comity to enforce contracts which contravene such policy, even though such contracts are valid where made.”⁸²⁸

⁸²⁵ TRPA § 1.05; TBOC §§ 1.101-1.105.

⁸²⁶ Commentators generally suggest that uncertainty as to whether the statutory limited liability of Members will be recognized in a jurisdiction other than the jurisdiction of the LLC's organization is a drawback to using an LLC for a business with operations in more than one state, but the only authorities cited for that concern are the Texas cases discussed herein. *See, e.g.,* Lederman, *Miami Device: The Florida Limited Liability Company*, 67 TAXES 339, 342 (June 1989); and Roche, Keatinge and Spudis, *Limited Liability Companies Offer Pass-Through Benefits Without S Corp. Restrictions*, 74 J. TAX'N 248, 253 (April 1991).

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

⁸²⁸ 115 S.W.2d at 475. The *Limpia Royalties* case was cited and its rationale followed in *Cherokee Village v. Henderson*, 538 S.W.2d 169, 173 (Tex. Civ. App.—Houston 1976, writ *dism'd*), a personal injury case in which the property on which the injury occurred was held pursuant to a trust agreement. The trust agreement, which apparently was governed by Texas law, recited that no partnership was intended and that no party had any right to incur any liability on account of any other party. The defendants in the case were holders of beneficial interests in the trust, which was a successor to a general partnership in which the holders had been partners. Two years after the creation of the trust, but two years prior to the injury, three individuals withdrew

The sections of the Tex. LLC Stats. providing for qualification of Foreign LLCs were intended to repudiate, and resolve the concern raised by, the *Limpia Royalties* case with respect to limited liability of non-corporate entities created under the laws of other states but not authorized to be created under Texas law.⁸²⁹ The Bill Analysis⁸³⁰ used by the Legislature in connection with the consideration of H.B. 278 states:

The provisions of Part 7 providing for the qualification of foreign Limited Liability Companies is intended to eliminate the concern raised by *Means v. Olympia [sic] Royalties*, 115 S.W.2d 468 (Tex. Civ. App.—Ft. Worth 1938 [writ dism'd]), as to whether a Texas court would honor the limitation of liability of a foreign business entity. Moreover, the definition of “Foreign Limited Liability Company” is sufficiently broad to provide for the qualification of any business entity affording limited liability, not entitled to qualify under another statute, whether or not characterized as a limited liability company.⁸³¹

from the arrangement by a document which purported to be an amendment to the venture’s “agreement of general partnership” and an assumed name certificate was filed in which the defendants were listed as general partners. The court was not persuaded by the defendants’ testimony that these actions were erroneous. In holding that the defendants were liable and that the trust was a partnership under Texas law, the court wrote:

Article 6132b, the Texas Uniform Partnership Act, Section 6, defines a partnership as “an association of two or more persons to carry on as co-owners a business for profit.” Section 7 of this Act sets forth certain criteria for determining the existence of a partnership under the Act. Under this section it is provided that with the exception of certain circumstances not here existent, the receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner of the business. TEX. REV. CIV. STAT. ANN. art. 6132a, the Texas Uniform Limited Partnership Act, sets forth the method by which limited partners, who do not wish to be bound by the obligations of the partnership, may carry on a business as a limited partnership. TEX. REV. CIV. STAT. ANN. art. 6138a sets forth the requirements for creation of a Real Estate Investment Trust. Section 8 of that Act provides for limited liability of the shareholders of such a trust. Appellants here do not contend that there was compliance with the requisites of either of these statutes.

Where two or more persons associate themselves as co-owners of a business for profit they become jointly and severally responsible for obligations incurred in the conduct of such business unless they have established, under some applicable statute, an association which the law recognizes as providing limited personal liability.

⁸²⁹ H.B. 278 § 46 Part Seven. Prior to the enactment of H.B. 278, Texas was already firmly committed by statute to the internal affairs doctrine for both corporate and non-corporate business organizations. The 1977 amendment to Texas Uniform Limited Partnership Act, art. 6132a § 32(c) specified that, in the case of a foreign limited partnership qualified in Texas, “its internal affairs and the liability of its limited partners shall be governed by the laws of the jurisdiction of its formation.” That principle is carried forward in Texas Revised Limited Partnership Act, article 6132a-1 § 9.01(a): “The laws of the state under which a foreign limited partnership is formed govern its organization and internal affairs and the liability of its partners” (whether or not the foreign limited partnership is registered to do business in Texas). The 1989 amendment to Texas Business Corporation Act art. 8.02 prescribes that “only the laws of the jurisdiction of incorporation of a foreign corporation shall govern (1) the internal affairs of the foreign corporation . . . and (2) the liability, if any, of shareholders . . .” The TBOC provides substantively the same. TBOC §§ 1.002(27), (28), 1.102-1.105.

⁸³⁰ Bill Analysis of H.B. 278 by Wolens at 10 (1991). See 1991 Bill Analysis Summary at 41.

⁸³¹ “Foreign Limited Liability Company” is broadly defined in LLC Act § 1.02(9) as follows:

D. Decisions in Other States. There is precedent in other jurisdictions suggesting that their courts would apply the internal affairs doctrine to unincorporated entities not organized or qualified to do business as foreign entities under local law, thus preserving the liability shield of Texas law for LLCs and LLPs. Further, there apparently are no reported cases in other jurisdictions that follow the reasoning of, or reach the same result as, the *Limpia Royalties* case.

This issue of which jurisdiction's law governs liabilities of partners to third parties arose in *King v. Sarria*, an 1877 New York case of first impression.⁸³² The defendants entered into a contract of partnership in Cuba, which was then ruled by Spanish law. Under the contract, defendant Sarria became a special partner whose liability was expressly limited to a fixed amount. As a special partner under Spanish law, Sarria was entitled to participate in the profits of the partnership, but could not be made liable for its debts. The plaintiffs sought to recover from Sarria a sum of money due under a contract with the partnership.

The court held that the partnership agreement was governed by the laws of Spain⁸³³ and that the liability of Sarria and the extent of the authority of his partners to bind him⁸³⁴ were to be determined by those laws. The court stated:

(9) "Foreign Limited Liability Company" means an entity formed under the laws of a jurisdiction other than this state (a) that is characterized as a limited liability company by such laws or (b) although not so characterized by such laws, that elects to procure a certificate of authority pursuant to Article 7.01 of this act, that is formed under laws which provides [sic] that some or all of the persons entitled to receive a distribution of the assets thereof upon the entity's dissolution or otherwise or to exercise voting rights with respect to an interest in the entity shall not be liable for the debts, obligations or liabilities of the entity and which is not authorized to qualify to do business in this state under any other statute.

See also supra notes 703-710 and related text and TBOC §§ 9.001-9.003.

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

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

See also TBOC §§ 1.104 and 1.105.

⁸³² *King v. Sarria*, 69 N.Y. 24 (Ct. of App. 1877).

⁸³³ Where a partnership is formed under the laws of a particular state and there is no conflicting choice of law provision in the agreement, it is as if the partners have implicitly agreed to be bound by the laws of that state. *See Rogers v. Guaranty Trust*, 298 U.S. 123 (1933); *Seidman & Seidman v. Wolfson*, 123 Cal. Rptr. 873 (Cal. Ct. App. 1975) (California court held that New York law should determine the rights and obligations among partners in an accounting firm where the partnership agreement so provided); *Hill-Davis Co. v. Atwell*, 10 P.2d 463 (Cal. 1932) (a court will generally refer to the law of the state of the entity's organization to determine the precise nature of the powers or qualities enjoyed by such entity); *Gilman Paint & Varnish v. Legum*, 80 A.2d 906, 29 A.L.R. 2d 236 (Md. 1951) (the liability to third persons of a partner with limited liability is an issue to be determined under Maryland law where the partners were all from Maryland, the

[W]here the essentials of a contract made under foreign laws are not hostile to the law and policy of the State, the contract may be relied upon and availed of in the courts of this State. If the substance of the contract is against that law and policy, our judicatories will refuse to entertain it and give it effect.⁸³⁵

In *King v. Sarria*, the court held that the Spanish statute limiting liability of particular partners was not contrary to New York public policy and therefore applied the Spanish statute to limit Sarria's liability.⁸³⁶ However, in reaching this conclusion, the court noted that the Spanish statute resembled New York's own statute for the formation of limited partnerships.⁸³⁷

The 1982 New York case of *Downey v. Swan*⁸³⁸ helps answer the question of what happens when the forum state has no corresponding statute. In *Downey*, the defendant Swan was a member of a limited partnership association formed under New Jersey law. Under New Jersey law, the members and managers of a limited partnership association were not personally liable for a wrongful death that occurred on property owned by the partnership. In remanding the case to the trial court for a determination whether the association was operating after its term had expired, the court held that if the association were still in existence, the liabilities of its members would be governed by New Jersey law and the limited liability afforded by that law would be given full effect.⁸³⁹ Because New York had no limited partnership association law, the New York court could not have applied analogous New York law to reach the same result.⁸⁴⁰

partnership agreement was made in Maryland, it was a Maryland partnership in its inception and no representations were made otherwise); *Froelich & Kuttner v. Sutherland*, 22 F.2d 870 (D.C. 1927) (where entity was organized under Philippine statutes, that country's laws determined whether the organization was a general partnership, limited partnership or a corporation).

⁸³⁴ The court in *King v. Sarria* noted that, since the contract in question was made by persons other than Sarria, the plaintiff had to show that the other partners had authority to bind Sarria and that the plaintiff was relying upon the mutual general agency which results from the relation of partnership to show that authority. The court noted that, if the Spanish statute were not applicable, the plaintiff would prevail "for by virtue of the relationship of partnership, one partner becomes the general agent for the other, as to all matters within the scope of the partnership dealings, and has thereby given to him all authority needful for carrying on the partnership, and which is usually exercised by partners in that business" and "that any restriction which by agreement amongst the partners is attempted to be imposed upon the authority, which one partner possesses as the general agent of the other, is operative only between the partners themselves, and does not limit the authority as to third persons . . . unless they know that such restriction has been made." *Sarria*, 69 N.Y. at 28-29. The court noted that the foregoing common law principles, which are comparable to TUPA §§ 9, 13, 14 and 15(1) (without the LLP exception), were qualified by the provisions of any applicable statute providing for the formation of partnerships with limited liability.

⁸³⁵ *Sarria*, 69 N.Y. at 34.

⁸³⁶ For a contract to be void as against New York public policy, it must be quite clearly repugnant to the public conscience. See *Kloberg v. Teller*, 171 N.Y.S. 947, 948 (Sup. Ct. Bronx Co. 1918).

⁸³⁷ The court indicated that the same reasoning would apply to contract and tort claims.

⁸³⁸ *Downey v. Swan*, 454 N.Y.S. 2d 895 (N.Y. App. Div. 1982).

⁸³⁹ Cf. *Schneider v. Schimmels*, 64 Cal. Rptr. 273 (1967) (California court permitted recovery for loss of consortium pursuant to a Colorado statute although California did not have a similar statute granting such damages).

⁸⁴⁰ Cf. *Abu-Nassar v. Elders Fututes, Inc.*, No. 88-Civ. 7906, U.S. Dist. LEXIS 3794 (S.D.N.Y. Mar. 28, 1991), in which an LLC organized under Lebanese law was treated as though it were a foreign corporation for purposes of analyzing choice of law and veil piercing liability.

In a case involving a Texas LLP law firm, the internal affairs doctrine was recognized by a federal district court in Massachusetts. In *Liberty Mutual Insurance Co. v. Gardere & Wynne, L.L.P.*,⁸⁴¹ although the court granted a motion to transfer a case to a federal court in Texas largely to avoid having to decide numerous questions about the effect of the Texas LLP status⁸⁴²

⁸⁴¹ *Liberty Mutual Insurance Co. v. Gardere & Wynne, L.L.P.*, 1994 WL 707133, Civ. A. No. 94-10609-MLW (D. Mass. Dec. 6 1994).

⁸⁴² *Liberty Mutual Insurance Co. v. Gardere & Wynne, L.L.P.* involved claims of breach of fiduciary duty and conflict of interest asserted by Liberty Mutual Insurance Company (“Liberty”) against the Dallas based law firm of Gardere & Wynne, L.L.P. (“Gardere”), which had represented Liberty for many years. Gardere was a Texas partnership that had taken the steps to become a registered LLP under the TRPA. Two Gardere lawyers, Nabors and Woods, also were defendants in the suit; Nabors clearly was a partner in Gardere, but the facts were uncertain about whether Woods’s election to “income partner” status had been given effect before he left Gardere to join another firm. Liberty filed its suit in the federal district court in Massachusetts, where its principal office was located. Gardere, Nabors, and Woods moved for dismissal or, alternatively, to have the case transferred to Texas.

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

Massachusetts had no counterpart to the Texas LLP statute. The court observed that, if it undertook to consider the motions to dismiss, its analysis would be complicated the fact that Gardere was not a general partnership “in the traditional sense familiar to Massachusetts judges and lawyers.” The court identified numerous procedural and substantive questions emanating from the uncertainty of Gardere’s organizational status under Massachusetts law, including the following issues:

- (1) Whether, for Massachusetts law purpose, Gardere was a limited partnership;
- (2) If Gardere was a limited partnership, whether suit could be brought against it by naming only its general partners as defendants;
- (3) If Gardere was a limited partnership and could be sued by naming only its general partners, whether the “general partners” were only those partners who, under TRPA, could be liable for the alleged breaches of duty claimed by Liberty;
- (4) Whether the breaches of duty alleged by Liberty were the type of “errors, omissions, negligence, incompetence, or malfeasance” enumerated in TRPA for which a registered LLP member’s liability was limited to cases of direct involvement or failure to prevent errors and omissions;
- (5) With respect to the individual defendants’ claims of lack of personal jurisdiction, whether certain Gardere partners who had actually visited Massachusetts from time to time had been agents of other Gardere partners, by operation of general partnership law;
- (6) Whether such presence by other Gardere partners constituted agency on behalf of the individual defendants when it occurred prior to the individual defendants’ joining the Gardere firm; and
- (7) If such agency occurred, whether it was effective with respect to an “income partner” such as Woods, who did not have an equity interest or many of the rights held by equity partners (assuming Woods actually became an income partner).

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

The court assumes that, if this case were tried in a state or federal court in Massachusetts, the court would look to Texas substantive law to determine the liability of partners in a Texas RLLP for debts arising out of claims for breach of fiduciary duty by other partners. See Mass.Gen.L. ch. 109, § 48 (liability of limited partners of a foreign limited partnership “shall be governed by the laws of the state under which it is organized”); *Klaxon v. Stentor Elec. Mfgs. Co.*, 313 U.S. 487, 496, 61 S.Ct. 1020, 1021-22 (1941) (federal court in diversity case applies choice of law principles of state in which federal court is located). Thus, Texas law will apply to this question whether or not the case is transferred . . .⁸⁴³

The *Gardere* case illustrates the difficult procedural issues which can be encountered when liability is asserted against an LLC or an LLP outside of the jurisdiction of its creation. Under general conflict of law principles, (i) for contract claims, in the absence of a valid contractual choice of law provision, the law of the jurisdiction with the most significant contacts will govern, and (ii) for tort claims, the law of the state with the most significant relationship to the occurrence and the parties will generally govern.⁸⁴⁴ Whether a court adjudicating a claim against a foreign LLC or LLP, after applying one state’s laws in determining that an LLC or LLP is liable for a contract or tort claim, will then apply the internal affairs doctrine or the full faith and credit clause of the Constitution to uphold the liability shield of the entity’s jurisdiction of organization remains an issue in those few jurisdictions still lacking statutory guidance, although the better authority to date would apply the internal affairs principle and uphold the statutory liability shield.

E. Qualification as Foreign Entity and Other Ways to Reduce Extraterritorial Risk. Since all 50 states (including Texas) plus the District of Columbia now have LLC statutes, the LLC extraterritorial risk analysis requires analysis of the applicable LLC statute in each of the states in which the LLC contemplates doing business. Generally qualification as a foreign LLC in a jurisdiction will protect Members’ limited liability, but failure to qualify may not result in the loss of limited liability, although it may result in the imposition of statutory penalties. The LLC statutes in Texas, New York and Delaware, which each contain provisions for the registration/qualification of foreign LLCs, expressly provide that the failure of a foreign LLC to so qualify shall not affect the limited liability of its members or managers, which shall be

The court concluded that, despite the deference normally accorded to a plaintiff’s choice of forum, the complicated issues stemming from *Gardere*’s uncertain legal status under Massachusetts law, combined with the fact these issues would be moot if the case were transferred to Texas, compelled the court to transfer the litigation to a federal district court sitting in Texas. The court thus saved itself from resolving the many issues it had identified that were produced by the incompatibility of Texas and Massachusetts partnership law by transferring the case to Texas.

⁸⁴³ *Gardere & Wynne*, 1994 WL 707133 at *6 n. 7.

⁸⁴⁴ Elizabeth S. Miller, *Procedural and Conflict of Laws Issues Arising In Connection With Multi-State Partnerships*, ABA Bus. L. Sec. (1996 Spring Meeting).

determined by the laws of the LLC's jurisdiction of organization.⁸⁴⁵ Likewise, since all states plus the District of Columbia have LLP statutes, foreign qualification needs to be considered as a means of reducing extraterritorial risk for LLPs. Delaware, New York, and Maryland all provide for foreign qualification.⁸⁴⁶

Although the LLP is the entity of choice for many professionals, not all states permit all types of professionals to avail themselves of limited liability for professional malpractice (whether through a professional corporation, a PLLC or an LLP), thus necessitating additionally a review of the applicable professional rules in each jurisdiction in which the entity proposes to transact business.⁸⁴⁷

VIII. DECISION MATRIX.

Key elements in deciding among business entities are:

- (1) How the entity will be taxed under federal and state law; and
- (2) Who will be liable for its contract, tort and statutory obligations (the entity itself will always be liable to the extent of its assets; the question is whether owners will be liable if entity's assets insufficient to satisfy all claims).

These two considerations tend to receive the principal focus in the entity choice decision, although management, capital raising, interest transferability, continuity of life and formation issues such as cost and timing can be critical in many cases.

If the owners are content to pay federal income taxes at the entity level at corporate rates of 15% to 35%, plus Margin Taxes, and then pay federal income taxes on earnings distributed to them, the choice is typically a "C corporation" (i.e., a regular business corporation without an S-corporation election)⁸⁴⁸ or an LLC that elects to be taxed as a "C" corporation under the

⁸⁴⁵ LLC Act §§ 7.01, 7.02; N.Y. LLC Law §§ 801, 802 (2006); 6 DEL. CODE §§ 18-901, 18-902 (2006). N.Y. LLC Law § 802 further provides that within 120 days after the filing of its application for authority, the foreign LLC must publish once each week for six successive weeks in one daily and one weekly newspaper (each designated by the county clerk in the county where the LLC is located) generally the same information required to be filed with the New York Department of State and must file a proof of publication with the New York Department of State, and failure to file such proof of publication will result in automatic suspension of the LLC's right to transact business in New York.

⁸⁴⁶ DEL. CODE ANN. tit. 6 § 15-1101 et seq (2005); N.Y. P'SHIP LAW § 121-1502 (McKinney 1998 & Supp. 2006); MD. CODE ANN., CORPS. & ASS'NS § 9A-1101 (1999). N.Y. P'SHIP LAW § 121-1502 (McKinney 1998 & Supp. 2006) further provides that within 120 days after the filing of its application for authority, the foreign LLP must publish once each week for six successive weeks in one daily and one weekly newspaper (each designated by the county clerk in the county where the LLP is located) generally the same information required to be filed with the New York Department of State and must file a proof of publication with the New York Department of State, and failure to file such proof of publication will result in automatic suspension of the LLP's right to transact business in New York.

⁸⁴⁷ See Rogers, *Questions of Law and Ethics Face Firms Becoming LLPs, LLCs*, 12 ABA/BNA Lawyers' Manual of Professional Conduct 411 (No. 23 Dec. 11, 1996); *Meyer v. Oklahoma Alcoholic Laws Enforcement Comm'n.*, 890 P.2d 1361 (Okla. Ct. App. 1995) (finding that an LLC is not permitted to hold liquor license).

⁸⁴⁸ See *supra* notes 80-89, 253-259 and related text.

Check-the-Box Regulations.⁸⁴⁹ Such an LLC may be preferable to a corporation in closely held situations because of greater governance structuring flexibility.⁸⁵⁰

If the owners do not want the entity's earnings to be taxed twice under the IRC, the entity selection process becomes more complicated,⁸⁵¹ and the choices are:

- General partnership⁸⁵²
- LLP⁸⁵³
- Limited partnership⁸⁵⁴
- LLC that elects to be taxed as a partnership under the Check-the-Box Regulations⁸⁵⁵
- S-corporation⁸⁵⁶

A. If limited liability of the owners is not important and all of them are individuals, the choice is a general partnership in which partners are jointly and severally liable for all partnership liabilities, as such a general partnership is not subject to the Margin Tax.⁸⁵⁷

B. If the owners are willing to accept liability for their own torts but want to avoid liability for contracts and torts of other partners for which they have no culpability and are willing to risk being subject to the Margin Tax, the LLP becomes the entity of choice.⁸⁵⁸

C. The limited partnership will provide tax flow through without the S-corporation restrictions discussed below, with no self-employment tax on income of limited partners, and with limited liability for limited partners,⁸⁵⁹ but has its own limitations:

1. Must have a general partner which is liable for all partnership obligations — contract and tort — but under Check-the-Box Regulations, capitalization of general partner is not important and a limited partnership can elect to also be an LLLP which has the effect of limiting the liability of the general partner;⁸⁶⁰
2. Limited partners who participate in the management of the business may become liable as general partners, but the limited partnership statutes

⁸⁴⁹ See *supra* notes 80-89, 533-721 and related text.

⁸⁵⁰ See *supra* notes 608-665 and related text.

⁸⁵¹ See *supra* notes 80-89 and related text.

⁸⁵² See *supra* notes 350-433 and related text.

⁸⁵³ See *supra* notes 722-820 and related text.

⁸⁵⁴ See *supra* notes 434-532 and related text.

⁸⁵⁵ See *supra* notes 80-89, 533-721 and related text.

⁸⁵⁶ See *supra* notes 260-271 and related text.

⁸⁵⁷ See *supra* notes 350-433 and related text.

⁸⁵⁸ See *supra* notes 722-820 and related text.

⁸⁵⁹ See *supra* notes 434-532 and related text.

⁸⁶⁰ See *supra* notes 80-89 and 451-459 and related text.

generally allow a degree of participation without general partner personal liability unless the creditor relied upon the limited partner as a general partner;⁸⁶¹ and

3. Effective for tax years beginning on or after January 1, 2007, the Margin Tax is imposed on LLPs, although the LLP is a species of general partnership to which the Margin Tax generally is not applicable.⁸⁶²

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

- (i) Effective for tax years beginning on or after January 1, 2007, the Margin Tax has replaced the Texas franchise tax and is imposed on LLCs;⁸⁶³
- (ii) Questions remain as to whether, or to what extent, individuals who are Members of an LLC will be subject to federal self-employment taxes;⁸⁶⁴ and
- (iii) Questions regarding:
 - State income taxation issues in other states; and
 - The extent to which other states will recognize statutory limitation of Members' liability and the related questions of whether/how to qualify as a foreign LLC.⁸⁶⁵

E. The S-corporation will give limitation of owner liability and federal income tax flow through (even when there is only one owner), but an S-corporation is subject to the Texas Margin Tax, and there are limitations on its availability under the IRC.⁸⁶⁶ S-corporation status is not available where the entity:

1. has more than 100 equity holders;
2. has more than one class of stock;
3. has among its shareholders any:
 - General or limited partnership;
 - Trust (certain exceptions);
 - Non resident alien; or

⁸⁶¹ See *supra* notes 80-89 and 451-459 and related text.

⁸⁶² See *supra* notes 113-213 and related text.

⁸⁶³ See *supra* notes 113-207 and related text.

⁸⁶⁴ See *supra* notes 562-574 and related text.

⁸⁶⁵ See *supra* notes 821-847 and related text.

⁸⁶⁶ See *supra* notes 260-274 and related text.

- Corporation (exception for “qualified subchapter S subsidiary”).

IX. TAX COSTS IN CHOICE OF ENTITY DECISION.

The following chart compares the taxes that would be paid by different entities and their owners based on assumed gross receipts, gross margin and net income in 2010. In each case, the entity is assumed to have (i) \$1,000 of gross revenue, (ii) \$700 of gross margin for Margin Tax purposes, which would be the maximum taxable margin under Tex. Tax Code § 171.101(a)(1) and all of which is apportioned to Texas under Tex. Tax Code § 171.101(a)(2), and (iii) \$100 of net income that is of a type subject to self-employment taxes (i.e., is income from a trade or business) and is distributed (after taxes) to its owners. It is also assumed that the owners will have earned income or wages in excess of the base amount for the tax year and will therefore be subject to only the 2.9% Medicare tax (and not the 12.40% social security equivalent tax to a base of \$106,800 in 2010).

Item	C-Corporation	S-Corp or Limited Liability Company ^(a)	General Partner in General or Limited Partnership ^(a)	Limited Partner in Limited Partnership ^(a)
Entity Level				
Total Revenue	1,000.00	1,000.00	1,000.00	1,000.00
Taxable Margin	700.00	700.00	700.00	700.00
Net Income	100.00	100.00	100.00	100.00
Margin Tax ^(b)	7.00	7.00	7.00	7.00
Taxable Income of Entity	93.00	93.00	93.00	93.00
Fed. Income Tax (at 35%)	32.55	0	0	0
Income After Taxes ^(c)	60.45	93.00	93.00	93.00
Owner Level				
Distribution & Share of Income	60.45	93.00	93.00	93.00
Self-Employment Tax	0	2.90 ^(d)	2.90	0
Taxable Income of Owner	60.45	91.55 ^(e)	91.55 ^(e)	93.00
Fed. Income Tax on Dividends (at 15%)	9.07			
Fed. Tax on Income Allocation (at 35%)		32.04	32.04	32.55
Amount Received After Taxes	51.38	58.06	58.06	60.45

- (a) Assumes that (i) the entity is treated as a partnership for federal income tax purposes and (ii) one of its owners is a business entity.
- (b) Assumes that (i) Margin Tax is applicable since gross receipts are all in 2010, (ii) the gross margin for Margin Tax purposes is \$700, which would be the maximum taxable margin under Tex. Tax Code § 171.101(a)(1), and all of it is apportioned to Texas under Tex. Tax Code § 171.101(a)(2), and (iii) the applicable Margin Tax rate is 1% (the rate is 0.5% for a narrowly defined group of retail and wholesale businesses). Under Tex. Tax Code § 171.101(a)(1) a taxable entity's taxable margin is the lesser of (x) 70% of its total revenue or (y) an amount determined by subtracting from its total revenue either its cost of goods sold or its compensation paid as elected or deemed elected pursuant to the Tex. Tax Code. See *supra* notes 113-207 and related text. Assumes the business cannot take advantage of exclusions for businesses with \$11 million or less in total revenue. Tex. Tax Code § 171.002.
- (c) Post Margin Tax, the income after taxes of most entities is the net income of the entity less the Margin Tax and, in the case of the C-corporation, the applicable federal income taxes.
- (d) A non-managing member of an LLC may not be subject to the self-employment tax; a shareholder of an S-corporation is not subject to self-employment tax on actual or constructive dividends but would be subject to self-employment tax on compensation received.
- (e) Only one-half of the self-employment tax is deductible against the individual's income for federal income tax purposes.

X. CONCLUSION.

There are several entity forms to consider when organizing a business in Texas. The characteristics of each, which are discussed above and are tabulated on the Entity Comparison Chart attached as Appendix A, will influence the choice among the entities for a particular situation.

APPENDIX A: ENTITY COMPARISON CHART

Note: Chart reflects requirements and allowances from the TBOC, not from source law, which may apply to some entities until January 1, 2010.

Item	Sole Proprietorship	General Partnership	Limited Liability Partnership	Limited Partnership	Limited Liability Company	“C” Corp.	“S” Corp.
Limited liability of owners for entity obligations	No	No	Yes	Yes	Yes	Yes	Yes
Name	No requirements	No requirements	L.L.P. must contain “limited liability partnership” or an abbreviation thereof.	Must contain “limited partnership,” “limited,” or an abbreviation of either.	Must contain “limited liability company,” “limited company,” or an abbreviation of either (unless formed prior to September 1, 1993 in compliance with the laws then in effect).	Must contain “corporation,” “company,” “incorporated,” “limited,” or an abbreviation of any of these.	Must contain “corporation,” “company,” “incorporated,” “limited,” or an abbreviation of any of these.
Filing Requirements	Assumed name certificate filing and payment of applicable filing fees	Assumed name certificate filing and payment of applicable filing fees	Annual registration and filing fee of \$200 per partner; must maintain liability insurance or meet alternative financial responsibility test	Certificate of formation and filing fee of \$750	Certificate of formation and filing fee of \$300	Certificate of formation and filing fee of \$300	Certificate of formation and filing fee of \$300
Ownership Types	Individuals	Any	Any	Any	Any	Any	Limited
No. of Owners	One	Minimum of 2	Minimum of 2	Minimum of 2	Single member LLCs permitted in texas	No restrictions	No more than 100

Item	Sole Proprietorship	General Partnership	Limited Liability Partnership	Limited Partnership	Limited Liability Company	“C” Corp.	“S” Corp.
Professionals	Yes	Yes	Yes	Yes	Yes	Yes, but generally governed by TBOC Title 7 Professional Entities if there is conflict with TBOC Title 2 Corporations. For entities existing prior to January 1, 2006, generally governed by Texas Professional Corporation Act or Texas Professional Association Act	Yes, but generally governed by TBOC Title 7 Professional Entities if there is conflict with TBOC Title 2 Corporations. For entities existing prior to January 1, 2006, generally governed by Texas Professional Corporation Act or Texas Professional Association Act
Ownership Classes	One	Multiple classes allowed	Multiple classes allowed	Multiple classes allowed but must have at least 1 general partner and 1 limited partner.	Multiple classes allowed	Multiple classes allowed	Limitation as to 1 class of stock
Transferability of Interests	Freely transferable	Economic interest is transferable unless restricted by partnership agreement; however, the status of partner is not transferable without consent of all partners	Economic interest is transferable unless restricted by partnership agreement; however, the status of partner is not transferable without consent of all partners	Economic interest is transferable unless restricted by partnership agreement; however, the status of partner is not transferable without consent of all partners	Economic membership interest freely transferable unless restricted by articles of organization or regulations; however, unless otherwise provided in articles of organization or regulations, the status of member is not transferable without consent of all members	Freely transferable unless restricted by articles of incorporation, bylaws or shareholder agreement	Freely transferable unless restricted by articles of incorporation, bylaws or shareholder agreement

**APPENDIX B: BASIC TEXAS BUSINESS ENTITIES AND
FEDERAL/STATE TAXATION ALTERNATIVES CHART**

<i>Texas Law Entity</i>	<i>Check-the-Box</i>	<i>Federal Taxation</i>	<i>TX Franchise Tax until 1/1/07¹</i>	<i>TX Margin Tax 1/1/07</i>
Proprietorship	Not Applicable	Form 1040, Schedule C or E	None	None
LLC / single individual member	Disregarded²	Form 1040, Schedule C or E (Proprietorship)	Yes	Yes
LLC / single entity member	Disregarded²	Division of Member Entity	Yes	Yes
General Partnership or LLP	Partnership³	Partnership	None	Depends
General Partnership or LLP	Corporation	C or S-Corp⁴	None	Depends
Limited Partnership	Partnership³	Partnership	None	Yes
Limited Partnership	Corporation	C or S-Corp⁴	None	Yes⁵
LLC / multi-members	Partnership³	Partnership	Yes	Yes
LLC / multi-members	Corporation	C or S-Corp⁴	Yes	Yes
Corporation	Not Applicable	C or S-Corp⁴	Yes	Yes

¹ Effective January 1, 2007, the Margin Tax replaced the Texas franchise tax and is applicable to all partnerships (other than general partnerships composed entirely of individuals). *See supra* notes 113-207 and related text.

² Unless a single member LLC affirmatively makes an election on IRS Form 8832 to be taxed as a corporation, it defaults to being disregarded for federal tax purposes. Treas. Reg. § 301.7701-3(b)(ii). Thus, where the single member of the LLC is an individual, the result is that the LLC is treated as a proprietorship for federal income tax purposes; where the single member of the LLC is an entity, the result is that the LLC is treated as if it were a division of the owning entity for federal income tax purposes.

³ Unless a partnership or multi-member LLC affirmatively makes an election on IRS Form 8832 to be taxed as a corporation, it defaults to being taxed as a partnership for federal tax purposes. Treas. Reg. § 301.7701-3(b)(i). *See supra* note 79 and related text.

⁴ To be taxed as an S Corp, the entity and all of its equity owners must make a timely election on Form 2553 and meet several other requirements, generally having only citizen/resident individuals or estates as equity owners (with the exception of certain qualifying trusts and other holders), no more than 100 owners, and only one “class of stock.” IRC § 1361(b).

⁵ Unless LP qualifies as a “passive” entity. Tex. Tax Code § 171.0003. *See supra* notes 118-131 and related text.

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Amendments to Texas Business Organizations Code Enacted in 2009 Legislative Session

The TBOC was amended in the 2009 Legislative Session by the following bills:¹

- S.B. 1442 by Sen. Troy Fraser (a 64-page bill generally updating TBOC), *available at* <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=81R&Bill=SB1442>.²
S.B. 1442 amended the TBOC generally as follows:

Section 1 amended the definitions in TBOC § 1.002 to clarify that a “conversion” transaction may be known by another name (i.e., domestication, continuance or transfer transaction) in a jurisdiction outside Texas. A conversion transaction may be effected in relation to any kind of organization, including a foreign entity (which remains defined as an organization formed under the laws of the jurisdiction other than Texas). The definitions of “conversion,” “converted entity” and “converting entity” were also corrected to change references from “foreign entity” or “entity” to “non-Code organization” or “organization”. Two new definitions are added: (1) A “non-United States entity” is defined to mean a foreign entity formed under, and the internal affairs of which are governed by, the laws of a “non-United States jurisdiction,” which means any foreign country or other foreign jurisdiction other than the United States, the District of Columbia, or any other possession or territory of the United States, and (2) the definition of “shareholder” or “holder of shares” was changed to include a beneficial owner of shares if a for-profit corporation adopts a procedure to recognize and deal directly with a beneficial owner, which change was modeled after Model Business Corporation Act (“MBCA”) § 1.40(21).

Section 2 eliminated the prohibition previously in TBOC § 2.003(2)(E) against a domestic entity operating as a railroad company. Title 112 of Texas Revised Civil Statutes was revised in the 2007 Legislative Session by H.B. 3711 to eliminate a number of provisions that allowed the formation of railroad companies. That change was made under the erroneous assumption that railroad companies could be formed under the TBOC. The deletion of the prohibition previously in TBOC § 2.003(2)(E) corrects this situation by allowing railroad companies to be formed under the TBOC. Railroad companies will continue to be regulated by the provisions of Title 112 and other Texas laws in respect of their operations and powers.

Section 3 added a new subsection (f) to TBOC §3.202 to prohibit ownership interest certificates from being issued in bearer form. Bearer form certificates have no registered owners and have been criticized by federal and other law enforcement agencies as a means to avoid disclosure of actual ownership of entities in order to prevent discovery of the persons responsible for illegal activities by the culpable entity. This change does not affect ownership interest certificates held by nominees.

¹ The descriptions of legislation described below are based on the text of the respective bills, bill analyses prepared by the Codification Committee of the Business Law Section of the State Bar of Texas or staff of the Legislature, and a report dated June 24, 2009 prepared by George S. Christian.

² S.B. 1442 was drafted by the Codification Committee of the Business Law Section and supported in the Legislature by the Texas Business Law Foundation.

Section 4 added new Subchapter F to TBOC Chapter 3 that authorizes emergency provisions in the governing documents of domestic entities that are triggered by some catastrophic event. Under new TBOC § 3.251 an “emergency” exists if a majority of the domestic entity’s governing persons cannot readily participate in a meeting because of the catastrophic event. Under new TBOC §3.252 the governing persons, owners or members of a domestic entity may (unless otherwise provided in its governing documents) adopt provisions in its governing documents for managing a domestic entity during the emergency, including provisions (i) prescribing procedures for calling a meeting of the governing persons; (ii) establishing minimum requirements for participation at that meeting of the governing persons; and (iii) designating additional or substitute governing persons. The emergency provisions must be adopted in accordance with the requirements of the entity’s existing governing documents and the TBOC. Under new TBOC §3.253, the emergency provisions are effective only during the emergency and not after the emergency ends. New TBOC §3.255 provides that the entity’s action taken in good faith in accordance with the emergency provisions binds the domestic entity and may not be used to impose liability on a managerial official, employee or agent of the domestic entity. These emergency provisions were modeled on similar provisions found in MBCA §2.07.

Section 5 added new subsections (d) and (e) to TBOC §4.005 to clarify that a certificate issued by the Secretary of State to the effect that a domestic filing entity is in existence or that a foreign filing entity is in existence or registered may be relied upon as conclusive evidence that the domestic filing entity is in existence or that the foreign filing entity is registered and authorized to transact business in this state. These provisions were based in part on MBCA §1.28(c).

Section 6 corrected language in TBOC §4.101(b) to indicate that the certificate of correction must be signed by the person authorized by the TBOC to sign the filing instrument being corrected. The prior language permitted the certificate of correction to be signed by any person authorized by the TBOC to act on behalf of the entity. Some provisions of the TBOC authorize only certain persons to execute specific types of filing instruments related to the domestic entity.

Section 7 added a new subsection (d) to TBOC §6.052 to clarify that a person’s participation or attendance at a meeting constitutes a waiver of notice of a particular matter at the meeting that is not within the purposes or business described in the meeting notice unless the person objects to considering the matter when it is presented. This provision would prevent a participating or attending person from later challenging approval of a matter for a lack of inclusion in the meeting notice. The provision is based on MBCA §7.06(b)(2).

Section 8 added new subsections (b) and (c) to TBOC §6.205 based on similar provisions of TBCA Article 9.10B to clarify that an electronic transmission by an owner, member or governing person of a consent to take an action is considered a signed writing if the electronic transmission contains or is accompanied by information from which it can be determined that the transmission was transmitted by such person and the date of the transmission. This result was implied in the existing TBOC provisions.

Section 9 added a new TBOC §9.005 that provides requirements for content to be added to an application for registration by a foreign LLC whose Company Agreement establishes or provides for the establishment of designated series of members, managers, membership interests or assets with the specified characteristics. This provision is modeled on §18-215(n) of the Delaware Limited Liability Company Act (“DLLCA”).

Section 10 amended TBOC §9.009(a) to add a requirement that a foreign limited partnership must amend its application for registration if there is a change in its general partner. This change will cause the rules for foreign limited partnerships to be equivalent to the requirements for amending a Certificate of Formation of a domestic limited partnership. The public filing of the identity of a limited partnership’s general partner or general partners is to help allow third parties to determine or confirm who has authority to act on behalf of the limited partnership.

Section 11 corrected TBOC §9.011(c) to clarify that the Margin Tax now applies to more entities than corporations and LLCs. As a condition to filing a certificate of withdrawal, any taxable entity under Chapter 171 of the Tax Code, other than a foreign nonprofit corporation, must file a Comptroller’s certificate that all taxes administered by the Comptroller under Title 2 of the Tax Code have been paid.

Section 12 added a new TBOC §9.012 to eliminate the filing of an unnecessary filing instrument in connection with a conversion of a foreign filing entity or foreign LLP into a domestic filing entity. A formal withdrawal of the registration of the foreign entity will no longer be necessary because the filing of the certificate of conversion clarifies the status of the converting foreign entity. The provision will also apply to a conversion and continuance transaction under TBOC §10.1025.

Section 13 corrected TBOC §9.104(d) to clarify that the Margin Tax applies to more entities than corporations and LLCs. As a result, any taxable entity under Chapter 171 of the Tax Code, other than a foreign non-profit corporation, must file a tax clearance letter from the comptroller that all margin taxes have been paid in order to file a certificate of reinstatement.

Section 14 added a new subdivision (15) to TBOC §9.251 (Activities Not Constituting Transacting Business in This State) to provide that mere ownership of real or personal property in Texas, without more, will not constitute transaction of business in Texas for the purposes of the requirement to register to do business under TBOC Chapter 9. For example, the ownership by a limited partner of a partnership interest in a limited partnership doing business in Texas, without more, will not require the limited partner to register to transact business in Texas. This amendment would not affect (i) the payment of taxes under the Tax Code, including the Margin Tax, or (ii) the long-arm jurisdiction statute which allows Texas courts to obtain personal jurisdiction over out-of-state entities or having sufficient minimum contacts with Texas. The new language is based on MBCA §15.01.

Sections 15 through 18 added provisions that authorize conversion and continuance transactions. Section 15 added a new TBOC §10.1025 to authorize a converting entity to elect to continue its existence in its current organizational form and jurisdiction of formation in connection with its conversion under Chapter 10. This election is only available to a domestic

entity of one organizational form that is converting into a non-U.S. entity of the same organizational form or a non-U.S. entity of one organizational form converting into a domestic entity of the same organizational form. The permitted election must be adopted and approved as part of the plan of conversion for the converting entity and permitted by, or not prohibited by or inconsistent with, the laws of the applicable non-U.S. jurisdiction. The concepts in this new section are based on similar concepts contained in the Delaware entity laws. Even though the converting entity continues to exist in the non-U.S. jurisdiction (as well as in Texas), the entity would not be required to qualify to do business in Texas as a foreign entity under TBOC Chapter 9 after its conversion and continuance.

Section 16 revised TBOC §10.103(a) to provide that, because a conversion of ownership or membership interests is not required in a conversion and continuance transaction, a description of such conversion is not necessary in the plan of conversion. In addition, a statement must be included in the plan of conversion to the effect that the converting entity is electing to continue its existence in its current organizational form and jurisdiction of formation after the conversion becomes effective.

Section 17 added new TBOC §10.109 that specifies the effects of a conversion and continuance transaction. In this type of transaction, the converting entity continues to exist both in its current organizational form and jurisdiction of formation and in the same organizational form in the new jurisdiction of formation, as a single entity subject to the laws of both jurisdictions. The property interests, liabilities and obligations of the entity remain unchanged.

Section 18 added to TBOC §10.154 a new subsection (c) that requires the certificate of conversion to be titled a “certificate of conversion and continuance” and to include a statement certifying that the converting entity is electing to continue its existence outside the U.S. in its current organizational form and jurisdiction of formation.

Section 19 added a new subsection (g) to TBOC §10.361 to permit a beneficial owner of an ownership interest that is entitled to dissenters’ rights to file a petition for appraisal. An ownership interest is entitled to dissenters’ rights only if the record or registered owner has taken the steps in Subchapter H of Chapter 10 to perfect those rights, and a petition for appraisal may be filed only if the dissenting record or registered owner and the entity responsible for satisfying the obligations to dissenters have not agreed on the fair market value of the ownership interest. If the dissenting record or registered owner is the trustee of a voting trust or other nominee holder of the ownership interest for a beneficial owner, then the new subsection (g) authorizes the beneficial owner, as the person with the direct economic interest in the ownership interest entitled to dissenters’ rights, to pursue the dissenters’ rights by petitioning a court for appraisal. The nominee holder of the ownership interest then need not serve as plaintiff in the appraisal action. This provision is based on a 2007 amendment to § 262(e) Delaware General Corporation Law (the “DGCL”).

Section 20 corrected an error in TBOC §10.366(b) by changing “another owner” to read “an owner.”

Section 21 clarified the provisions of TBOC §10.367(b) to specify the rights of a dissenting owner after the termination of the owner’s right of dissent under that section. Under

TBOC § 10.367(a) an owner's rights to dissent are terminated when the owner withdraws the demand for payment of the fair value of the ownership interests under TBOC § 10.356 or fails to comply with the procedural requirements under TBOC §§ 10.356 and 10.361, or a court adjudges that the owner is not entitled to dissent. Under new TBOC § 10.367(b), the owner's status as an owner of the owner's ownership interest is restored as if the owner's demand for payment of the fair value of the ownership interest had not been made under TBOC §10.356. If the owner's ownership interest was cancelled, converted or exchanged as a result of the action or a subsequent action, the dissenting owner is entitled to receive the same cash, property, rights and other consideration received by the owners of the same class and series of ownership interests held by the owner as if the owner's demand for the payment of the fair market value of the ownership interest had not been made under TBOC §10.356. The validity of any actions of the domestic entity cannot be challenged because of the restoration of the owner's ownership interest or the other rights or entitlements of the owner under new TBOC § 10.367(b)(5). The dissenting owner is also entitled to receive any dividends or other distributions made with respect to his or her ownership interest as if the demand had not been made. These changes are intended to clarify the provisions in response to an improper reading of the prior provisions by the court in *Sembera v. Petrofac Tyler, Inc.*, 253 S.W.3 815 (Tex. App.-Tyler 2008, pet. denied). The *Sembera* court improperly interpreted the phrase "restored without prejudice to any interim proceeding" in TBCA Article 5.13.C, which is similar to the current language of TBOC § 10.367(b), to create a condition precedent to the shareholder's rights to be restored in the ownership of his or her shares.

Section 22 corrected TBOC §11.101(b) to clarify that the Margin Tax now applies to more entities than corporations and LLCs. As a result, any taxable entity under Chapter 171 of the Tax Code, other than a nonprofit corporation, must file a Comptroller's certificate that all taxes administered by the Comptroller under Title 2 of the Tax Code have been paid in order to file a certificate of termination.

Section 23 corrected TBOC §11.202(e) to clarify that the Margin Tax now applies to more entities than corporations and LLCs. As a result, any taxable entity under Chapter 171 of the Tax Code, other than a nonprofit corporation, must file a tax clearance letter from the Comptroller that all margin taxes have been paid in order to file a certificate of reinstatement.

Section 24 amended TBOC §11.253(c) to clarify that any taxable entity under Chapter 171 of the Tax Code, other than a nonprofit corporation, must file a tax clearance letter from the Comptroller that all margin taxes have been paid as a condition to filing a certificate of reinstatement.

Section 25 corrected TBOC §11.314 to clarify that the location of "the principal place of business in this state" of the domestic partnership or LLC is what the prior provisions intended.

Section 26 added a new subsection (c) to TBOC §12.001 to clarify and confirm the authority of the Secretary of State to issue certificates evidencing filing of an instrument, a letter acknowledging the filing of an instrument or both a certificate and a letter. New subsection (d) clarifies that TBOC §§ 12.001, 12.003 and 12.004 do not apply to domestic real estate investment trusts.

Section 27 amended TBOC §21.152 to clarify, in subsection (a), that the Certificate of Formation must include a designation of rights of each class and series of shares only if more than one class or series of shares is authorized. A new subsection (d) was also added to this section to expressly state the requirement, which is implied in Chapter 21 (and in the TBCA), that the authorized class or classes or series of shares collectively have general voting rights and the right to the residual corporate assets upon winding up and termination. If more than one class or series of shares is authorized, these two fundamental rights need not be in a single class or series of shares. If only one class of shares is authorized, those shares must have the two fundamental rights, but the Certificate of Formation does not need to so state. The new subsection (d) is modeled after MBCA §6.01(b).

Section 28 amended TBOC §21.153(a) to clarify that the Certificate of Formation must include a designation of rights of each class or series of shares only if more than class or series of shares is authorized.

Section 29 clarified TBOC §21.154(a) by making it subject to the provisions of Section 21.152.

Section 30 added a new subsection (c) to TBOC §21.157 to clarify that a for-profit corporation may issue shares into escrow, or make other security arrangements, when the consideration is future services or benefits, or a promissory note payable, to the corporation, and may provide that the shares may not be transferred, or be entitled to receive distributions, until the note is paid or the services are performed. A corporation's authority to so issue shares is implicit in Chapter 21 (and in the TBCA). This express statement of authority does not affect any of the applicable conditions to an issuance of shares provided in Subchapter D of Chapter 21. An issuance into escrow will be conditioned upon, among other things, the corporation's receipt of the required statutory consideration (such as the par value of any par-value shares). The new subsection (c) is modeled after MBCA §6.21(e).

Section 31 amended TBOC §21.163(a)(4) to eliminate the ability of a corporation to issue scrip in bearer form.

Section 32 amended TBOC §21.171 to clarify, in new subsections (a) and (b), the meaning of "outstanding" shares and the requirement that there always be outstanding shares of one or more classes or series that collectively have general voting rights and the right to the residual corporate assets upon winding up and termination. These concepts are implicit in Chapter 21 (and in the TBCA). The requirement of the new subsection (b), like that of the new subsection (d) to be added to TBOC §21.152, may be satisfied collectively by classes or series of shares. If more than one class or series of shares is outstanding, the two fundamental rights need not be in a single class or series of shares. The new subsection (b) is modeled after MBCA §6.03(c).

Section 33 amended TBOC §21.201 to add new subsections (b)-(d) that authorize a for-profit corporation to adopt a procedure for recognizing and directly dealing with a beneficial owner of its shares. Chapter 21 of the TBOC, like the TBCA, contemplates that a corporation directly communicates and deals with only a record or registered holder of its shares. It is typical, however, in the case of publicly held securities, for shares to be held by a nominee,

through securities depositories (i.e., in “street name”), so that the ultimate owner of the shares is not the record or registered holder. The new TBOC §21.201 subsections enable a corporation, if it desires, to recognize the beneficial owner as the “shareholder” and to communicate and deal directly with the beneficial owner instead of the record or registered holder. The extent of this recognition is at the corporation’s discretion: it may recognize the beneficial owner for all purposes or only for certain purposes, such as giving notice of shareholders’ meetings or paying dividends. The procedure for recognition is also subject to the corporation’s discretion, except that it must include the nominee’s filing with the corporation of a statement identifying, and providing other relevant information regarding, the beneficial owner. A beneficial owner’s decision to follow the procedure to become recognized as the “shareholder” is also subject to his or her discretion. This provision is modeled after MBCA §7.23 . The heading of TBOC §21.201 was also changed to reflect the content of the new subsections.

Section 34 corrected TBOC §21.224 to add “or” so that the text parallels TBOC §21.223.

Section 35 corrected TBOC §21.361(a) to move language that should have related only to cumulative voting for directors to its rightful position as a qualifier for subdivision (2) only.

Section 36 amended TBOC §21.406(a) to permit a Certificate of Formation to grant corporate directors different voting rights, without the existing condition in subsection (a) that the directors be elected by separate classes or series of shares. Also, a new sentence is added at the end of the subsection to clarify that any different director voting rights apply to votes not only on board matters, but also on committee matters, unless the Certificate of Formation provides otherwise. These changes are modeled after provisions of DGCL 141(d).

Section 37 clarified TBOC §21.418(b) to connect the provisions of subsection (b) to the contract or transaction described in subsection (a), as well as the relationship or interest of the director or officer described in subsection (a). It also clarifies that board action regarding an interested director contract or transaction may be taken by a unanimous written consent of directors or of board committee members, including the consent of the interested director. This provision, which is implied in Chapter 21 (and in the TBCA), treats action taken by unanimous written consent in the same manner as action taken at a directors’ or committee meeting at which the interested director participates and votes.

Section 38 corrected TBOC §101.054(a)(2) to fix the cross-reference to read “101.101” instead of “101.101(b).”

Section 39 added a new subsection (c) to TBOC §101.106 to clarify that §§ 9.406 and 9.408 of the Texas Business & Commerce Code (“TB&CC”) do not apply to membership interests in an LLC. TBOC §§ 9.406 and 9.408 contain limitations on the enforceability of contractual provisions that restrict transfer of payment intangibles and other general intangibles. Since uncertificated LLC membership interests are considered general intangibles under the TB&CC, there had been a concern that those two TB&CC sections could impair or negate restrictions on transfer of membership interests permitted by the TBOC and often included in a Company Agreement. New TBOC §101.106(c) is intended to eliminate that concern by expressly stating that such TB&CC sections will not impair the enforcement as a contract among

the members of any provision in a Company Agreement that would otherwise be ineffective under those sections.

Section 40 clarifies TBOC §101.112(c) to specify that although a charging order constitutes a lien on the judgment debtor's membership interest in an LLC, that lien may not be foreclosed upon under the TBOC or any other law. This was the intent and effect of the other provisions in TBOC §101.112.

Section 41 amended TBOC §101.206 to add a new subsection (f) to clarify that 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 plan or other benefits program. In addition, subsection (a) was clarified to indicate that the restrictions on distributions by an LLC are subject to distributions made in compliance with Chapter 11. Subsection (d) was clarified by revising the sentence structure to conform to the source provision in the LLC Act. New TBOC §101.206(f) is modeled on DLLCA §18-607(a).

Section 42 added new TBOC §101.208 to clarify that a Company Agreement of an LLC may establish or provide for the establishment of record dates with respect to allocations and distributions. This provision is modeled after DLLCA §18-606.

Section 43 corrected the heading of TBOC §101.251 to more accurately describe the content of that section.

Section 44 amended TBOC §101.255(b) to make similar clarifying changes for LLC's as are being made by Section 37 of S.B. 1442 to the provisions of TBOC §21.418(b) for for-profit corporations.

Section 45 added a new Subchapter M to Chapter 101 to permit LLCs to establish series of members, managers, membership interests or assets to which different assets and liabilities may be allocated. The provisions are modeled after the series LLC provisions in DLLCA § 18-215. Through appropriate provisions in the Company Agreement and Certificate of Formation, the assets of one series could be isolated from the liabilities attributable to a different series. These provisions would allow considerable flexibility in structuring LLCs in Texas. 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.

Section 46 adds new TBOC §151.004 to clarify that a partnership may have elected or appointed officers in accordance with TBOC §3.103. This change makes clear that TBOC §3.103 applies to partnerships, as originally intended by that provision.

Section 47 amends Section 152.801(a) to clarify that the liability protection provided to partners in an LLP applies to any obligation of the partnership, including an obligation of the partnership to another partner. The amendment also clarifies that the partnership agreement of an LLP may specify that a partner is personally liable for a debt or obligation of the partnership, notwithstanding that the partnership is an LLP.

Section 48 amends Section 152.802(f) to require a certificate from the comptroller as to the payment of all taxes administered under Title 2 of the Tax Code in order to file a withdrawal notice by an LLP. This change is required because amendments to the Tax Code in 2007 have made LLPs subject to the Margin Tax.

Section 49 added a new subsection (c) to TBOC §152.906 to require a certificate from the Comptroller as to the payment of all taxes administered under Title 2 of the Tax Code in order to file a withdrawal of registration by a foreign LLP. This change is required because amendments to the Tax Code in 2007 have made LLPs subject to the Margin Tax.

Section 50 added a new subsection (f) to TBOC §152.914 to add the requirement that a tax clearance letter from the Comptroller stating that a foreign LLP has satisfied all Margin Tax obligations must be filed in connection with the filing of a certificate of reinstatement if the partnership is a taxable entity under Chapter 171 of the Tax Code. This change is required because amendments to the Tax Code in 2007 have made LLPs subject to the state franchise tax.

Section 51 clarified TBOC §153.103(1)(A) to provide that such provision applies to officers as well as agents or employees of the limited partnership.

Section 52 amended TBOC §153.210 to add a new subsection (b) to clarify that the limitations on distributions by a limited partnership do not apply to payments for reasonable compensation for present or past services or reasonable payments made in the ordinary course of business pursuant to a bona fide retirement plan or other benefits program. This provision is modeled after Delaware Revised Uniform Limited Partnership Act (“DRULPA”) §17-607(a). In addition, TBOC §153.210(a) is clarified to indicate that the restrictions on distributions by a limited partnership are subject to distributions made in compliance with TBOC Chapter 11.

Section 53 amended TBOC §153.256(c) to clarify that although a charging order constitutes a lien on the judgment debtor’s partnership interest in an limited partnership, that lien may not be foreclosed upon under the TBOC or any other law. This was the intent and effect of the other provisions in TBOC §153.256.

Sections 54 and 55 amended TBOC §153.309(c) and 153.311(d) to clarify that the limitation on a limited partner’s liability is not affected by the forfeiture of a limited partnership’s right to transact business in Texas because of its failure to file reports with the Secretary of State or by any resulting cancellation of its Certificate of Formation or foreign registration by the Secretary of State. The amendments are intended to make the TBOC provisions consistent with the corresponding provisions in TRLPA §§13.06(d) and 13.08(b) from which they are derived.

Section 55 corrected terminology used in TBOC §153.311. The words “cancellation” or “cancel” were changed to read “termination” or “terminate” to clarify that the registration of the foreign limited partnership is “revoked” instead of “cancelled.” These changes are consistent with the terminology of other provisions of the TBOC.

Section 56 corrected terminology used in TBOC § 153.312(a) for the same reasons amendments were made to TBOC § 153.311. Subsection (b) is amended to clarify that a limited partnership must pay all taxes, penalties and interest due and accruing before termination or

revocation in order to seek reinstatement by the Secretary of State. This change is required because amendments to the Tax Code in 2007 have made limited partnerships subject to the Margin Tax.

Section 57 added a new subsection (c) to TBOC §154.001 to clarify that TB&CC §§9.406 and 9.408 do not apply to partnership interests in a partnership. TB&CC §§9.406 and 9.408 contain limitations on the enforceability of contractual provisions that restrict transfer of payment intangibles and other general intangibles. Subsection (c) also expressly states that such TB&CC sections will not supersede the enforcement as a contract among the partners of any provision in a partnership agreement that would otherwise be ineffective under those sections.

Section 58 amended TBOC §200.317(b) to make similar clarifying changes for REIT's as are being made by Section 37 of S.B. 1442 to the provisions of Section 21.418(b) for for-profit corporations.

Section 59 corrected an erroneous cross-reference in TBOC §402.005(a) to read "Section 402.003" instead of "Section 402.003(a)."

Sections 60 and 61 added new subsections to TB&CC §§9.406 and 9.408 to clarify that the provisions of those sections do not apply to an interest in a partnership or LLC. These provisions are based on similar provisions in the Delaware and Virginia versions of the UCC and correspond to Sections 39 and 56 of S.B. 1442.

Section 62 added a definition of "foreign filing entity" to TB&CC §71.002, which contains the definitions of the terms used in the assumed name statute. Other changes correct language to remove the word "registered" from the phrase "limited liability partnership." The TBOC has eliminated the use of that word in referring to those kinds of partnerships. The term "person" is expanded to include foreign filing entities, and the definition of "office" is revised to specify what is the office of a foreign filing entity.

Sections 63 and 64 amended TB&CC §§71.003(b) and 71.051 to add foreign filing entities to these provisions and to change the reference to "limited liability partnership" from "registered limited liability partnership," which is consistent with the terminology in the TBOC.

Section 65 corrected TB&CC §71.052 to eliminate references to "corporation" in subsection (2)(E). These references are not needed because the definition of the term "company" does not include incorporated entities (i.e. corporations). Subsection (4) is also amended to add a reference to a foreign filing entity and to change references to "limited liability partnership" from "registered limited liability partnership," which is consistent with the terminology in the TBOC.

Section 66 amended TB&CC §71.101 to add a reference to a foreign filing entity and to change references to "limited liability partnership" from "registered limited liability partnership," which is consistent with the terminology in the TBOC.

Section 67 amended TB&CC §71.102 to change references to "limited liability partnership" from "registered limited liability partnership" and "for-profit corporation" from "business corporation" which are consistent with the terminology in the TBOC. Another change clarifies that the type of entity can be either foreign or domestic. Another change eliminates an

unnecessary requirement to state the registered office and registered agent if the registrant is required to and maintains a registered office in Texas. In that situation, the registrant only needs to list the address of its principal office.

Section 68 amended TB&CC §71.103 to add a reference to a foreign filing entity and to change references to “limited liability partnership” from “registered limited liability partnership,” which is consistent with the terminology in the TBOC. Subsection (b) was clarified to provide that an entity that maintains a registered office in this state must file the certificate in the county in which its registered office is located, if the entity’s principal office is not located in Texas, or in which its principal office is located if the principal office is in Texas. Subsection (c) was revised to clarify that it applies only to an entity that does not maintain a registered office in the state.

Section 69 amended TB&CC §71.152(b) to delete provisions relating to a registered office or registered agent in conformance to the change made to TB&CC §71.102 by Section 67 of S.B. 1442.

Section 70 amended Section 19(A) of the Texas Professional Association Act to require a certificate from the Comptroller of Public Accounts as to payment of all taxes under Title 2 of the Tax Code in order to file articles of dissolution by a professional association. This change is required because amendments to the Tax Code in 2007 made professional associations subject to the Margin Tax.

Section 71 amended TRLPA §2.03(a) to require a certificate from the Comptroller of Public Accounts as to the payment of all taxes administered under Title 2 of the Tax Code in order to file a certificate of cancellation by a limited partnership. This change is required because amendments to the Tax Code in 2007 made limited partnerships subject to the Margin Tax.

Section 72 amended TRLPA §9.06 to require a certificate of the Comptroller of Public Accounts as to the payment of all taxes administered under Title 2 of the Tax Code in order to file a certificate of cancellation by a limited partnership. This change is required because amendments to the Tax Code in 2007 have made limited partnerships subject to the Margin Tax.

Section 73 repealed TBOC §2.006, which contains provisions that allow formation of corporations that operate certain kinds of railroads. This provision is no longer needed as a result of the deletion of the prohibition in Section 2.003(2)(E) of the Code by Section 2 of S.B. 1442.

Section 74 provided that the effective date of S.B. 1442 is September 1, 2009.

- H.B. 1787 by Rep. Burt Solomons (R-Carrollton), *available at* <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=81R&Bill=HB1787>

H.B. 1787 amended Chapter 5 of the TBOC to require that a registered agent for service of process consent in a written or electronic form to be developed by the Secretary of State to

serve as such.³ This consent requirement is applicable to any domestic or foreign entity, including any corporation, partnership, LLC or financial institution, that designates a registered agent in a filing with the Secretary of State. It applies to both for-profit and non-profit entities, and to both individual and corporate agents.

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

A registered agent in Texas must be a resident individual or business registered or authorized to do business in the state.

H.B. 1787 specifies the sole duties of a registered agent, which are: (1) to forward or notify the entity of any process, notice, or demand served on the agent; and (2) to provide the notices required or permitted by law to the entity.⁴ A person named a registered agent without the person's consent is not required to perform these duties.⁵

H.B. 1787 provides that the appointment of a person as registered agent is an affirmation by the entity that a person has consented to serve as the registered agent.⁶ The maintenance of a person as registered agent after a transfer of a majority interest in the ownership or membership interests of the entity is an affirmation by the governing authority of the entity that the person consents to continue as the agent.⁷

H.B. 1787 shields a person appointed as the registered agent from liability by reason of the person's appointment for the debts, liabilities, and obligations of the entity.

The resignation of a registered agent terminates both the appointment of the agent and the designation of the registered office.

A person who has not consented to appointment as registered agent is shielded from a judgment, decree or order of a court, agency or other tribunal for a debt, obligation or liability of the entity, whether in contract or tort. This liability protection extends to a claim of a person who reasonably relies on the unauthorized designation by reason of the person's failure or refusal to perform the duties of registered agent.⁸

H.B. 1787 creates a statement of rejection that may be filed by a person designated or appointed as a registered agent without the person's consent.⁹ Filing this statement terminates the appointment and the designation of the registered office, and triggers a notice from the

³ TBOC § 5.201(b) as amended by H.B. 1787 § 2.

⁴ TBOC § 5.206(a) as added by H.B. 1787 § 5.

⁵ TBOC § 5.206(b) as added by H.B. 1787 § 5.

⁶ TBOC § 5.2011 as added by H.B. 1787 § 3.

⁷ *Id.*

⁸ TBOC § 5.208 as added by H.B. 1787 § 5.

⁹ TBOC § 5.205 as added by H.B. 1787 § 5.

Secretary of State to the entity of the necessity of designating or appointing a new registered agent or registered office.

H.B. 1787 extends TBOC §§ 4.007 and 4.008, which prescribe civil remedies and criminal penalties for filing a false statement, to a registered agent filing that names the registered agent without the person's consent.¹⁰

H.B. 1787 is effective January 1, 2010.

¹⁰ TBOC § 5.207 as added by H.B. 1787 § 5.



EGAN ON ENTITIES

Byron Egan is a partner in the Dallas office of Jackson Walker L.L.P. specializing in corporate, financing, mergers and acquisitions, and securities related matters. He is also a prolific speaker and writer, having penned more than 240 papers relating to business entities. Mr. Egan writes about the issues that he deals with every day as a seasoned corporate lawyer: corporation, partnership and limited liability company formation, entity governance, financing transactions, mergers and acquisitions, and securities laws.

This bulletin, called Egan on Entities, contains introductions to Mr. Egan's recent significant writings in four areas of the law relating to business entities, including how they are formed, governed and combined with other entities.¹ These writings contain practical insights regarding these subjects developed from his law firm practice and his interaction with others, as well as a thorough analysis of statutory and case law from which these practical insights have been developed.

Full versions of the writings referenced below can be found in the links identified below.

For further information or to provide your suggestions for additional bulletins, feel free to contact Mr. Egan directly at 214 953-5727, or by email at began@jw.com. Additionally, a listing of Mr. Egan's writings available online may be accessed at: <http://www.jw.com/site/jsp/attvinfo.jsp?id=77>.

More about Byron Egan: In addition to practicing corporate, financing, mergers and acquisitions, and securities law at Jackson Walker L.L.P. and making himself available as a resource to other lawyers, Mr. Egan currently serves as Senior Vice Chair and Chair of Executive Council of the ABA Business Law Section's Mergers & Acquisitions Committee and was Co-Chair of its Asset Acquisition Agreement Task Force, which published the ABA Model Asset Purchase Agreement with Commentary. A former Chair of both the Texas Business Law Foundation and the Business Law Section of the State Bar of Texas, as well as that Section's Corporation Law Committee, Mr. Egan has been involved in the drafting and enactment of many Texas business entity statutes, and that experience continues to enrich his current law practice. Four of Mr. Egan's law journal articles have received the Burton Award for excellence in legal writing presented at the Library of Congress. In 2009, his paper entitled "Director Duties: Process and Proof" was awarded the Franklin Jones Outstanding CLE Article Award and an earlier version of that article was honored by the State Bar Corporate Counsel Section's Award for the Most Requested Article in the Last Five Years. A profile of Mr. Egan published in The M&A Journal is available at: <http://www.jw.com/site/jsp/publicationinfo.jsp?id=540>.

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1.

CHOICE OF ENTITY AND FORMATION

EXCERPTED FROM: “Choice of Entity Decision Tree In Troubled Times” – prepared for a May 22, 2009 program in San Antonio at the TexasBarCLE & Business Law Section of State Bar of Texas’ program on Choice of Entity In Troubled Times. Published on the JW website and full text available at: <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1175>

Key Issues Covered:

- Key factors in entity selection
- Summaries of key provisions of Texas and Delaware laws relating to
 - Corporations
 - General Partnerships
 - Limited Partnerships
 - Limited Liability Partnerships
 - Limited Liability Companies
- Summaries of U.S. and Texas tax treatment of entities

See also “*Good Faith, Fair Dealing and Other Contractual and Fiduciary Issues*” – prepared for a July 23, 2009 program in Austin at the UT Law 2009 Partnerships and LLCs Conference. Published on the JW website and full text available at: <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1220>

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

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

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

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

Federal and state taxation of an entity and its owners for entity income is a major factor in the selection of the form of entity for a particular situation. Under the Internal Revenue Code of 1986 and the “Check-the-Box” regulations promulgated by the Internal Revenue Service, an unincorporated business entity may be classified as an “association” taxable as a corporation subject to income taxes at the corporate level ranging from 15% to 35% of taxable net income, absent a valid S-corporation status election, which is in addition to any taxation which may be imposed on the owner as a result of distributions from the business entity. Alternatively, the entity may be classified as a partnership, a non-taxable “flow-through” entity in which taxation is imposed only at the ownership level. Although generally a corporation may be

classified only as a corporation for federal income tax purposes, an LLC or partnership may elect whether to be classified as a partnership. A single-owner LLC is disregarded as a separate entity for federal income tax purposes unless it elects otherwise.

Texas does not have a state personal income tax. The Texas Legislature has replaced the Texas franchise tax on corporations and LLCs with a novel business entity tax called the “Margin Tax,” which is imposed on all business entities other than general partnerships wholly owned by individuals and certain “passive entities.” Essentially, the calculation of the Margin Tax is based on a taxable entity’s, or unitary group’s, gross receipts after deductions for either (x) compensation or (y) cost of goods sold, provided that the “tax base” for the Margin Tax may not exceed 70% of the entity’s total revenues. This “tax base” is apportioned to Texas by multiplying the tax base by a fraction of which the numerator is Texas gross receipts and the denominator is aggregate gross receipts. The tax rate applied to the Texas portion of the tax base is 1% for all taxpayers, except a narrowly defined group of retail and wholesale businesses that will pay a ½ of 1% rate.

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

For the full version, please go to the Jackson Walker L.L.P. website, www.jw.com, where the full text is available at: <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1175>.

2.

CORPORATE GOVERNANCE

EXCERPTED FROM: “Fiduciary Duties of Corporate Directors and Officers in Texas” – 43 Texas Journal of Business Law 45 (Spring 2009). Published on the JW website and full text available at: <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1230>

Key Issues Covered:

- Fiduciary duties of directors and officers generally in both Texas and Delaware
- Fiduciary duties in insolvency situations
- Fiduciary duties regarding compensation
- Fiduciary duties regarding mergers and acquisitions
- Fiduciary duties regarding alternative entities

See also “*Recent Fiduciary Duty Cases Affecting Advice to Directors and Officers of Delaware and Texas Corporations*” – prepared for a February 12, 2010 program in Dallas at the UT School of Law 32nd Annual Conference on Securities Regulation and Business Law. Published on the JW website and full text available at:

<http://www.jw.com/site/jsp/publicationinfo.jsp?id=1344>

The conduct of corporate directors and officers is subject to particular scrutiny in the context of executive compensation and other affiliated party transactions, business combinations (whether friendly or hostile), when the corporation is charged with illegal conduct, and when the corporation is insolvent or in the zone of insolvency. The high profile stories of how much corporations are paying their executive officers,

corporate scandals, bankruptcies and related developments have further focused attention on how directors and officers discharge their duties, and have caused much reexamination of how corporations are governed and how they relate to their shareholders and creditors. Where the government intervenes (by investment or otherwise) or threatens to do so, the scrutiny intensifies, but the courts appear to resolve the controversies by application of traditional principles while recognizing the 800-pound gorilla in the room.

The individuals who serve in leadership roles for corporations are fiduciaries in relation to the corporation and its owners. These troubled times make it appropriate to focus upon the fiduciary and other duties of directors and officers, including their duties of care and loyalty. Increasingly the courts are applying principals articulated in cases involving mergers and acquisitions (“*M&A*”) to cases involving executive compensation, perhaps because both areas often involve conflicts of interest and self-dealing or because in Delaware, where many of the cases are tried, the same judges are writing significant opinions in both areas. Director and officer fiduciary duties are generally owed to the corporation and its shareholders, but when the corporation is insolvent, the constituencies claiming to be beneficiaries of those duties may expand to include the entity’s creditors.

While federal securities laws and stock exchange listing requirements have mandated changes in corporate governance practices, our focus will be on state corporate statutes and common law. Our focus is in the context of entities organized under the applicable Delaware and Texas statutes.

For the full version, please go to the Jackson Walker L.L.P. website, www.jw.com, where the full text is available at: <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1230>.

3.

MERGERS & ACQUISITIONS

EXCERPTED FROM: “Acquisition Agreement Issues” – prepared for Penn State Law and City Bar Center for CLE, New York City Bar, Sixth Annual Institute on Corporate, Securities, and Related Aspects of Mergers and Acquisitions, New York, NY, Sept. 25, 2009, available at: <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1244>

Key Issues Covered:

- Alternative structures for sales of businesses
- Successor liability
- Form of asset purchase agreement with commentary

See also “*Contractual Limitations on Seller Liability in M&A Transactions*” – prepared for an April 22, 2010 program in Denver at the ABA Section of Business Law Spring Meeting. Published on the JW website and full text available at:

<http://www.jw.com/site/jsp/publicationinfo.jsp?id=1362>

See also “*Challenges in Joint Venture Formation*” – prepared for the UT School of Law 32nd Annual Corporate Counsel Institute in Dallas on April 16 and in Houston on April 30, 2010. Published on the JW website and full text available at:

<http://www.jw.com/site/jsp/publicationinfo.jsp?id=1376>

Buying or selling a business in uncertain times, including the purchase of a division or a subsidiary, revolves around a purchase agreement between the buyer and the selling entity and sometimes its owners. Purchases of assets are characterized by the acquisition by the buyer of specified assets from an entity,

which may or may not represent all or substantially all of its assets, and the assumption by the buyer of specified liabilities of the seller, which typically do not represent all of the liabilities of the seller. When the parties choose to structure an acquisition as an asset purchase, there are unique drafting and negotiating issues regarding the specification of which assets and liabilities are transferred to the buyer, as well as the representations, closing conditions, indemnification and other provisions essential to memorializing the bargain reached by the parties. There are also statutory (e.g., bulk sales and fraudulent transfer statutes) and common law issues (e.g., de facto merger and other successor liability theories) unique to asset purchase transactions that could result in an asset purchaser being held liable for liabilities of the seller which it did not agree to assume.

A number of things can happen during the period between the signing of an asset purchase agreement and the closing of the transaction that can cause a buyer to have second thoughts about the transaction. For example, the buyer might discover material misstatements or omissions in the seller's representations and warranties, or events might occur, such as the filing of litigation or an assessment of taxes, that could result in a material liability or, at the very least, additional costs that had not been anticipated. There may also be developments that could seriously affect the future prospects of the business to be purchased, such as a significant downturn in its revenues or earnings or the adoption of governmental regulations that could adversely impact the entire industry in which the target operates.

The buyer initially will need to assess the potential impact of any such misstatement, omission or event. If a potential problem can be quantified, the analysis will be somewhat easier. However, the impact in many situations will not be susceptible to quantification, making it difficult to determine materiality and to assess the extent of the buyer's exposure. Whatever the source of the matter, the buyer may want to terminate the acquisition agreement or, alternatively, to close the transaction and seek recovery from the seller. If the buyer wants to terminate the agreement, how strong is its legal position and how great is the risk that the seller will dispute termination and commence a proceeding to seek damages or compel the buyer to proceed with the acquisition? If the buyer wants to close, could it be held responsible for the problem and, if so, what is the likelihood of recovering any resulting damage or loss against the seller? Will closing the transaction with knowledge of the misstatement, omission or event have any bearing on the likelihood of recovering? The dilemma facing a buyer under these circumstances seems to be occurring more often in recent years.

The issues to be dealt with by the parties to an acquisition transaction will depend somewhat on the structure of the transaction and the wording of the acquisition agreement. Regardless of the wording of the agreement, however, there are some situations in which a buyer can become responsible for a seller's liabilities under successor liability doctrines. The analysis of these issues is somewhat more complicated in the acquisition of assets, whether it be the acquisition of a division or the purchase of all the assets of a seller. The paper has the following topics:

This paper includes:

- An overview of the three basic forms of business acquisitions:
 - Statutory business combinations (e.g., mergers, consolidations and share exchanges);
 - Stock purchases; and
 - Asset purchases.
- Introductory matters concerning the reasons for structuring the transaction as an asset purchase.
- A discussion of the various successor liability doctrines and some suggested means of minimizing the risk.

- An initial draft of certain key provisions of an Asset Purchase Agreement which focuses on the definition and solution of the basic issues in any asset purchase: (1) what assets are being acquired and what liabilities are being assumed, (2) what assets and liabilities are being left behind, (3) what are the conditions of the obligations of the parties to consummate the transaction and (4) what are the indemnification obligations of the parties. While these matters are always deal specific, some generalizations can be made and common problems identified.

For the full version, please go to the Jackson Walker L.L.P. website, www.jw.com, where the full text is available at: <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1244>.

4.

SECURITIES LAWS

EXCERPTED FROM: “Major Themes of the Sarbanes-Oxley Act” – 42 Texas Journal of Business Law 339 (Winter 2008). Published on the JW website and full text available at: <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1186>

Key Issues Covered:

- Effects of the Sarbanes-Oxley Act of 2002 (“SOX”) on issuers, directors and professionals generally
- SOX audit committee provisions
- SOX auditor independence provisions
- SOX prohibitions on misleading statements to auditors
- SOX internal controls provisions
- Attorney responsibilities under SOX
- Letters to auditors regarding loss contingencies
- Attorney-client and work product privilege considerations

See also “*Responsibilities of Attorneys and Other M&A Professionals After the Sarbanes-Oxley Act*” – prepared for a November 13, 2009 program in New Orleans at the ABA 14th Annual National Institute on Negotiating Business Acquisitions. Published on the JW website and full text available at: <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1274>

The Sarbanes-Oxley Act of 2002 (“SOX”) was trumpeted by the politicians and in the media as a “tough new corporate fraud bill” in response to the corporate scandals that preceded it and as a means to protect investors by improving the accuracy and reliability of corporate disclosures. Among other things, SOX amended the Securities Exchange Act of 1934 (the “1934 Act”) and the Securities Act of 1933. Although SOX does have some specific provisions, and generally establishes some important public policy changes, it has been implemented in large part through rules adopted and to be adopted by the Securities and Exchange Commission (“SEC”) and the Public Company Accounting Oversight Board (“PCAOB”), which have impacted auditing standards and have increased scrutiny on auditors’ independence and procedures to verify company financial statement positions and representations. Further, while SOX is by its terms generally applicable only to public companies, its principles are being applied by the marketplace to privately held companies and nonprofit entities.

Following the enactment of SOX and the adoption of rules thereunder, the role of independent auditors in detecting financial statement fraud within public companies has received enhanced scrutiny. In turn, companies are expected both to implement controls for dealing with alleged fraud internally and to

provide their auditors with detailed information on a wide range of corporate issues. Companies involve legal counsel, both inside and outside, for a wide variety of tasks, from conducting investigations of alleged fraud to dealing with employee issues (including whistleblower complaints) and advising directors on their duties in connection with corporate transactions. Auditors are increasingly asking for information regarding these often privileged communications to supplement their reliance on management representations. Making such privileged information available to auditors, however, subjects companies to the risk of loss of attorney client and work product privileges, which can provide a road-map to success for adversaries in civil litigation.

Further, in providing such information to auditors, the provider must comply with the requirements of Section 303 of SOX and expanded Rule 13b2-2 under the 1934 Act adopted pursuant to SOX §303. The SOX §303 requirements specifically prohibit officers and directors, and “persons acting under [their] direction,” from coercing, manipulating, misleading or fraudulently influencing an auditor “engaged in the performance of an audit” of the issuer’s financial statements when the officer, director or other person “knew or should have known” that the action, if successful, could result in rendering the issuer’s financial statements filed with the SEC materially misleading. Since attorneys and other mergers and acquisitions professionals representing a corporation are usually engaged by, and are acting at the direction of, its directors or officers, they are subject to the SOX §303 Requirements. The SEC has demonstrated its willingness to bring sanction proceedings against lawyers when they have been perceived to have failed in their responsibilities.

The SOX §303 requirements should influence an attorney in communicating with accountants, and reinforce the importance of providing meaningful information to auditors and clients. The SOX §303 requirements, however, should not be viewed as repudiating or supplanting the ABA Statement of Policy regarding Lawyers’ Responses to Auditors’ Requests for Information regarding client loss contingencies. Resulting from a compromise reached in 1976 between the lawyers and the accountants, this ABA Statement of Policy provides a framework under which lawyers can provide information to auditors regarding client loss contingencies in connection with their examination of client financial statements, while minimizing the risk of loss of attorney-client privilege in the process.

In addition, the requirements of SOX §307 are specifically applicable to attorneys. The SEC rules under SOX §307 generally provide that, in the event that an attorney has “credible evidence based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation [of any U.S. law or fiduciary duty] has occurred, is ongoing, or is about to occur,” the attorney has a duty to seek to remedy the problem by “reporting up the ladder” within the issuer to the issuer’s chief legal officer, or to both the chief legal officer and the chief executive officer, or if those executives do not respond appropriately, to the issuer’s board of directors or an appropriate committee thereof. SEC rulemaking and enforcement actions post-SOX attempt to place lawyers in the role of “gatekeepers” or “sentries of the marketplace” whose responsibilities include “ensuring that our markets are clean.” These SEC actions will directly affect the role of the lawyer in dealing with clients, auditors, M&A professionals and others.

For the full version, please go to the Jackson Walker L.L.P. website, www.jw.com, where the full text is available at: <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1186>.

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Additionally, a more complete listing of Mr. Egan's recent writings is available online and may be accessed at: <http://www.jw.com/site/jsp/attyinfo.jsp?id=77>.