FIDUCIARY DUTIES IN OIL PATCH DEALS

By

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Involvement: Mr. Egan is Senior Vice Chair and Chair of Executive Council of the M&A Committee of the American Bar Association and served as Co-Chair of its Asset Acquisition Agreement Task Force, which wrote the *Model Asset Purchase Agreement with Commentary* (2001). He is Chair of the Texas Business Law Foundation; is a former Chair of the Business Law Section of the State Bar of Texas and former Chair of that section's Corporation Law Committee; and on behalf of these groups, has been instrumental in the drafting and enactment of many Texas business entity and other statutes. He is also a member of the American Law Institute.

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FIDUCIARY DUTIES IN OIL PATCH DEALS

BY

BYRON F. EGAN *

I. GENERAL.

A. Introduction. In selecting a form of business entity for an oil patch deal in Texas the organizer or initial owners can 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 business objectives for which the entity is being organized. 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 and managers of the business from liabilities arising out of its activities. An increasingly important factor in choosing the form of entity, and its state of domicile, is the extent to which the fiduciary duties and personal liability of the entity's governing persons may be limited in the entity's governing documents. The 83rd Texas Legislature, 2013 Regular Session (the "2013 Legislative Session"), which convened on January 11, 2013 and adjourned on May 27, 2013, did not change the forms of business entity from which to choose or the principal entity choice factors for an oil patch deal, but did enhance their flexibility and the desirability of Texas as a place to organize a business.

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

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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: Alexandra E. Hanson, Nelson H. Hunt, William H. Hornberger, Michael L. Laussade and Monica Pace Messick of Jackson Walker L.L.P. in Dallas.

requirements.[1] The Texas LLP statute was later amended to extend its LLP shield to contracts. 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] and the LLC has become the entity of choice for private deals.[3]

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.[4] 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,[5] although they could elect to be governed by the TBOC prior to that time.[6]

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.[7] 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

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

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

3 Statistical information provided by the Secretary of State shows that on May 1, 2013 there were 518,916 active Texas LLCs compared with 365,220 active Texas corporations, 129,880 active Texas limited partnerships and 3,797 active Texas LLPs, and in 2012 new Texas entities formed were as follows: 95,548 LLCs, 23,410 corporations, 6,099 limited partnerships and 695 LLPs.

4 A detailed Table of Contents for the TBOC showing this organization appears in Appendix C.

5 TBOC § 402.005.

6 TBOC § 402.003.

7 *See infra* notes 158-172 and related text.

addition to federal tax laws, an entity and its advisors must comply with federal anti money laundering and terrorist regulations.[8]

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."[9] 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. 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.[10]

B. Statutory Updating.

Texas' entity statutes are continually being updated and improved through the efforts of the Texas Business Law Foundation[11] and the Business Law Section of the State Bar of Texas[12] in an effort to make Texas a more attractive jurisdiction for the organization of entities.[13] 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

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8 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 SND List and OFAC guidance are available on the OFAC website at http://www.ustreas.gov/offices/enforcement/ofac/.

9 *See infra* notes 193-311 and related text.

10 *See infra* notes 698-710 and related text.

11 *See An Introduction to the Texas Business Law Foundation* attached as Appendix G.

12 *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).

13 *Cf.* Jens Dammann & Matthias Schuündeln, *The Incorporation Choices of Privately Held Corporations*, 27 J.L. ECON. & ORG. 79 (Apr. 2011).

later enhanced by the organization of the Texas Business Law Foundation.[14] 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 ("1997 S.B. 555"), which became effective September 1, 1997, making numerous changes in Texas' business entity statutes, some of which were quite innovative.[15] 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, [16] and significant changes were made to Texas' other entity statutes.[17] In the 79th Session of the Texas Legislature (the "2005 Legislative Session"), which convened January 11, 2005 and adjourned *sine die* on May 30, 2005, changes were again made to the Texas entity statutes,[18] including the TBOC.[19] 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.[20] Additional changes were made to the TBOC and other Texas statutes affecting business entities 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.[21] This tradition of updating Texas' entity

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14 *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.

15 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).

16 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 ("2003 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.

17 *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 ("2003 H.B. 1165"); *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 ("2003 H.B. 1637").

18 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 ("2005 H.B. 1507"); 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 ("2005 H.B. 1319").

19 2005 H.B. 1319.

20 *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 ("2007 H.B. 1737"), which became effective September 1, 2007; Daryl B. Robertson, *2007 Amendments to the Texas Business Organizations Code*, 42 TEX. J. BUS. L. 257 (Fall 2007).

21 *See* Rick Tulli & Daryl Robertson, *2009 Legislative Update on Texas Business Organizations Code Amendments*, 43 TEX. J. BUS. L. 571 (Winter 2009); Byron F. Egan, *Choice of Entity Alternatives* (May 28, 2010), *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=1396, which at Appendix D 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 ("2009 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 ("2009 H.B. 1787").

statutes through the efforts of the Business Law Section and the Texas Business Law Foundation continued in the 82nd Texas Legislature, 2011 Regular Session (the "2011 Legislative Session"), which convened on January 11, 2011 and adjourned on May 30, 2011.[22] As discussed below, this tradition continued in the 2013 Legislative Session.

C. Texas Business Organizations Code.

1. Background. In the 2003 Legislative Session, the TBOC, which was previously introduced but not passed in the 1999[23] and 2001 Legislative Sessions, was again introduced and finally passed.[24] The TBOC prior to the 2013 Legislative Session[25] included

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[22] The TBOC was amended in the 2011 Legislative Session by the following bills, which were sponsored by the Texas Business Law Foundation, to be effective September 1, 2011:

> S.B. 748 ("2011 S.B. 748") by Sen. John J. Carona was a 58-page package of amendments to the corporation, non-profit corporation, partnership and LLC provisions of the TBOC to address issues that have arisen in recent experience under the TBOC and to make the statute more user friendly for Texas entities, *available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB748.
>
> S.B. 323 ("2011 S.B. 323") by Sen. John J. Carona amended the TBOC to provide that the TBOC provisions that limit the liability of shareholders of Texas corporations apply to managers and members of Texas LLCs if LLC "veil piercing" becomes recognized in Texas, *available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB323.
>
> S.B. 1568 ("2011 S.B. 1568") by Sen. Craig Estes clarified that a derivative plaintiff must own stock at the time of filing the derivative action and continuously to the completion of the action, *available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB1568.

The Texas Business Law Foundation also sponsored the following legislation in the 2011 Legislative Session:

> H.B. 2991 ("2011 H.B. 2991") by Rep. Joe Deshotel amended chapter 271 of the Texas Business and Commerce Code effective September 1, 2011 to add additional safe harbors for choosing the law of a particular jurisdiction to govern large transactions, *available at* http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=82R&Bill=HB2991.
>
> S.B. 782 ("2011 S.B. 782") by Sen. John Carona amended Texas Business and Commerce Code Chapter 9 effective July 1, 2013 to adopt changes to Uniform Commercial Code Article 9 approved and recommended by the National Conference of Commissioners on Uniform State Laws for enactment in all states (the majority of the changes are in the nature of language adjustments for clarity or to update Article 9 to reflect advances in technology or business practices), *available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB782.

Further information regarding each of the five bills referenced above appears in Appendix E (*Legislation Sponsored by the Texas Business Law Foundation in the 2011 Legislative Session*) in Byron F. Egan, *Choice of Entity Decision Tree* (May 24, 2013), *available at* http://www.jw.com/publications/article/1846.

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

[24] 2003 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.

amendments made during the 2005 Legislative Session, the 2007 Legislative Session, the 2009 Legislative Session[26] and the 2011 Legislative Session.[27] The TBOC is still a work in progress, and will be amended in subsequent Legislative Sessions as gaps and ambiguities are discovered, and as business organization practices and needs evolve. The TBOC provides considerable flexibility to organizations in establishing their capital structures, effecting business combination transactions and governing their internal affairs. It is a model for future statutes nationwide and solidifies Texas' position as a leader in corporate law.

2. Source Law Codified. The TBOC is principally a codification of the existing Texas statutes governing non-profit and for-profit private-sector entities, rather than substantive modifications to existing law.[28] These statutes consist of the following: the Texas Business Corporation Act (the "TBCA"),[29] the Texas Non-Profit Corporation Act (the "TNPCA"),[30] the Texas Miscellaneous Corporation Laws Act (the "TMCLA"),[31] the Texas Limited Liability Company Act (the "LLC Act"),[32] the Texas Revised Partnership Act (the "TRPA"),[33] the Texas Revised Limited Partnership Act (the "TRLPA"),[34] the Texas Real Estate Investment Trust Act (the "TREITA"),[35] the Texas Uniform Unincorporated Nonprofit Associations Act (the "TUUNA"),[36] the Texas Professional Corporation Act (the "TPCA"),[37] the Texas Professional Associations Act (the "TPAA"),[38] the Texas Cooperative Associations Act (the "TCAA"),[39] 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

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25 TEX. BUS. ORGS. CODE. ANN. (Vernon 2011), *available at* http://tlo2.tlc.state.tx.us/statutes/bo.toc.htm (hereinafter "TBOC"); *see* Byron F. Egan, *Legislative Update: Business Law*, TexasBarCLE Webcast on Legislative Update: Business Law, July 2, 2013, *available at* http://www.jw.com/publications/article/1871.

26 2005 H.B. 1319, 2007 H.B. 1737, 2009 S.B. 1442 and 2009 H.B. 1787.

27 *See* Byron F. Egan, *Business Entities in Texas after 2011 Texas Legislature*, TexasBarCLE Webcast on Legislative Changes Affecting Business Entities, July 13, 2011, *available at* http://www.jw.com/publications/article/1629; Daryl B. Robertson, *2011 Legislative Update: Amendments to the Texas Business Organizations Code and Texas Business and Commerce Code*, XXX CORP. COUNS. REV. 159 (Nov. 2011).

28 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").

29 TEX. BUS. CORP. ACT ANN. arts. 1.01 *et. seq.* (Vernon Supp. 2013) (hereinafter "TBCA").

30 TEX. REV. CIV. STAT. ANN. art. 1396-1 (Vernon Supp. 2013) (hereinafter "TNPCA").

31 TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon Supp. 2013) (hereinafter "TMCLA").

32 TEX. REV. CIV. STAT. ANN. art. 1528n (Vernon Supp. 2013) (hereinafter "LLC Act").

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

34 TEX. REV. CIV. STAT. ANN. art. 6132a-1 (Vernon Supp. 2013) (hereinafter "TRLPA").

35 TEX. REV. CIV. STAT. ANN. art. 6138A (Vernon Supp. 2013) (hereinafter "TREITA").

36 TEX. REV. CIV. STAT. ANN. art. 1396-1B (Vernon Supp. 2013) (hereinafter "TUUNA").

37 TEX. REV. CIV. STAT. ANN. art. 1528e (Vernon Supp. 2013) (hereinafter "TPCA").

38 TEX. REV. CIV. STAT. ANN. art. 1528f (Vernon Supp. 2013) (hereinafter "TPAA").

39 TEX. REV. CIV. STAT. ANN. art. 1396-1A (Vernon Supp. 2013) (hereinafter "TCAA").

Texas statutes are not "domestic entities" [40] 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.[41] Generally entities organized under Texas special statutes prior to January 1, 2006 were subject to the transition rules applicable to other Texas entities and continued to generally reference the source law rather than the TBOC until January 1, 2010, after which all Texas entities are governed by the TBOC.[42]

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 of Title 1, separate "spokes" contain provisions governing different types of entities which are not common or similar among the different entities. To determine applicable law for a given business entity, one should look first to the general provisions in Title 1, and then to the entity-specific provisions containing additions and modifications to the general rules. However, where a direct conflict exists between a provision of Title 1 and a provision of any other Title, the other Title will govern the matter.[43]

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.[44] Domestic entities already in existence on January 1, 2006 continued to be governed by then existing entity statutes until January 1, 2010,[45] 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.[46]

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,[47] 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

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40 TBOC § 2.003.

41 TBOC § 23.001.

42 TBOC § 402.005. Note that the Texas Finance Code has been amended by 2007 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 ("2007 H.B. 1962").

43 TBOC § 1.106(c).

44 TBOC § 402.001(a).

45 TBOC § 402.005.

46 TBOC § 402.003.

47 Revisor's Report, *supra* note 16. The Bar Committee was primarily responsible for drafting the TBOC in collaboration with the Secretary of State and the Texas Legislative Council.

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."[48] 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 document.[49] One other significant vocabulary change is that the Regulations of a limited liability company are now referred to as its "Company Agreement."[50] Other changes include the shift in the titles of filings from "Application for Certificate of Authority to Transact Business"[51] to "Application for Registration,"[52] from "Articles of Amendment"[53] to "Certificate of Amendment,"[54] and from "Articles of Dissolution"[55] to "Certificate of Termination."[56] 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,[57] 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.[58] 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.[59] "Person" was initially defined by reference to § 311.005 of the Government Code, and is now defined in TBOC § 1.002(69-b).[60]

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48 TBOC § 1.002(35).

49 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.

50 *See* TBOC § 101.052.

51 *See* TBCA art. 8.01.

52 *See* TBOC § 9.004.

53 *See* TBCA art. 4.04.

54 *See* TBOC § 3.053.

55 *See* TBCA art. 6.06.

56 *See* TBOC § 11.101.

57 TBOC § 1.002(18).

58 TBOC § 1.002(28).

59 TBOC § 1.002(22).

60 TBOC § 1.002(69-b) defines "person" as follows:

> (69-b) "Person" means an individual or a corporation, partnership, limited liability company, business trust, trust, association, or other organization, estate, government or governmental subdivision or agency, or other legal entity.

(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.[61] However, it adds the requirement that the document state what type of entity shall be formed upon its filing.[62] Other requirements differ slightly for each entity.[63]

(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.[64] For example, the filing fees for a certificate of formation for all domestic entities are now set forth in TBOC Chapter Four, Subchapter D.[65] 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.[66] 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).[67] 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.[68] Filings are generally effective when filed, not when the Secretary of State acknowledges them.[69] Additionally, documents with delayed effective dates may now be abandoned at any time prior to effectiveness.[70]

(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.[71] 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.[72] 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.[73] Under the TBOC an LLP

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61 TBOC §§ 3.003, 3.005, and the related Revisor's Report, *supra* note 16.

62 TBOC § 3.005 and the related Revisor's Report, *supra* note 16.

63 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.

64 *See* TBOC Chapter 4, Subchapter D.

65 *See id.* and the related Revisor's Report, *supra* note 16.

66 TBOC § 4.151 and the related Revisor's Report, *supra* note 16.

67 *See* TBCA art. 3.03.

68 *See* TBOC § 4.002 the related Revisor's Report, *supra* note 16.

69 TBOC § 4.051.

70 TBOC § 4.057.

71 *See* TBOC §§ 5.054-5.063.

72 TRLPA § 1.03.

73 TBOC §§ 5.055, 153.102 and the related Revisor's Report, *supra* note 16.

is called a limited liability partnership rather than a "registered" limited liability partnership as it was known under TRPA.[74]

(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.[75] Also, the TBOC extends to all types of domestic entities the right for officers and directors to rely on opinions, reports, and statements given by certain people in the execution of their duties.[76] 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.[77]

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.[78] 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.[79]

(f) Construction. The TBOC incorporates the provisions of the Code Construction Act[80] to assist in its interpretation.[81] 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.[82] 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, such entities 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.[83]

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

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

76 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 16.

77 TBOC § 3.152 and the related Revisor's Report, *supra* note 16.

78 *See* TBOC § 6.002.

79 TBOC § 6.002.

80 TEX. GOV'T CODE ANN. § 311 (Vernon Supp. 2011).

81 TBOC § 1.051.

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

83 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.

However, limited liability partnerships were only entitled to continue following the registration requirements of the TRPA and TRLPA until their existing registrations expired,[84] at which point they were required to renew under the TBOC (although until January 1, 2010 they continued to be substantively governed by the TRPA and TRLPA).

D. TBOC Amendments Made in 2013 Legislative Session. In the 2013 Legislative Session, both technical and substantive changes were made to the TBOC to be effective September 1, 2013, as discussed below:

1. TBOC Updating. TBOC provisions relating to corporations, partnerships and LLCs were updated by (i) simplifying the required contents for amended and restated certificates of formation, (ii) requiring limited partnerships to give winding up notices to potential claimants much like corporations are currently required to do, (iii) clarifying that the governing documents of partnerships and LLCs may eliminate monetary liability of their governing persons to the same extent that a corporate certificate of formation can do so for directors and to the further extent permitted by the specific partnership and LLC provisions of the TBOC, (iv) clarification that partnership agreements and LLC company agreements may provide rights to persons who are not parties thereto (e.g., officers, managers or creditors), and (v) clarification of the powers of an LLC series and that a series is not a separate entity.[85] Expanding on the foregoing, the following changes were made to the TBOC in the 2013 Legislative Session by S.B. 847:

(a) Simplification of Amended and Restated Certificates of Formation. TBOC § 3.059(d) was amended to delete the requirement that a restated certificate of formation with amendments "identify by reference or description each added, altered, or deleted provision," although the certificate of formation still must set forth the text of the restated certificate of formation as amended.[86]

(b) Limitation or Elimination of Liability for Governing Persons of LLCs and Partnerships. TBOC § 7.001(d) was amended to clarify the contractual power of the owners of general and limited partnerships and LLCs, in their respective partnership agreements in the case of a partnership or certificate of formation or company agreement in the case of an LLC, to limit or eliminate the liability of their governing persons to the extent they could already under the TBOC and to the further extent for-profit corporations could already do so.[87] The

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84 TBOC § 402.001(b).

85 S.B. 847 ("S.B. 847") by Sen. John J. Carona, *available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=SB847. *See* Daryl B. Robertson, *Legislative Update: 2013 Amendments to the Texas Business Organizations Code*, 2013 Texas State Bar Annual Meeting, Business Law and Corporate Counsel Section CLE, Dallas, TX, June 21, 2013.

86 S.B. 847 § 1.

87 TBOC § 7.001 was amended by S.B. 847 § 2 to read in its entirety as follows:

Sec. 7.001. LIMITATION OF LIABILITY OF GOVERNING PERSON.

(a) Subsections (b) and (c) apply to:

(1) a domestic entity other than a partnership or limited liability company;

(2) another organization incorporated or organized under another law of this state; and

change means that owners of partnerships and LLCs have at least the same freedom as owners of for-profit corporations do to agree to the limitation or elimination of liabilities of governing persons. Such limitation or elimination can go beyond what is permissible for a corporation to the extent permitted in the other TBOC provisions governing the partnership or LLC. For an LLC, the TBOC § 7.001(d) amendment states that the liability of a governing person may be "limited or eliminated" by its certificate of formation or company agreement to the same extent TBOC §§ 7.001(b) and (c) permit the limitation or elimination of liability of a governing partner of a for-profit corporation (or other organization to which these sections apply).[88] In addition,

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(3) to the extent permitted by federal law, a federally chartered bank, savings and loan association, or credit union.

(b) The certificate of formation or similar instrument of an organization to which this section applies 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.

(d) The liability of a governing person may be limited or eliminated [~~restricted~~]:

(1) in a general partnership by its partnership agreement to the same extent Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent permitted under Chapter 152;

(2) in a limited partnership by its partnership agreement to the same extent Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent permitted under Chapter 153 and, to the extent applicable to limited partnerships, Chapter 152; and

(3) in a limited liability company by its certificate of formation or company agreement to the same extent Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent permitted under Section 101.401.

[88] TBOC §§ 7.001(b) and (c) apply to (1) a domestic entity other than a partnership or limited liability company, (2) another organization incorporated or organized under another Texas law and (3) to the extent permitted by federal law, a federally chartered bank, savings and loan association or credit union. TBOC § 7.001(b) provides that the certificate of formation or similar instrument of an organization to which the subsection applies 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. TBOC § 7.001(c) provides that TBOC § 7.001(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

the liability of the governing person of an LLC may be limited or eliminated "to the additional extent permitted under TBOC § 101.401."[89]

(c) Winding up Notices for Limited Partnerships. The winding-up provisions in TBOC Chapter 11 were amended to require a limited partnership (but not a general partnership) to send a written notice of the partnership's winding up to each known claimant. Claimants against a limited partnership should be provided written notice of the winding up because, as with other filing entities, claims against a limited partnership are subject to extinguishment after the third anniversary of the date of entity termination under TBOC § 11.359.[90]

(d) Rights of Third Persons in Company and Partnership Agreements. TBOC provisions were added to clarify that third parties may be provided rights under the governing documents of LLCs and partnerships. TBOC § 101.052 was amended to provide that an LLC company agreement may afford rights to any person, including a person who is not a party to the company agreement, to the extent set forth in the agreement.[91] TBOC § 154.104 was added to clarify that a general or limited partnership agreement may provide rights to any person, including a person who is not a party to the partnership agreement, to the extent set forth in the agreement.[92] Thus, an officer or a creditor of the LLC or partnership may be provided rights under its governing documents.

(e) LLC Series.

(1) Power. The TBOC provisions governing the powers of an LLC series were clarified to state that an LLC series has the ability to acquire and sell assets and to "exercise any power or privilege as necessary or appropriate to the conduct, promotion or attainment of the business, purposes, or activities of the series."[93] TBOC § 101.605 continues to

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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 the governing person is expressly provided by an applicable statute.

89 TBOC § 101.401 provides that the company agreement "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." The amendments to TBOC § 7.001(d) are consistent with *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355, 396 (Tex. App. — Houston [1s1Dist.] 2012; case settled in 2013 while writ of error pending), wherein, in connection with claims by a former minority interest owner that the majority owner of the LLC breached its fiduciary duties, the court concluded that the statutory restriction on the limitation or elimination of liability for governing persons contained in TBOC § 7.001 expressly did not apply to LLCs. As a result the LLC's members were thus free to expand or eliminate, as between themselves, any and all potential liability of the LLC's majority owner under TBOC §§ 7.001(d)(3) and 101.401.

90 Because TBOC § 11.359 only applies to a "filing entity," it does not apply to a general partnership.

91 TBOC § 101.052(e) as amended by S.B. 847 § 5.

92 S.B. 847 § 10.

93 TBOC § 101.605 as amended by S.B. 847 § 6.

specify that a series has the power and capacity, in its name, to (1) sue and be sued, (2) contract, (3) hold title to assets of the series, and (4) grant liens and security interests in its assets. TBOC § 101.609(c) was added to clarify that an LLC series and its associated governing persons and officers generally have the powers and rights set forth in the TBOC.[94]

(2) Not a Separate Domestic Entity. Although an LLC series has the rights, powers and duties provided in the TBOC for a separate domestic entity, a series is not a separate domestic entity or organization for purposes of the TBOC.[95] Although it has been argued that the TBOC definitions of "domestic entity" and "organization" are broad enough that a series constitutes a domestic entity,[96] that interpretation was never the intent of TBOC Subchapter M, which was modeled after similar provisions in the Delaware Limited Liability Company Act ("DLLCA") which have been interpreted to provide that a series, while having the powers and capacity of a "person" under the statute, should not be treated as a separate independent entity for purposes of the DLLCA.[97]

While an LLC series is not a separate domestic entity under the TBOC, the IRS has issued a Notice of Proposed Rulemaking in which the proposed regulations would provide an LLC series, for federal income tax purposes, will be treated as a separate entity formed under local law irrespective of what the applicable state law provides.[98] In contrast, because the Texas Margin Tax is applied to specific types of entities that generally make filings with the Texas Secretary of State to establish their existence, the Texas Comptroller of Public Accounts has indicated its position that an LLC, together with all of its series, will be treated as a single entity for Texas franchise tax purposes.[99]

2. Social Purposes in For-Profit Corporations. The TBOC was amended to allow for-profit corporations to include "social purposes" in their certificates of formation and to specify that their governing persons are entitled to consider those social purposes in making decisions on behalf of the corporations.[100] Previously the TBOC, like the corporation statutes of

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94 S.B. 847 § 8.

95 TBOC § 101.622 as amended by S.B. 847 § 9.

96 TBOC § 1.002(18) defines "domestic entity" to mean "an organization formed under or the internal affairs of which are governed by this code."

97 *See* Norman M. Powell, "Series LLCs, the UCC, and the Bankruptcy Code — A Series of Unfortunate Events?", *UCC Law Journal*, Westlaw 41 UCC LJ2 Art. 2 (Fall 2008) (treating a series as a separate entity is inconsistent with (x) the long standing Delaware policy that Delaware entities generally can only be created by a filing of an instrument with the Delaware Secretary of State and (y) the statutory requirement that each series terminates on the dissolution of the LLC; a series cannot exist absent the continued existence of the LLC, a fact that suggests that the series is not a separate and distinct entity).

98 IRS Notice of Proposed Rulemaking RIN 1545-B169, "Series LLCs and Cell Companies," proposing amendments to 26 CFR Part 301.

99 Texas Comptroller Policy Letter dated May 5, 2010 (Accession No. 201005184L). The Texas franchise tax impacts of this single entity position can be prejudicial to taxpayers in some cases. For example, all of the series will have to be included on one franchise tax report, and all of the series will have to use the same deduction; either (i) compensation or (ii) cost of goods sold, regardless of which deduction might be more beneficial to any given series.

100 S.B. 849 ("S.B. 849") by Sen. John J. Carona, *available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=SB849.

other states, had drawn a clear line between the purposes of for-profit and nonprofit corporations, with (i) a "for-profit" corporations being governed by TBOC Chapter 21[101] and generally for the purpose of creating value for its owners and (ii) a "nonprofit corporation" being governed by TBOC Chapter 22[102] and generally solely for charitable, benevolent, religious and similar purposes.[103] Directors and officers of a for-profit corporation have a fiduciary duty to act in the best interests of the corporation and effectively its shareholders.[104] Directors and officers of a for-profit Texas corporation have been able to justify making charitable contributions by the corporation because of public relations, marketing and other benefits that arguably enhance shareholder wealth, but there has been concern how far they may go to focus on benefiting society over profit. As a result, a number of states have adopted legislation authorizing the formation of "benefit corporations" that are more or less consistent with the pattern provided by a model benefit corporation statute,[105] that require that the corporation have some social purpose set forth in its charter, and provide for governance, disclosure and accountability to give assurance that the social purposes will be followed.[106] Delaware has adopted, effective August

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101 TBOC § 1.002(25).

102 TBOC § 1.002(59).

103 TBOC § 2.002 provides:

> Sec. 2.002. PURPOSES OF NONPROFIT ENTITY. The purpose or purposes of a domestic nonprofit entity may include one or more of the following purposes:
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> (1) serving charitable, benevolent, religious, eleemosynary, patriotic, civic, missionary, educational, scientific, social, fraternal, athletic, aesthetic, agricultural, and horticultural purposes;
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> (2) operating or managing a professional, commercial, or trade association or labor union;
>
> (3) providing animal husbandry; or
>
> (4) operating on a nonprofit cooperative basis for the benefit of its members.

104 *See infra* notes 402-430.

105 As of June 28, 2013, according to the website "www.benefitcorp.net/state-by-state-legislative-status," the following 17 states (plus Washington, D.C.) have passed legislation authorizing the formation of benefit corporations in one form or another: Arizona, Arkansas, California, Colorado, Hawaii, Illinois, Maryland, Massachusetts, Louisiana, Nevada, New Jersey, New York, Oregon, Pennsylvania, South Carolina, Vermont, Virginia and Washington, D.C. Some form of benefit corporation legislation has also been introduced in Alabama, Connecticut, Florida, Iowa, Montana, North Carolina, Rhode Island and West Virginia.

106 In J. William Callison, *Putting New Sheets on a Procrustean Bed: How Benefit Corporations Address Fiduciary Duties, The Dangers Created, and Suggestions for Change*, available at http://ssrn.com/abstract=2102655, the characteristics of the "Model Benefit Corporation Legislation" (the "Model") proposed by B Lab Corporation ("Blabs"), which is the foundation for many benefit corporation statutes, are summarized as follows:

> 1. A "benefit corporation" is a business corporation, formed pursuant to the state's general business corporation law, which has elected to subject itself to the benefit corporation provisions of the Model. The corporation's articles of incorporation must state that it is a "benefit corporation," thereby placing potential investors, creditors and others who inspect organizational documents on notice of the corporation's status. There are no name requirements, either in the positive sense where benefit corporations must designate themselves as such or in the negative sense where corporations that are not benefit corporations cannot use a name implying benefit corporation status.

2. If an existing corporation seeks to become a benefit corporation, or if an existing corporation seeks to merge into a benefit corporation, shareholders owning at least two-thirds of the interests must approve the election. Similarly, a two-thirds shareholder vote is needed to terminate benefit corporation status. Notably, the Model does not presently contain dissenters' rights or other provisions to protect the interests of non-controlling shareholders who invested in what they believed to be a profit-maximizing business.

3. A benefit corporation must have the purpose of "creating general public benefit." In addition to, but not instead of, a general public benefit, the articles of incorporation may identify specific public benefits "that it is the purpose of the benefit corporation to create." * * *

4. "General public benefit," to be pursued by all benefit corporations, is defined very broadly as "a material positive impact on society and the environment, taken as a whole, assessed against a third-party standard, from the business and operations of a benefit corporation." * * *

A "third party standard" is a "recognized standard for defining, reporting and assessing corporate social and environmental performance." A third party standard is also developed by an independent organization, credible, and transparent. * * *

5. The creation of general public benefit and any specific public benefit "is in the best interests of the benefit corporation." Directors shall (*i.e.*, must), in discharging their duties and in considering the corporation's best interests, consider the effects of any action or inaction on (a) shareholders, (b) the employees and workforce of the benefit corporation, its subsidiaries and its suppliers, (c) the interests of customers as beneficiaries of the general public benefit, (d) community and societal factors (including those of all communities in which the corporation, its subsidiaries and its suppliers have offices or facilities), (e) the local and global environment, (f) the corporation's short-term and long-term interests, including benefits that may accrue from long-term plans and the possibility that those interests may be best served by the corporation's continued independence, and (g) the corporation's ability to accomplish its general public benefit purpose and any specific public benefit purpose. There is no hierarchy to or prioritization of the interests that directors must consider. In addition, under the Model, directors may consider "other pertinent factors or the interests of any other group that they deem appropriate." Further, the Model provides that directors are not personally liable for monetary damages for any action taken as a director or the failure of the benefit corporation to create public benefit, and that directors do not have liability to beneficiaries of the corporation's general public benefit purpose or specific public benefit purpose arising from the person's status as a beneficiary.

The standards of conduct set forth for directors establish, and are intended to establish, director fiduciary duties. They effect the essential nature of a benefit corporation in two ways: first, directors who consider the enumerated factors are insulated from shareholder claims that they breached their fiduciary duties by not acting to maximize shareholder benefit, and, second, they establish positive rules for director action. The first aspect is contained in the Model's provision that the consideration of the enumerated interests and factors does not constitute a violation of fiduciary standards and that directors are not monetarily liable for damages. The second aspect is emphasized through the Model's creation of "benefit enforcement proceedings" against directors and officers who do not march to the benefit corporation tune.

6. "Benefit enforcement proceedings" may be brought directly by the benefit corporation or derivatively by (a) a shareholder, (b) a director, (c) a person or group owning 5% or more of equity interests in a benefit corporation's parent corporation (subsidiaries/parent corporations are defined using a 50% ownership standard), or (d) other persons specified in the corporation's articles of incorporation or bylaws. * * *

1, 2013, a modified form of "public benefit corporation" legislation,[107] and other states have adopted other simpler legislation to authorize business corporations to have social purposes.[108]

In response to this trend, the TBOC was amended, effective September 1, 2013,[109] to allow a for-profit corporation to adopt in its certificate of formation a "social purpose"[110] and

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> 7. The board of directors of a benefit corporation must include an independent "benefit director." The benefit director must prepare an annual opinion concerning (a) whether the benefit corporation acted in all material respects in accordance with its general public benefit purpose and any specific public benefit purpose; (b) whether directors and officers complied with their obligations to consider the best interests listed in the Model; and (c) a description of any ways in which the corporation or its directors or officers failed to comply.
>
> 8. Benefit corporations must prepare an "annual benefit report" meeting numerous requirements, including a narrative description of the ways the benefit corporation pursued general public benefit during the year and the extent to which it was created, circumstances hindering the creation of public benefit, and the process and rationale for choosing or changing the third-party standard used. * * *

[107] The "public benefit corporations" Delaware legislation adds a new subchapter XV to the DGCL (§§ 361 through 368), effective August 1, 2013, to enable Delaware corporations to be operated as or (subject to certain restrictions) to become "public benefit corporations," which would remain subject to all other provisions of the DGCL except as modified or supplanted by the new subchapter. Under this Delaware legislation, a public benefit corporation is a corporation managed in a manner that balances the stockholders' pecuniary interests, the interests of those materially affected by the corporation's conduct, and one or more public benefits identified in its certificate of incorporation. A public benefit corporation is required, in its certificate of incorporation, to identify itself as a public benefit corporation and to state the public benefits it intends to promote. "Public benefits" are defined as positive effects (or minimization of negative effects) on persons, entities, communities or interests, including those of an artistic, charitable, cultural, economic, educational, literary, medical, religious, scientific or technological nature. Directors, in managing the business and affairs of the public benefit corporation, must balance the pecuniary interests of the stockholders, the interests of those materially affected by the corporation's conduct, and the identified public benefits, but do not have any duty to any person solely on account of any interest in the public benefit. Where directors perform this balancing of interests, they will be deemed to have satisfied their fiduciary duties to stockholders and the corporation if their decision is both informed and disinterested and not such that no person of ordinary, sound judgment would approve.

Public benefit corporations must report to stockholders regarding the corporation's promotion and attainment of its public benefits. Enforcing the promotion of the public benefits is by stockholders holding at least 2% of the corporation's outstanding shares (or, in the case of listed companies, the lesser 2% of the outstanding shares or shares having at least $2 million in market value) being afforded the right to maintain a derivative lawsuit to enforce the statutory requirements. *See* John F. Grossbauer and Mark A. Morton, *2013 Proposed Amendments to the Delaware General Corporation Law*, April 2, 2013, *available at* http://www.potteranderson.com/publication/2013-proposed-amendments-to-the-delaware-general-corporation-law; Richards, Layton & Finger E-Alerts / Newsletters, *Significant Proposed Amendments to the General Corporation Law of the State of Delaware in 2013: Ratification, Second-Step Mergers, Public Benefit Corporations and Other Matters*, March 20, 2013, *available at* http://www.rlf.com/KnowledgeCenter/EAlertsNewsletters/4606.

[108] Robert R. Keatinge, *Low Profit Limited Liability Companies (L^3Cs), For Benefit Corporations and Other Developments in Entity Law: A Different Perspective*, IACA 35th Annual Conference Remembering the Past While Embracing the Future, Williamsburg, Virginia, May 22, 2012.

[109] S.B. 849 by Sen. John J. Carona, *available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=SB849.

authorizes the directors and officers of the corporation to consider such social purpose in making decisions relating to the corporation's business and activities. These 2013 TBOC amendments also clarify that, in making those decisions, directors and officers will be protected from potential liability for breach of duty if they consider the corporation's social purposes in addition to the pecuniary benefits to its shareholders.

This new TBOC § 3.007(d) authorization for a for-profit corporation to include one or more social purposes in its certificate of formation is in addition to the for-profit purpose or purposes required to be stated by TBOC § 3.005(a)(3).[111] It overrides the TBOC § 2.008 provision that a corporation having the purpose of operating a nonprofit institution must be formed as a nonprofit corporation.[112] In order to be deemed to have a "social purpose" within the meaning of the new TBOC provisions, a for-profit corporation must include in its certificate of formation a statement of one or more social purposes.[113] In addition, the for-profit corporation may include in its certificate of formation a provision that requires its Board and officers to consider any social purpose specified in the certificate of formation in discharging their duties under the TBOC or otherwise.[114] These social purpose provisions can be added by amendment to the certificate of formation of an existing for-profit corporation. Since the social purpose cannot be the only purpose stated in the certificate of formation, the for-profit corporation should continue to have some kind of "for-profit" purpose. The TBOC (unlike the social purpose corporation statutes proposed by Blabs and the new DGCL provision) does not require any disclosure of the extent to which the corporation has adhered to its social purposes or

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110 TBOC § 1.002(82-a) provides "Social purposes" means one or more purposes of a for-profit corporation, other than the creation of pecuniary benefits for the corporation's shareholders, that are specified in the corporation's certificate of formation and consist of promoting one or more material positive impacts on society or the environment or of minimizing adverse impacts of the corporation's activities on society or the environment, including:

(A) providing low-income or underserved individuals or communities with beneficial products or services;

(B) promoting economic opportunity for individuals or communities beyond the creation of jobs in the normal course of business;

(C) preserving the environment;

(D) improving human health;

(E) promoting the arts, sciences, or advancement of knowledge;

(F) increasing the flow of capital to entities with a social purpose; and

(G) conferring any particular benefit on society or the environment.

111 TBOC § 3.007(d) added by S.B. 849 provides as follows:

> (d) Notwithstanding Section 2.008, a for-profit corporation may include one or more social purposes in addition to the purpose or purposes required to be stated in the corporation 's certificate of formation by Section 3.005(a)(3). The corporation may also include in the certificate of formation a provision that the board of directors and officers of the corporation shall consider any social purpose specified in the certificate of formation in discharging the duties of directors or officers under this code or otherwise.

112 TBOC § 2.008.

113 TBOC § 3.007(d) added by S.B. 849.

114 TBOC § 3.007(d) added by S.B. 849.

any enforcement mechanism, but the TBOC authorizes a corporation to include provisions to such effect in its certificate of formation if it desires.[115]

A director or officer is entitled to consider any social purposes specified in the certificate of formation of the for-profit corporation in discharging director or officer duties.[116] The use of "is entitled to" is intentional and in lieu of the verb "shall," "may" or "must."[117] The use of "is entitled to" is intended to better protect directors by recognizing their right to consider the social purposes of the corporation in making decisions relating to the corporation, as opposed to focusing solely or primarily on the pecuniary benefits to the corporation or its shareholders of any such decisions. A parallel amendment was also made to TBOC § 21.401(b) to clarify that a director "is entitled to," instead of "may," consider the long-term and short-term interests of the corporation and its shareholders, including the possibility that those interests may be best served by the continued independence of the corporation, in discharging director duties.

TBOC § 21.401(d) was added to provide that an officer is entitled to consider the long-term and short-term interests of the corporation and its shareholders, as well as to consider any social purposes specified in the certificate of formation of the corporation, in discharging the officer's duties, but subject to direction by the Board.[118] To prevent any negative inference for the directors and officers of a for-profit corporation without a social purpose specified in its certificate of formation, TBOC § 21.401(e) was added to specify that nothing in the TBOC prohibits or limits a director or officer from considering, approving or taking an action that promotes or has the effect of promoting a social, charitable or environmental purpose.[119] There are for-profit corporations, some of which are publicly held, that promote social, charitable or environmental activities or purposes that are ancillary or related to their principal business or businesses or that are intended to enhance the goodwill and reputations of the corporations in various constituencies for the benefit of their principal business or businesses. New TBOC § 21.401(e) should further validate such activities even without amendment of the corporation's governing documents.

Further, a shareholders' agreement may be entered into to govern, with regard to the social purpose specified in the certificate of formation of the for-profit corporation, the exercise of corporate powers, the management of the operations and affairs of the corporation, the approval by shareholders or other persons of corporate actions or the relationship among the shareholders, the directors and the corporation.[120]

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115 TBOC § 3.005(b).

116 TBOC § 21.401(c) added by S.B. 849.

117 For further explanation of the interpretation of these verbs, *see* § 311.016 of the Code Construction Act in the Texas Government Code.

118 S.B. 849 § 4.

119 TBOC § 21.401(e) added by S.B. 849.

120 TBOC § 21.101(a)(11) added by S.B. 849.

E. Amendments to Texas Business & Commerce Code in 2013 Legislative Session.

1. TB&CC Article 4. Texas Business and Commerce Code ("TB&CC") § 4A.108 was amended effective September 1, 2013 so that international consumer wire transfers will remain covered by TB&CC § 4A.108. The amendment was necessitated by an amendment to the federal Electronic Funds Transfer Act effected by the Dodd-Frank Wall Street Reform and Consumer Protection Act that would have removed the statutory framework for such transfers.[121]

2. Uniform Commercial Code Article 9. TB&CC Chapter 9 (Secured Transactions) is the body of law that controls secured transactions covering personal property, and related agreements between creditors and debtors. TB&CC § 9.516(b) was amended effective July 1, 2013 to eliminate the requirement that certain organization information (including type of organization, jurisdiction of organization, and organization ID number) be indluced in financing statements.[122] This amendment was necessary to conform the requirements of the TB&CC with industry standard forms approved by the International Association of Commercial Administrators.

3. Fraudulent Transfers. TB&CC § 24.003 was amended effective September 1, 2013 to repeal TB&CC § 24.003(c) that provided that each general partner's nonpartnership assets are added to all of the partnership's assets in determining the solvency of the partnership for fraudulent transfer purposes.[123]

4. Assumed Name Certificate Filings. Chapter 71 of the TB&CC requires a filing entity to file an assumed name certificate if it conducts business in Texas under a name other than the one in its certificate of formation on file with the Secretary of State and include certain information.[124] TB&CC § 71.002(2) was amended to require an assumed name filing for an LLC series established by its company agreement if its name differs from that in the LLC's certificate of formation (which will usually be the case).[125] TB&CC § 71.102 was amended to eliminate the requirement that an assumed name certificate include a filing entity's registered office (as it is already in another filing with the Secretary of State), and for those entities that do not have a registered office in Texas it will only be necessary to include the address of the principal office in Texas or elsewhere.[126] These amendments to Chapter 71 of the TB&CC are effective September 1, 2013.

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121 S.B. 230 by Sen. John J. Carona, available at http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=SB230.

122 SB 474 by Sen. John J. Carona, *available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=SB474.

123 S.B. 847 § 11.

124 *See infra* notes 955-959.

125 H.B. 1624 by Rep. Philip Cortez, *available at* http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=83R&Bill=HB1624. H.B. 1624 as passed did not contain any requirements as to the naming of any series.

126 S.B 699 by Sen. John J. Carona (at the request of the Secretary of State), *available at* http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=83R&Bill=SB699.

F. Amendments to Finance Code in 2013 Legislative Session.

1. Compound or "PIK" Interest. Prior to the 2013 Legislative Session, the Texas Legislature had not addressed whether a lender may charge interest on interest. The phrase "compound interest" means that accrued interest is added periodically to the principal, and interest is computed upon the new principal thus formed. Some loans provide for some or all of the accrued, but unpaid, interest to be "paid in kind" or "PIK interest" in the form of additional promissory notes (often called "PIK notes") issued from time to time. Both instances are distinguishable from the mere allowance of interest on overdue installments of interest, which is not compound interest.[127]

Generally, Texas courts have held that a lender and a borrower may agree that interest accrues on past-due interest.[128] However, the cases permitting the charge of interest on past-due interest do not specifically provide for the calculation of "compound interest." In one case, a Texas court provided that it had not been able to find any authority for the proposition that true compound interest necessarily renders a contract usurious.[129] There are other cases that also appear to support compounding of interest.[130] The facts in some of these cases are not entirely clear from the opinions. Therefore, some practitioners in Texas have been cautious about the practice of compounding interest if such compounding would cause the total interest on the loan to exceed the applicable ceiling with respect to the original principal amount of the loan.

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127 *Spiller v. Spiller*, 901 S.W.2d 553, 557 (Tex.App. – San Antonio 1995, writ denied) (quoting 45 Am. Jur. 2d, *Interest and Usury* § 76 (1969)).

128 *Bothwell v. Farmers' & Merchants' State Bank & Trust Co.*, 120 Tex. 1, 30 S.W.2d 289, 291 (1930).

129 *Bair Chase Prop. Co., LLC v. S & K Dev. Co., Inc., 260 S.W.3d 141-142 (FN 7) (Tex.App. – Austin 2008, pet. denied).* In this case, the lender sued the borrower to recover unpaid principal and interest due on a promissory note. *Id*. at 136. The note provided for interest at a rate equal to the lesser of 12% per annum or the maximum rate of interest permitted by law. *Id*. The borrower responded to the lender's suit by filing a counterclaim alleging usury in connection with the note. *Id*. at 137. The lender then filed a plea in abatement and sent the borrower a corrected payoff sheet, charging 18% per annum compounded interest on all accrued principal and interest after default on the note. *Id*. at 141. While the corrected payoff sheet did not, on its face, exceed the maximum lawful rate of interest, the borrower argued that compounding the interest on an annual basis caused the actual rate of interest to exceed the maximum lawful rate of interest. *Id*. The borrower further argued that the corrected payoff sheet provided for simple interest on accrued interest, distinguishable from "true" compound interest. *Id*. at 142. However, the court held that the interest being charged was in fact "true" compound interest, and such compound interest did not render the note usurious. *Id*. Thus the lender properly corrected the usury violation. *Id*. at 143. In light of the court's holding that the lender properly corrected the alleged usury violation, the court did not address whether the initial loan transaction was usurious. *Id*. at 138.

130 *Shoberg v. Shoberg*, 830 S.W.2d 149, 153 (Tex. App. – Houston [14th Dist.] 1992, writ denied) (holding that the borrower's argument that interest compounded monthly was usurious was without merit); *William C. Dear & Assoc., Inc. v. Plastronics Inc.*, 913 S.W. 2d 251, 254 (Texas App. – Amarillo 1996, writ denied) (holding that where the lender and the borrower did not have an agreement as to a specified rate of interest, the lender's invoice charging 1% interest per month compounded monthly was usurious); *S&J Inv. v. American Star Energy & Minerals Corp.*, 2001 Tex. App. LEXIS 7730 at *4 (Tex. App. – Amarillo 2001, writ denied) (holding that agreement providing that past due payments shall bear interest monthly at the rate of 12% per annum or the maximum rate permitted by law effectively provided for monthly compounding interest, and was not usurious).

The 2013 amendments to Finance Code § 306.003 are effective September 1, 2013 and allow parties to commercial loans to agree that accrued interest may be paid on a periodic basis by adding it to the principal balance of the loan.[131] Such interest may simply be added to the principal balance of the loan or evidenced by a separate promissory note or other agreement. When so added, such interest no longer constitutes interest and instead constitutes part of the principal balance of the loan for purposes of calculating the maximum interest on the loan.

2. Computation Method. In 1997 the Texas Legislature amended the Finance Code to provide that a lender may calculate interest on commercial loans based on a year consisting of 360 days and treat each month as having thirty (30) days.[132] Monthly interest is calculated as follows: (principal amount) x (annual rate/360) x (actual days outstanding, but not to exceed thirty (30) days each month). Interest computed under this method is constant across each month.[133]

Interest can also be calculated using the 365/365 or 366/366 method. Under this method, monthly interest will fluctuate due to the difference in days as between each month. For example, the amount of interest collected in January will be greater than the amount collected in February. Monthly interest is calculated as follows: (principal amount) x (annual rate/365 or 366, as applicable) x (actual days outstanding). The 360/12 30-day month method and the 365/365 (or 366/366) methods will produce the same amount of interest given a full calendar year. However, for loans maturing in under a year, the 360/12 30 day month method may produce a higher rate of interest due to use of 30-day months.[134]

Commercial lenders typically use the 365/360 method, which method produces a higher effective rate of interest. Under this method, interest is calculated using a per diem rate based on a 360-day year, resulting in the borrower paying interest on an extra five (5) or six (6) days. The formula for calculating interest under this method is (principal amount) x (annual rate/360) x (actual days outstanding).[135] Prior to the 2013 legislation, lenders using the 365/360 method had to be careful when charging interest at or near the maximum lawful rate because such rate may become usurious solely due to use of the 365/360 method. For example, a loan with a stated rate of 10% will actually have a rate equal to 10.139% once the 365/360 method is applied. If the actual rate exceeds the maximum lawful rate, then the interest will be usurious.[136]

The 2013 amendments to Finance Code § 306.003 are effective September 1, 2013 and allow parties to commercial loans to agree that interest may be calculated using the

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131 H.B. 1979 by Rep. Mike Villarreal, *available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=HB1979.

132 TEX. FIN. CODE ANN. § 306.003 (2011).

133 John M. Nolan, Esq. et al., Texas Annotated Promissory Note FN 49, *available at* www.texasbarcle.com/materials/special/nolan.pdf.

134 *Id*.

135 *Id*.

136 *Lawler v. Lomas & Nettleton Mortgage Investors*, 691 S.W. 2d 593 (Tex. 1985).

365/365 or 366/366 method in addition to any other method otherwise permitted under the Finance Code.[137]

3. No Negative Implication. The 2013 amendments to Finance Code § 306.003 confirm that the provisions in Chapter 306 of the Finance Code that authorize specific amounts or practices with respect to certain types of loans do not affect or negatively impact any laws otherwise applicable to other loans.[138] This change makes clear that any safe harbors in the Finance Code do not imply that a particular amount or practice is otherwise not permissible for lenders or loans that cannot take advantage of such safe harbors.

4. Terminology. Legislation prepared by the Department of Banking revised provisions in certain laws governing certain banks and trust companies in Texas to conform to changes in terminology made by the TBOC and primarily substitutes the term "certificate of formation" for the term "articles of association."[139]

5. Bank Regulation. Finance Code provisions relating to the subpoena and other regulatory powers of state bank and trust company regulators, the opening of state bank deposit or loan production offices, limitations on the providing by a state bank or trust company of confidential information to its advisory directors, meetings of the board of directors of a state bank, holding real estate and mineral royalty interests, and other matters relating to the regulation of state banks, trust companies and bank holding companies were amended.[140]

G. Uniform Trade Secrets Act – Amendments to Civil Practices and Remedies Code in 2013 Legislative Session. The Texas Uniform Trade Secrets Act ("TUTSA")[141] was adopted effective September 1, 2013 as Chapter 134A of the Civil Practices and Remedies Code to generally modernize existing Texas law relating to misappropriation of trade secrets and join 46 other states which have adopted the Uniform Trade Secrets Act in one form or another,[142] although TUTSA differs from the Uniform Trade Secrets Act in a number of respects.[143] Before

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137 H.B. 1979 by Rep. Mike Villarreal, *available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=HB1979. H.B. 1979 also confirmed that the provisions in Chapter 306 are meant to be safe harbors and do not create a negative implication for other transactions.

138 H.B. 1979 by Rep. Mike Villarreal, *available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=HB1979. H.B. 1979 also confirmed that the provisions in Chapter 306 are meant to be safe harbors and do not create a negative implication for other transactions.

139 S.B. 804 by Sen. John J. Carona, *available at* http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=83R&Bill=SB804.

140 H.B. 1664 by Rep. Mike Villarreal, *available at* http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=83R&Bill=HB1664.

141 SB 953 by Sen. John J. Carona, *available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=SB953.

142 Uniform Law Commission Enactment Status Map, http://www.uniformlaws.org/Act.aspx?title=Trade%20Secrets%20Act (last visited June 24, 2013).

143 Among its differences from the Uniform Trade Secrets Act, TUTSA (i) does not require that information have been in "continuous use", resulting in a broader class of trade secrets, (ii) provides that injunctive relief is a proper remedy, (iii) provides that attorneys' fees are available to a plaintiff where

enactment of TUTSA, Texas law on trade secrets was cobbled together from Texas common law, the Restatement of Torts, the Restatement (Third) of Unfair Competition, and the Texas Theft Liability Act.[144] There follows an analysis of TUTSA:

1. Definition of a Trade Secret. TUTSA provides an expansive definition of protectable trade secrets, which are defined in TUTSA § 134A.002(6) as follows:

> (6) "Trade secret" means information, including a formula, pattern, compilation, program, device, method, technique, process, financial data, or list of actual or potential customers or suppliers, that:
>
> (A) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and
>
> (B) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

The TUTSA § 134A.002(6) definition of a trade secret differs from Texas common law, under which a trade secret consisted of any formula, pattern, device, or compilation of information used in a business, which gives the owner an opportunity to obtain a competitive advantage over his competitors who do not know or use it.[145] While Texas common law was unsettled as to whether there must be "continuous use" of a trade secret in order to afford that secret protection, TUTSA eliminates any "continuous use" requirement and extends protection to a plaintiff who has not yet had an opportunity or acquired the means to put a trade secret to use, resulting in a wider class of protected trade secrets.[146] "Negative know-how" (i.e. "what not to do" information) is protected under TUTSA.[147] While under Texas common law "[b]efore information can be termed a trade secret, there must be a substantial element of

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misappropriation was willful and malicious, and are available to a defendant where a claim of misappropriation was made in bad faith, and (iv) provides that damages for misappropriation can include both actual loss and unjust enrichment, or alternatively imposition of a reasonable royalty, plus exemplary damages not exceeding twice any damage award.

144 Joseph F. Cleveland, Jr. and J. Heath Coffman, *Should Texas Adopt the Uniform Trade Secrets Act?*, News for the Bar, State Bar Litigation Section, Spring 2013, *available at* http://www.litigationsection.com/downloads/News_for_the_Bar_Spring_2013.pdf,

145 Joseph F. Cleveland, Jr. and J. Heath Coffman, *Should Texas Adopt the Uniform Trade Secrets Act?*, News for the Bar, State Bar Litigation Section, Spring 2013, *available at* http://www.litigationsection.com/downloads/News_for_the_Bar_Spring_2013.pdf, citing *In re Bass*, 113 S.W.3d 735, 739 (Tex. 2003); *Hyde Corp. v. Huffines*, 158 Tex. 566, 314 S.W.2d 763, 776 (Tex. 1958) (quoting RESTATEMENT OF TORTS § 757 (1939)).

146 Joseph F. Cleveland, Jr. and J. Heath Coffman, *Should Texas Adopt the Uniform Trade Secrets Act?*, News for the Bar, State Bar Litigation Section, Spring 2013, *available at* http://www.litigationsection.com/downloads/News_for_the_Bar_Spring_2013.pdf, citing *In re Bass*, 113 S.W.3d 735, 739 (Tex. 2003); *Hyde Corp. v. Huffines*, 158 Tex. 566, 314 S.W.2d 763, 776 (Tex. 1958) (quoting RESTATEMENT OF TORTS § 757 (1939)).

147 *Id.*

secrecy,"[148] under TUTSA § 134A.002(6) a "trade secret" means information that "is the subject of efforts that are reasonable under the circumstances to maintain its secrecy."

2. Definition of Misappropriation. TUTSA § 134A.002(3) defines the conduct that constitutes "misappropriation" of a trade secret as follows:

> (3) "Misappropriation" means:
>
> (A) acquisition of a trade secret of another by a person who knows or has reason to know that the trade secret was acquired by improper means; or
>
> (B) disclosure or use of a trade secret of another without express or implied consent by a person who:
>
> (i) used improper means to acquire knowledge of the trade secret;
>
> (ii) at the time of disclosure or use, knew or had reason to know that the person's knowledge of the trade secret was:
>
> (a) derived from or through a person who had utilized improper means to acquire it;
>
> (b) acquired under circumstances giving rise to a duty to maintain its secrecy or limit its use; or
>
> (c) derived from or through a person who owed a duty to the person seeking relief to maintain its secrecy or limit its use; or
>
> (iii) before a material change of the person's position, knew or had reason to know that it was a trade secret and that knowledge of it had been acquired by accident or mistake.

This definition specifies that prohibited conduct includes (1) acquiring a trade secret by improper means or (2) disclosing a trade secret without consent. Under this definition liability attaches only to those *who know or have reason to know* a trade secret was acquired by improper means. Under Texas common law, liability was imposed on defendants who obtained and used a trade secret by accident or mistake, such as a defendant who unknowingly acquires a competitor's trade secrets through a new employee, a customer, or the acquisition of an existing business.[149] Under TUTSA, however, an employer is only liable for misappropriation if the employer knew or had reason to know that the trade secret was acquired by "improper means."

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148 *Astoria Indus. of Ohio, Inc. v. SNF, Inc.*, 223 S.W.3d 616, 634 (Tex. App.—Fort Worth 2007, pet. denied).

149 Joseph F. Cleveland, Jr. and J. Heath Coffman, *Should Texas Adopt the Uniform Trade Secrets Act?*, News for the Bar, State Bar Litigation Section, Spring 2013, *available at* http://www.litigationsection.com/downloads/News_for_the_Bar_Spring_2013.pdf.

TUTSA § 134A.002(2) defines "improper means" to include theft, bribery, misrepresentation, breach or inducement of a breach of a duty to maintain secrecy, to limit use of, or to prohibit discovery of a trade secret, or espionage through electronic or other means." Since this statutory definition of "improper means" includes a breach of the duty "to limit the use of" trade secret information, it effectively provides a license agreement may prohibit reverse engineering.[150]

3. Remedies Include Injunctions and Damages. Injunctive relief is authorized for actual or threatened misappropriation of trade secrets.[151] In addition to or in lieu of injunctive relief, a claimant is entitled to recover damages for misappropriation, which "can include both the actual loss caused by misappropriation and the unjust enrichment caused by misappropriation that is not taken into account in computing actual loss" and "may be measured by imposition of liability for a reasonable royalty for a misappropriator's unauthorized disclosure or use of a trade secret."[152] The award of exemplary damages is authorized if willful and malicious misappropriation is proven by clear and convincing evidence, and the total amount of exemplary damages may not exceed twice the amount of actual damages.[153] A court may award reasonable attorney's fees to the prevailing party if: (1) a claim of misappropriation is made in bad faith; (2) a motion to terminate an injunction is made or resisted in bad faith; or (3) willful and malicious misappropriation exists.[154]

4. Preservation of Secrecy. In an action over the disclosure of trade secrets, a court is directed to preserve the secrecy of an alleged trade secret by reasonable means and there is a presumption in favor of granting protective orders to preserve the secrecy of trade secrets.[155]

5. Statute of Limitations. The Texas Civil Practice and Remedies Code § 16.010 three-year statute of limitations governs an action for misappropriation of trade secrets under TUTSA.

6. Effect on Other Law. TUTSA § 134A.007 provides that the TUTSA replaces conflicting Texas tort, restitutionary and other laws, but does not affect (1) contractual remedies, whether or not based upon misappropriation of a trade secret, (2) other civil remedies

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150 "Reverse engineering" is defined in TUTSA § 134.002(5) as "the process of studying, analyzing, or disassembling a product or device to discover its design, structure, construction, or source code, provided that the product or device was acquired lawfully or from a person having the legal right to convey it."

151 TUTSA § 134A.003.

152 TUTSA § 134A.004(a).

153 TUTSA § 134A.004(b). Texas Civil Practice and Remedies Code § 41.008(b) generally limited an award of exemplary damages to the greater of the following: (1) twice the amount of economic damages, plus any noneconomic damages (up to $750,000.00) found by the jury or (2) $200,000.00, but Texas common law had no specific exemplary damages cap for misappropriation of trade secrets. *See* Joseph F. Cleveland, Jr. and J. Heath Coffman, *Should Texas Adopt the Uniform Trade Secrets Act?*, News for the Bar, State Bar Litigation Section, Spring 2013, *available at* http://www.litigationsection.com/downloads/News_for_the_Bar_Spring_2013.pdf.

154 TUTSA § 134A.005.

155 TUTSA § 134A.006.

not based on misappropriation of trade secrets, or (3) criminal remedies, whether or not based upon misappropriation of a trade secret.

H. Powers of Attorney – Amendments to Estates Code in 2013 Legislative Session. The statutory durable power of attorney form in Estates Codes § 752.051 was changed effective January 1, 2014 from an "opt-out" form to an "opt-in" form (i.e. from a form in which powers are granted unless expressly excluded to one in which powers are not granted unless affirmatively so provided) and wording was added regarding the fiduciary duties and other legal responsibilities of an agent appointed pursuant to a statutory durable power of attorney.[156]

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[156] H.B. 2918 by Rep. Senfronia Thompson, available at http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=83R&Bill=HB2918, provides as follows:

> Sec. 752.051. FORM. The following form is known as a "statutory durable power of attorney":
>
> STATUTORY DURABLE POWER OF ATTORNEY
>
> NOTICE: THE POWERS GRANTED BY THIS DOCUMENT ARE BROAD AND SWEEPING. THEY ARE EXPLAINED IN THE DURABLE POWER OF ATTORNEY ACT, SUBTITLE P, TITLE 2, ESTATES CODE. IF YOU HAVE ANY QUESTIONS ABOUT THESE POWERS, OBTAIN COMPETENT LEGAL ADVICE. THIS DOCUMENT DOES NOT AUTHORIZE ANYONE TO MAKE MEDICAL AND OTHER HEALTH-CARE DECISIONS FOR YOU. YOU MAY REVOKE THIS POWER OF ATTORNEY IF YOU LATER WISH TO DO SO.
>
> You should select someone you trust to serve as your agent (attorney in fact). Unless you specify otherwise, generally the agent's (attorney in fact's) authority will continue until:
>
> (1) you die or revoke the power of attorney;
>
> (2) your agent (attorney in fact) resigns or is unable to act for you; or
>
> (3) a guardian is appointed for your estate.
>
> I, _____ (insert your name and address), appoint _____ (insert the name and address of the person appointed) as my agent (attorney in fact) to act for me in any lawful way with respect to all of the following powers that I have initialed below.
>
> TO GRANT ALL OF THE FOLLOWING POWERS, INITIAL THE LINE IN FRONT OF (N) AND IGNORE THE LINES IN FRONT OF THE OTHER POWERS LISTED IN (A) THROUGH (M).
>
> TO GRANT A POWER, YOU MUST INITIAL THE LINE IN FRONT OF THE POWER YOU ARE GRANTING.
>
> TO WITHHOLD A POWER, DO NOT INITIAL THE LINE IN FRONT OF THE POWER. YOU MAY, BUT DO NOT NEED TO, CROSS OUT EACH POWER WITHHELD [~~except for a power that I have crossed out below.~~
>
> [~~TO WITHHOLD A POWER, YOU MUST CROSS OUT EACH POWER WITHHELD~~].
>
> _____(A) Real property transactions;
>
> _____(B) Tangible personal property transactions;
>
> _____(C) Stock and bond transactions;
>
> _____(D) Commodity and option transactions;
>
> _____(E) Banking and other financial institution transactions;
>
> _____(F) Business operating transactions;
>
> _____(G) Insurance and annuity transactions;

____ (H) Estate, trust, and other beneficiary transactions;

____ (I) Claims and litigation;

____ (J) Personal and family maintenance;

____ (K) Benefits from social security, Medicare, Medicaid, or other governmental programs or civil or military service;

____ (L) Retirement plan transactions;

____ (M) Tax matters;

____ (N) ALL OF THE POWERS LISTED IN (A) THROUGH (M). YOU DO NOT HAVE TO INITIAL THE LINE IN FRONT OF ANY OTHER POWER IF YOU INITIAL LINE (N).

[~~IF NO POWER LISTED ABOVE IS CROSSED OUT, THIS DOCUMENT SHALL BE CONSTRUED AND INTERPRETED AS A GENERAL POWER OF ATTORNEY AND MY AGENT (ATTORNEY IN FACT) SHALL HAVE THE POWER AND AUTHORITY TO PERFORM OR UNDERTAKE ANY ACTION I COULD PERFORM OR UNDERTAKE IF I WERE PERSONALLY PRESENT.~~]

SPECIAL INSTRUCTIONS:

Special instructions applicable to gifts (initial in front of the following sentence to have it apply):

____ I grant my agent (attorney in fact) the power to apply my property to make gifts outright to or for the benefit of a person, including by the exercise of a presently exercisable general power of appointment held by me, except that the amount of a gift to an individual may not exceed the amount of annual exclusions allowed from the federal gift tax for the calendar year of the gift.

ON THE FOLLOWING LINES YOU MAY GIVE SPECIAL INSTRUCTIONS LIMITING OR EXTENDING THE POWERS GRANTED TO YOUR AGENT.

_____

_____

_____

_____

_____

_____

_____

_____

_____

UNLESS YOU DIRECT OTHERWISE ABOVE, THIS POWER OF ATTORNEY IS EFFECTIVE IMMEDIATELY AND WILL CONTINUE UNTIL IT IS REVOKED.

CHOOSE ONE OF THE FOLLOWING ALTERNATIVES BY CROSSING OUT THE ALTERNATIVE NOT CHOSEN:

(A) This power of attorney is not affected by my subsequent disability or incapacity.

(B) This power of attorney becomes effective upon my disability or incapacity.

YOU SHOULD CHOOSE ALTERNATIVE (A) IF THIS POWER OF ATTORNEY IS TO BECOME EFFECTIVE ON THE DATE IT IS EXECUTED.

IF NEITHER (A) NOR (B) IS CROSSED OUT, IT WILL BE ASSUMED THAT YOU CHOSE ALTERNATIVE (A).

If Alternative (B) is chosen and a definition of my disability or incapacity is not contained in this power of attorney, I shall be considered disabled or incapacitated for

purposes of this power of attorney if a physician certifies in writing at a date later than the date this power of attorney is executed that, based on the physician's medical examination of me, I am mentally incapable of managing my financial affairs. I authorize the physician who examines me for this purpose to disclose my physical or mental condition to another person for purposes of this power of attorney. A third party who accepts this power of attorney is fully protected from any action taken under this power of attorney that is based on the determination made by a physician of my disability or incapacity.

I agree that any third party who receives a copy of this document may act under it. Revocation of the durable power of attorney is not effective as to a third party until the third party receives actual notice of the revocation. I agree to indemnify the third party for any claims that arise against the third party because of reliance on this power of attorney.

If any agent named by me dies, becomes legally disabled, resigns, or refuses to act, I name the following (each to act alone and successively, in the order named) as successor(s) to that agent: _____.

Signed this _____ day of _____, _____

_____

(your signature)

State of _____

County of _____

This document was acknowledged before me on _____(date) by _____

(name of principal)

_____

(signature of notarial officer)

(Seal, if any, of notary) _____

(printed name)

My commission expires: _____

IMPORTANT INFORMATION FOR AGENT (ATTORNEY IN FACT)

Agent's Duties

When you accept the authority granted under this power of attorney, you establish a "fiduciary" relationship with the principal. This is a special legal relationship that imposes on you legal duties that continue until you resign or the power of attorney is terminated or revoked by the principal or by operation of law. A fiduciary duty generally includes the duty to:

(1) act in good faith;

(2) do nothing beyond the authority granted in this power of attorney;

(3) act loyally for the principal's benefit;

(4) avoid conflicts that would impair your ability to act in the principal's best interest; and

(5) disclose your identity as an agent or attorney in fact when you act for the principal by writing or printing the name of the principal and signing your own name as "agent" or "attorney in fact" in the following manner:

(Principal's Name) by (Your Signature) as Agent (or as Attorney in Fact)

In addition, the Durable Power of Attorney Act (Subtitle P, Title 2, Estates Code) requires you to:

I. 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

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(1) maintain records of each action taken or decision made on behalf of the principal;

(2) maintain all records until delivered to the principal, released by the principal, or discharged by a court; and

(3) if requested by the principal, provide an accounting to the principal that, unless otherwise directed by the principal or otherwise provided in the Special Instructions, must include:

(A) the property belonging to the principal that has come to your knowledge or into your possession;

(B) each action taken or decision made by you as agent or attorney in fact;

(C) a complete account of receipts, disbursements, and other actions of you as agent or attorney in fact that includes the source and nature of each receipt, disbursement, or action, with receipts of principal and income shown separately;

(D) a listing of all property over which you have exercised control that includes an adequate description of each asset and the asset's current value, if known to you;

(E) the cash balance on hand and the name and location of the depository at which the cash balance is kept;

(F) each known liability;

(G) any other information and facts known to you as necessary for a full and definite understanding of the exact condition of the property belonging to the principal; and

(H) all documentation regarding the principal's property.

Termination of Agent's Authority

You must stop acting on behalf of the principal if you learn of any event that terminates this power of attorney or your authority under this power of attorney. An event that terminates this power of attorney or your authority to act under this power of attorney includes:

(1) the principal's death;

(2) the principal's revocation of this power of attorney or your authority;

(3) the occurrence of a termination event stated in this power of attorney;

(4) if you are married to the principal, the dissolution of your marriage by court decree of divorce or annulment;

(5) the appointment and qualification of a permanent guardian of the principal's estate; or

(6) if ordered by a court, the suspension of this power of attorney on the appointment and qualification of a temporary guardian until the date the term of the temporary guardian expires.

Liability of Agent

The authority granted to you under this power of attorney is specified in the Durable Power of Attorney Act (Subtitle P, Title 2, Estates Code). If you violate the Durable Power of Attorney Act or act beyond the authority granted, you may be liable for any damages caused by the violation or subject to prosecution for misapplication of property by a fiduciary under Chapter 32 of the Texas Penal Code.

THE ATTORNEY IN FACT OR AGENT, BY ACCEPTING OR ACTING UNDER THE APPOINTMENT, ASSUMES THE FIDUCIARY AND OTHER LEGAL RESPONSIBILITIES OF AN AGENT.

corporation and subject to income taxes at the corporate level ranging from 15% to 35% of taxable net income (absent a valid S-corporation status election) in addition to any taxation which may be imposed on the owner as a result of distributions from the business entity. Alternatively, the entity may be classified as a partnership, a non-taxable "flow-through" entity in which taxation is imposed only at the ownership level. Finally, if it is a single-owner LLC or LP, it may be disregarded as a separate entity for federal income tax purposes.[157]

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.[158] 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.[159] 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:[160]

(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").[161] 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.[162] Additionally, to be eligible for partnership classification, the business entity must not be automatically classified as a

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157 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").

158 T.D. 8697, 1997-1 C.B. 215, *corrected by* T.D. 8697, 1997 WL 108762 (IRS TD Mar 13, 1997).

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

160 *Id.*

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

162 *Id.* § 301.7701-1(a)(2).

corporation under the Check-the-Box Regulations (e.g., domestic incorporated entities, life insurance companies and most entities whose interests are publicly traded).[163] Among the entities that the Check-the-Box Regulations automatically classify as corporations are over 85 specific types of foreign business entities.[164] 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.[165]

(b) The Default Rules. The default rules under Treas. Reg. § 301.7701-3(b)(1) provide that a domestic eligible entity (an entity organized in the U.S. 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),[166] (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).[167] 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.[168]

(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

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163 *Id.* § 301.7701-2.

164 Treas. Reg. § 301.7701-2(b)(8).

165 *Id.* § 301.7701-3(a).

166 Treas. Reg. § 301.7701-3(b)(2)(ii) provides:

> [A] member of a foreign eligible entity has limited liability if the member has no personal liability for the debts of or claims against the entity by reason of being a member. This determination is based solely on the statute or law pursuant to which the entity is organized, except that if the underlying statute or law allows the entity to specify in its organizational documents whether the members will have limited liability, the organizational documents may also be relevant. For purposes of this section, a member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such. A member has personal liability for purposes of this paragraph even if the member makes an agreement under which another person (whether or not a member of the entity) assumes such liability or agrees to indemnify that member for any such liability.

167 *Id.* § 301.7701-3(c).

168 *Id.* § 301.7701-3(g)(2).

basis[169] 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.[170] Therefore, unless an existing eligible entity elected to change the classification claimed prior to January 1, 1997, the entity will be "grandfathered" and will not be required to make an election to protect its classification. However, the one exception to this rule is when a single owner entity previously claimed to be classified as a partnership.[171] 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.[172] If an entity elects to change its classification, there can be severe adverse consequences and tax counsel should be consulted.

3. Former Classification Regulations. Prior to January 1, 1997, under former Treasury Regulation section 301.7701-2[173] (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 the limited purpose of understanding older partnership and LLC agreements in which they may be embodied and they may still be encountered in drafts of new documents based on outdated precedent for years to come, which in each case may unnecessarily (from a tax perspective) restrict the current business objectives of the parties. 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

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169 The term "reasonable basis" has the same meaning as under I.R.C. § 6662, which addresses the accuracy-related penalties. Treas. Reg. § 301.7701-3(h)(2)(i). The "reasonable basis" standard is defined in Treas. Reg. § 1.6662-3(b)(3) as follows:

> Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in [Treas. Reg.] § 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in [Treas. Reg.] § 1.6662-4(d)(2).

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).

170 Treas. Reg. § 301.7701-3(h)(2).

171 *Id.* § 301.7701-3(b)(3).

172 *Id.* § 301.7701-3(f)(2).

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

cause dissolution of the organization (hereinafter, "Dissolution Event").[174] 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.[175] 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.[176] Despite the fact that such an agreement constitutes the agreement of a majority of the members of the organization, the use of any prior agreement to continue the business, by eliminating the possibility of dissolution upon a Dissolution Event, may have created continuity of life and would have jeopardized the classification of the entity as a partnership for federal income tax purposes.[177] 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

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174 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).

175 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).

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

177 *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.

authority to act on behalf of the organization independently of its members.[178] 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.[179] 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.[180] 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.[181]

(d) Free Transferability of Interest. The characteristic of free transferability of interest does not exist in a case where a member can, without the consent of other members, assign only his right to a share in the profits but cannot assign his rights to participate in the management of the organization.[182] 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.[183] 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.[184] 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.

J. 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,[185] which was equal to the greater of (i) 0.25% of "taxable capital"

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178 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 173, at § 2.02.

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

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

181 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.

182 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).

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

184 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.

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

(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,[186] or (y) the LLC had not more than 35 members.[187] 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 cases 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 in deference to article 8, Section 24(a) of The Texas Constitution.[188] 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.[189]

2. Franchise Tax Change Proposals. Efforts to reduce Texas' dependence on property taxes to fund public 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.[190] The 2005 Texas Legislature also proposed: (i) a payroll based tax; and (ii) an

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

187 34 TEX. ADMIN. CODE § 3.558(b)(10) (2002) (Public Finance, Franchise Tax, Earned Surplus: Officer and Director Compensation).

188 Commonly referred to as the "Bullock Amendment" and prohibiting income based taxes on a person's share of partnership income.

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

190 *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 ("2003 H.B. 3146"). 2003 H.B. 3146 in the 2003 Legislative Session, by Representative Ron Wilson, attempted to amend the Texas Tax Code to define "corporation" for franchise purposes as "every corporation, limited liability company, limited partnership, business trust, real estate investment trust, savings and loan association, banking corporation, and any other entity for which any of the owners have limited liability" and exclude, in the case of a partnership, the distributive share of the partnership's income or loss attributable to natural persons. *See also* Tex. H.B. 3, 79th Leg. R.S. (2005), *available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=79R&Bill=HB3. House Bill 3, as passed by the House on March 14, 2005, would have enacted a Reformed Franchise Tax which would have applied 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 required 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 have included most corporations, LLCs and partnerships as "taxable entities" and would have allowed 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

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*.[191] 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 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."[192] 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 ("2006 H.B. 3").[193] Texas Tax Code Chapter 171[194] was amended by 2006 H.B. 3 to replace the current

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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.

191 176 S.W.3d 746 (Tex. 2005).

192 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.

193 Tex. H.B. 3, 79th Leg., 3d C.S. (2006) ("2006 H.B. 3"); the text of 2006 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).

194 Chapter 171 of the Texas Tax Code was modified and largely replaced by the provisions of 2006 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 2006 H.B. 3 and in 2007 by H.B. 3928. 2007 H.B. 3928 by Rep. Jim

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 2007 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.[195] 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.[196] The third bill,[197] 2009 S.B. 636, allowed "destination management companies" to exclude "payments 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 2009 S.B. 636 provided 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.[198] Thus,

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Keffer, 80th Leg., R.S. (2007) ("2007 H.B. 3928"), *available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=80R&Bill=HB3928.

[195] H.B. 4611 by Rep. Rene Oliveira (D-Brownsville), *available at* http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB4611 ("2009 H.B. 4611"). 2009 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.

[196] H.B. 4765 by Rep. Rene Oliveira (D-Brownsville), *available at* http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB4765 ("2009 H.B. 4765") (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 would have expired on December 31, 2011; thereafter, the exemption would be reduced from $1 million to $600,000 absent future amendments; the reduction was made contingent on the passage of an increase in the smokeless tobacco tax; 2009 H.B. 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 ("2009 H.B. 2154") (provided the smokeless tobacco tax required by 2009 H.B. 4765).

[197] S.B. 636 by Sen. Kel Seliger (R-Amarillo), *available at* http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=SB636 ("2009 S.B. 636"). The bill adds a new subsection 171.1011(g-6) to the Texas Tax Code.

[198] 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

corporations, limited partnerships, certain general partnerships, LLPs, LLCs, business trusts and professional associations are subject to the Margin Tax.[199] The Margin Tax is not imposed on sole proprietorships, general partnerships that are owned 100% by natural persons or the estate of a natural person,[200] certain narrowly defined passive income entities[201] (including certain real

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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;

(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.

[199] Texas Tax Code Ann. § 171.0002(a).

[200] Since an LLP is classified under both the TRPA and the TBOC as a species of general partnership, under a literal reading of 2006 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. 2007 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.

[201] 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.

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

estate investment trusts ("REITs")),[202] grantor trusts,[203] estates of a natural person, an escrow,[204] or a REMIC. Effective January 1, 2012, the Margin Tax does not apply to certain unincorporated political action committees.[205] Political action committees formed as Texas non-profit corporations are still subject to the Texas franchise tax.[206]

(b) Passive Entities. In order to be exempt in any given tax year, a "passive entity" must receive at least 90% of its gross income, for federal income tax purposes,[207] from partnership allocations from downstream non-controlled flow through entities, dividends, interest, royalties, or capital gains from the sale of (i) real estate,[208] (ii) securities or (iii) commodities. Real estate rentals, as well as other rent and income from working 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."[209] In addition, only non-business trusts, general partnerships and limited partnerships can qualify as passive entities. LLCs and corporations (including S-corps) cannot qualify as passive entities, even if 90% of their income is from qualifying passive sources.

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(3) holding a seat on the board of directors of an entity does not by itself constitute conduct of an active trade or business.

202 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).

203 An interpretative question under 2006 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 2006 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).

204 Tex. Tax Code Ann. § 171.0002(c).

205 Article 45 of Senate Bill 1 ("2011 S.B. 1") passed in 2011 Special Session.

206 *See Texas Tax Policy News* (Tex. Comptroller of Pub. Acts. Oct. 2011).

207 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)."

208 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).

209 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").

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.[210]

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.[211] 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.[212] 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,[213] 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 (i.e. corporations or LLCs) between a passive entity and its ultimate natural person owners.

(c) LLPs. In 2007 the Texas Legislature in 2007 H.B. 3928 "clarified" (or expanded) the scope of the Margin Tax to apply to LLPs.[214] Also, the Comptroller has determined that LLPs can qualify to be passive entities if they otherwise meet the 90% test for passive revenue.[215]

(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

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210 2006 H.B. 3 § 22 raised some historical questions about whether or to what extent partnership divisions could be honored. For example, 2006 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* 2006 H.B. 3 § 22.

211 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*).

212 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").

213 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").

214 2007 H.B. 3928 § 2 amended TEX. TAX CODE ANN. § 171.0002(a) to add "limited liability partnership" to the statutory definition of "taxable entity."

215 34 TEX. ADMIN. CODE § 3.582(c)(1)(C).

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.[216]

(e) Up To $1 Million Minimum Deduction Beginning 2014. In the 2013 Legislative Session, HB 500 amended Section 171.101(a) and (b) of the Tax Code effective January 1, 2014 to allow for a minimum deduction of up to $1 million from an entity's taxable margin.[217] The $1 million deduction passed in the 2013 Legislature change does not include a statutory expiration date. The versions of the Margin Tax[218] effective through 2013 have included revenue thresholds ranging from $600,000 up to $1,000,000 below which the Margin Tax simply did not apply. These taxability thresholds did not act as deductions. Beginning in 2014 taxable entities, or combined groups, with $1 million or less in gross revenues will not be subject to the Margin Tax, and those with gross revenues above $1 million will receive up to a minimum $1 million deduction.

(f) Basic Calculation and Rates Through 2013. Through 2013, the basic calculation of the Margin Tax is a taxable entity's (or unitary group's) gross receipts less the greatest of: (a) 30% of gross revenue; or (b) compensation or (c) cost of goods sold ("COGS"). Initially, the election to use COGS or compensation as the deduction had to be made on or before the due date of the return and such election could not be amended thereafter.[219] In a rare reversal of policy, the Texas Comptroller has reversed its position and now allows post-due date amendments to the COGs vs. compensation deduction.[220] 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 through 2013 is 1% for all taxpayers except a narrowly defined group of retail and wholesale businesses which pay a 0.5% rate.[221] There is a safety net so that the "tax base" for

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216 *See*, *e.g.*, TEX. TAX CODE ANN. § 171.088.

217 *See* Section 6 of HB 500 83rd Tex. Leg. Session.

218 *See e.g.*, 2009 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 was reduced from $1 million to $600,000 and the reduction was made contingent on the passage of an increase in the smokeless tobacco tax; 2009 H.B. 4765 was effective January 1, 2010); 2009 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 2009 H.B. 4765, which was intended to raise new revenue by increasing tobacco taxes to offset some of the fiscal impact of 2009 H.B. 4765). In addition there is a staggered phase-in of the Margin Tax for taxpayers with annual revenues greater than $600,000 and less than $900,000.

219 *See, e.g.*, Texas Comptroller of Public Accounts Hearing 104,076 (Accession No. 201102012H, Feb. 23, 2011).

220 www.window.state.us/tax info/franchise/cog-compensation.html.

221 Article 51 of 2011 S.B. 1 from the 2011 Special Session extended the .5% rate to "apparel rental activities classified as Industry 5999 or 7299" of the 1987 SIC Manual. Tex. Tax Code § 171.0001(12)(B) (effective January 1, 2012).

the Margin Tax may not exceed 70% of a business's total revenues.[222] 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. There is also an alternative "EZ" calculation based on a .575% tax rate, with no dedutions for taxpayers with less than $10,000,000 in gross revenue.[223] Entities 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.[224]

(g) Basic Calculation and Rates Beginning 2014. For reports due on or after January 1, 2014, the basic calculation of the Margin Tax will a taxable entity's (or unitary group's) gross receipts less the greatest of: (a) 30% of gross revenue; or (b) $1 million; or (c) compensation; or (d) COGS.[225] The tax rate applied to the Texas portion of the tax base for reports due in 2014 will be 0.975% for all taxpayers except a narrowly defined group of retail and wholesale businesses which pay a 0.4875% rate.[226] If the Texas Comptroller certifies on or after September 1, 2014 that probable revenue for the state fiscal biennium ending August 31, 2014 is estimtated to exceed the probable revenue reported in the comptroller's Biennal Revenue Estimate for the 2014-2015 fiscal bienium by enough to cover the revenue loss from the additional tax rate cut, then the tax rate applied to the Texas portion of the tax base for reports due in 2015 will be 0.95% for all taxpayers except a narrowly defined group of retail and wholesale businesses which pay at a 0.475% rate.[227]

(h) 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),[228] or IRS Form 1065 (for partnerships and other pass-through entities),[229] plus dividends, interest, gross rents and royalties, and net capital gain income,[230] minus bad debts, certain foreign items, and income from related entities to the extent already included in the margin tax base.[231]

(i) Gross Revenue. The original version of the Margin Tax from 2006 H.B. 3 included 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 taxes collected from a third party and

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222 *See id.* § 171.101.

223 *Id.* § 171.1016.

224 *See infra* note 312 and related text.

225 *See* Section 6 of HB 500 83rd Tex. Leg. Session.

226 *See* Section 2 of HB 500 83rd Tex. Leg. Session (effective for reports originally due on or after January 1, 2014 and before January 1, 2015).

227 *See* Section 2 of HB 500 83rd Tex. Leg. Session (effective for reports originally due on or after January 1, 2015 and before January 1, 2016).

228 *Id.* § 171.1011(c)(1).

229 *Id.* § 171.1011(c)(2).

230 *Id.* § 171.1011(c)(1)(A).

231 *Id.* § 171.1011(c)(1)(B).

remitted to a taxing authority); [232] (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);[233] (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";[234] 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;[235] (C) the federal tax basis of securities and loans underwritten or sold;[236] (D) lending institutions may exclude loan principal repayment proceeds;[237] (E) dividends and interest received from federal obligations;[238] (F) reimbursements received by a "management company"[239] 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

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232 *Id.* § 171.1011(f).

233 *Id.* § 171.1011(g)(1).

234 *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.

235 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.

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

237 *Id.* § 171.1011(g-1).

238 *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.

239 *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.

leasing services company from a client company for wages, payroll taxes on those wages, employee benefits, and workers' compensation benefits for the assigned employees of the client company.[240]

Health care providers[241] 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."[242] Health care institutions[243] may exclude 50%[244] 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.[245] 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).[246]

Article 45 of 2011 S.B. 1 from the 2011 Special Session allows certain "live event promotion company[ies]" to exclude payments to artists.[247] Article 45 also allows qualified "courier and logistics company[ies]" to exclude certain subcontracting payments to non-employees performing delivery services.[248]

Sections 7 and 8 of H.B. 500 from the 2013 Texas Legislature allow new exclusions from revenue for certain: (i) pharmacy network reimbursments; (ii) aggregate and

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240 "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).

241 "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."

242 Tex. Tax Code § 171.1011(n).

243 *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.

244 *Id.* § 171.1011(o).

245 *Id.* § 171.1011(r).

246 *Id.* § 171.1011(s).

247 *Id.* § 171.1011(g-5) (effective January 1, 2012).

248 *Id.* § 171.1011(g-7) (effective January 1, 2012).

barite transport subcontracting payments; (iii) landman subcontracting service payments; (iv) costs of vaccines; (v) waterway transport service company expenses; and (vi) revenues derived from motor carrier taxes and fees.[249]

(j) 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. Section 171.101(a)(1) allows a taxpayer to include in the "compensation" deduction the cost of all benefits to the extent deductible for federal income tax purposes.[250] It also includes "net distributive income" from partnerships, limited liability companies, and S Corporations to natural persons,[251] 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.[252] The deduction for wages and cash compensation for the return due May 15, 2012 may not exceed $330,000 plus benefits that are deductible for federal income tax purposes for any single person.[253] Compensation apparently does not include social security or Medicare contributions, and such amounts apparently are not otherwise deductible for Margin Tax purposes.

(k) The Cost of "Goods" Sold Deduction. Under the Margin Tax, "goods" means real or tangible personal property sold in the ordinary course of business;[254] 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.[255] 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.[256] 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.[257] Up to 4% of administrative and overhead expenses may be included in "cost of goods sold" to the

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249 *See* Sections 7 and 8 of H.B. 500 83rd Tex. Leg. Session (effective for reports due on or after Jan. 1, 2014).

250 *See Winstead, P.C. vs. Susan Combs, Comptroller of Public Accounts of the State of Texas, and Greg Abbott, Attorney General of the State of Texas*, Cause No. D-1-GN-12-000141 (Dist. Ct. of Travis County, 201st Judicial Dist. of Texas, Feb. 7, 2013) (finding certain limitations in Comptroller Rule 3.589(c)(2) invalid).

251 *Id.* § 171.1013(a)(1) & (2).

252 *Id.* § 171.1013(a)(3).

253 *Id.* § 171.1013(c).

254 *Id.* § 171.1012(a)(1).

255 *Id.* § 171.1012(c).

256 *Id.* § 171.1012(c) and (d).

257 *Id.* § 171.1012(e).

extent they are allocable to the costs of acquiring or producing goods.[258] The "cost of goods sold" must be capitalized to the extent required by I.R.C. § 263A.[259]

For reports due on or after January 1, 2014, Section 9 of H.B. 500 from the 2013 Texas Legislature includes a defined list of operations and depreciation costs of certain pipelines within the definition of COGS. In addition, movie theaters are expressly authorized to deduct the cost of the films they show.[260]

(l) 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 15[261] 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.[262] The Margin Tax returns are based on financial data for the preceding calendar year.

(m) Unitary Reporting. In another change from the franchise tax which did not provide for consolidated tax reporting, the Margin Tax requires Texas businesses to file on a unitary and combined basis. An affiliated group of entities in a "unitary business"[263] must file a combined return including all taxable entities within the group.[264] The unitary group includes all affiliates[265] with a common owner (i.e., greater than 50% owned),[266] and the group includes entities with no nexus in Texas.[267]

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258 *Id.* § 171.1012(f).

259 *Id.* § 171.1011(g).

260 *See* Section 9 of H.B. 500 83rd Tex. Leg. Session (effective for reports due on or after Jan. 1, 2014).

261 *Id.* § 171.151(c).

262 *See* 2006 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.

263 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."

264 *Id.* § 171.1014.

265 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*]

266 *Id.* § 171.0001(8).

267 *See id.* § 171.1014(c).

(n) 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."[268] The application of this standard proved unworkable, and the Comptroller's Rule 3.590[269] 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.[270]

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

> (i) Corporation A owns 10% of Corporation C and 60% of Corporation B, which owns 41% of Corporation C. Corporation A has a controlling interest in Corporation B and a controlling interest in Corporation C of 51% of stock ownership because it has control of the stock owned by Corporation B.
>
> (ii) Corporation A owns 10% of Limited Liability Company C and 15% of Corporation B, which owns 90% of Limited Liability Company C. Corporation A does not have controlling interest in Limited Liability Company C and does not have a controlling interest in Corporation B. Corporation B has a controlling interest in Limited Liability Company C.
>
> (iii) Individual A owns 100% of 10 corporations, each of which owns 10% of Partnership B. Individual A has a controlling interest in each of the ten corporations and in Partnership B.
>
> (iv) Corporation A holds a 70% interest in Partnership B that owns 60% of Limited Liability Company C. Corporation A owns the remaining 40% of Limited Liability Company C. Corporation A owns a controlling interest in Partnership B and a 100% controlling interest in Limited Liability Company C.[271]

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."[272] 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."[273] The controlling interest standard for partnerships and trusts

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268 *Id.* § 171.0001(1).

269 34 TEX. ADMIN. CODE § 3.590 (Public Finance, Margin: Combined Reporting) (Effective January 1, 2008).

270 *Id.* § 3.590 (b)(4)(E).

271 *Id.* § 3.590.

272 34 T.A.C. § 3.590(b)(4)(A)(i).

273 34 T.A.C. § 3.590(b)(4)(A)(ii).

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."[274]

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.[275] 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.[276] Passive entities or exempt entities are not part of the group.[277]

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.[278] 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.[279]

(o) Apportionment. The Margin Tax is apportioned using a single-factor gross receipt formula (Texas gross receipts divided by aggregate gross receipts).[280]

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274 34 T.A.C. § 3.590(b)(4)(A)(iii).

275 *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.

276 Tex. Tax Code § 171.1014(a).

277 34 T.A.C. § 3.590(b)(2)(B) & (F).

278 *Id.* § 171.1014(d).

279 *Id.* § 171.1014(c)(3).

280 *Id.* § 171.106(a).

Receipts that are excluded from the tax base must also be excluded from gross receipts for apportionment purposes.[281]

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.[282] 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).[283] 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).[284]

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.[285] 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.[286]

(p) 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.[287] 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.[288] In addition, taxpayers must submit a notice of intent to preserve the right to claim the temporary credit for business loss carryforwards with the first report due from a taxable entity after January 1, 2008, on a form prescribed by the Comptroller.[289] A taxable entity may only claim the credit if the entity was subject to franchise tax on May 1, 2006.[290] 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.[291]

"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."[292] 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

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281 *Id.* § 171.1055(a).

282 *Id.* § 171.103(a).

283 *Id.* § 171.103(b).

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

285 *Id.* § 171.105(c).

286 *Id.* § 171.105(b).

287 34 TEX. ADMIN. CODE § 3.594 (2007) (Public Finance, Franchise Tax, Margin: Temporary Credit).

288 *Id.*

289 *Id.*

290 *Id.*

291 *Id.*

292 *Id.*

carryforward amount x 2.25% x 4.5%.[293] For report years 2018–2027, the credit for the business loss carryforward amount x 7.75% x 4.5%.[294]

(q) New R&D Credit From 2013 Texas Legislature. H.B. 800 from the 2013 Texas Legislature allows a taxpayer[295] to elect to take: (i) sales tax exemption for "tangible personal property directly used in qualified research;"[296] or (ii) a Texas franchise tax credit for certain "qualified research" expenditures. The definition for "qualified research" is tied to the definition in Section 41 of the Internal Revenue Code[297] and is further conditioned by the requirement that the qualified research must be conducted within Texas.[298] If the taxpayer elects to take a franchise tax credit for qualified research expenditures rather than utilize the sales tax exemption, the amount of the credit is:

> 5%[299] X ((qualified research expenditures in the tax report year) - (50% of the average qualified research expenditures during the three tax periods preceding the tax report))

The R&D tax credit may not exceed 50% of the amount of the franchise tax due in any given report year[300] before the application of any other credits, but unused credits may be carried forward for up to 20 years.[301]

(r) New Relocation Deduction From 2013 Texas Legislature. Section 13 of H.B. 500 from the 2013 Texas Legislature adds Section 171.109 to the Texas Tax Code, and the new Section allows a taxable entity that does not have nexus with Texas[302] to deduction from its apportioned margin "relocation costs incurred in relocating the taxable entity's main office or other principal place of business to this state from another state" on or after September 1, 2013.

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293 *Id.*

294 *Id.*

295 Note that if the taxpayer is a member of a combined group, and one member of the combined group elects to use the sales tax exemption on R&D equipment purchases in a given report year, then all members of the combined group are prohibited from taking the franchise tax credit for that year. Section 2 of H.B. 800 83rd Tex. Leg. Session;Tex. Tax Code Section 171.653.

296 *See* Section 2 of H.B. 800 83rd Tex. Leg. Session; Tex. Tax Code Section 151.3182(b) (effective Jan. 1, 2014).

297 *See* Section 2 of H.B. 800 83rd Tex. Leg. Session (effective Jan. 1, 2014); Tex. Tax Code Section 151.3182(a)(3).

298 *See* Section 3 of H.B. 800 83rd Tex. Leg. Session (effective Jan. 1, 2014); Tex. Tax Code Section 171.651(3).

299 A higher credit amount of 6.25% is allowed for contracts with institutions of higher education.

300 Tex. Tax Code Section 171.658 (added by H.B. 800 2013 Tex. Legislature).

301 Tex. Tax Code Section 171.659 (added by H.B. 800 2013 Tex. Legislature).

302 In addition, the entity must not be part of a unitary affiliated group in which another member is doing business in Texas. See Section 13 H.B. 500 2013 Texas Legislature adding Section 171.109 to the Texas Tax Code (effective Sep. 1, 2013).

(s) New Historic Structure Rehabilitation Credit From 2013 Legislature. Section 14 of H.B. 500 from the 2013 Texas Legislature provides for a franchise tax credit for the rehabilitation of certain historic structures.[303] The rehabilitation credit takes effect January 1, 2015. The amount of the credit may not exceed 25% of the total eligible coss and expenses inccurred in the qualifying rehabilitation project.[304] The credit in any one year may not exceed the franchise tax due for the report year, but may be carried forward for up to five consecutive reports.[305]

(t) 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.[306]

(u) 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.[307]

4. Constitutionality of Margin Tax Upheld in *Allcat*. On November 28, 2011, the Texas Supreme Court reported its *Allcat* decision[308] that the Texas franchise, tax does not does not violate the Texas Constitution's so-called "Bullock Amendment" which prohibits "a tax on the net incomes of natural persons."[309] Allcat Claims Service, L.P., and one of its individual partners, John Weakly, filed their case on July 29, 2011 asserting that the margin tax was effectively a personal income tax as it applied to the income of partnerships owned by natural persons. Relying heavily on the separate legal entity status of partnerships under Texas law, the Texas Supreme Court ruled that the franchise tax is a tax **on business entities**, not on natural persons, and consequently that the margin tax does not violate the "Bullock Amendment." Prior to *Allcat*, many commentators and public officials considered the Margin

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303 See Section 14 H.B. 500 2013 Texas Legislature adding Section 171.901 through 171.909 to the Texas Tax Code (effective Jan. 1, 2015).

304 Tex. Tax Code Section 171.905 (effective Jan. 1, 2015).

305 Tex. Tax Code Section 171.906 (effective Jan. 1, 2015).

306 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.

307 *See infra* notes 698-710 and related text.

308 *In re Allcat Claims Service, L.P.*, No. 11-0589, 2011 WL 6091134 (Tex. Nov. 28, 2011).

309 The Bullock Amendment to Texas Constitution article 8, section 24(a),[309] 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]

Tax to be an income tax, particularly in the case of a partnership providing professional services (e.g., accounting, engineering, law or medical).[310]

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[310] *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). Former Comptroller Carole Keeton Strayhorn in a May 2, 2006 letter to Texas Governor Rick Perry, which can be found at http://www.cpa.state.tx.us/news/60502taxplan.pdf, wrote that portions of 2006 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." In a letter (dated April 21, 2006) (on file with author) to the Attorney General of Texas requesting a formal opinion whether 2006 H.B. 3 requires voter approval under the Bullock Amendment, Comptroller Strayhorn wrote:

> 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.
>
> An alternative interpretation of the partnership/unincorporated association proviso for which supporters of the legislation may contend would read into the proviso the word "net" so that, they would say, to trigger the referendum the tax would have to be on a person's share of partnership or unincorporated association "net income." In other words, under this much more restrictive interpretation, only a tax on the net income of a partnership or unincorporated association, from which a natural person received a share, would trigger the required referendum. Interpolation of words into a constitutional provision should not be utilized where it would defeat the overriding intent evidenced by the provision. Mauzy v. Legislative Redistricting Board, 471 S. W. 2d 570 (Tex. 1971). Interpolation of the word "net" in this proviso materially changes its meaning and would not be consistent with the caption and ballot language. The electorate voted on whether a personal income tax was to be approved by the Legislature without voter approval, and nothing suggests that it is only taxation of "net income" of the unincorporated association that was so objectionable as to require further voter approval.
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> * * *
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> This provision means that if the tax is determined by deducting from gross income any items of expense that are not specifically and directly related to transactions that created the income, it is an income tax. And, if it is an income tax, it is within the Bullock Amendment. Proposed Section 171.1012 (relating to the cost of goods sold deduction) and 171.1013 (relating to the compensation deduction) clearly include indirect and overhead costs of production and/or compensation that make the margin tax an income tax under this preexisting Texas definition found in Chapter 141, thereby invoking the Bullock Amendment.
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> * * *
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> Certainly it is the case that not all expenses are deducted under the margin tax concept, and thus under some technical accounting definitions the margin tax would not be on "net income" as that term is sometimes used in accounting parlance (i.e., the concluding item on an income

The *Allcat* decision affords Texas lawmakers more flexibility to analyze what types of taxes would be permissible under the Bullock Amendment and additional latitude in crafting revisions to address continuing complaints about the margin tax. For example, applying the 1991 franchise tax base to most types of business entities, even if expressly linked to net income as reported for federal income tax purposes, should be permissible under the *Allcat* standard.

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.[311] The minutes of

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> 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.

311 *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 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.

FASB's 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.[312] 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.

> 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."

[312] 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 for state tax purposes 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.[313] 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 2013-3 issued in January 2011,[314] 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.[315] However, in Revenue Procedure 99-51 and Revenue Procedure 2013-3 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

313 *See infra* notes 331-335 and related text.

314 Rev. Proc. 99-51, 1999-52 I.R.B. 761 (December 27, 1999) (superceded); Rev. Proc. 2013-3, 2013-1 I.R.B. 111 (December 31, 2012).

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

end of the day preceding the date of conversion. Until the IRS no-ruling policy is superseded, practitioners dealing with the conversion of existing S-corporations to partnerships in order to avoid Texas entity taxes may want to consider the alternative of using a subsidiary LLP (i.e., Checking-the-Box to be taxed as a corporation) in lieu of a limited partnership, and specifically drafting equal, pro rata treatment of the partners in the partnership agreement to overcome the single class of stock concern.

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

8. 2013 Legislative Sales and Property Tax Changes. The 2013 Legislative Session did not generate new Texas taxes or tax increases. There were, however, several important new state tax laws passed, the most important of which are described below or were previously outlined in the Margin Tax portions of this paper.

(a) Sales Tax. H.B. 1133 adds a sales tax credit for state sales taxes paid on the sale or lease of tangible personal property directly used by a cable TV, Internet access, or transmitting telecommunications provider.[316]

H.B. 1223 authorizes a sales tax refund for purchases of electricity, computer equipment, software, and mechanical, plumbing and electrical systems (and other similar named items) necessary and essential to the operation of a qualifying data center. To qualify a data center must be a new or refurbished facility of at least 100,000 square feet in a single building or portion thereof with an uninterruptable power source used by a single occupant and create at least 20 full-time jobs, not including those moved from elsewhere in the State paying at least 120% of the county average wage. The data center must make a make a capital investment of at least $150 million after September 1, 2013. An application must be submitted to the Comptroller and the exemption lasts for 10 or up to 15 years depending on the level of investment made.[317]

(b) Property Tax Incentive Under Chapter 313. H.B. 3390 extends the authority of school districts to enter into value limitation agreements under Chapter 313 of the Texas Tax Code through 2022. H.B. 3390 makes numerous changes throughout Chapter 313, and highlights include: (i) clarification that personal property associated with an expansion is eligible for limitation, (ii) changes to the jobs requirement so that applicants must commit to create at least 25 qualifying jobs (10 in rural or strategic investment areas); (iii) clarification that jobs granted "in connection with a project" (i.e. contractor jobs) are qualifying jobs; (iv) extends the value limitation period from eight to ten years, but credits for taxes paid during the qualifying

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316 H.B. 1133 from the 2013 Texas Legislature, *available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=HB1133; Tex. Tax Code Section 151.3186 (effective Sep. 1, 2013).

317 H.B. 1233 from the 2013 Texas Legislature, *available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=HB1233; Tex. Tax Code Section 151.4292 (effective Sep. 1, 2013).

period are eliminated; (v) authorization for the agreement to provide for a deferral of the value limitation up to four years, except that an application which is a part of a series of applications may provide for a six year deferral; and (vi) authorization for a minimum annual PILOT payment of $50,000.[318]

S.B. 1510 simplifies the property tax rate notice for counties and cities. The new revised notice must provide the proposed tax rate, the preceding year's tax rate, and the effective tax rate. If the county or city is proposing to increase the tax rate above the lower of the effective rate and rollback rate, the notice must also include the rollback rate. The notice also instructs property owners how to calculate their total taxes with each rate. The notice must be published in the newspaper, mailed to each property owner, and posted on the county or city's website.[319]

K. 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).[320] 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.[321] 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.[322]

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318 H.B. 3390 from the 2013 Texas Legislature, *available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=HB3390; Tex Tax Code Chapter 313 (effective Jan. 1, 2014 except that applications filed after Jan. 1, 2013 may opt to comply with the new provisions).

319 S.B. 1510 from the 2013 Texas Legislature, *available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=SB1510; Tex. Loc. Gov't Code Section 140.010 (effective Jan. 1, 2014).

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

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

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

(c) Asset Sale. A sale or exchange of all or substantially all of the assets of an entity may require approval of the owners, depending on the nature of the transaction, the entity's organization documents and applicable state law.[323] In most states, shareholder approval of an asset sale has historically been required when a corporation is selling all or substantially all of its assets. The Delaware courts have used both "qualitative" and "quantitative" tests in interpreting the phrase "substantially all," as it is used in Section 271 of the Delaware General Corporation Law ("DGCL"), which requires stockholder approval for a corporation to "sell, lease or exchange all or substantially all of its property and assets."[324]

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[323] *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).

[324] *See Gimbel v. Signal Co., 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 Int'l, Inc.*, 858 A.2d 342 (Del. Ch. 2004), *appeal refused*, 871 A.2d 1128 (Del. 2004), in which (A) the sale of assets by a subsidiary with approval of its parent corporation (its stockholder), but not the stockholders of the parent, was alleged by the largest stockholder of the parent to contravene DGCL § 271; (B) without reaching a conclusion, the Chancery Court commented in dicta that "[w]hen an asset sale by the wholly owned subsidiary is to be consummated by a contract in which the parent entirely guarantees the performance of the selling subsidiary that is disposing of all of its assets and in which the parent is liable for any breach of warranty by the subsidiary, the direct act of the parent's board can, without any appreciable stretch, be viewed as selling assets of the parent itself" (the Court recognized that the precise language of DGCL § 271 only requires a vote on covered sales by a corporation of "its" assets, but felt that analyzing dispositions by subsidiaries on the basis of whether there was fraud or a showing that the subsidiary was a mere alter ego of the parent as suggested in *Leslie v. Telephonics Office Technologies, Inc.*, 1993 WL 547188 (Del. Ch., Dec. 30, 1993) was too rigid); 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," quoting BALOTTI AND FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, §10.2 at 10-7 (3rd ed. Supp. 2004), 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* Morton and Reilly, *Clarity or Confusion? The 2005 Amendment to Section 271 of the Delaware General Corporation Law*, X Deal Points – The Newsletter of the Committee on Negotiated Acquisitions 2 (Fall 2005); *see also* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 Bus. Law. 843, 855-58 (2005); BALOTTI AND FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, §10.2 (3rd ed. Supp. 2009). 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:

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 provided, in essence, that shareholder approval is required under Texas law only if it is contemplated that the corporation will cease to conduct any business following the sale of assets.[325] 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 voted against the sale could perfect appraisal rights). TBCA article 5.09(A) provided 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.[326]

> (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"). *See* Morton and Reilly, *Clarity or Confusion? The 2005 Amendment to Section 271 of the Delaware General Corporation Law*, X Deal Points – The Newsletter of the Committee on Negotiated Acquisitions 2 (Fall 2005); *cf. Weinstein Enterprises, Inc. v. Orloff*, 870 A.2d 499 (Del. 2005) for a discussion of "control" in the context of a DGCL § 220 action seeking inspection of certain documents in the possession of a publicly held New York corporation of which the defendant Delaware corporation defendant was a 45.16% stockholder.

325 *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).

326 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

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.[327] 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.[328]

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.[329]

Texas 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,

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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).

327 See TBOC § 153.152.

328 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.

329 *See Knapp v. N. Amer. 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).

foreign corporation, or other entity did not expressly assume."[330] 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.[331] 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.[332] 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 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,[333] 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

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330 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 & 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).

331 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).

332 *See Grohman v. Kahlig*, 318 S.W.3d 882 (Tex. 2010), in which the Texas Supreme Court held that the conversion of two corporations into limited partnerships did not violate the terms of a security agreement covering shares of stock in the corporations that required the pledgor not to "sell, transfer, lease or otherwise dispose of the Collateral or any interest therein" without the pledgor's consent, and not to "allow the Collateral to become wasted or destroyed," because the pledged shares of stock were converted to limited partnership units and the definition of "Collateral" in the security agreement encompassed "all replacements, additions, and substitutions," and the shares of stock that were canceled in the conversion were first replaced with limited partnership units that represented the same interest in the businesses; thus, the Collateral was not transferred, and the pledgee's security interest was not impaired.

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

conversion rather than an existing entity (which would be a merger).[334] Partnerships, limited partnerships, and LLCs are afforded comparable rights.[335]

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.[336] This election, which is intended to afford foreign entities a means to

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

(1) the converting entity shall continue to exist, without interruption, but in the organizational form of the converted entity rather than in its prior organizational form;

(2) all rights, titles, and interests to all real estate and other property owned by the converting entity shall continue to be owned by the converted entity in its new organizational form without reversion or impairment, without further act or deed, and without any transfer or assignment having occurred, but subject to any existing liens or other encumbrances thereon;

(3) all liabilities and obligations of the converting entity shall continue to be liabilities and obligations of the converted entity in its new organizational form without impairment or diminution by reason of the conversion;

(4) all rights of creditors or other parties with respect to or against the prior interest holders or other owners of the converting entity in their capacities as such in existence as of the effective time of the conversion will continue in existence as to those liabilities and obligations and may be pursued by such creditors and obligees as if the conversion had not occurred;

(5) a proceeding pending by or against the converting entity or by or against any of its owners or members in their capacities as such may be continued by or against the converted entity in its new organizational form and by or against the prior owners or members without any need for substitution of parties;

(6) the ownership or membership interests in the converting entity that are to be converted into ownership or membership interests in the converted entity as provided in the plan of conversion shall be so converted, and the former holders of ownership or membership interests in the converting entity shall be entitled only to the rights provided in the plan of conversion or rights of dissent and appraisal under the TBOC;

(7) if, after the effectiveness of the conversion, an owner or member of the converted entity would be liable under applicable law, in such capacity, for the debts or obligations of the entity, such owner or member shall be liable for the debts and obligations of the entity that existed before the conversion takes effect only to the extent that such owner or member: (a) agreed in writing to be liable for such debts or obligations, (b) was liable under applicable law, prior to the effectiveness of the conversion, for such debts or obligations, or (c) by becoming an owner or member of the converted entity becomes liable under applicable law for existing debts and obligations of the converted entity; and

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

See also TBCA art. 5.20.

[335] *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.

[336] TBOC § 10.1025 as added in the 2009 Legislative Session by 2009 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

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.[337]

(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.[338]

(1) Conversions of Entities Classified as Partnerships. There generally should be no adverse federal income tax consequences arising from a properly structured conversion of an entity classified as a domestic partnership for federal income tax

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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* Byron F. Egan, *Choice of Entity Alternatives* (May 28, 2010), *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=1396, which at Appendix D describes (i) 2009 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, and (ii) 2009 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.

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."

337 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 2009 S.B. 1442 §§ 15-18. *See* Byron F. Egan, *Choice of Entity Alternatives* (May 28, 2010), *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=1396, which at Appendix D describes (i) 2009 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, and (ii) 2009 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.

338 *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).

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.[339] 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.[340] 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.[341] 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.[342]

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.[343] Nevertheless, with careful planning, most conversions of this type can be accomplished without recognition of gain.[344]

(2) Conversions of Entities Classified as Corporations. Conversion of an entity classified as a corporation into an entity classified as a partnership or an entity ignored for federal income tax purposes will generally be treated as a taxable liquidating transaction with respect to the corporation and, in the case of conversion to a partnership entity, a contribution transaction with respect to the partnership entity.[345] A corporation cannot be

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339 *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.

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

341 *See* I.R.C. § 731 (1997); I.R.C. § 736 (1993); I.R.C. § 751(b) (2004); Treas. Reg. § 301.7701-3(g) (2006); Priv. Ltr. Rul. 201214014 (April 6, 2012).

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

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

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

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

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.[346] 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.[347] 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.[348] 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."[349]

L. Joint Ventures. A joint venture is a vehicle for the development of a business opportunity by two or more entities acting together,[350] and is often used for oil patch deals. A joint venture may be structured as a corporation, partnership, LLC, trust, contractual arrangement,[351] or any combination of such entities and arrangements.[352] Structure decisions for a particular joint venture will be driven by the venturers' tax situation, accounting goals, business objectives and financial needs, as well as the venturers' planned capital and other contributions

346 I.R.C. § 336 (1988).

347 I.R.C. § 331(a) (1982).

348 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).

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

350 *See* Appendix D - Joint Venture Formation.

351 *See Dernick Resources, Inc. v. David Wilstein, et al*, 312 S.W.3d 864 (Tex. App.—Houston [1st Dist.] 2009), which involved an oil and gas drilling and production arrangement pursuant to a contract that was called a "joint venture agreement" and in which the court 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. *See infra* note 485.

352 *See* JOINT VENTURE TASK FORCE OF NEGOTIATED ACQUISITIONS COMMITTEE, MODEL JOINT VENTURE AGREEMENT WITH COMMENTARY (Am. Bar Ass'n., 2006).

to the venture, and antitrust and other regulatory considerations.[353] A key element in structuring any joint venture is the allocation among the parties of duties, including fiduciary duties.[354]

M. 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.[355]

N. 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.

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,[356] which was amended in 1997 by 1997 S.B. 555,[357] in 2003 by 2003 H.B. 1165, in 2005 by 2005 H.B. 1507 and in 2007 by 2007 H.B. 1737. However, corporations formed after January 1, 2006 are organized under and governed by the TBOC. For entities formed before January 1, 2006, only the ones voluntarily opting into the TBOC, or

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353 *See* Byron F. Egan, *Legislative Update: Business Law*, TexasBarCLE Webcast on Legislative Update: Business Law, July 2, 2013, *available at* http://www.jw.com/publications/article/1871.

354 *See infra* notes 402-408, 513-524, 592-622, 757-791, 982, and related text.

355 *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.

356 TBCA arts. 1.01 *et. seq.*

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

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.[358]

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."[359] 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 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%.[360] The tax rate schedule for a C-corporation is as follows:[361]

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358 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).

359 TBOC § 1.008(b).

360 I.R.C. §§ 11(a), 11(b).

361 I.R.C. § 11(a).

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%[362]	$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%[363]	$15,000,000
$18,333,333	--	35%	-0-

Under the IRC, the capital gains of a corporation are generally taxed at the same rates as ordinary income.[364]

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

Because a C-corporation is a separately taxable entity, there is no flow-through of income, deductions (including intangible drilling costs and depletion allowances), NOLs or capital losses to a C-corporation's shareholders, although a C-corporation's shareholders are not subject to self-employment tax on distributions they receive. Additionally, a C-corporation can carry forward 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),[366] and a shareholder will recognize taxable gain or loss on his or her interest in the corporation upon the corporation's liquidation or the shareholder's disposition thereof. However, both S- and C-corporations may be parties to a tax-free reorganization in which neither the corporation nor its shareholders are subject to taxation.

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362 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.

363 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.

364 *See* I.R.C. § 1201(a).

365 *See Pediatric Surgical Associates, P.C. v. Comm'r*, 81 T.C.M. (CCH) 1474 (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.

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

2. Taxation of S-Corporations.

(a) Effect of S-Corporation Status. S-corporation status is achieved by an eligible C-corporation making an election to be so treated. All shareholders, including their spouses if their stock is community property, must consent to such election. 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 date (subject to certain temporary exceptions enacted in 2009 and 2010)[367] (subject to certain very limited exceptions reducing the 10-year recognition period for certain taxpayers in the 2009, 2010, 2011, 2012 and 2013 tax years),[368] 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.[369]

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.[370] To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year.[371]

(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),[372] (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),[373] (iii) have no more than one class of stock[374] 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

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367 I.R.C. § 1374 (1989); Treas. Reg. § 1.1374-1 (2005); *but see* temporary exceptions in Sec. 2014 of Small Business Jobs Act of 2010, P.L. 111-240; Sec. 1251 of American Recovery and Reinvestment Act of 2009, P.L. 111-5.

368 *See* I.R.C. § 1374(d)(7)(B) (enacted as part of P.L. 111-5 (American Recovery and Reinvestment Act of 2009) and P.L. 111-240 (Creating Small Business Jobs Act of 2010)) (providing exceptions for (i) in the case of any tax year beginning in 2009 and 2010 if the 7th tax year in the recognition period preceded such year; and (ii) in the case of any tax year beginning in 2011, if the 5th year in the recognition period preceded such tax year). *See* I.R.C. § 1374(d)(7)(C) (providing that for purposes of determining the net recognized built-in gain for tax years beginning in 2012 or 2013, a five-year recognition period applies in lieu of the otherwise applicable 10-year recognition period. *See* American Taxpayer Relief Act of 2012, P.L. 112-240, § 326.

369 I.R.C. § 1374 (1989).

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

371 I.R.C. § 1366(d)(2)(A) (2007).

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

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

374 I.R.C. § 1361(b)(1)(D) (2005); *see supra* notes 313-315 and related text.

and I.R.C. § 501(c)(3) organizations).[375] S-corporations may have a C-corporation as a subsidiary (even if the S-corporation owns 80% or more of the C-corporation). Additionally, an S-corporation may now own a qualified subchapter S subsidiary ("QSSS"). A QSSS includes any domestic corporation that qualifies as an S-corporation and is owned 100% by an S-corporation that elects to treat its subsidiary as a QSSS.[376] 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.[377]

(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.[378]

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[379] 15 least 80% of the total combined voting power of all classes of voting stock and at least 80% of the total number of shares of all other classes of stock of the corporation immediately after the transfer.[380]

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

376 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).

377 I.R.C. § 1362(d)(1)-(3) (2005).

378 *See* BITTKER & EUSTICE, *supra* note 173, at § 6.04.

379 For these purposes, I.R.C. § 368(c) defines "control" as follows:

> [O]wnership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

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

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.[381] 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.[382] Beginning in 2014 there will be an alternative minimum deduction of $1 million, and there are minor temporary tax rate reductions applicable in 2014 and 2015.[383]

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.[384]

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.[385] 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.[386] 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*,[387] 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

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381 *See supra* notes 193-307 and related text.

382 Tex. Tax Code Ann. § 171.001 (Vernon 2010). *See supra* note 222 and related text.

383 H.B. 500 from the 2013 Texas Legislature.

384 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).

385 *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. BUS. L. 405, 406-416 (Fall 2009).

386 *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.).

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

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.[388]

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.).[389] 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.[390]

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

> Because "[a]lter ego applies when there is such unity between corporation and individual that the separateness of the corporation has ceased," *Castleberry v. Branscum*, 721 S.W.2d 270, 272 (Tex.1986), an alter ego finding is relevant to the determination of the judgment debtor's net worth. * * *
>
> 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.

389 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 Corp.*, 162 S.W.3d 581, 586-87 (Tex. App.—El Paso 2005, no pet.).

390 *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 Enter. of Texas, Inc. v. Bettina*

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.*[391] 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.[392] *SSP* rejects the single

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Inv., Inc., 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)) 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).

391 275 S.W.3d 444 (Tex. 2008).

392 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.
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> 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]

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.[393]

Officers and other agents of a corporation are not covered by TBCA article 2.21 or TBOC § 21.223 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.[394] There are causes of action for holding an officer personally liable for the officer's

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> The single business enterprise liability theory is fundamentally inconsistent with the approach taken by the Legislature in Article 2.21.
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> 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. BUS. L. 41, 64, 67 and 72 (Spring 2005); Alan R. Bromberg, Byron F. Egan, Dan L. Nicewander and Robert S. Trotti, *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 31 BULL. OF BUS. L. SEC. OF THE ST. B. OF TEX. 1, 2, 19, 22 (June 1994).

393 *See Tryco Enterprises, Inc. v. Robinson*, 390 S.W.3d 497 (Tex. App.—Houston [1stDist.] 2012) (actual fraud found where controllers caused corporation to transfer its assets to an entity they owned to avoid paying a judgment and to forfeit its charter for failure to pay franchise taxes).

394 Directors and officers are personally liable to creditors under the Tex. Tax Code for debts of a corporation whose charter is forfeited for failure to pay franchise taxes if the debts were incurred after the date the report, tax or penalty was due and before the corporate privileges are reinstated. Tex. Tax Code section 171.255 provides in relevant part:

> (a) If the corporate privileges of a corporation are forfeited for the failure to . . . pay a tax or penalty, each director or officer of the corporation is liable for each debt of the corporation that is created or incurred in this state after the date on which the report, tax, or penalty is due and before the corporate privileges are revived. The liability includes liability for any tax or penalty imposed by this chapter on the corporation that becomes due and payable after the date of the forfeiture.
>
> (b) The liability of a director or officer is in the same manner and to the same extent as if the director or officer were a partner and the corporation were a partnership.
>
> (c) A director or officer is not liable for a debt of the corporation if the director or officer shows that the debt was created or incurred:
>
> (1) over the director's objection; or
>
> (2) without the director's knowledge and that the exercise of reasonable diligence to become acquainted with the affairs of the corporation would not have revealed the intention to create the debt.

Tex. Tax Code Ann. § 171.255 (Vernon 2012).

own wrongful conduct, for an individual is liable for his own torts although a corporation may assume the liability pursuant to an indemnification arrangement.[395]

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.[396] Shareholders elect directors, who are given the power to manage the affairs of the corporation generally, as well as to formulate policies and objectives.[397] Shareholders retain the power to vote on certain major matters.[398] Directors appoint officers, who are delegated the

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395 *See* TBOC §§ 8.001 et seq.

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

397 *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 2009 S.B. 1442 § 36.

398 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 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

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.[399] 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.[400] 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.[401] Thus, the management structure of corporations is generally flexible enough to

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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 2009 S.B. 1442 § 4, provides than 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.

399 *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).

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

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

(1) restrict the discretion or powers of the board of directors;

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

(3) establish the natural persons who shall be the directors or officers of the corporation, their term of office or manner of selection or removal, or terms or conditions of employment of any director, officer, or other employee of the corporation, regardless of the length of employment;

(4) govern the authorization or making of distributions, whether in proportion to ownership of shares, subject to the limitations in TBCA 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;

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

E. Fiduciary Duties.

1. General. Directors of a corporation owe fiduciary duties of care, loyalty and obedience to the corporation.[402] The duty of care requires directors to exercise the degree of

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(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.

402 *Gearhart Industries, Inc. v. Smith Intern. Inc.*, 741 F.2d 707 (5th Cir. 1984); *see* Byron F. Egan, *Fiduciary Duties of Corporate Directors and Officers in Texas*, 43 TEX. J. BUS. LAW 45 (Spring 2009), *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=1230; Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, University of Texas School of Law 35th Annual Conference on Securities Regulation and Business Law (Feb. 8, 2013), *available at* http://www.jw.com/publications/article/1830; Byron F. Egan & 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). *See also* Appendix E - Confidentiality Agreements Are Contracts With Long Teeth.

care that an ordinarily prudent person would exercise under similar circumstances.[403] 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.[404] 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.[405] The duty of obedience requires directors to obey the law and the articles of incorporation.[406] The fiduciary duty of loyalty requires controlling shareholders to deal fairly with the minority shareholders.[407] In Texas (but not in Delaware) minority shareholders may have an additional cause of action against controlling shareholders who engage in unfairly oppressive conduct that harms minority shareholders even if no fiduciary duty or statutory breach is found.[408]

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.[409] 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.[410] Under Texas law, the business judgment rule appears to be more favorable to directors than under Delaware law, since

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

404 *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 Chem. Co. v. Ryan*, 970 A.2d 235 (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).

405 *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); Appendix F – Dissident Director Who Harms Corporation to Further Personal Objectives Violates Duty of Loyalty; *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).

406 *Gearhart*, 741 F.2d at 719.

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

408 *See* Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, University of Texas School of Law 35th Annual Conference on Securities Regulation and Business Law (Feb. 8, 2013) at pages 394-407, *available at* http://www.jw.com/publications/article/1830.

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

410 *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, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, University of Texas School of Law 35th Annual Conference on Securities Regulation and Business Law (Feb. 8, 2013), *available at* http://www.jw.com/publications/article/1830; 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.[411]

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.[412]

4. Corporate Opportunities Renunciation. Generally the duty of loyalty prohibits a director from usurping business opportunities that otherwise might be pursued by the corporation.[413] 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.[414] 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.[415]

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

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

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

413 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).

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

415 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.[416] 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.[417] 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.[418]

In 1985, Texas followed Delaware's lead in the area of interested director transactions and adopted TBCA article 2.35-1,[419] the predecessor to TBOC § 21.418. In general, these Texas Corporate Statues 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.[420] 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.[421] TBOC § 21.418 mirrors these clarifications.[422] Under the Texas Corporate Statues, if

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416 DGCL § 144(a).

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

418 *See Michelson v. Duncan*, 407 A.2d 211, 219 (Del. 1979). In *Gantler v. Stephens*, 965 A.2d 695 (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.
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> * * *
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> [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).

419 TBOC § 21.418; TBCA art. 2.35-1.

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

421 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.[423] 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.[424]

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 that was 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.

Effective September 1, 2011, TBOC § 21.418 was amended by 2011 S.B. 748 to read in its entirety as follows:

> Sec. 21.418. CONTRACTS OR TRANSACTIONS INVOLVING INTERESTED DIRECTORS AND OFFICERS. (a) This section applies to a contract or transaction between a corporation and:
>
> (1) one or more directors or officers, or one or more affiliates or associates of one or more directors or officers, of the corporation; or
>
> (2) an entity or other organization in which one or more directors or officers, or one or more affiliates or associates of one or more directors or officers, of the corporation:
>
> (A) is a managerial official; or
>
> (B) has a financial interest.
>
> (b) An otherwise valid and enforceable contract or transaction described by Subsection (a) is valid and enforceable, and is not void or voidable, notwithstanding any relationship or interest described by Subsection (a), if any one of the following conditions is satisfied:
>
> (1) the material facts as to the relationship or interest described by Subsection (a) and as to the contract or transaction are disclosed to or known by:

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422 TBOC § 21.418(d), as amended in the 2011 Legislative Session by 2011 S.B. 748, 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.

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

424 *Id*.

(A) the corporation's board of directors or a committee of the board of directors and the board of directors or committee in good faith authorizes the contract or transaction by the approval of the majority of the disinterested directors or committee members, regardless of whether the disinterested directors or committee members constitute a quorum; or

(B) the shareholders entitled to vote on the authorization of the contract or transaction, and the contract or transaction is specifically approved in good faith by a vote of the shareholders; or

(2) the contract or transaction is fair to the corporation when the contract or transaction is authorized, approved, or ratified by the board of directors, a committee of the board of directors, or the shareholders.

(c) Common or interested directors of a corporation may be included in determining the presence of a quorum at a meeting of the corporation's board of directors, or a committee of the board of directors, that authorizes the contract or transaction.

(d) A person who has the relationship or interest described by Subsection (a) may:

(1) be present at or participate in and, if the person is a director or committee member, may vote at a meeting of the board of directors or of a committee of the board that authorizes the contract or transaction; or

(2) sign, in the person's capacity as a director or committee member, a unanimous written consent of the directors or committee members to authorize the contract or transaction.

(e) If at least one of the conditions of Subsection (b) is satisfied, neither the corporation nor any of the corporation's shareholders will have a cause of action against any of the persons described by Subsection (a) for breach of duty with respect to the making, authorization, or performance of the contract or transaction because the person had the relationship or interest described by Subsection (a) or took any of the actions authorized by Subsection (d).

The changes to TBOC § 21.418 by 2011 S.B. 748 were intended to clairify what was already intended. TBOC § 21.418(a) was amended to clarify that it also applies to affiliates or associates of directors or officers that have the conflicting relationship or interest. TBOC § 21.418(b) was further amended to clarify that the contract or transaction is not void or voidable, and is valid and enforceable, notwithstanding the conflicting relationship or interest if the requirements of the Section are satisfied. Provisions formerly located in TBOC § 21.418(b) permitting the execution of a consent of directors, or the presence, participation or voting in the meeting of the board of directors, by the director or officer having the conflicting relationship or interest were moved to a new TBOC § 21.418(d). Finally, a new TBOC § 21.418(e) was added specifying that neither the corporation nor any of its shareholders have any cause of action

against any of the conflicted officers or directors for breach of duty in respect of the contract or transaction because of such relationship or interest or the taking of any actions described by TBOC § 21.418(d).

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.[425] 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.[426] 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 approving stock repurchases in violation of DGCL § 174.[427] 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.[428]

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

> **102 CONTENTS OF CERTIFICATE OF INCORPORATION.**
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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:
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> * * *
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> (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.

426 DGCL § 102(b)(7).

427 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); *Burtch v. Seaport Capital, LLC (In re Direct Response Media, Inc.)*, 466 B.R. 626 (D. Del. 2012) (noting that the Delaware Supreme Court has held that when a duty of care breach is not the exclusive claim, a court may not dismiss solely on an exculpatory provision).

428 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. 2001). 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 has 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

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.[429] 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.[430]

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.[431] Different classes and series of common stock and preferred stock may be utilized to accommodate the desires of various types of investors.[432] Equity can be raised at the base level by common stock and at

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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.

429 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.

430 *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. Super. 193l); *Holloway v. Skinner*, 898 S.W.2d 793, 795 (Tex. 1995). If an officer commits a tort while acting for the corporation, under the law of agency, the officer is liable personally for his actions. *See* Dana M. Muir and Cindy A. Schipani, *The Intersection of State Corporation Law and Employee Compensation Programs: Is it Curtains for Veil Piercing?*, 1996 U. Ill. L. Rev. 1059, 1078-1079 (1996); *cf. Centurion Planning Corp., Inc. v. Seabrook Venture II*, 176 S.W.3d 498, 509 (Tex. App.—Houston [1st Dist.] 2004, no pet.). The corporation may also be liable under *respondeat superior*.

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

432 *See id.* at 357–59.

levels ranking above the common stock by preferred stocks.[433] 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.[434] 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.[435] 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.[436]

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.[437] 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.[438] They also specify certain procedures that must be followed to assure the enforceability of the share transfer restrictions, such as the placement of a restrictive legend on stock certificates and the maintenance of a copy of the document containing the transfer restrictions at the corporation's principal place of business or registered office.[439] 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 federal and state securities laws. Transfers of

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433 *See id.*; TBOC §§ 21.152-21.157.

434 TBOC §§ 21.175 and 21.161.

435 TBOC § 21.159.

436 TBOC § 21.157(c), as added in the 2009 Legislative Session by 2009 S.B. 1442 § 30.

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

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

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

shares are generally required to be registered under such laws absent an applicable exemption from registration.[440]

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.[441] 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.[442] 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.[443] 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.

4. No Bearer Shares. Certificates for shares in a Texas corporation may not be registered in bearer form.[444] 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.

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440 *See infra* notes 819-822 and related text.

441 TBOC § 21.201.

442 TBOC § 21.201(b)-(d) as added in the 2009 Legislative Session by 2009 S.B. 1442 § 33.

443 TBOC § 10.154(c) and TBOC § 10.361(g) as added in the 2009 Legislative Session by 2009 S.B. 1442 §§ 18 and 19.

444 TBOC § 3.202 (f) as added in the 2009 Legislative Session by 2009 S.B. 1442 § 3. Also TBOC § 21.163(a)(4) was amended in the 2009 Legislative Session by 2009 S.B. 1442 § 31 to eliminate the ability of a corporation to issue scrip in bearer form.

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.[445] 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.[446] 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 filing fee.[447] Under the TBOC, a certificate of formation is the proper filing document.[448] 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.[449] After the Secretary of State officially

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445 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."

446 TBOC § 3.003.

447 TBCA arts. 3.02 and 3.03.

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

449 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, 2010. TBOC § 5.201(b), as amended in the 2009 Legislative Session by 2009 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.

acknowledges the filing of the corporation's certificate of formation,[450] 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.[451] 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.[452] 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.[453] In the absence of a contrary provision in the corporation's governing document, the TBCA or the TBOC, bylaws may be adopted or amended orally or by acts evidenced by a uniform course of proceeding or usage and acquiescence.[454]

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

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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.

450 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.

451 TBCA art. 3.06; TBOC § 21.059.

452 TBCA art. 2.33A; TBOC § 21.057.

453 TBCA art. 2.23; TBOC § 21.058.

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

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.[455]

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.[456] 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.,[457] 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.[458]

L. Anti-Takeover. TBCA Part Thirteen and TBOC Chapter 21, Subchapter M deal with business combinations involving public companies where there is a change of control after which there are minority shareholders by imposing a special voting requirement for business combinations and other transactions involving a new controlling shareholder.[459] These anti-

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455 *See* CT Corporation, *What Constitutes Doing Business* (2008). In the 2009 Legislative Session 2009 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.

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

457 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.

458 *See supra* notes 323-326 and related text.

459 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 & 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).

takeover provisions (i) apply only to an "issuing public corporation"[460] and (ii) prohibit a "business combination"[461] (which includes a merger, share exchange, sale of assets, reclassification, conversion or other transaction between the issuing public corporation and any "affiliated shareholder"[462]) 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.[463] 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.[464]

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"),[465] (4) the Texas Revised Limited Partnership Act ("TRLPA")[466] 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.[467] 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.[468] The definition 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.[469] Within the TBOC, Chapter 152 is specifically applicable to general partnerships, though many of the general provisions in

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460 "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).

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

462 "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.

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

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

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

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

467 TRPA § 2.02; TBOC § 152.051(c).

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

469 TBOC §§ 402.001 and 402.005.

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."[470] 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.[471] Until January 1, 2010 (at which time *all* partnerships became subject to the TBOC),[472] Texas general partnerships which were formed prior to January 1, 2006 and did not opt into the TBOC were governed by the TRPA.[473] 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."[474] The definition of "person" under the new TBOC comes from the Government Code,[475] 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."[476]

2. Factors Indicating Partnership. Under the Tex. GP Stats., the following five factors indicate that persons have created a partnership:[477]

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

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470 TBOC § 1.008(f).

471 TBOC §§ 402.001 and 402.003.

472 TBOC § 402.005.

473 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. BUS. J. 828 (Sept. 1994).

474 TRPA § 1.01(14).

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

476 TEX. GOV'T CODE ANN. § 311.005.

477 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. BUS. L. 465 (Fall 2009).

- Contributing or agreeing to contribute money or property to the business.

In *Ingram v. Deere*,[478] the Supreme Court of Texas held that while "common law required proof of all five factors to establish the existence of a partnership, . . . TRPA does not require direct proof of the parties' intent to form a partnership" and instead uses a "totality-of-the-circumstances test" in determining the existence of a partnership. The Supreme Court explained:

> Whether a partnership exists must be determined by an examination of the totality of the circumstances. Evidence of none of the factors under the Texas Revised Partnership Act will preclude the recognition of a partnership, and even conclusive evidence of only one factor will also normally be insufficient to establish the existence of a partnership under TRPA. However, conclusive evidence of all five factors establishes a partnership as a matter of law. In this case, Deere has not provided legally sufficient evidence of any of the five TRPA factors to prove the existence of a partnership. Accordingly, we reverse the court of appeals' judgment and reinstate the trial court's take-nothing judgment.[479]

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:[480]

- 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.[481]

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478 288 S.W.3d 886, 895-96 (Tex. 2009).

479 288 S.W.3d at 903-904 (Tex. 2009).

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

481 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.

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."[482]

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.
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> Mining partnerships can exist in conjunction with other defined relationships. For example, even though parties may have adopted a joint operating agreement which disclaims any partnership relationship, a mining partnership may exist nonetheless by operation of law.
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> * * *
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> The disclaimer of partnership between joint oil and gas interest owners became an accepted and trusted principle of oil and gas law. If there were any doubts about the contract provision, one only had to refer to the Texas Uniform Partnership Act, which stated that "operation of a mineral property under a joint operating agreement does not of itself establish a partnership." The idea that no mining partnership existed in joint oil and gas operations became so well accepted that there have been very few recent mining partnership cases in Texas, and those that do exist generally support this conventional wisdom.
>
> Notwithstanding the conventional wisdom, however, mining partnerships are being created, and they remain in existence even in the face of the standard "boiler plate" denials of partnership. If the elements of mining partnership exist, then the mining partnership exists as a matter of law without regard to the intent of the parties thereto.
>
> Further, joint oil and gas operations are often commenced and carried out without the adoption of a joint operating agreement. When this occurs, the probability that the parties to an undocumented joint operation have created a mining partnership is significantly increased. * * *
>
> 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.

[482] *In re Wilson*, 355 B.R. 600 (S.D. Tex. 2006) (citing *Niday v. Niday*, 643 S.W.2d 919 (Tex. 1982)); *see Rojas v. Duarte*, 393 S.W.3d 837 (Tex. App.—El Paso 2012 (two individuals found to have verbally formed a partnership under TRPA and *Ingram v. Deere*, *supra* note 478; Steven A. Waters & 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 (Tex. 1957)).

5. Joint Ventures. The definition of a partnership under Tex. GP Stats. includes a "joint venture" or any other named association that satisfies the definition of "partnership."[483] 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.[484] 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 traditional definition of a partnership) regardless of how the venturers characterize and document their relationship.[485]

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*.[486] They also resolve old questions about whether an agreement to share losses was necessary to create a partnership by providing that it is unnecessary.[487]

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483 TRPA § 2.02; TBOC § 152.051(b).

484 *See* Byron F. Egan, *Joint Venture Formation*, 44 TEX. J. BUS. LAW 129 (2012); Alan R. Bromberg and Larry E. Ribstein, *Bromberg & Ribstein on Partnership*, § 2.06 (Aspen Publishers 2003).

485 In *Dernick Resources, Inc. v. David Wilstein, et al*, 312 S.W.3d 864 (Tex. App.—Houston [1st Dist.] 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. The court 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.

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

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

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.[488] 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.[489]

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.[490] 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.[491] 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.[492]

The Margin Tax is not applicable to a general partnership (other than an LLP) if all of its partners are individuals.[493] The Margin Tax is imposed on a general partnership which has a business entity as a partner.[494]

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.[495]

C. Owner Liability Issues. Under Tex. GP Stats.,[496] 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

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488 *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).

489 I.R.C. § 7701(a)(2) (2006).

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

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

492 TEX. TAX CODE ANN. § 17.001(a)(1) (Vernon 2002 & Supp. 2004). *But see supra* notes 158-172 and related text.

493 *See supra* notes 193-307 and related text and *infra* note 952 and related text.

494 *Id.*

495 I.R.C. § 1402(a) (2004).

496 TRPA § 3.03; TBOC § 152.303.

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.[497] Provisions in a partnership agreement that serve to allocate liability among the partners are generally ineffective against third-party creditors.[498] A partner who is, however, forced to pay more than his allocable share of a particular liability should have a right of contribution under Tex. GP Stats. from the partnership or the other partners who did not pay their allocable share.[499]

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.[500]

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.[501] 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.[502]

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.[503] Previously, a creditor could obtain a judgment enforceable against an individual partner's assets without suing the partnership.[504] Generally, Tex. GP Stats. require that there be a judgment against the partnership and that the

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497 TRPA § 3.04; TBOC § 152.304.

498 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).

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

500 TRPA § 3.07; TBOC § 152.304(b).

501 TRPA § 6.02(c).

502 *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).

503 TRPA § 3.05; TBOC § 152.306.

504 *See* statues cited *supra* note 1.

individual partner has been served in that action; however, a judgment against a partnership is not automatically a judgment against its partners.[505]

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.

Under the TBOC, a judgment creditor of a partner in a general partnership may on application to a court of competent jurisdiction secure a "charging order" against the partner's partnership interest.[506] In a "charging order" a court "charges" the partnership 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 partner to receive distributions on an interest subject to a prior perfected security interest. The TBOC provides that a charging order is a creditor's exclusive remedy against a general partnership interest, but that does not preclude a partner from granting a UCC security interest in a general partnership interest or a creditor from enforcing it, in each case subject to the partnership agreement. The general partnership charging order provisions are comparable to those provided by the TBOC for limited partnerships[507] and LLCs.[508]

D. <u>Management</u>. 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.[509] In

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

506 TBOC § 152.308, as added effective September 1, 2011 by 2011 S.B. 748 § 43, reads as follows:

> Sec. 152.308. PARTNER'S PARTNERSHIP INTEREST SUBJECT TO CHARGING ORDER. (a) On application by a judgment creditor of a partner or of any other owner of a partnership interest, a court having jurisdiction may charge the partnership interest of the judgment debtor to satisfy the judgment.
>
> (b) To the extent that the partnership interest is charged in the manner provided by Subsection (a), the judgment creditor has only the right to receive any distribution to which the judgment debtor would otherwise be entitled in respect of the partnership interest.
>
> (c) A charging order constitutes a lien on the judgment debtor's partnership interest. The charging order lien may not be foreclosed on under this code or any other law.
>
> (d) The entry of a charging order is the exclusive remedy by which a judgment creditor of a partner or of any other owner of a partnership interest may satisfy a judgment out of the judgment debtor's partnership interest.
>
> (e) This section does not deprive a partner or other owner of a partnership interest of a right under exemption laws with respect to the judgment debtor's partnership interest.
>
> (f) A creditor of a partner or of any other owner of a partnership interest does not have the right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the partnership.

507 TBOC § 153.256; *see* note 585 and related text.

508 TBOC § 101.112; *see* note 828 and related text.

509 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.[510] 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.[511]

E. Fiduciary Duties.

1. General. Under Tex. GP Stats., a partner in a general partnership 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.[512] These duties are fiduciary in nature although not so labeled.[513]

2. Loyalty. The duty of loyalty requires a general partner to place the interests of the partnership ahead of his own interests.[514] 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;

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

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

512 TRPA § 4.04; TBOC § 152.204.

513 *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).

514 *Meinhard v. Salmon*, 249 N.Y. 458, 463-64, 164 N.E. 545, 546 (N.Y. 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.

- Appropriation of partnership opportunities;
- Refusal to distribute profits to other members of the partnership;
- Diversion of an asset of the partnership for a non-intended use;
- Failure to disclose plans and conflicts to partners; and
- A general lack of candor with partners.[515]

3. Care. The duty of care requires a partner to act as an ordinarily prudent person would act under similar circumstances.[516] 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.[517]

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.[518]

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.[519] 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,[520] which represents a change from cases under TUPA.[521] A managing partner stands in a higher fiduciary relationship to other partners than partners typically occupy.[522]

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

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515 *See* TRPA § 4.04(b); TBOC § 152.205; *Bromberg & Ribstein*, *supra* note 484, at § 6.07.

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

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

518 *Bromberg & Ribstein*, *supra* note 484, at §§ 6.05(c) and 6.06.

519 TRPA § 4.05; TBOC § 152.210.

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

521 *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).

522 *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, writ granted), *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.

standards by which the performance of the obligation is to be measured, or (iv) eliminate the obligation of good faith, although the agreement may within reason determine the standards by which the performance of the obligation is to be measured.[523] In the 2013 Legislative Session, TBOC § 7.001(d)(1) was amended to provide that the liability of a partner may be limited or eliminated "in a general partnership by its partnership agreement to the same extent [TBOC § 7.001] Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections [a for-profit corporation] apply and to the additional extent permitted under" TBOC § 152.002.[524]

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 a 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.[525] 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.[526] 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.[527] 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.[528] General partnership interests may be evidenced by transferable certificates, but ordinarily no such certificates are issued.[529]

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."[530] Neither federal securities act defines a partnership interest, whether general or limited, as a "security." However, by overwhelming precedent, limited

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523 TRPA § 1.03(b); TBOC § 152.002; *see infra* notes 549-550 and related text.

524 *See supra* notes 87-89 and 425-430 and related text.

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

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

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

528 TRPA § 4.01(g); TBOC § 152.201.

529 TRPA § 5.02(b); TBOC § 3.201.

530 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).

partnership interests are considered investment contracts for purposes of the securities laws.[531] The question of whether a general partnership interest is a security requires a case-by-case analysis. A general partner interest may be a security when the venture, although a general partnership *de jure*, functions *de facto* as a limited partnership (i.e., certain partners do not actively participate in management and rely primarily on the efforts of others to produce profits). In *Williamson v. Tucker*,[532] 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.[533]

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."[534] The results should not be affected by the fact that some of the general partners may have remained passive[535] or that the general partnership had made an LLP election.[536]

H. <u>Continuity of Life</u>. 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.[537] The statutes provide for "events of withdrawal" and "events of winding up."[538] Upon the occurrence of an event of withdrawal, the business of the partnership is not required to be wound up.[539] An event of withdrawal occurs (i) upon the occurrence of events specified in the partnership agreement, (ii) when the

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531 *See SEC 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) (stating that the issue is whether the limited partnership interest meets the test of an investment contract).

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

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

534 *Id.* at 241.

535 *Id.*

536 *Cf. SEC v. Merchant Capital, LLC*, 400 F.Supp.2d 1336 (N.D. Ga. 2005), *rev'd in part and vacated in part*, 483 F.3d 747 (11th Cir. 2007).

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

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

539 TRPA § 2.06(a), TBOC § 152.502.

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.[540] Except for the partner's right to withdraw, the statutory events of withdrawal may be modified by the partnership agreement,[541] 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 partnership agreement or the withdrawal is otherwise wrongful.[542] Unless the partnership agreement provides otherwise,[543] the interest of a withdrawing partner (except for a partner who wrongfully withdraws) must be redeemed by the partnership at fair market value.[544] 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.[545]

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.[546] The factors discussed in Part III.A. are used to determine whether or not a general partnership exists.[547] Thus, it is not necessary that any written partnership agreement exists or that any significant expenses be incurred in the formation of a partnership.[548] 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.[549] 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

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540 TRPA § 6.01; TBOC § 152.501(b).

541 TRPA § 1.03; TBOC § 152.002.

542 TRPA § 6.02; TBOC § 152.503.

543 TRPA § 1.03; TBOC § 152.002.

544 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.

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

546 TRPA § 2.02(a); TBOC § 152.051.

547 TRPA § 2.03(a); TBOC § 152.052(a); *see supra* notes 477-481 and related text.

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

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

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.[550] Public policy limitations in some cases may limit the extent to which a partnership agreement may effectively reduce the fiduciary duties of a partner.

Unless the partnership agreement specifically provides otherwise, profits and losses of a general partnership are shared per capita and *not* in accordance with capital contributions or capital accounts.[551]

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.[552]

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.[553] 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.[554]

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.[555] 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

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

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

552 *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).

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

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

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

domestic limited partnerships are now governed by the TBOC.[556] Like other entities formed under Texas law, limited partnerships formed on or after January 1, 2006 are governed by the TBOC,[557] 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.[558] 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, 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.[559]

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.[560] 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.[561] Under certain circumstances, a partner's contribution of property may result in a net reduction in liability[562] 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.[563] 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.[564]

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.[565]

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556 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).

557 TBOC § 401.001.

558 TBOC § 402.005; TRLPA § 13.10.

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

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

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

562 I.R.C. § 752 (1986).

563 I.R.C. § 731 (1997).

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

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.[566] 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.[567] On January 13, 1997, the IRS issued proposed regulations under IRC § 1402 that would define "limited partner" for employment tax purposes as follows, irrespective of the partner's status under state law, as follows:

> Generally, an individual will be treated as a limited partner under the proposed regulations unless the individual (1) has personal liability (as defined in § 301.7701-3(b)(2)(ii) of the Procedure and Administration Regulations) for the debts of or claims against the partnership by reason of being a partner; (2) has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or, (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.[568]

The proposed regulations would also have allowed 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.[569]

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.[570] The legislative history indicates that Congress wanted the IRS to withdraw the controversial proposed regulation discussed above, which would impose a tax on limited partners.[571] 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.[572]

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565 *See supra* notes 193-307 and related text.

566 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).

567 *Lauren A. Howell, et vir. v. Commissioner*, TC Memo 2012-303 (Nov. 1, 2012).

568 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).

569 *Id*.

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

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

572 S. 949, 105th Cong. § 734 (1997).

The IRS is nevertheless successfully challenging taxpayer claims of limited partner status where the taxpayer provided services to the partnership.[573]

C. Owner Liability Issues. A general partner of a limited partnership has the same unlimited liability as does a partner of a general partnership.[574] 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 "LLLP."[575]

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).[576] Veil piercing is inapplicable to Texas limited partnerships.[577] A limited partner may lose this limited liability, however, if he or she

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573 *See Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 TC 137 (Feb. 9, 2011) (partners'distributive shares of the law firm's income found not to arise as a return on the partners' investment and were not "earnings which are basically of an investment nature;" the attorney partners' distributive shares arose from legal services they performed on behalf of the law firm and were held to be self-employment income); *Lauren A. Howell v. Commissioner*, TC Memo 2012-303 (Nov. 1, 2012) (spouse providing marketing advice, signing contracts, contributing a business plan and providing credit card held "not merely a passive investor" and not a limited partner for self-employment tax purposes).

574 *See* TRLPA §§ 4.01(d), 4.03(a); TBOC § 153.152. *See KAO Holdings, L.P. v. Young*, 261 S.W.3d 60 (Tex. 2008), in which the Supreme Court of Texas held that under TRPA § 3.05(c), "while partners are generally liable for the partnership's obligations, a judgment against the partnership is not automatically a judgment against the partner, and that judgment cannot be rendered against a partner who has not been served merely because judgment has been rendered against the partnership. The purpose of the provision is to state that service is necessary, not that it is sufficient. Partners against whom judgment is sought should be both named and served so that they are on notice of their potential liability and will have an opportunity to contest their personal liability for the asserted partnership obligation."

575 TRPA § 3.08(e); TRLPA § 2.14; TBOC §§ 152.805, 153.351, 153.353. *See infra* notes 967-973 and related text.

576 *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* 2009 S.B. 1442 §§ 54 and 55. *See* Elizabeth S. Miller, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 TEX. J. BUS. L. 405, 426-435 (Fall 2009).

577 *See Asshauer v. Wells Fargo Foothill*, 263 S.W.3d 468, 474 (Tex. App.—Dallas 2008, pet. denied). 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

participates in the management of partnership business.[578] 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 officer, agent or employee of the limited partnership (but not a director) 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.[579]

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.[580] 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.[581] A corporation can serve as the general partner of a limited partnership, although the ordinary grounds for piercing the corporate veil (e.g. if the corporate general partner is not sufficiently capitalized in light of known and contingent liabilities) may be applied to hold the shareholders of such a corporate general partner liable in certain factual contexts.[582]

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.[583] 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.[584]

Under the TBOC, a judgment creditor of a partner in a limited partnership may on application to a court of competent jurisdiction secure a "charging order" against the partner's partnership interest.[585] In a "charging order" a court "charges" the partnership interest such that

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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.

578 *Id.*

579 TRLPA § 3.03(b); TBOC § 153.103.

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

581 TRLPA § 3.03(d); Revisor's Note to TBOC § 153.102.

582 *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).

583 TBOC § 153.210(a).

584 TBOC § 153.210(b).

585 TBOC § 153.256 reads as follows:

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 partner to receive distributions on an interest subject to a prior perfected security interest. The TBOC provides that a charging order is a creditor's exclusive remedy against a limited partnership interest, but that does not preclude a partner from granting a UCC security interest in a limited partnership interest or a creditor from enforcing it, in each case subject to the partnership agreement. The limited partnership charging order provisions are comparable to those provided by the TBOC for general partnerships[586] and LLCs.[587]

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.[588] 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.[589] 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.[590] A limited partnership may have elected or appointed officers (but not directors).[591]

> Sec. 153.256. PARTNER'S PARTNERSHIP INTEREST SUBJECT TO CHARGING ORDER. (a) On application by a judgment creditor of a partner or of any other owner of a partnership interest, a court having jurisdiction may charge the partnership interest of the judgment debtor to satisfy the judgment.
>
> (b) To the extent that the partnership interest is charged in the manner provided by Subsection (a), the judgment creditor has only the right to receive any distribution to which the judgment debtor would otherwise be entitled in respect of the partnership interest.
>
> (c) A charging order constitutes a lien on the judgment debtor's partnership interest. The charging order lien may not be foreclosed on under this code or any other law.
>
> (d) The entry of a charging order is the exclusive remedy by which a judgment creditor of a partner or of any other owner of a partnership interest may satisfy a judgment out of the judgment debtor's partnership interest.
>
> (e) This section does not deprive a partner or other owner of a partnership interest of a right under exemption laws with respect to the judgment debtor's partnership interest.
>
> (f) A creditor of a partner or of any other owner of a partnership interest does not have the right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited partnership.

586 TBOC § 152.308; *see supra* note 506 and related text.

587 TBOC § 101.112; *see infra* note 828 and related text.

588 TRLPA § 4.03(a); TBOC § 153.152.

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

590 TRLPA § 3.02; TBOC § 154.101.

591 TBOC § 151.004.

F. Fiduciary Duties.

1. Texas. Case law has adopted fiduciary standards for general partners of limited partnerships mirroring the unbending fiduciary standards espoused in general partnership cases.[592] Because of their control over partnership affairs, general partners may be subjected to an even higher fiduciary standard with respect to limited partners.[593] Those in control of the general partner have been held to the same high standards.[594]

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.[595] 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.[596] Courts, however, continue to refer to the trustee standard.[597]

A general partner in a limited partnership owes the duties of care and loyalty to the partnership and the other partners.[598] The Tex. LP Stats. define the duty of care as requiring

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592 *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.).

593 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]."

594 *See In re Bennett*, 989 F.2d 779, 790 (5th Cir. 1993), *opinion amended on rehearing*, 1993 WL 268299 (5th Cir. July 15, 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").

595 TRLPA §§ 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).

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

597 *See McBeth v. Carpenter*, 565 F.3d 171 (C.A.5 (Tex. 2009)); *Hughes v. St. David's Support Corp.,* 944 S.W.2d 423, 425-26 (Tex. App.—Austin 1997, writ denied).

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

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.[599] An error in judgment does not by itself constitute a breach of the duty of care.[600] 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.[601] 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.[602]

In Texas, the duty of loyalty is defined as including:[603]

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 in the Tex. LP Stats. mirror the common areas traditionally encompassed by the duty of loyalty (e.g., self-dealing, conflicts of interest and usurpation of partnership opportunity).[604] 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.[605] 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

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

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

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

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

603 TRPA § 4.04(b); TBOC § 152.205.

604 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); s*ee 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.).

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

good faith and in a manner that the partner reasonably believes to be in the best interest of the partnership.[606]

Under the TBOC *limited* partners, as limited partners, generally do not owe fiduciary duties to the partnership or to other partners.[607] 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).[608] 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.[609] 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 of the general partner, contractual veto powers over partnership actions or service as an agent of the partnership).[610] In such situations, the limited partner's conduct could be judged by fiduciary principles.[611]

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

607 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").

608 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."

609 *See, e.g., Strebel v. Wimberly II*, 311 S.W.3d 267 (Tex. App.—Houston [1st Dist.] 2012) *pet. filed*; *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).

610 *McBeth v. Carpenter*, 565 F.3d 171 (5th Cir. 2009) (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).

611 *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*

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."[612] This language indicates that the partnership agreement may modify the internal liabilities of a general partner. Although there are questions 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,[613] in *Strebel v. Wimberly II*[614] the Court denied a limited partner's claims for general partner breach of fiduciary duty on the basis of a limited partnership agreement provision that "the General Partner shall have no duties (including fiduciary duties) except as expressly set forth in this Agreement." In the 2013 Legislative Session, TBOC § 7.001(d)(2) was amended to provide that the liability of a general partner may be limited or eliminated "in a limited partnership by its partnership agreement to the same extent [TBOC § 7.001] Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply [a for-profit corporation] and to the additional extent permitted under Chapter 153 and, to the extent applicable to limited partnerships, Chapter 152."[615]

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.[616] For example, the partnership agreement may not eliminate the duty of care, but may determine the standards by which the performance of the obligation is to be measured, if the standards are not "manifestly unreasonable."[617] In one case decided prior to the passage of the TRPA and the TBOC, the Court stated that, when the parties bargain on equal

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also Daniel v. Falcon Interest Realty Corp., 190 S.W.3d 177 (Tex. App.—Houston [1st Dist.] 2005, no pet. hist).

612 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 892-995 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 Dunnagan v. Watson*, 204 S.W. 3d 30 (Tex. App.—Ft. Worth 2006, *pet. denied*); 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 763.

613 *See* TRPA § 1.03(b); TBOC § 152.002(b). "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.

614 311 S.W.3d 267 (Tex. App.—Houston [1st Dist.] 2012) *pet. filed*.

615 See supra notes 87-88 and 524 and related text

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

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

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.[618]

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."[619] 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."[620] 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.[621] 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.[622]

2. Delaware. Delaware concepts of general partner fiduciary duties generally parallel Texas law, and are framed in the Delaware statutes.[623] Delaware, however, expressly

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

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

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

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

622 *See* TRPA § 4.03; TBOC §§ 153.551, 153.552.

623 The duties of a partner in a Delaware general partnership are set forth in Section 15-404 of the Delaware Revised Uniform Partnership Act ("DRPA"). Section 15-404(a)-(d) of DRPA, DEL. CODE ANN. tit. 6, § 15-404(a)(d) (Supp. 2013), provides as follows:

> **§ 15-404. General standards of partner's conduct.**
>
> (a) The only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care set forth in subsections (b) and (c) of this section.
>
> (b) A partner's duty of loyalty to the partnership and the other partners is limited to the following:
>
> (1) To account to the partnership and hold as trustee for it any property, profit or benefit derived by the partner in the conduct or winding up of the partnership business or affairs or derived from a use by the partner of partnership property, including the appropriation of a partnership opportunity;

allows the limitation or elimination of partner fiduciary duties in the partnership agreement.[624] Although limitations on fiduciary duty in a partnership agreement may be respected by courts

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> (2) To refrain from dealing with the partnership in the conduct or winding up of the partnership business or affairs as or on behalf of a party having an interest adverse to the partnership; and
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> (3) To refrain from competing with the partnership in the conduct of the partnership business or affairs before the dissolution of the partnership.
>
> (c) A partner's duty of care to the partnership and the other partners in the conduct and winding up of the partnership business or affairs is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.
>
> (d) A partner does not violate a duty or obligation under this chapter or under the partnership agreement solely because the partner's conduct furthers the partner's own interest.

Section 17-403(a) of the Delaware Revised Limited Partnership Act ("DRLPA), makes the DRPA § 15-404 fiduciary duties applicable to the general partner of a limited partnership as follows:

> **§ 17-403. General powers and liabilities.**
>
> (a) Except as provided in this chapter or in the partnership agreement, a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership that is governed by the Delaware Uniform Partnership Law in effect on July 11, 1999 (6 Del. C. § 1501 et seq.).

[624] Section 17-1101(b)-(f) of DRLPA, DEL. CODE ANN. tit. 6, § 17-1101(b)-(f) (Supp. 2013), 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 of elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a limited partnership or to another partner or to an other person that is a party to or is otherwise bound by a partnership agreement; provided, that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

DEL. CODE ANN. tit. 6, § 17-1101(b)-(f) (Supp. 2010); *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

when they are expressly set forth in the four corners of the partnership agreement,[625] "a topic as important as this should not be addressed coyly."[626] Importantly, where Delaware courts have

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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); Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations* at 13-27, University of Texas School of Law 35th Annual Conference on Securities Regulation and Business Law (Feb. 8, 2013), *available at* http://www.jw.com/publications/article/1830.

See Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 25 (2007), in which Delaware Supreme Court Chief Justice Steele argues that parties forming limited partnerships and companies should be free to adopt or reject some or all of the fiduciary duties recognized at common law in the context of corporations, that courts should look to the parties' agreement and apply a contractual analysis, rather than analogizing to traditional notions of corporate governance, in limited partnership and LLC fiduciary duty cases, and that Delaware courts should analyze limited partnership fiduciary duty cases as follows:

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

See infra note 780 regarding Chief Justice Steele's views in respect of fiduciary duties in the LLC context.

625 *Gerber v. EPE Holdings*, C.A. No. 3543-VCN, 2013 WL 209658 (Del. Ch. Jan. 18, 2013), involved allegations by one of EPE's limited partners that EPE's purchase of interests in an entity controlled by EPE's ultimate controlling person (its "*controller*") was unfair to EPE, in violation of its limited partnership agreement ("*LPA*"), and in breach of the duty of good faith owed by EPE, the controller and some of its affiliates to the EPE unitholders. In finding no breach of fiduciary duties, the Delaware Court of Chancery noted that EPE's LPA provided that:

> Except as expressly set forth in [the LPA], neither the General Partner nor any [of its affiliates] shall have any duties or liabilities, including fiduciary duties, to the Partnership or any Limited Partner and provisions of [the LPA], to the extent that they restrict or otherwise modify the duties and liabilities, including fiduciary duties, of the General Partner or any [of its affiliates] otherwise existing at law or in equity, are agreed by the Partners to replace such other duties and liabilities of the General Partner or such other Indemnitee.

While the LPA did impose a contractual duty of good faith on the General Partner and affiliates whenever their actions were undertaken on behalf of the partnership, the LPA also imposed an "express standard" for the specific situation at issue in *Gerber*—resolving conflicts of interest—which required review and approval by "Special Approval" of the Conflicts Committee established by the General Partner pursuant to the LPA. The *EPE* transaction was, in fact, approved by the Conflicts Committee, which Committee was not under an express contractual duty to act in good faith; rather the Conflicts Committee was charged with approving those transactions that were, within the Committee's subjective belief, in the best interest of EPE. Accordingly, because fiduciary duties were specifically excluded by contract and EPE followed the

proscribed approval process provided for in the LPA, the Court found that the EPE unitholder had no right to place a higher standard on the Special Approval process and did not have a claim against EPE.

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

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

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

> This is yet another case in which a general partner of a limited partnership contends that the partnership agreement eliminates the applicability of default principles of fiduciary duty, and in which this court finds that the drafters of the agreement did not make their intent to eliminate such duties sufficiently clear to bar a fiduciary duty claim. Here, the drafters of the American Real Estate Partners, L.P. partnership agreement did not clearly restrict the fiduciary duties owed to the partnership by its general partner, a defendant entity wholly owned by defendant Carl Icahn. Indeed, the agreement seems to contemplate that the general partner and its directors could be liable for breach of fiduciary duty to the partnership if they acted in bad faith to advantage themselves at the expense of the partnership.
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> Once again, therefore, this court faces a situation where an agreement which does not expressly preclude the application of default principles of fiduciary is argued to do so by implication. Indeed, this case presents the court with an opportunity to address a contractual provision similar to the one it interpreted on two occasions in *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, and contemporaneously with this case in *Gelfman v. Weeden Investors, L.P.* In each of those cases, this court held that the traditional fiduciary entire fairness standard could not be applied because it was inconsistent with a contractual provision providing a general partner with sole and complete discretion to effect certain actions subject solely to a contract-specific liability standard. The court's decision was based on two factors. First, the court noted the difference between the sole and complete discretion standard articulated in the agreements, which explicitly stated that the general partner had no duty to consider the interests of the partnership or the limited partner in making its decisions, and the traditional notion that a fiduciary acting in a conflict situation has a duty to prove that it acted in a procedurally and substantively fair manner. Second, and even more critically, however, each of the agreements indicated that when the sole and complete discretion standard applied, any other conflicting standards in the agreements, other contracts, or under law (including the DRULPA) were to give way if it would interfere with the general partners' freedom of action under the sole and complete discretion standard. That is, in each case, the agreement expressly stated that default principles of fiduciary duty would be supplanted if they conflicted with the operation of the sole and complete discretion standard.

found that parties have expressly limited fiduciary duties in partnership agreements, they have been reluctant to impose any sort of implied covenant of good faith or fair dealing, viewing this concept instead as more of a gap-filler where the parties had not contemplated for the particular circumstance.[627]

> This case presents a twist on *Gotham Partners* and *Gelfman*. Like the provisions in *Gotham Partners* and *Gelfman*, § 6.13(d) sets forth a sole discretion standard that appears to be quite different from the duty of a fiduciary to act with procedural and substantive fairness in a conflict situation. What is different about § 6.13(d), however, is that it does not expressly state that default provisions of law must give way if they hinder the General Partner's ability to act under the sole discretion standard. Rather, § 6.13(d) merely states that other standards in the Agreement or agreements contemplated by the agreement give way to the sole discretion standard. By its own terms, § 6.13(d) says nothing about default principles of law being subordinated when the sole discretion standard applies.
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> This court has made clear that it will not be tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties. The DRULPA puts investors on notice that fiduciary duties may be altered by partnership agreements, and therefore that investors should be careful to read partnership agreements before buying units. In large measure, the DRULPA reflects the doctrine of *caveat emptor*, as is fitting given that investors in limited partnerships have countless other investment opportunities available to them that involve 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.

627 The implied covenant of good faith and fair dealing "provides a limited gap-filling tool that allows a court to impose contractual terms to which the parties would have agreed had they anticipated a situation they failed to address." *Gerber v. EPE Holdings*, C.A. No. 3543-VCN, 2013 WL 209658 at *28. Generally speaking, if a party to a contract such as a limited partnership agreement is entitled to exercise discretion, such discretion, if challenged, would be examined under the implied covenant's requirement that it be exercised reasonably. *See ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC,* 50 A.3d 434, at 440 - 441 (Del. Ch. July 9, 2012). However, what is reasonable:

> depends on the parties' original contractual obligations and reasonable expectations at the time of contracting. Fundamentally, therefore, [t]he implied covenant cannot be invoked to override the express terms of the contract.

Gerber v. EPE Holdings, C.A. No. 3543-VCN, 2013 WL 209658 at *28, citing *In re Encore Energy P'rs,* 2012 WL 3792997, at *12 (Del. Ch. Aug. 31, 2012).

In *Gerber v. EPE Holdings*, although the Plaintiff did not correctly allege claims of breach of implied covenant of good faith and fair dealing, the court choose to consider the argument and examine Delaware common law and the limited partnership agreement at issue to determine whether such a covenant could be implied. Ultimately, the court found that "[h]owever, tempting it may be in a particular case, the implied covenant is not generally a placeholder to facilitate full fiduciary analysis;" and it held that the contractual

A corporation that controls the general partner may owe a duty of loyalty to the limited partnership.[628] Directors of a corporate general partner who dominate and control the underlying limited partnership can be liable for the corporate general partner's breach of fiduciary duty to the limited partners.[629] Similarly, the parent and grandparent entities of the managing owner of a Delaware statutory business trust may be liable, directly or indirectly, for exercising control over or aiding and abetting the managing owner's actions to serve its own self-interest in violation of its fiduciary duties to the Delaware statutory business trust, which suffered significant losses as a result of a transfer of certain of its assets to a third party shortly before the transferee's collapse.[630]

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.[631] 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.[632] A limited partnership is permitted, if provided in a written partnership agreement, to indemnify a general partner who is determined to meet certain standards. These standards require that the general partner conducted himself in good faith, reasonably believed the conduct was in the best interest of the partnership (if the conduct was in an official capacity) or that the conduct was not opposed to the partnership's best interest (in cases of conduct outside the general partner's official capacity), and, in the case of a criminal proceeding, had no reasonable cause to believe the conduct was unlawful.[633] 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.[634] General partners may only be indemnified to the extent consistent with the statute.[635] 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

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framework established by the limited partnership agreement could not be reconciled with a judicially-imposed standard based on the implied covenant. *Id.* at *29-30.

628 *James River-Pennington, Inc. v. CRSS Capital, Inc.*, C.A. No. 13870, 1995 WL 106554, at *11 (Del. Ch. Mar. 6, 1995) (also recognizing also that the general partner's fiduciary duties might be modified by the limited partnership agreement); *Bigelow/Diversified Secondary P'ship Fund 1990 v. Damson/Birtcher Partners*, C.A. No. 16630-NC, 2001 WL 1641239, at *1-2, 8-9 (Del. Ch. Dec. 4, 2001) (holding that various "upstream" entities controlling general partners could owe fiduciary duties to either the partnership or the limited partners, the Court explained: "While mere ownership—either direct or indirect—of the general partner does not result in the establishment of a fiduciary relationship, 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.").

629 *In re USACafes, L.P. Litig.*, 600 A.2d 43, 48 (Del. Ch. 1991).

630 *Cargill, Inc. v. JWH Special Circumstance LLC*, 959 A.2d 1096 (Del. Ch. 2008).

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

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

633 TRLPA § 11.02; TBOC § 8.101(a).

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

635 TRLPA § 11.13; TBOC § 8.004.

common law.[636] Insurance providing coverage for unindemnifiable areas is expressly permitted.[637]

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.[638] 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.[639]

A general partner in a Texas limited partnership does not need to have an economic ownership interest in the limited partnership. A general partner does not have to make any capital contribution, share in profits or losses or have a capital account in the limited partnership. Although a general partner is personally liable for all of the debts and obligations of the limited partnership[640] and 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.[641]

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.[642] 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.[643]

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

637 TRLPA § 11.18; TBOC § 8.151.

638 TRLPA § 5.01; TBOC § 153.201.

639 TRLPA § 5.02(d); TBOC § 153.202.

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

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

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

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

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.[644] 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.[645] 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.[646] 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.[647] Until an assignee of a partnership interest becomes a partner, the assignee has no liability as a partner solely by reason of the assignment.[648]

Limited partnership interests are generally considered "securities" within the meaning of federal and state securities laws. Transfers of limited partnership interests are generally required to be registered under such laws absent an application exemption from such registration.[649]

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.[650] A limited partnership was dissolved under TRLPA, or is 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 the Tex. LP Stats. (i.e., death, removal, voluntary withdrawal and, unless otherwise provided in the partnership agreement, bankruptcy of a general partner)[651] absent certain circumstances[652] or (iv) a court of competent jurisdiction dissolving the partnership because (a) the economic purpose of the partnership is likely to be unreasonably frustrated, (b) a partner has engaged in conduct relating to the partnership that makes it not reasonably practicable to carry on the

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644 TRLPA § 7.02; TBOC § 153.251.

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

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

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

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

649 *See infra* notes 819-822 and related text.

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

651 TRLPA § 4.02; TBOC § 153.155.

652 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 2007 H.B. 1737, a winding up of a limited partnership is not required by the TBOC if the limited partnership agreement provides that withdrawal of the general partner does not require winding up of the limited partnership.

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.[653]

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.[654] However, upon the withdrawal of a general partner (unless the limited partnership agreement otherwise provides),[655] 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.[656]

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.[657] Additionally, a filing fee of $750 must be paid upon filing the certificate of formation.[658]

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

654 TRLPA § 8.04; TBOC § 11.052.

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

656 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.

657 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, judgment aff'd in part, rev'd in part, 249 S.W.3d 380 (Tex. 2008)); *Garrett v. Koepke*, 569 S.W.2d 568,569 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.); *Brewer v. Tehuacana Venture, Ltd.*, 737 S.W.2d 349, 352 (Tex. App.—Houston [14th Dist.] 1987, no writ).

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

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.[659] 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.[660] An oral limited partnership agreement is subject to the statute of frauds.[661]

The name of the limited partnership must contain the word "limited," the phrase "limited partnership," or an abbreviation of either.[662]

Unless the partnership agreement provides otherwise, unanimity is required to amend a limited partnership agreement.[663] 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 which contain provisions for the qualification of foreign limited partnerships to do business as

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

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

661 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. 2011). *See Chacko v. Mathew*, 2008 WL 2390486 (Tex. App.—Houston [14th Dist.] June 12, 2008, pet. denied).

662 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.

663 TRPA § 4.01(i); TBOC § 152.208.

such so that the limited liability of the limited partners will be recognized under local law.[664] 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.[665]

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.[666] 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.[667] Requirements for limited partner approval of an asset transaction are left to the limited partnership agreement if the partners wish to provide such requirements.

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

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

666 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.

667 *See supra* notes 325-326 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.[668] Because until January 1, 2010 some LLCs were governed by the LLC Act[669] 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.[670]

"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."[671] 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.[672] An LLC is subject to Texas Margin Tax.[673]

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.[674] This freedom of contract, however, could have resulted

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668 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).

669 The Texas Limited Liability Company Act, as amended, is found at TEX. REV. CIV. STAT. ANN. art. 1528n (Vernon Supp. 2011) (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. 2011); TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon 2003 & Supp. 2004); TEX. REV. CIV. STAT. ANN. art. 6132a-1, arts. 1-13 (Vernon Supp. 2011).

670 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).

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

672 *See supra* notes 158-172 and related text.

673 *See supra* notes 193-307 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).

674 *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.[675]

The Tex. LLC Stats. in many cases provide "default" provisions[676] 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.[677] 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.[678] 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.[679]

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.[680] 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

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

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

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

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

679 Treas. Reg. § 301.7701-3(b)(ii).

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

surplus."[681] 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.[682] 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.[683] Texas administrative regulations provided that a single Member LLC could not deduct compensation paid to the Member in computing "net taxable earned surplus."[684] 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.[685]

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.[686]

(b) Flexible Statute. In Revenue Ruling 88-76,[687] 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.[688] 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.[689] 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).[690]

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681 *Id.* § 171.002(a).

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

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

684 34 TEX. ADMIN. CODE § 3.562(f)(2) (2003) (Public Finance, Franchise Tax, Limited Liability Companies).

685 *See supra* notes 193-307 and related text.

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

687 1988-2 C.B. 360, *obsoleted by* Rev. Rul. 98-37, 1998-2 C.B. 133.

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

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

690 LLC Act §§ 3.02(A), 6.01(B); TBOC § 101.052.

(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.[691] 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.[692] Some state LLC statutes do not authorize single Member LLCs.[693]

(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.[694] 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.[695] Under certain circumstances, a Member's contribution of property may result in a net reduction in liability[696] 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.[697] 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.[698] The tax rate on self-employment income aggregates up to 15.3% and consists of (i) a 12.40% social security equivalent tax on self-employment income up to a 2013 contribution base of $113,700 (adjusted annually for inflation), plus (ii) a 2.9% (3.8% on individual self-employment income in excess of $200,000 [$250,000 in the case of a joint return; $125,000 in the case of a married taxpayer filing separately])

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

692 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).

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

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

695 I.R.C. §§ 722, 723.

696 I.R.C. § 752.

697 I.R.C. § 731.

698 *See* I.R.C. § 1401; SSA Pub. No. 05-10003 (2011), *available at* http://www.ssa.gov/pubs/10003.html.

component for hospital insurance ("Medicare") (there is no ceiling).[699] An individual's wage income is applied against the contribution base.[700] Self-employment income generally means an individual's net earnings from the individual's trade or business.[701] An individual's self-employment income includes his distributive share of the trade or business income from a partnership of which he is a partner (including an LLC classified as a partnership for federal income tax purposes), *subject to* the exception that a limited partner's distributive share of income or loss from a limited partnership generally will not be included in his net income from self employment.[702]

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.[703] 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.[704] 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.[705] 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

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699 The combined rate of tax on self-employment income of 15.3% consists of a 12.4% component for old-age, survivors, and disability insurance ("OASDI" or "social security") and a 2.9% (3.8% on individual self-employment income in excess of $200,000 [$250,000 in the case of a joint return; $125,000 in the case of a married taxpayer filing separately]) component for hospital insurance ("Medicare"). A similar addition to Medicare tax applies for FICA purposes. This self-employment tax is treated as part of the income tax and must also be taken into account for purposes of the estimated tax. If the taxpayer has wages subject to FICA, then the taxpayer's social security equivalent wage base would be reduced by amount of wages on which these taxes were paid. There is no cap on self-employment income subject to the Medicare tax.

700 *Id*.

701 I.R.C. § 1402(a).

702 I.R.C. § 1402. *See Howell v. Comm'r*, TC Memo 2012-303 (Nov. 1, 2012).

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

704 26 C.F.R. § 1.1402(a)-2, 62 Fed. Reg. 1702 (proposed Jan. 13, 1997).

705 *See id*.

> 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.[706]

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

The Taxpayer Relief Act of 1997 prohibited the IRS from issuing any temporary or final regulations relating to the definition of a limited partner for employment tax purposes that would be effective before July 1, 1998.[707] The legislative history indicates that Congress wanted the IRS to withdraw the controversial proposed regulation discussed above, which would impose a tax on limited partners.[708] 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.[709] Congress may again consider ways to rationalize the self-employment tax treatment of LLCs, partnerships and S-corporations.[710]

The IRS is nevertheless successfully challenging taxpayer claims of limited partner status where the taxpayer provided services to the partnership.[711]

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706 *Id*.

707 H.R. CONF. REP. NO. 105-220, at 765 (1997).

708 *Id*.

709 *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.

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

711 *See Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 TC 137 (Feb. 9, 2011) (partners'distributive shares of the law firm's income found not to arise as a return on the partners' investment and were not "earnings which are basically of an investment nature;" the attorney partners' distributive shares arose from legal services they performed on behalf of the law firm and were held to be self-employment income); *Lauren A. Howell v. Commissioner*, TC Memo 2012-303 (Nov. 1, 2012) (spouse

C. Members; Managers. The owners of an LLC are called "Members,"[712] and are analogous to shareholders in a corporation or limited partners of a limited partnership.[713] 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.[714] 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,[715] and in that case the Members would be analogous to general partners in a general or limited partnership but without personal liability for the LLC's obligations.[716] For an LLC to be taxed as a partnership, it must have at least two Members, although the TBOC expressly permits an LLC to have only one Member;[717] 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).[718]

Under the Tex. LLC Stats., any "person" may become a Member or Manager.[719] Because of the broad definition given to "person" by the Tex. LLC Stats., any individual, corporation, partnership, LLC or other person may become a Member or Manager.[720] 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.[721] It has all of the powers of a Texas corporation or limited partnership, subject to any restrictions imposed by statute or its governing documents.[722]

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providing marketing advice, signing contracts, contributing a business plan and providing credit card held "not merely a passive investor" and not a limited partner for self-employment tax purposes).

712 LLC Act § 4.01; TBOC §§ 1.002(53), 101.101, 101.102.

713 1991 Bill Analysis Summary at 41.

714 *See* LLC Act § 2.13; TBOC § 101.302; 1991 Bill Analysis Summary at 41.

715 LLC Act § 2.12; TBOC §§ 1.002(35), 101.251.

716 1991 Bill Analysis Summary at 41.

717 TBOC § 101.101.

718 *See supra* notes 158-172 and related text and notes 691-693 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.

719 LLC Act § 4.01C; TBOC § 101.102(a).

720 "Person" is defined in TBOC § 1.002(69-b) as follows:

> (69-b) "Person" means an individual or a corporation, partnership, limited liability company, business trust, trust, association, or other organization, estate, government or governmental subdivision or agency, or other legal entity.

"Person" was similarly defined in LLC Act § 1.02(4).

721 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.

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.[723] The initial certificate of formation must contain: (1) the name of the LLC, (2) a statement that it is an LLC, (3) the period of its duration, unless such duration is perpetual, (4) its purpose, which may be any lawful purpose for which LLCs may be organized, (5) the address of its initial registered office and the name of its initial registered agent at that address, (6) if the LLC is to have a Manager or Managers, a statement to that effect and the names and addresses of the initial Manager or Managers, or if the LLC will not have Managers, a statement to that effect and the names and addresses of the initial Members, (7) the name and address of each organizer, (8) specified information if the LLC is to be a professional LLC, and (9) any other provisions not inconsistent with law.[724] 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.[725] 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.[726]

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.[727] 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.[728] 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.[729]

> 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.").

722 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.

723 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.

724 TBOC §§ 3.005, 3.010, 3.014.

725 TBOC §§ 4.051, 4.052.

726 TBOC § 3.006(b).

727 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).

728 TBOC § 5.053.

729 *Id.*

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.[730] Any such amendment must include a statement that it was approved in accordance with the proper provisions of governing laws,[731] or for entities governed by the LLC Act, alternately as provided in the articles of organization or Regulations, along with the date of approval.[732]

LLC Act section 2.23G provided 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.[733]

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.[734] 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,[735] but an oral Company Agreement is subject to the statute of frauds.[736] The complexity of the matters typically addressed in a Company Agreement make it rare and inadvisable to have an oral Company Agreement.

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730 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.

731 LLC Act § 3.06(3); TBOC § 3.053(4).

732 LLC Act § 3.06(3).

733 *See* TBOC §§ 101.051, 101.052.

734 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).

735 TBOC § 101.001(1); DLLCA § 18-101(7).

736 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. 2011). 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*, 982 A.2d 286 (Del. Ch. 2008), judgment aff'd by 986 A.2d 1150 (Del. 2009) (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).

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.[737] For example, the TBOC provides that the Company Agreement or certificate of

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[737] 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].

formation may only be amended by unanimous member consent,[738] but if either document provides otherwise (such as for amendment by manager consent), then it may be amended pursuant to its own terms.[739] The only statutory provisions not subject to contrary agreement are enumerated in TBOC section 101.054.[740] While the structure and wording of the TBOC relating to these matters differs from the source LLC Act, the requirements for amending a Company Agreement have not substantively changed.[741]

> (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.

738 TBOC §§ 101.053, 101.356(d).

739 *See* TBOC §§ 101.052, 101.054.

740 *See supra* note 737.

741 *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 2003 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

Although the Company Agreement will ordinarily contain the capital account and other financial and tax provisions found in a typical limited partnership agreement,[742] 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.[743] 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.[744]

Under the TBOC a Member has no right to withdraw or be expelled from the Company unless provision therefor is made in the Company Agreement.[745] The TBOC provides that a Member who validly exercises right to withdraw pursuant to a Company Agreement provision is entitled to receive the fair value (a term not defined in the TBOC) of the Member's interest within a reasonable time thereafter unless the Company Agreement otherwise provides.[746]

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."[747]

G. <u>Management</u>. 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.[748] 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.[749] The certification of formation or the Company Agreement, however, may provide that the management of the business and affairs of the LLC may be

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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.

742 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.

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

744 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).

745 TBOC § 101.107.

746 TBOC § 101.205.

747 *See, e.g.*, OHIO REV. CODE ANN. § 1705.01(J) (West 2003) ("operating agreement"); DEL. CODE ANN. tit. 6, § 18-101(7) (2013) ("limited liability company agreement").

748 LLC Act §§ 2.12, 2.21; TBOC §§ 101.251-101.253.

749 LLC Act §§ 2.12, 1.02(4); TBOC § 101.302; TEX. GOV'T CODE § 311.005(2).

reserved to its Members.[750] 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.[751] 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).[752] 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.[753] Lenders and others dealing with an LLC can determine with certainty who has authority to bind the LLC by reference to its certificate of formation, Company Agreement, and resolutions, just as in the case of a corporation. In routine business transactions where verification of authority is not the norm in transactions involving corporations, the same principles of apparent authority should apply in the LLC context.

Members and Managers acting on behalf of an LLC should disclose that they are acting on behalf of the entity and that it is an LLC. Under common law agency principles, an agent can be personally liable on a contract made for an undisclosed or unnamed principal.[754]

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.[755] 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.[756]

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750 LLC Act § 2.12; *see* TBOC § 101.251.

751 TBOC § 101.252. Along the same lines, LLC Act § 2.21B provided 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.

752 LLC Act § 2.21C; TBOC §§ 1.002(35), (37), 101.254(a).

753 LLC Act § 2.21D; TBOC § 101.254(b).

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

755 *See* TBOC § 101.303.

756 *See* LLC Act § 2.14; TBOC § 101.307.

H. Fiduciary Duties.

1. Texas. The Tex. LLC Stats. do not address specifically whether Manager or Member fiduciary or other duties exist or attempt to define them,[757] but they implicitly recognize that these duties may exist in statutory provisions which permit them to be expanded or restricted, and liabilities for the breach thereof to be limited or eliminated, in the Company Agreement.[758] The duty of Managers in a Manager-managed LLC and Members in a Member-

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[757] *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).

[758] 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 that a Company Agreement may expand or reduce (but not eliminate) fiduciary duties as follows:

> 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.

TBOC § 7.001, as amended in 2013 by S.B. 847 § 2, does allow for the limitation or elimination of liabilities for breach of fiduciary duties as follows:

> Sec. 7.001. LIMITATION OF LIABILITY OF GOVERNING PERSON.
>
> (a) Subsections (b) and (c) apply to:
>
> (1) a domestic entity other than a partnership or limited liability company;
>
> (2) another organization incorporated or organized under another law of this state; and
>
> (3) to the extent permitted by federal law, a federally chartered bank, savings and loan association, or credit union.
>
> (b) The certificate of formation or similar instrument of an organization to which this section applies 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.

managed LLC to the LLC is generally assumed to be fiduciary in nature, measured by reference to the fiduciary duties of corporate directors in the absence of modification in the Company Agreement. The fiduciary duties of Managers could also be measured by reference to the law of agency.[759]

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.[760] 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.[761]

(d) The liability of a governing person may be limited or eliminated [~~restricted~~]:

(1) in a general partnership by its partnership agreement to the same extent Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent permitted under Chapter 152;

(2) in a limited partnership by its partnership agreement to the same extent Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent permitted under Chapter 153 and, to the extent applicable to limited partnerships, Chapter 152; and

(3) in a limited liability company by its certificate of formation or company agreement to the same extent Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent permitted under Section 101.401.

Thus, the TBOC now allows the elimination of liabilities – to a specified and limited extent – but does not allow the elimination of fiduciary duties, although fiduciary duties may be expanded or reduced in a company agreement. Thus, in theory, equitable remedies may exist to address acts for which any monetary liability has been eliminated by a company agreement.

759 *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* Elizabeth S. Miller, *Practical Pitfalls in Drafting Texas Limited Liability Company Agreements*, 45:1 TEX. J. BUS. L. 27 (2012) ("Absent provisions in the company agreement otherwise, managers and managing members would seemingly owe the common law fiduciary duties of an agent to the LLC as principal, even without resort to analogies to corporate or partnership law.").

760 *See supra* notes 402-425 and related text.

761 *See Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355, 391-97 (Tex. App.—Houston [1st Dist.] 2012 (case settled while petition pending) (Court declined to recognize a fiduciary duty of a majority

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.[762] 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.[763] Unlike the DLLCA which allows an LLC agreement to eliminate fiduciary duties (but not the contractual duty of good faith and fair dealing),[764] the Tex. LLC Stats. only permit an LLC Company Agreement to "restrict" duties, but allows the elimination of liability for breach of fiduciary duties (other than the duty of loyalty).[765]

The contractual elimination or restriction of fiduciary duties is an important developing issue in the context of fiduciary duties for Texas LLCs. The Texas Legislature in

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member to a minority member generally since Texas does not recognize such a relationship between majority and minority shareholders in closely held corporations, but concluded that the majority member's position as the controlling member and sole manager was sufficient to create a fiduciary duty to the minority member in a transaction in which the minority member's interest was being redeemed; the Court also concluded that an exculpation provision in the LLC's articles of organization referring to the manager's "duty of loyalty to [the LLC] or its members" could be read to create a fiduciary duty to the members individually which would include a duty of candor to disclose material facts relating to the value of the interest to be redeemed); *Suntech Processing Sys., L.L.C. v. Sun Communications, Inc.*, 2000 WL 1780236, at *6 (Tex. App.—Dallas Dec. 5, 2000, pet. denied) (not designated for publication) (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; the Court pointed out that the Regulations expressly provided for a duty of loyalty to the LLC rather than between the Members, and, noting the absence of Texas case law on fiduciary duties of LLC Members and looking to case law regarding fiduciary duties of shareholders of a closely held corporation, held that there was no fiduciary relationship between the Members as a matter of law). *See* Elizabeth S. Miller, *Practical Pitfalls in Drafting Texas Limited Liability Company Agreements*, 45:1 TEX. J. BUS. L. 27, 46 (2012).

762 *See* LLC Act § 2.20B; TBOC § 101.401. Prior to the effectiveness of 1997 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. 1997 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, but a comparable provision was added back in TBOC § 7.001 as amended in 2013 by S.B. 847 § 2 as quoted *supra* in note 758.

763 DEL. CODE ANN. tit. 6, § 18-1101(a)-(f) (2013).

764 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 April 1, 2009, pet. denied). 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 523 and 613.

765 *See supra* note 758 and related text.

2013 amended TBOC § 7.001(d)(3) to expand the permitted contractual limitation or elimination of liabilities for monetary damages for breach of fiduciary duties by Members and Managers of Texas LLCs, but does not allow the elimination of liabilities for breaches of the duty of loyalty or acts or omissions not in good faith.[766]

A Company Agreement provision restricting fiduciary duties and limiting liability for breaches thereof as permitted by TBOC §§ 7.001 and 101.401 could read as follows:

> This Agreement is not intended to, and does not, create or impose any fiduciary duty on any Member or Manager. Furthermore, each of the Members, the Managers and the Company hereby, to the fullest extent permitted by Applicable Law [defined to mean the TBOC and other applicable Texas and federal statutes and regulations thereunder], restricts, limits, waives and eliminates any and all duties, including fiduciary duties, that otherwise may be implied by Applicable Law and, in doing so, acknowledges and agrees that the duties and obligations of each Member or Manager to each other and to the Company are only as expressly set forth in this Agreement and that no Member or Manager shall have any liability to the Company or any other Member or Manager for any act or omission except as specifically provided by Applicable Law or in this Agreement or another written agreement to which the Member or Manager is a party. The provisions of this Agreement, to the extent that they restrict, limit, waive and eliminate the duties and liabilities of a Member or Manager otherwise existing at law or in equity, are agreed by the Members to replace such other duties and liabilities of such Members or Managers.
>
> Notwithstanding anything to the contrary contained in this Agreement,
>
> (1) the Managers shall not permit or cause the Company to engage in, take or cause any of the following actions except with the prior approval of a majority of the outstanding Units voting: [*list specific actions*]:
>
> (2) the Members and Managers and each of their respective Affiliates are permitted to have, and may presently or in the future have, investments or other business relationships, ventures, agreements or arrangements (i) with entities engaged in the business of the Company, other than through the Company (an "Other Business") and (ii) with [*additional entity specifics*]; [*provided*, that any transactions between the Company and an Other Business will be on terms no less favorable to the Company than would be obtainable in a comparable arm's-length transaction];[767] and

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766 *See supra* notes 87-89 and related text.

767 *See infra* notes 773-777 and related text for cases holding that wording such as this provision may contractually import the common law fiduciary duty of loyalty in Delaware

(3) there shall be a presumption by the Company that any actions taken in good faith by the Manager on behalf of the Company shall not violate any fiduciary or other duties owed by the Managers to the Company or the Members.[768]

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

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 § 2.20B, the precursor to TBOC § 101.401, indicate that even before the 2013 Legislative Session there was 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.

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, <u>if</u> 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; <u>or</u>

(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; <u>or</u>

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[768] S.B. 847 in the 2013 Legislative Session amended TBOC § 7.001(d)(3) to read as follows:

(d) The liability of a governing person may be limited or <u>eliminated</u> [~~restricted~~]:

* *

(3) in a limited liability company <u>by its certificate of formation or company agreement</u> to the <u>same</u> extent <u>Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent</u> permitted under Section 101.401 [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.].

See supra notes 87-89 and 425-430.

(iii) The transaction is fair to the LLC as of the time it is authorized, approved or ratified by the Managers or Members.[769]

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.[770]

2. Delaware. Delaware law permits the elimination of fiduciary duties in an LLC,[771] but not all Delaware LLC agreements effectively do so.[772] In *Auriga Capital Corp. v.*

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769 LLC Act § 2.17; TBOC § 101.255 as amended in the 2009 Legislative Session by 2009 S.B. 1442 § 44 and in the 2011 Legislative Session by 2011 S.B. 748 § 38.

770 *Id.*; *see* TRPA § 4.04; *see also* TBOC § 152.204.

771 DLLCA § 18-1101(b), (c), (d) and (e) provides:

> (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.

772 *In re Atlas Energy Resources LLC*, Consolidated 2010 WL 4273122 (Del Ch. Oct. 28, 2010), involved breach of fiduciary duty claims arising from a merger between a publicly traded LLC and its controlling unitholder. In *In re Atlas*, the Chancery Court held that an LLC agreement eliminated the traditional fiduciary duties of the LLC's directors and officers, replacing them with a contractually-defined duty of good faith, which was not breached, but did not address the duties of the controlling unitholder, which were held to be equivalent to those of a controlling shareholder of a Delaware corporation. The Court commented that LLCs are creatures of contract designed to afford the maximum amount of freedom of contract, private ordering, and flexibility to the parties involved. One aspect of this flexibility, the Court wrote, is that parties to an LLC agreement can contractually expand, restrict, modify or fully eliminate the fiduciary duties owed by its members, subject to certain limitations, but in the absence of explicit

Gatz Properties, LLC,[773] Delaware Chancellor Strine, in finding for the minority investors who had challenged the merger of the LLC into an entity controlled by the Manager, held that the LLC agreement contractually incorporated a core element of the traditional common law fiduciary duty of loyalty by providing that the Manager could enter into a self-dealing transaction (such as its purchase of the LLC) only if it proved that the terms were fair. The LLC agreement provided that, without the consent of the holders of two-thirds of the interests not held by the Manager or its affiliates, the Manager would not be entitled to cause the LLC to enter into any transaction with an affiliate that is less favorable to the LLC than that which could be entered into with an unaffiliated third party. The LLC agreement's exculpation provision provided that the Manager would not be liable to the LLC for actions taken or omitted by the Manager in good faith and without gross negligence or willful misconduct. As the LLC agreement's exculpatory provision expressly did not excuse bad faith action, willful misconduct, or even grossly negligent action, by the LLC Manager, the Manager was liable for the losses caused by its flawed merger. The Chancellor mused that under traditional principles of equity applicable to an LLC and in the absence of a contrary LLC agreement provision, a Manager of an LLC would owe to the LLC and its members the common law fiduciary duties of care and loyalty.

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provisions in the LLC agreement to the contrary, the traditional fiduciary duties owed by corporate directors and controlling shareholders apply in the LLC context. Because this LLC agreement did not eliminate the fiduciary duties of the controlling unitholder, it owed directly to the LLC's minority unitholders the traditional fiduciary duties that controlling shareholders owe minority shareholders. Since the merger created a conflict between the controlling unitholder's interest in acquiring the balance of the LLC for the lowest possible price and the minority unitholders' interest in obtaining a high price for their units and the LLC agreement did not address this conflict of interest, the Court evaluated the merger under the entire fairness standard of review in order to assure that the controlling unitholder "has been assiduous in fulfilling those duties," held that "plaintiffs' allegations as to price and process, adequately suggest that the merger was not entirely fair to the public unitholders," and denied defendants' motion to dismiss the claim for breach of fiduciary duty by the controlling unitholder.

DLLCA § 18-1101(e) was followed in *In re Heritage Org., 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*, 2008 WL 5197164 (Del. Ch. December 11, 2008) (under freedom of contract principles, fiduciary duties held to be defined, but not eliminated, by LLC agreement).

[773] 40 A.3d 839 (Del. Ch. 2012).

The Delaware Supreme Court affirmed *Auriga* in *Gatz Properties, LLC v. Auriga Capital Corp.*,[774] holding that although the LLC agreement did not use words such as "entire fairness" or "fiduciary duties," there was nonetheless an explicit contractual assumption by the parties of an obligation on the part of the Manager and Members of the LLC to obtain a fair price for the LLC in transactions between the LLC and affiliates, but the Supreme Court expressly rejected the Chancellor's conclusion that the fiduciary duties were "default" fiduciary duties:

> The pivotal legal issue presented on this appeal is whether Gatz owed contractually-agreed-to fiduciary duties to Peconic Bay [the LLC] and its minority investors. Resolving that issue requires us to interpret Section 15 of the LLC Agreement, which both sides agree is controlling. Section 15 pertinently provides that:
>
> > Neither the Manager nor any other Member shall be entitled to cause the Company to enter into any amendment of any of the Initial Affiliate Agreements which would increase the amounts paid by the Company pursuant thereto, or enter into any additional agreements with affiliates on terms and conditions which are less favorable to the Company than the terms and conditions of similar agreements which could then be entered into with arms-length third parties, without the consent of a majority of the non-affiliated Members (such majority to be deemed to be the holders of 66-2/3% of all Interests which are not held by affiliates of the person or entity that would be a party to the proposed agreement).
>
> The Court of Chancery determined that Section 15 imposed fiduciary duties in transactions between the LLC and affiliated persons. We agree. To impose fiduciary standards of conduct as a contractual matter, there is no requirement in Delaware that an LLC agreement use magic words, such as "entire fairness" or "fiduciary duties." Indeed, Section 15 nowhere expressly uses either of those terms. Even so, we construe its operative language as an explicit contractual assumption by the contracting parties of an obligation subjecting the manager and other members to obtain a fair price for the LLC in transactions between the LLC and affiliated persons. Viewed functionally, the quoted language is the contractual equivalent of the entire fairness equitable standard of conduct and judicial review.
>
> We conclude that Section 15 of the LLC Agreement, by its plain language, contractually adopts the fiduciary duty standard of entire fairness, and the "fair price" obligation which inheres in that standard. Section 15 imposes that standard in cases where an LLC manager causes the LLC to engage in a conflicted transaction with an affiliate without the approval of a majority of the minority

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774 59 A.3d 1206 (Del. 2012), *aff'g* 40 A.3d 839. *See* Jessica Liou, *Fiduciary Duty Bound (Part 1): "Default" Fiduciary Duties Apply in Delaware LLC's…Or Maybe They Don't*, Weil Bankruptcy Blog, Mar. 8, 2013, http://business-finance-restructuring.weil.com/fiduciary-duties/fiduciary-duty-bound-part-1-default-fiduciary-duties-apply-in-delaware-llcsor-maybe-they-dont/.

members. There having been no majority-of-the-minority approving vote in this case, the burden of establishing the fairness of the transaction fell upon Gatz. That burden Gatz could easily have avoided. If (counterfactually) Gatz had conditioned the transaction upon the approval of an informed majority of the nonaffiliated members, the sale of Peconic Bay would not have been subject to, or reviewed under, the contracted-for entire fairness standard.

* * *

Entire fairness review normally encompasses two prongs, fair dealing and fair price. "However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness." In this case, given the language of Section 15 which speaks only in terms of fair price, the Court of Chancery formally applied only the fair price prong. But, in doing so that court also properly considered the "fairness" of how Gatz dealt with the minority "because the extent to which the process leading to the self-dealing either replicated or deviated from the behavior one would expect in an arms-length deal bears importantly on the price determination." The court further held that "in order to take cover under the contractual safe harbor of Section 15, Gatz bears the burden to show that he paid a fair price to acquire [the LLC].

* * *

Although the trial court's adjudication subjects Gatz to liability under Section 15 of the LLC Agreement, another provision, Section 16, permits both exculpation and indemnification of Peconic Bay's manager in specified circumstances. Gatz, however, did not cause those circumstances to come about. Having failed to satisfy the criteria of Section 16, Gatz was not eligible for exculpation or indemnification, and the Court of Chancery properly so held.

Section 16 of the LLC Agreement pertinently provides:

> No Covered Person [defined to include, among others, the members, manager, and officers and the employees] shall be liable to the Company, [or] any other Covered Person or any other person or entity who has an interest in the Company for any loss, damage or claim incurred by reason of any act or omission performed or omitted by such Covered Person in good faith in connection with the formation of the Company or on behalf of the Company and in a manner reasonably believed to be within the scope of the authority conferred on such Covered Person by this Agreement, except that a Covered Person shall be liable for any such loss, damage or claim incurred by reason of such Covered Person's gross negligence, willful misconduct or willful misrepresentation.

> Gatz was not entitled to exculpation because the Court of Chancery properly found that he had acted in bad faith and had made willful misrepresentations in the course of breaching his contracted-for fiduciary duty. Consequently, Section 16 of the LLC Agreement provides no safe harbor.
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> * * *
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> At this point, we pause to comment on one issue that the trial court should not have reached or decided. We refer to the court's pronouncement that the Delaware Limited Liability Company Act imposes "default" fiduciary duties upon LLC managers and controllers unless the parties to the LLC Agreement contract that such duties shall not apply. Where, as here, the dispute over whether fiduciary standards apply could be decided solely by reference to the LLC Agreement, it was improvident and unnecessary for the trial court to reach out and decide, *sua sponte*, the default fiduciary duty issue as a matter of statutory construction. The trial court did so despite expressly acknowledging that the existence of fiduciary duties under the LLC Agreement was "no longer contested by the parties." For the reasons next discussed, that court's statutory pronouncements must be regarded as dictum without any precedential value.
>
> First, the Peconic Bay LLC Agreement explicitly and specifically addressed the "fiduciary duty issue" in Section 15, which controls this dispute. Second, no litigant asked the Court of Chancery or this Court to decide the default fiduciary duty issue as a matter of statutory law. In these circumstances we decline to express any view regarding whether default fiduciary duties apply as a matter of statutory construction. The Court of Chancery likewise should have so refrained.

While the Supreme Court opinion in *Gatz* did not resolve the issue of whether fiduciary duties would be implied in the absence of the contractual elimination or modification of fiduciary duties in the LLC agreement,[775] the Delaware Court of Chancery "recently considered the issue of default fiduciary duties and held that, subject to clarification from the Supreme Court, managers and managing members of an LLC do owe fiduciary duties as a default matter."[776] Further, the DLLCA has been amended, effective August 1, 2013, to provide that

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775 *See infra* note 777 and related text.

776 *Zimmerman v. Adhezion Biomedical LLC*, C.A. No. 6001-VCP, at *44 (Del. Ch. Jan. 31, 2013) (*emphasis added*), referencing Feeley v. NHAOCG, LLC, 2012 WL 5949209, at *8-10 (Del. Ch. Nov. 28, 2012). In *Zimmerman*, Robert Zimmerman, co-founder and former CEO of Adhezion, sued the current majority owners, alleging breach of the LLC Agreement (failure to obtain consent of the common members) and fiduciary duties (self-dealing transactions) when such majority owners caused Adhezion to enter into certain financing transactions. The majority owners denied any fundamental breach of fiduciary duty, and argued, in any event, that the LLC Agreement proscribed an applicable standard of review (the business judgment rule), which they contend they did not breach.

The Court of Chancery found that the majority owners did breach the LLC Agreement in issuing units without written consent, involving a detailed analysis of the LLC Agreement, which the Court found to be an unusually ambiguous contract. It also noted that the LLC Agreement imposed duties of good faith (to act with an objective standard of reasonableness) and enumerated specific safe harbors for intercompany

dealings; and accordingly, because the Court found that (i) Zimmerman failed to show that the financing transactions were unfair to Adhezion and (ii) the financing transactions were approved in compliance with the requisite safe harbor, the Court held that the majority owners had not breached their contracted-for fiduciary duties to the company. With respect to this latter finding, the Court of Chancery specifically distinguished *Auriga*, which placed the burden of proving the fairness of the self-dealing transaction on the LLC manager (because of language in the LLC Agreement prohibited such a manager from entering into self-dealing transaction without the consent of the other managers), as opposed to the LLC Agreement in *Zimmerman*, which gave members, directors, or officers the affirmative right to engage in transactions with the company, so long as such a transaction was comparable to a third-party one. Ultimately, the Court awarded Zimmerman $1 for his successful breach of contract claim with respect to the majority owners' failure to obtain written consent and otherwise found that the majority owners were protected by the indemnification provisions of the LLC Agreement with respect to Zimmerman's requests for attorneys' fees advanced by Adhezion on behalf of the majority owners.

See also Kelly v. Blum, 2010 WL 629850 (Del.Ch. February 24, 2010), the Chancery Court denied motions for summary judgment, dealing with (among other things) fiduciary duties in a merger challenged by a minority Member/Manager of an LLC who was squeezed out in a merger into a sister company of the majority Member. The Court held that: (i) the claims of the minority were direct rather than derivative, (ii) the Managers and majority Members owed traditional fiduciary duties to the minority Member in the absence of any express provisions in the operating agreement to limit fiduciary duties, and (iii) the corporate parent of the majority Member and the surviving Member could be liable for aiding and abetting breaches of fiduciary duty. In so holding, the Court explained:

> Though few Delaware cases deal specifically with the distinction between derivative and direct claims in the LLC context, Sections 18-1001 to 18-1004 of the Delaware Limited Liability Company Act ("LLC Act") were modeled, in significant part, on the corporate derivative suit. Consequently, "case law governing corporate derivative suits is equally applicable to suits on behalf of an LLC," and I look to corporate case law to determine the proper method for distinguishing between derivative actions brought on behalf of Marconi and Kelly's direct claims.
>
> The distinction between the rights of an LLC and the individual rights of its members is often quite narrow. Though several early Delaware cases addressing this distinction relied largely on the "amorphous and confusing concept of 'special injury,'" the Delaware Supreme Court expressly disavowed use of that concept in *Tooley*. In *Tooley*, the Court stated that determining whether a claim is derivative or direct depends solely upon two questions: First, "who suffered the alleged harm," the LLC or its members, and second, "who would receive the benefit of any recovery or other remedy," the LLC or its members, individually. In answering these questions, the Court looks to the nature of the wrong alleged, not merely at the form of words used in the complaint.
>
> In the second count of the Complaint, Kelly claims that, by virtue of their status as Members or Managers of Marconi, Defendants Blum, Breen, Kestenbaum, MBC Investment, and MBC Lender each "owed various fiduciary duties to Kelly as the minority equity owner." Kelly further avers that these Defendants violated their duties of loyalty and care to him by entering into a self-interested Merger on terms that were unfair to Kelly.
>
> The basic approach of the LLC Act is to "provide members with broad discretion in drafting the [LLC] Agreement and to furnish default provisions when the members' agreement is silent." In the case of fiduciary duties, the LLC Act permits LLC contracting parties to expand, restrict, or eliminate duties, including fiduciary duties, owed by members and managers to each other and to the LLC. Section 18-1101(c) does not specify a statutory default provision as do other sections of the LLC Act; rather, it implies that some default fiduciary duties may exist "at law or in equity," inviting Delaware courts to make an important policy decision and determine the default level of those duties.

Accepting that invitation, Delaware cases interpreting Section 18-1101(c) have concluded that, despite the wide latitude of freedom of contract afforded to contracting parties in the LLC context, "in the absence of a contrary provision in the LLC agreement," LLC managers and members owe "traditional fiduciary duties of loyalty and care" to each other and to the company. Thus, unless the LLC agreement in a manager-managed LLC explicitly expands, restricts, or eliminates traditional fiduciary duties, managers owe those duties to the LLC and its members and controlling members owe those duties to minority members. Therefore, I must determine whether the 2008 LLC Agreement expanded, restricted, or eliminated the default fiduciary duties the Managers (Blum, Breen, and Kestenbaum) and controlling Members (MBC Investment and MBC Lender) owed to Kelly, and whether a breach of any existing duty would support a direct, as opposed to a derivative, claim.

In large measure, the 2008 LLC Agreement is silent on the issue of duties owed by Managers to the LLC and its Members, with the exception of Sections 7.5 and 7.9. In its entirety, Section 7.5, entitled "Duties," states that

> [t]he Board of Managers shall manage the affairs of the Company in a prudent and business-like manner and shall devote such time to the Company affairs as they shall, in their discretion exercised in good faith, determine is reasonably necessary for the conduct of such affairs.

In relevant part, Section 7.9, which limits the monetary liability of Managers, states that

> [i]n carrying out their duties hereunder, the Managers shall not be liable for money damages **for breach of fiduciary duty to the Company nor to any Member** for their good faith actions or failure to act ... but only for their own willful or fraudulent misconduct or willful breach of their contractual or **fiduciary duties** under this Agreement.

(Emphasis added).

I do not read these clauses, individually or collectively, as "explicitly disclaim[ing or limiting] the applicability of default principles of fiduciary duty." Indeed, far from limiting such duties, Section 7.9 suggests that the parties intended traditional fiduciary duties to apply. Additionally, Section 7.5 does not limit the Managers' duties so much as place control of Marconi's affairs in the board of Managers, rather than the Members, allowing each Manager the discretion to determine the amount of time she must devote to running Marconi.

Because no clause in the 2008 LLC Agreement explicitly restricts or eliminates the default applicability of fiduciary duties, I find that Blum, Breen, and Kestenbaum, as Managers of Marconi, were required to treat Kelly in accordance with such traditional fiduciary duties. Furthermore, if the allegations in Kelly's Complaint are true, then Blum, Breen, and Kestenbaum entered the Merger largely intending to profit from a "premeditated scheme to squeeze Kelly out of Marconi and seize control of the FCC license" held by Marconi-actions that support a claim for breach of the duty of loyalty. Thus, drawing reasonable inferences in Kelly's favor, I find that his Complaint alleges sufficient facts to support his claim that the Managers breached these duties by entering into a Merger designed solely to eliminate Kelly's interest in Marconi.

Even though Kelly alleged facts that, if true, are sufficient to show that Blum, Breen, and Kestenbaum may have breached their fiduciary duties, those Defendants still might avoid liability because the 2008 LLC Agreement contains an exculpatory provision limiting the monetary liability of Managers. Section 18-1101(e) of the LLC Act permits members, in their LLC agreement, to limit or eliminate a manager's or member's liability for "breach of contract and breach of duties (including fiduciary duties)," except for liability arising from a "bad faith violation of the implied contractual covenant of good faith and fair dealing." While somewhat analogous to 8 *Del. C.* § 102(b)(7), which authorizes a

unless modified in an LLC's governing documents, common law fiduciary duties apply to LLCs.[777]

The DLCCA aggressively adopts a "contracterian approach" (i.e., the bargains of the parties manifested in LLC agreements are to be respected and rarely trumped by statute or

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> corporation to adopt provisions limiting liability for a director's breach of the duty of care, Section 18-1101(e) goes further by allowing broad exculpation of *all* liabilities for breach of fiduciary duties-including the duty of loyalty.
>
> Here, Section 7.9 of the 2008 LLC Agreement eliminates the Managers' monetary liability for all conduct except "willful or fraudulent misconduct or willful breach of ... contractual or fiduciary duties under this Agreement." Although the default duties of loyalty and care remain, this provision requires more than application of a standard like entire fairness and requires that Kelly allege facts showing scienter. That is, under Section 7.9, liability attaches only where a Manager willfully breaches his fiduciary duties.
>
> * * *
>
> As with LLC managers, "in the absence of provisions in the LLC agreement explicitly disclaiming the applicability of default principles of fiduciary duty," controlling members in a manager-managed LLC owe minority members "the traditional fiduciary duties" that controlling shareholders owe minority shareholders. Controlling shareholders-typically defined as shareholders who have voting power to elect directors, cause a break-up of the company, merge the company with another, or otherwise materially alter the nature of the corporation and the public shareholder's interests-owe certain fiduciary duties to minority shareholders. Specifically, and very pertinently to this case, such fiduciary duties include the duty "not to cause the corporation to effect a transaction that would benefit the fiduciary at the expense of the minority stockholders."
>
> * * *
>
> Because the 2008 LLC Agreement is silent as to what duties controlling members owe minority members, I find that MBC Investment and MBC Lender owed Kelly traditional fiduciary duties, including, among others, the duty not to cause Marconi to enter a transaction that would benefit the controlling Members at the expense of Kelly, Marconi's minority Member. I also find that Kelly has stated facts that, if true, are sufficient to show that MBC Investment and MBC Lender did, with the aid of their appointed Managers, effect the Merger in order to benefit themselves at the expense of Kelly. Thus, Kelly has stated a direct claim that is not subject to any exculpation provision in the Agreement, and I deny Defendants' motion to dismiss Count II of Kelly's Complaint as to MBC Investment and MBC Lender.

[777] DLLCA § 18-1104 has been amended, effective August 1, 2013, as follows: "In any case not provided for in this chapter, the rules of law and equity, including the rules of law and equity relating to fiduciary duties and the law merchant, shall govern." [new language underlined]. The synopsis accompanying the amendment in Delaware H.B. 126 explains it as follows:

> Section 8 amends Section 18-1104 to confirm that in some circumstances fiduciary duties not explicitly provided for in the limited liability company agreement apply. For example, a manager of a manager-managed limited liability company would ordinarily have fiduciary duties even in the absence of a provision in the limited liability company agreement establishing such duties. Section 18-1101(c) continues to provide that such duties may be expanded, restricted or eliminated by the limited liability company agreement.

If adopted, this section would become effective August 1, 2013. For the text of this and proposed amendments to the DLLCA, see *Proposed LLC Act Amendments* at www.practicallaw.com/4-525-3603.

common law).[778] The DLCCA does not have any provision which itself creates or negates Member or Manager fiduciary duties, but instead allows modification or elimination of fiduciary

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[778] In *Fisk Ventures, LLC v. Segal*, 2008 WL 1961156 (Del. Ch. 2008), *judgment aff'd* 984 A.2d 124 (Del. 2009), 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 DLLCA § 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

duties[779] by an LLC agreement,[780] but does not allow the elimination of "the implied contractual covenant of good faith and fair dealing."[781] An LLC agreement eliminating fiduciary duties as permitted by the DLLCA could read as follows:

> 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 *Related Westpac LLC v. JER Snowmass LLC*, 2010 WL 2929708 (Del. Ch. July 23, 2010), the Delaware Chancery Court held that one Member of an LLC could not force another to advance funds in a joint redevelopment project and consent to related projects, finding that the partner's refusal was permitted by the project's operating agreements. In so deciding, the Court refused to find that a condition of reasonableness to the right to refuse consent:

> In this decision, I dismiss the complaint. Under the operating agreements that govern the LLCs, the defendant member could not unreasonably withhold its consent to certain decisions. But as to the type of decisions at issue in this case — so-called "material actions" — the defendant member was not subject to such a constraint and had contractually bargained to remain free to give or deny its consent if that was in its own commercial self-interest. Here, the plaintiff operating member seeks to have the court impose a contractual reasonableness overlay on a contract that is clearly inconsistent with the parties' bargain. Delaware law respects contractual freedom and requires parties like the operating member to adhere to the contracts they freely enter. The operating agreements here preclude the relief the operating member seeks, including its attempt to end-run the operating agreements by arguing that the defendant member had a fiduciary duty to act reasonably in granting consent. Under the plain terms of the operating agreements, the defendant member had bargained for the right to give consents to decisions involving material actions or not, as its own commercial interests dictated. Having bargained for that freedom and gained that concession from the operating member, the defendant member is entitled to the benefit of its bargain and the operating member cannot attempt to have the court write in a reasonableness condition that the operating member gave up. The words "not unreasonably withheld" are well known and appear in other sections of the operating agreements. They do not qualify the defendant member's right to deny consent to major decisions involving a material action.
>
> Likewise, the operating agreements clearly state the sole remedy the operating member has if the defendant member fails to meet a capital call. The operating member again seeks to have this court impose a remedy inconsistent with the plain terms of the operating agreements. This court cannot play such a role, and the operating member's claims relating to the capital call are dismissed because they are inconsistent with the operating agreements.

[779] Section 18-1101 of the Delaware Limited Liability Company Act provides 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.

780 *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 624 and related text regarding Chief Justice Steele's views in respect of fiduciary duties in the limited partnership context.

781 *Id. 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 food 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).

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

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

Provisions in Company Agreements purporting to limit fiduciary duties need to be explicit and conspicuous as LLC coyness can lead to unenforceability.[782] A provision which

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> In *Kuroda v. SPJS Holdings, L.L.C.*, 971 A.2d 872 (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); *see supra* notes 95-100. 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.

782 *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,

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.

Persons who control Members can be held responsible for fiduciary duty breaches of the Members.[783] 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.[784]

> create a conflict of interest or a potential conflict of interest for the True North Mangers. Both [First Solar] and Solar Cells hereby waive any such conflict of interest or potential conflict of interest and agree that neither True North nor any True North Manager shall have any liability to [First Solar] or to Solar Cells with respect to any such conflict of interest or potential conflict of interest, provided that the True North managers have acted in a manner which they believe in good faith to be in the best interest of [First Solar].

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

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

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

[783] In *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, 2009 WL 1124451 (Del.Ch. April 20, 2009), 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)

In reviewing and analyzing the Delaware holdings in *Auriga* and *Gatz*, an article from Business Law Today published by the American Bar Association (the "*ABA Article*") offers specific advice for drafters of LLC Agreements with respect to modifying the fiduciary duties which may now be implied by law.[785] To dispense with the unpredictability of such implications, the ABA Article suggests specific provisions and strategies for three types of common LLC situations: (1) LLCs as private equity/hedge funds, (2) LLCs as joint ventures/multimember LLCs, and (3) LLCs in structured finance transactions, as discussed below.

(1) Private Equity/Hedge Funds. In LLC hedge or private equity funds, a Manager may owe fiduciary duties to the LLC fund and the investor Members; however, the Manager typically also manages other similarly situated funds, creating an inherent conflict of interest. Accordingly, the ABA Article recommends including unambiguous provisions modifying or eliminating fiduciary duties in the LLC agreement of such a fund to permit Managers to more effectively make decisions without the fear of a breach of fiduciary duty claim affecting each action. To do so, drafters could include a provision in the LLC agreement that explicitly eliminates all fiduciary duties for Managers and its affiliates, although a downside to such an "all or nothing" approach is that it may cause potential investors to question the loyalty of such conflicted Managers and balk. A next option would be to provide that default principles of fiduciary duties would not be applicable to certain actions of the Managers which would be subject to a "sole discretion" standard.[786] Another option to curtail the application of default fiduciary duties would be to provide for advisory committee approval of Managers' actions, invoking a review mechanic similar to that of a "special committee" in the corporate context.[787] Finally, drafters could specifically authorize certain relationships or transactions they know to be potentially problematic but acceptable for the LLC in advance, notwithstanding any fiduciary duties that may exist. Calling out specific situations where fiduciary duty conflicts tend to arise may be particularly helpful where

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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).

784 *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).

785 Altman, Paul, Elisa Erlenbach Maas and Michael P. Maxwell, *Eliminating Fiduciary Duty Uncertainty: The Benefits of Effectively Modifying Fiduciary Duties in Delaware LLC Agreements*, Business Law Today, February 22, 2013, available at http://apps.americanbar.org/buslaw/blt/content/2013/02/article-05-altman.shtml.

786 Such a "sole discretion" standard should be well defined in a manner that precludes application of traditional fiduciary duties. *Id.*

787 If appropriately drafted, such a structure would permit Managers to contractually "cleanse" interested transactions and avoid becoming subject to the more strict entire fairness review. *Id. Cf. Gerber v. EPE Holdings, infra* note 625, regarding the use of such a committee in the context of a limited partnership.

broader modifications or the outright elimination of fiduciary duties are not feasible in a particular fund.[788]

(2) Joint Ventures; Multimember LLCs. Because of the many advantages of the LLC structure, more joint ventures, start-up companies, large and small businesses, and even large publicly held companies are being formed as LLCs. In these multimember LLC structures, there are a number of factors to consider in the fiduciary duty context, including the duration of any duties, Manager and non-Manager duties, duties amongst the LLC's Members, and potential conflicts of interest. In order to memorialize their desired level of fiduciary duty commitments, parties to a multimember LLC could seek to avoid the uncertainty of default duties and clearly delineate each person's obligations to the LLC and each other. For example, in the context of potential conflicts of interest, parties to a multimember LLC agreement could seek to avoid the application of the corporate opportunity doctrine by including specific provisions on what the business of the LLC will likely be, what it will seek to accomplish, and what (if any) opportunities the Members and Managers will be able to pursue without having to present them to the LLC first (or at all).[789] Multimember LLCs could also seek to modify or eliminate fiduciary duties by contract in order to provide flexibility and certainty for Managers and Members making decisions in a management capacity for the LLC. In publicly traded LLCs with many Members, the number of potential plaintiffs in a fiduciary duty-gone-wrong claim can be magnified, and accordingly, a well-reasoned LLC agreement with appropriate advance fiduciary duty modifications is of paramount importance. The ABA Article points out that the means of effecting such modifications in the publicly traded LLC arena can vary – for example, an LLC Agreement could establish a "special approval" process for potential conflicted transactions such that a Manager of an LLC and its affiliates could rebut any claim for breach of fiduciary duty simply by following a proscribed approval process.[790]

(3) Structured Finance. Fiduciary duties can also be modified in structured finance transactions involving the use of an LLC established to own specific assets ("*SPEs*"). SPEs must follow specific guidelines, including having an individual with no relationship to the parent Member designated as an "independent Manager," who must approve any material actions of the LLC. This relationship carries special fiduciary duty considerations. For example, in a bankruptcy situation, lenders and credit agencies will often require that the fiduciary duties in the SPE's LLC agreement be modified such that independent Manager must take into account the interest not only of the SPE and the SPE's parent Member, but also the SPE's creditors with respect to its interest in the SPE when deciding to approve a material action.[791] Because the creditors of an SPE may be prejudiced by a voluntary bankruptcy filing of the SPE, an independent Manager who also owes fiduciary duties to the SPE's creditors can make the SPE more attractive to future debt investors.

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788 *Id.*

789 *Id.*

790 *Id.*

791 *Id.*

The alternatives discussed above are but a few in the evolving world of provisions that are emerging in LLC agreements in the light of the increasing likelihood that courts will imply certain fiduciary duties to Managers and Members of an LLC in the absence of contrary language in the LLC agreement. Drafters have the opportunity to consider and contract around thorny issues such as conflicts of interest, approval processes for material actions, and other highly-litigated matters in the LLC agreement rather than waiting for the courts to impose a potentially undesirable standard.

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.[792] The restrictions on indemnification applicable to for-profit corporations are not applicable to LLCs.[793] This approach is similar to the approach taken under Delaware law, but could be subject to public policy limitations.[794] 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.[795] The Company Agreement ordinarily would contain provisions relative to when and under what circumstances capital contributions are required,[796] capital accounts and the allocation of profits and losses comparable to those in a limited partnership agreement.

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792 LLC Act § 2.20A; TBOC § 101.402.

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

794 *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).

795 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.

796 In Elizabeth S. Miller, *Practical Pitfalls in Drafting Texas Limited Liability Company Agreements*, 45:1 TEX. J. BUS. L. 27, 46 (2012), the author discusses issues with Company Agreement provisions relating to capital contributions:

> Provisions that require future capital contributions or permit capital calls should be carefully considered. The BOC provides for non-liability of the members to LLC creditors for the LLC's obligations, but there are nevertheless certain situations in which

a member may be held liable to the LLC in an action by an LLC creditor. A creditor of an LLC may enforce a member's obligation to make a contribution to the LLC even though it has been released by the LLC if the creditor extended credit or otherwise reasonably relied on the obligation after the member signed a writing reflecting the obligation and before the writing was amended or cancelled to reflect the release. * * *

Sometimes it may be desirable for the company agreement to grant manager(s) or managing member(s) the right to call for contributions when they conclude the LLC needs additional cash. These "cash call" or "capital call" provisions ordinarily do not give creditors any rights unless the call has already been made because a creditor may not enforce a conditional obligation to make a contribution unless the conditions or obligations have been satisfied or waived. Conditional obligations include contributions payable upon a discretionary call of the LLC before the call occurs. Nevertheless, these provisions should be carefully drafted to avoid any implication that the members have agreed to waive their limited liability. Additionally, even if creditors cannot invoke a discretionary capital call provision, the members should consider carefully the extent to which they want to expose themselves to this type of obligation, at whose discretion, and with what consequences in the event of a failure to contribute.

* * *

Generally, even in a manager-managed LLC whose certificate of formation does not identify the initial members, the identities of one or more initial members will be understood at the time an LLC is formed, and it is prudent for the initial members to execute a written company agreement prior to or contemporaneously with the filing of the certificate of formation so that it is clear who the members are and what their economic and governance rights are. The BOC expressly recognizes, however, the formation of an LLC that does not initially have any members, sometimes referred to as a "shelf" LLC. Under this provision, an organizer may file a certificate of formation that identifies one or more initial managers, but the LLC need not have any members for a "reasonable period" after the LLC is formed.

While it is possible to utilize a "shelf" LLC, there are some questions associated with such a practice. First, what is a "reasonable period" after the tiling of the certificate of formation? Is it merely a temporal concept or does it also relate to the activities undertaken by the LLC? Presumably, the managers may undertake certain actions to facilitate the organization of the LLC and securing of investors, but it would be unwise to transact significant business prior to the admission of members. What is the tax classification of an LLC without members? If the LLC undertakes any significant business and there is a failure to obtain members or a dispute as to whether there are members and who they are, this could be a thorny situation.

At the point that there are persons who desire to be members in an LLC that has previously been formed but has no members, may they simply execute a company agreement identifying themselves as the members and thereby become members "in connection with the formation" of the LLC? It would appear so, but what if there is a dispute as to who the members will be, i.e., a fight over the LLC? If two factions each execute a company agreement claiming to be the members, who determines which is the company agreement of the LLC? Inasmuch as becoming a member "in connection with the formation of the LLC" when one is not named as an initial member in the certificate of formation depends upon a reflection of the person's membership in an LLC "record," it appears that the manager or managers may have a role in determining which company agreement is the company "record" of membership.

If, after the filing of the certificate of formation of an LLC, a substantial period of time elapses without the admission of members, the question might arise whether a person who desires to become a member must do so in accordance with the statutory procedures applicable "after the formation" of the LLC. This result would be problematic

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.[797] 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.[798] 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.[799] 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.[800] A Member who receives a distribution that is not permitted under the preceding sentence has no liability to return the distribution under the Tex. LLC Stats. unless the Member knew that the distribution was prohibited.[801] The limitations on distributions by an LLC do not apply to payments for reasonable compensation for past or present services or reasonable payments made in the ordinary course of business under a bona fide retirement or other benefits program.[802]

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.[803] Members may participate in the management of

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> because the statute requires that a person becoming a member after formation of the LLC must do so with the consent of all members unless a company agreement provides otherwise. It would be impossible to admit a member under such circumstances because the LLC has no members and thus no company agreement. It is more logical to interpret the statute as permitting persons to become members "in connection with the formation" of the LLC if the LLC has previously existed as a memberless shell entity, even if a substantial period of time has passed since the filing of the certificate of formation.

797 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 2009 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.

798 LLC Act §§ 5.02-1, 5.03; TBOC §§ 101.052, 101.201.

799 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.

800 LLC Act § 5.09A; TBOC § 101.206.

801 LLC Act § 5.09B; TBOC § 101.206(d); *see Weinstein v. Colborne Foodbotics, LLC*, 2013 CO 33 (No. 10SC143 June 10, 2013), available through http://www.courts.state.co.us, the Colorado Supreme Court held that (i) an insolvent LLC's members are not liable to the creditors of the LLC for an unlawful distribution although the LLC's members are liable to the LLC for the same, and (ii) an insolvent LLC's managers do not owe an LLC's creditors the same common law fiduciary duty that an insolvent corporation's directors might owe the corporation's creditors.

802 TBOC § 101.206(f) as amended in 2009 Legislative Session by 2009 S.B. 1442 § 41.

803 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.

the LLC without forfeiting this liability shield,[804] but may be liable for their own torts.[805] Since the Tex. LLC Stats. deal expressly with the liability of Members and Managers for LLC

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 996-1022 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.

804 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."

805 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, no pet.); *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

obligations, the principles of "piercing the corporate veil" should not apply to LLCs in Texas, although this issue is not settled.[806]

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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 2011); Byron F. Egan, *Acquisition Structure Decision Tree*, 150–153, prepared for the TexasBarCLE & Business Law Section of State Bar of Texas Choice and Acquisition of Entities in Texas Course on May 25, 2012, and available at: http://images.jw.com/com/publications/1736.pdf.

806 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, pet. denied), 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, no pet.) 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*, held 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 391 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.

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. In *Shook v. Walden*, 368 S.W.3d 604 (Tex. App.–Austin 2012, pet. denied), a Texas Court of Appeals discussed the history of TBCA Art. 2.21 and the application of veil

While TBOC § 101.114 (Liability for Obligations), like its source LLC Act § 4.03, provides that a member or manager is not liable for the debts, obligations or liabilities of an LLC, except as and to the extent the company agreement or regulations specifically provide otherwise and thus prohibits a court from holding the members or managers liable for the debts, obligations and liabilities of an LLC, some judicial opinions have failed to follow this express statutory mandate and have applied corporate veil piercing principles to LLCs, causing uncertainty as to the proper standards to be applied if LLC veil piercing is to be recognized. Some Texas opinions have applied corporate veil piercing standards in disregarding the statutory liability shield.[807] When applying corporate veil piercing standards to LLCs, these courts recognized that the provisions of TBCA Article 2.21 (Liability of Subscribers and Shareholders), which are carried over in TBOC §§ 21.223 (Liability for Obligations) through 21.226 (Liability for Obligations), were controlling with respect to such standards.

2011 S.B. 323 clarified the standards for the piercing of the LLC statutory liability shield, if LLC veil piercing is determined to be available notwithstanding the express no personal liability provisions of TBOC § 101.114 (Liability for Obligations), by adding a new TBOC § 101.002 (Applicability of Other Laws) which provides that TBOC §§ 21.223 (Liability for Obligations), 21.224 (Preemption of Liability), 21.225 (Exceptions to Limitations) and 21.226 (Liability for Obligations) in respect of for profit corporations apply to an LLC and its members, owners, assignees and subscribers, subject to the limitations contained in TBOC § 101.114 (Liability for Obligations). TBOC § 101.002 as added by 2011 S.B. 323 provides as follows:

> Sec. 101.002. APPLICABILITY OF OTHER LAWS. (a) Subject to Section 101.114, Sections 21.223, 21.224, 21.225, and 21.226 apply to a limited liability company and the company's members, owners, assignees, affiliates, and subscribers.
>
> (b) For purposes of the application of Subsection (a):
>
> (1) a reference to "shares" includes "membership interests";

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piercing principles to LLCs prior to the recent addition of TBOC § 101.002 in 2011, and concluded that the actual fraud standard should apply as a matter of common law to LLC veil piercing cases pre-dating the 2011 amendment to TBOC § 101.002. The majority opinion in *Shook* acknowledges the *Taurus* case discussed above (where federal court in Wisconsin applying Texas law concluded that *Castleberry* standard applied to LLC since LLC not corporation governed by TBCA Art. 2.21), but reaches a different conclusion and cites the Bill Analysis of 2011 S.B. 323 discussed *infra*, which the dissenting justice argued should have made the *Castleberry* standards apply to LLCs prior to the September 1, 2011 effectiveness of TBOC § 101.002. *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).

807 *See*, *e.g.*, *Shook v. Walden*, 368 S.W.3d 604 (Tex. App.–Austin, pet. denied); *McCarthy v. Wani Venture, A.S.*, 251 S.W.3d 573, (Tex. App.—Houston [1st Dist.] 2007, pet. denied); *In re JNS Aviation, LLC (Nick Corp. v. JNS Aviation, Inc.)*, 376 B.R. 500 (Bankr. N.D. Tex. 2007, amended in part by 2008 WL 686159 (Bankr. N.D. Tex. 2008)).

(2) a reference to "holder," "owner," or "shareholder" includes a "member" and an "assignee";

(3) a reference to "corporation" or "corporate" includes a "limited liability company";

(4) a reference to "directors" includes "managers" of a manager-managed limited liability company and "members" of a member-managed limited liability company;

(5) a reference to "bylaws" includes "company agreement"; and

(6) the reference to "Sections 21.157-21.162" in Section 21.223(a)(1) refers to the provisions of Subchapter D of this chapter.

If there was any uncertainty prior to 2011 S.B. 323, it should now be clear that the LLC liability shield is to be respected even if the LLC has only one member or is a disregarded entity for federal income tax purposes.[808]

Alter ego veil piercing principles similar to those applicable to Delaware corporations are applicable to Delaware LLCs, with the plaintiff having to demonstrate a misuse of the LLC form along with an overall element of injustice or unfairness.[809] Some state LLC statutes expressly deal with the veil piercing issue by providing that the LLC veil will be pierced to the same extent as the corporate veil[810] or that the Members will have the same liabilities as corporate shareholders.[811]

M. Nature and Classes of Membership Interests. A membership interest in an LLC is personal property.[812] It does not confer upon the Member any interest in specific LLC property.[813] A membership interest may be evidenced by a certificate if the Company Agreement so provides.[814]

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808 *See supra* note 679 and related text; *cf. Singh v. Duane Morris, L.L.P.*, 338 S.W.3d 176, 182 (Tex. App.—Houston [14th Dist.] 2011) (the fact that a corporation is an IRC Subchapter S-corporation with a single shareholder who is taxed on its earnings does not alter the bedrock principle of Texas law that an individual can incorporate a business and thereby normally shield himself from personal liability for the corporation's obligations).

809 *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).

810 *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).

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

812 LLC Act § 4.04; TBOC § 101.106.

813 LLC Act § 4.04; TBOC § 101.106.

814 LLC Act § 4.05B; TBOC § 3.201(e).

The Company Agreement may establish classes of Members having expressed relative rights, powers and duties, including voting rights,[815] 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.[816] The Company Agreement could provide for different classes of Members, each authorized to elect a specified number or percentage of the Managers.[817] 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.[818]

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.[819] The offer and sale

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815 Under TBOC § 101.354 Members vote on a per capita basis (i.e., one Member, one vote) unless the Company Agreement otherwise provides.

816 LLC Act § 4.02; TBOC § 101.104.

817 *See* LLC Act § 2.13; TBOC § 101.104.

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

819 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.

of an interest must either be registered under applicable federal and state securities laws[820] or effected in a private[821] or other transaction structured to be exempt from those requirements.[822]

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

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

> A general partnership interest normally is not a security, even if the investor elects to remain passive. But a general partnership interest may be a security if the rights of a partner are very limited in substance, or if the partner is an unsophisticated investor who must rely in fact on the business acumen of some other person.
>
> A limited partnership interest normally is a security. On unusual facts, however, a limited partnership might not be a security -- e.g., where there is a single limited partner who negotiates directly with the general partner and retains significant influence over the venture, or where the limited partner otherwise has an active role in the venture.

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

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

Id. at 1122. *See also SEC v. Parkersburg Wireless, LLC*, 991 F.Supp. 6, 8 (D.D.C. 1997) (holding that interests in an LLC with 700 Members were investment contracts); *SEC v. Vision Communications, Inc.*, CIV. No. 94-0615, 1994 WL 855061, at *1 (D.D.C. May 11, 1994) remanded by 74 F.3d 287 (D.C. Cir. 1996) (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).

[820] 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).

821 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);
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> (c) manner of offering (the offer should be communicated directly to the prospective investors without the use of public advertising or solicitation);
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> (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 § 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.

After being approved by Congress with wide bipartisan support, on April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (the "JOBS Act"). The JOBS Act is an amalgamation of various bills the combined impact of which is intended to provide entrepreneurs, start-ups and small businesses increased access to the capital markets while at the same time provide average investors increased investment opportunities. The JOBS Act considerably alters the regulations surrounding public and private security offerings and, for certain issuers with revenues of less than $1 billion, reduces the burden of certain periodic reporting obligations.

Title II of the JOBS Act will allow general solicitation and advertising (by all issuers, not just emerging growth companies) in connection with private offerings pursuant to Rule 506 of Regulation D and Rule144A, provided that all purchasers in Rule 506 offerings are accredited investors and all purchasers in Rule 144A offerings are qualified institutional buyers. The JOBS Act does not alter state preemption of offerings under Rule 506. Additionally, the JOBS Act clarifies that certain persons acting to bring issuers and potential purchasers together for a Rule 506 offering will not be required to register with the SEC as a broker or dealer if that person complies with certain requirements, including that it may not receive compensation or have possession of customer funds in connection with the purchase or sale of the securities. The Title II provisions of the JOBS Act become effective upon SEC rulemaking.

822 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).

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").[823] 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.[824] 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.[825]

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 ("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.[826] Under Post 9/1/95 B&CC Chapter 9, LLC membership interests should be classified as "general intangibles," whether or not represented by a certificate, and security interests would be perfected by a financing statement filing.[827]

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.[828] In a "charging order" a court "charges" the membership interest such that any

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823 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.

824 Pre 9/1/95 B&CC § 8.321.

825 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.

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

827 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.

828 LLC Act § 4.06A, as amended in 2007 by 2007 H.B. 1737; TBOC § 101.112, which provides:

> Sec. 101.112. MEMBER'S MEMBERSHIP INTEREST SUBJECT TO CHARGING ORDER. (a) On application by a judgment creditor of a member of a limited liability company or of any other owner of a membership interest in a limited liability company, a court having jurisdiction may charge the membership interest of the judgment debtor to satisfy the judgment.
>
> (b) If a court charges a membership interest with payment of a judgment as provided by Subsection (a), the judgment creditor has only the right to receive any distribution to which the judgment debtor would otherwise be entitled in respect of the membership interest.
>
> (c) A charging order constitutes a lien on the judgment debtor's membership interest. The charging order lien may not be foreclosed on under this code or any other law.

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. The TBOC provides that a charging order is a creditor's exclusive remedy against an LLC membership interest, but that does not preclude a member from granting a UCC security interest in a membership or enforcing it, in each case subject to the LLC's governing documents.

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.[829] 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.[830] 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.[831] 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.[832] 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.[833] Until an assignee is admitted as a Member, the assignee does not have liability as a Member solely as a result of the assignment.[834]

> (d) The entry of a charging order is the exclusive remedy by which a judgment creditor of a member or of any other owner of a membership interest may satisfy a judgment out of the judgment debtor's membership interest.
>
> (e) This section may not be construed to deprive a member of a limited liability company or any other owner of a membership interest in a limited liability company of the benefit of any exemption laws applicable to the membership interest of the member or owner.
>
> (f) A creditor of a member or of any other owner of a membership interest does not have the right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company.

See LLC Act § 7.03. TBOC § 101.112 provides substantially the same.

829 LLC Act § 4.05A; TBOC § 101.108.

830 *Id*.

831 LLC Act § 4.05A; TBOC § 101.109.

832 LLC Act § 4.05A; TBOC § 101.111.

833 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).

834 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.[835]

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;[836]

(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;[837]

(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);[838]

(4) the occurrence of any event that terminates the continued membership of the last remaining Member of the LLC, absent certain circumstances;[839] or

(5) entry of decree of judicial dissolution under the Tex. LLC Stats.[840]

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835 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.

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

837 LLC Act § 6.01A(2); TBOC § 11.051(3).

838 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.

839 LLC Act § 6.01A(5), as amended by 2003 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 2003 H.B. 1637 effective September 1, 2003; TBOC § 11.056.

840 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

Under the Tex. LLC Stats., the bankruptcy of a Member does not dissolve an LLC unless its certificate of formation or Company Agreement so provides. In Delaware, however, the bankruptcy of a Member dissolves the LLC unless its LLC agreement otherwise provides.[841]

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.[842] Under the LLC Act and the TBOC, revocation of a voluntary dissolution simply requires the written consent of all its members,[843] 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).[844]

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.[845] For voluntary dissolutions, the

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> in such a way that the new provision appears to be the converse of the corresponding provision under the Texas Limited Liability Company Act.
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> 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.

841 DLLCA § 18-304.

842 TBOC §§ 101.552.

843 LLC Act § 6.06A; TBOC § 101.552.

844 LLC Act § 6.01B; TBOC § 101.552.

845 LLC Act § 6.01B; TBOC § 11.152(b).

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.[846] For the occurrence of an event determined in the LLC's governing documents to require automatic dissolution, the LLC Act requires any cancellation election to be made within 90 days of the event, subject to amendment of the LLC's governing documents within three years to eliminate dissolution upon such event, while the TBOC allows one year to revoke such dissolution.[847] For other circumstances requiring termination under the TBOC, LLCs are permitted one year to cancel the event of termination.[848]

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.[849] Before filing a certificate of termination with the Secretary of State,[850] 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,[851] and (iii) collect its assets, discharge its obligations or make provision therefor and distribute the remaining assets to its Members.[852] 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.[853] 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.[854]

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846 LLC Act § 6.06A; TBOC § 11.151.

847 LLC Act § 6.01B; TBOC § 11.152(a).

848 TBOC § 11.152(a).

849 LLC Act § 6.03A; TBOC § 101.551.

850 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.

851 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.

852 LLC Act § 6.05; TBOC § 11.052.

853 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).

854 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.

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.[855] The merger must be pursuant to a written plan of merger containing certain provisions,[856] 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.[857]

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.[858] The Tex. LLC Stats. grant broad authority for who can execute merger documents on a company's behalf.[859] 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.[860]

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.[861]

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.[862] 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.[863]

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

856 The LLC Act's requirements appear in its § 10.02. The TBOC's requirements are in its §§ 10.002 and 10.003.

857 LLC Act §§ 9.03, 10.03; TBOC § 10.007 and Revisor's Note thereto.

858 LLC Act § 10.01A; TBOC §§ 10.001, 101.356, 101.052. Under TBOC § 101.354 "majority" is determined on a per capita basis (i.e., one Member, one vote) unless the Company Agreement provides otherwise.

859 LLC Act § 10.03A; TBOC §§ 10.001(b), 10.151(b).

860 *See* LLC Act § 10.05; TBOC § 10.006.

861 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.

862 *See supra* notes 325-326 and related text regarding the requirements of TBCA arts. 5.09 and 5.10 and the parallel TBOC provisions.

863 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.

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.[864] In particular, TBCA article 2.02-1 and Part 5 with respect to indemnification and mergers, respectively, and TMCLA article 7.06 with respect to the limitation of director liability (made applicable to Managers) were incorporated.[865]

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.[866] 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)

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[864] 1991 LLC Act § 8.12.

[865] *Id.*

[866] *See* LLC Act § 4.03; *see also supra* notes 803-811 and related text.

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 2003 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 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.[867] 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.[868] 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.[869] 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.[870] 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.[871]

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.[872] However, for

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867 LLC Act Part Seven; TBOC chapter 101.

868 "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.

869 *See* TBOC §§ 9.001 and 101.001 and the Revisor's Notes thereto.

870 LLC Act §§ 7.01A, 7.05; TBOC §§ 9.001, 9.004.

871 LLC Act § 7.01B; TBCA art. 8.01B; TBOC § 9.251.

872 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

matters affecting intrastate business in Texas, a Foreign LLC is subject to the same duties, restrictions, and liabilities as a domestic LLC.[873] 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.[874]

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.[875] 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").[876] Unlike the TPCA, however, physicians, surgeons and other doctors of medicine are not excluded from forming PLLCs under the Tex. LLC Stats.[877]

A PLLC is required to contain in its name the words "Professional Limited Liability Company" or an abbreviation thereof.[878] Only a "professional individual"[879] or a "professional organization"[880] may be a governing person[881] of a PLLC.[882] The PLLC, but not the other

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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).

873 LLC Act § 7.02A; TBOC § 9.203.

874 LLC Act § 7.13B; TBOC § 9.051(c).

875 *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).

876 TEX. REV. CIV. STAT. ANN. art. 1528e, §3(a) (Vernon 2011).

877 1993 LLC Bill Analysis at 6; LLC Act § 11.01; TBOC §§ 301.003, 301.012.

878 LLC Act § 11.02; TBOC § 5.059.

879 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).

880 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.

881 "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.

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.[883]

T. Series LLC. Subchapter M of TBOC Chapter 101[884] was added in the 2009 Legislative Session[885] to permit LLCs to establish series of members, managers, membership interests or assets to which different assets and liabilitiesmay be allocated.[886] 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 differentseries.[887] These provisions 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.[888] Each LLC series will have to file an assumed name certificate if it will have a name different from the LLC as will usually be the case.[889]

U. Diversity Jurisdiction. The cases are divided as to whether the citizenship of an LLC for federal diversity jurisdiction purposes should be determined by analogy to a partnership or a corporation. Where citizenship is determined in accordance with partnership precedent, an LLC is deemed a citizen of each state in which it has a Member.[890] Where corporate precedent is

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882 LLC Act § 11.03A; TBOC §§ 301.007(a), 301.004(2).

883 LLC Act § 11.05; TBOC § 301.010.

884 TBOC §§ 101.601-101.521.

885 Rick Tulli & Daryl Robertson, *2009 Legislative Update on Texas Business Organizations Code Amendments*, 43:3 TEX. J. BUS. L. 571 (2009).

886 Elizabeth S. Miller, *Practical Pitfalls in Drafting Texas Limited Liability Company Agreements*, 45:1 TEX. J. BUS. L. 27 (2012); Adrienne Randle Bond & Allen Sparkman, *The Series LLC: A New Planning Tool*, 45:1 TEX. J. BUS. L. 57 (2012); Jennifer Avery, David Lawrence, Todd Lowther, Karen Rose, Joshua Russ, Brandon Schubert, Andrew Wootton & Travis Youngblood, *Series LLCs: Nuts and Bolts, Benefits and Risks, and the Uncertainties that Remain*, 45:1 TEX. J. BUS. L. 9 (2012).

887 Michelle Harner, Jennifer Ivey-Crickenberger & Tae Kim, *Series LLCs: What Happens When One Series Fails? Key Considerations and Issues*, ABA Business Law Today (Feb. 22, 2013), *available at* http://apps.americanbar.org/buslaw/blt/content/2013/02/article-01-harner.shtml; Allen Sparkman, *Series LLCs in Interstate Commerce*, ABA Business Law Today (Feb. 22, 2013), *available at* http://apps.americanbar.org/buslaw/blt/content/2013/02/article-02-sparkman-a.shtml; Allen Sparkman, *Tax Aspects of Series LLCs*, ABA Business Law Today (Feb. 22, 2013), *available at* http://apps.americanbar.org/buslaw/blt/content/2013/02/article-03-sparkman-b.shtml.

888 Rick Tulli & Daryl Robertson, *2009 Legislative Update on Texas Business Organizations Code Amendments*, 43:3 TEX. J. BUS. L. 571 (2009).

889 *See supra* notes 124-125 and *infra* notes 955-959 and related text.

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

applied, an LLC is a citizen of its state of incorporation and the state where its principal place of business is located.[891]

VI. LIMITED LIABILITY PARTNERSHIP.[892]

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 ("1991 H.B. 278").[893] The LLP Provisions were refined and carried forward as section 3.08 of the TRPA[894] passed in 1993, and then were substantially expanded by 1997 S.B. 555 effective September 1, 1997.[895] The LLP Provisions were substantially revised and made more protective in the 2011 Legislative Session, effective September 1, 2011, by 2011 S.B. 748.

The LLP provisions initially appearing in the TBOC[896] took effect on January 1, 2006 and governed all LLPs formed on or after that date.[897] The source LLP Provisions in TRPA governed LLPs formed before that date which did not voluntarily opt in to TBOC governance until their registrations expired, unless they are revoked or withdrawn prior to expiration, and, after January 1, 2010, all LLPs (like all other Texas entities) became subject to the TBOC.[898] The LLP Provisions or TBOC LLP provisions, as each may be applicable to a particular LLP, will be hereinafter collectively referred to as "Tex. LLP Stats.," with differences between the two noted as appropriate.

B. Evolution of the LLP in Texas.

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891 *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).

892 The discussion of LLPs herein, insofar as it relates to LLP's under 1991 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).

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

894 TRPA § 1.01 et seq.

895 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).

896 *See* TBOC Title 1 and §§ 152.801-152.805.

897 TBOC §§ 401.001, 402.003, 402.005.

898 TBOC § 402.001(b). Even prior to January 1, 2010, LLP registration renewal was governed by the TBOC after January 1, 2006 under TBOC § 402.001(c). *See supra* notes 44-46 and related text.

1. First LLP in 1991 in Texas. The LLP Provisions of TUPA originated in 1991 in Senate Bill 302 ("1991 S.B. 302")[899] as an alternate means for allowing professionals the limitation of liability already available to them under the Texas Professional Corporation Act.[900] 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 1991 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.[901] Thus, the proposed amendments to TUPA that were contained in 1991 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. 1991 S.B. 302 passed the Senate but encountered criticism in hearings before the House Business and Commerce Committee on grounds, among others, that 1991 S.B. 302 was discriminatory against non-professional partnerships, that 1991 S.B. 302 did not tell persons dealing with a partnership whether the partnership had the liability shield, and that 1991 S.B. 302 did not require any substitute source of recovery for a person injured by partnership misconduct.[902] 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 with the Secretary of State, 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 1991 H.B. 278 in the Senate, and the House concurred in 1991 H.B. 278 as so amended. With the adoption of TRPA in House Bill 273 ("1994 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 1991 H.B. 278; (iii) the passage of TRPA in 1994 H.B. 273, maintaining the LLP entity created by 1991 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.

2. LLP Now Nationwide. 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

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899 Senate Bill 302 by Sen. John Montford ("1991 S.B. 302").

900 TEX. REV. CIV. STAT. ANN. art. 1528e (Vernon Supp. 2010).

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

902 *See* TEX. LAW. 7 (May 13, 1991); TEX. LAW. 1 (Oct. 21, 1991).

partners and employees.[903] The "full shield" LLP statutes of a number of states (including Colorado, Georgia, Idaho, Indiana, Maryland, Minnesota and New York) insulate a partner from personal liability for any debts, obligations or liabilities of, or chargeable to, the partnership, if such liability would exist solely by reason of their being partners, rendering professional services, or participating in the conduct of the business of the LLP, but do not protect a partner from liability arising from the partner's own negligence, wrongful acts or misconduct, or from that of any person acting under his direct supervision and control.[904]

3. 1997 Amendment to Limit Contract Liabilities. Although Texas was the first jurisdiction in the nation to permit the creation of LLPs, TRPA lagged behind other jurisdictions in providing partners of LLPs with protection from liabilities of the partnership. To address this deficiency, 1997 S.B. 555 amended TRPA section 3.08 in 1997 to bring the Texas statute more in line with the laws of other jurisdictions relating to LLPs, in particular the liability of partners of an LLP for contractual obligations. TRPA section 3.08(a), as so amended, provided that, except for liability for errors, omissions, negligence, incompetence or malfeasance committed by, or attributed to, a partner in an LLP, 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 an LLP.[905]

A new subsection (5) was added to TRPA section 3.08(a) by 1997 S.B. 555[906] to provide that in the case of an LLP, 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 an LLP did not impair the obligations under a contract existing before the effective date of 1997 S.B. 555.[907] 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 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.[908]

TRPA section 8.06 was amended by 1997 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

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903 *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).

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

905 TRPA § 3.08.

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

907 1997 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.

908 TBOC § 402.006.

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.

The amendment to TRPA section 3.08 making Texas a full shield state did not apply to contractual obligations incurred prior to the September 1, 1997 effective date of 1997 S.B. 555 by virtue of 1997 S.B. 555 section 125(d), which provided 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 were similarly unshielded for partnerships governed by the TBOC.[909] 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 the same obligation incurred thereafter would be shielded unless the partners had agreed to be liable therefor.

4. Insurance Requirement. A requirement for LLP status under the Tex. LLP Stats. prior to 2011 S.B. 748 was 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.[910]

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) was intended to provide some source of recovery as a substitute for the assets of partners who were shielded from liability by the Tex. LLP Stats. The $100,000 figure was arbitrary and might or might 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 was incurred was a requirement for the

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909 TBOC § 402.006.

910 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.

liability to be shielded, and it was not sufficient that a partner individually maintains insurance in such amount.[911]

The $100,000 requirement refered to the liability limit of the insurance, above any deductibles, retentions or similar arrangements; thus, deductibles, retentions and the like were permitted so long as the coverage would allow aggregate proceeds of at least $100,000. The statute was not explicit about the effect on one claim of exhaustion of the policy limits by a prior claim. The intent was 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 was shielded by Tex. LLP Stats.[912] The quoted phrase contained some flexibility; actual coverage of the misconduct that occurs was not an absolute necessity. The partner claiming the shield from liability, however, had 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) allowed 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 was on the partner claiming the liability shield of TBOC section 152.801 or TRPA section 3.08(a).[913]

The Tex. LLP Stats. provided 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

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911 In *Elmer v. Santa Fe Properties, Inc.*, 2006 WL 3612359 (Tex. App.—San Antonio 2006, no pet.), 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, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 TEX. J. BUS. L. 405, 440 (Fall 2009).

912 TRPA § 3.08(d)(1)(A); TBOC § 152.804(a)(1).

913 *See* TRPA § 3.08(d)(3); TBOC § 152.804(c).

extent of the debt or obligation or damages in question."[914] These provisions were intended to keep the existence of insurance from influencing a jury decision on liability or damages. The Tex. LLP Stats. specifically stated that if compliance with their insurance or fund provisions was disputed, "compliance must be determined separately from the trial or proceeding" to determine liability or damages.[915]

5. TBOC Prior to 2011 S.B. 748. The TBOC as originally adopted afforded LLP partners the same protection as TRPA section 3.08(a), although the TBOC in referring to the LLP dropped the "registered" in limited liability partnership and referred to an LLP as a limited liability partnership.[916] This provision, however, did 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. Prior to 2011 S.B. 748, the LLP shield in TBOC § 152.801 protected a partner in an LLP from both tort and contract liabilities of the LLP.

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.[917] 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.

The essence of the Tex. LLP Stats. prior to 2011 S.B. 748 was 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 was set forth in TBOC § 152.801 (prior to 2011 S.B. 748) 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.[918]

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914 TRPA § 3.08(d)(2); *see also* TBOC § 152.804(b).

915 TRPA § 3.08(d)(3); *see also* TBOC § 152.804(c).

916 TBOC §§ 1.002(48) and 152.801-152.805.

917 TRPA § 3.05(a), (d), (e); TBOC § 152.306(b). *See Bromberg & Ribstein*, *supra* note 484, § 1.01 and ch. 5 for a general discussion of the liabilities of general partners.

918 In *Evanston Ins. Co. v. Dillard Dep't Stores, Inc.*, 602 F.3d 610 (5th Cir. 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.

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 profferred 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.

(b) A partner in a limited liability partnership is not personally liable for a debt or obligation of the partnership arising from an error, omission, negligence, incompetence, or malfeasance committed by another partner or representative of the partnership while the partnership is a limited liability partnership and in the course of the partnership business unless the first partner:

(1) was supervising or directing the other partner or representative when the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative;

(2) was directly involved in the specific activity in which the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative; or

(3) had notice or knowledge of the error, omission, negligence, incompetence, or malfeasance by the other partner or representative at the time of the occurrence and then failed to take reasonable action to prevent or cure the error, omission, negligence, incompetence, or malfeasance.

(c) Sections 2.101(1), 152.305, and 152.306 do not limit the effect of Subsection (a) in a limited liability partnership.

(d) In this section, "representative" includes an agent, servant, or employee of a limited liability partnership.

(e) Subsections (a) and (b) do not affect:

(1) the liability of a partnership to pay its debts and obligations from partnership property;

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

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

(f) This section controls over the other parts of this chapter and the other partnership provisions regarding the liability of partners of a limited liability partnership, the chargeability of the partners for the debts and obligations of the partnership, and the obligations of the partners regarding contributions and indemnity.[919]

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).

[919] The provisions of TBOC § 152.801 prior to 2011 S.B. 748 were 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 2009 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.

The Tex. LLP Stats. prior to 2011 S.B. 748 expressly did not relieve a partner for any liability imposed by law or contract independently of his status as a partner.[920] In addition, there were three situations in which the LLP Provisions did not shield a partner from liability for a partnership obligation arising from the specified misconduct of a copartner or representative of the partnership:

(1) The miscreant copartner or representative was working under the supervision or direction of the partner.[921]

(2) The partner was directly involved in the specific activity in which the copartner or representative commits the misconduct.[922]

(3) The partner had "notice" or "knowledge" of the misconduct at the time of occurrence and fails to take reasonable steps to prevent the misconduct.[923]

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.[924] For example, an environmental lawyer who

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920 TRPA § 3.08(a)(3)(B); TBOC § 152.801(e).

921 TRPA § 3.08(a)(2); TBOC § 152.801(b)(1).

922 TRPA § 3.08(a)(2)(A); TBOC § 152.801(b)(2).

923 TRPA § 3.08(a)(2)(B); TBOC § 152.801(b)(3). Tex. LLP Stats. provided prior to 2011 S.B. 748 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.

924 *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

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

C. Liability Shielded After 2011 S.B. 748. The individual liability of partners of a general partnership that is an LLP is even more drastically altered after 2011 S.B. 748. The essence of the LLP liability shield continues to be that a partner in an LLP is not liable for the tort or contract liabilities of the partnership incurred while it is an LLP, but 2011 S.B. 748 removed wording in the LLP Provisions that a partner could have responsibility for the actions of another partner where the partner was supervising or involved in the actions of the miscreant partner or aware of the miscreant partner's actionable conduct.[925] A partner, however, is always liable for the partner's own tortious conduct.

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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).

[925] 2011 S.B. 748 § 46 provided as follows:

> SECTION 46. Section 152.801, Business Organizations Code, is amended to read 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 any [~~a debt or~~] obligation of the partnership incurred while the partnership is a limited liability partnership.
>
> (b) [~~A partner in a limited liability partnership is not personally liable for a debt or obligation of the partnership arising from an error, omission, negligence, incompetence, or malfeasance committed by another partner or representative of the partnership while the partnership is a limited liability partnership and in the course of the partnership business unless the first partner:~~
>
> [~~(1) was supervising or directing the other partner or representative when the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative;~~
>
> [~~(2) was directly involved in the specific activity in which the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative; or~~
>
> [~~(3) had notice or knowledge of the error, omission, negligence, 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.

1. LLP Shield. After 2011 S.B. 748, the liability of a partner in an LLP is shielded by TBOC § 152.801 as follows, effective September 1, 2011:

> Sec. 152.801. LIABILITY OF PARTNER. (a) Except as provided by the partnership agreement, a partner is not personally liable to any person, including a partner, directly or indirectly, by contribution, indemnity, or otherwise, for any obligation of the partnership incurred while the partnership is a limited liability partnership.
>
> (b) Sections 2.101(1), 152.305, and 152.306 do not limit the effect of Subsection (a) in a limited liability partnership.
>
> (c) For purposes of this section, an obligation is incurred while a partnership is a limited liability partnership if:
>
> (1) the obligation relates to an action or omission occurring while the partnership is a limited liability partnership; or
>
> (2) the obligation arises under a contract or commitment entered into while the partnership is a limited liability partnership.
>
> (d) Subsection (a) does not affect:
>
> (1) the liability of a partnership to pay its obligations from partnership property;

> (c) For purposes of this section, [~~(d) In this section, "representative" includes~~] an obligation is incurred while a partnership is [~~agent, servant, or employee of~~] a limited liability partnership if:
>
> (1) the obligation relates to an action or omission occurring while the partnership is a limited liability partnership; or
>
> (2) the obligation arises under a contract or commitment entered into while the partnership is a limited liability partnership.
>
> (d) Subsection [~~(c) Subsections~~] (a) does [~~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.
>
> (e) [~~(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.

(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.

(e) 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 obligations of the partnership, and the obligations of the partners regarding contributions and indemnity.[926]

2. Limits to LLP Shield. The LLP shield of TBOC § 152.801 after 2011 S.B. 748 does not protect partnership assets from claims of contract and tort creditors of the LLP.[927] Further, the LLP Provisions do not protect a partner in an LLP from liabilities of the partner imposed by law or contract independently of the partner's status as a partner in an LLP.[928] A partner is always liable for the partner's own tortious conduct.

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 and name 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.[929] 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.[930] 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.[931]

5. Shielded vs. Unshielded Obligations; Time Obligations Incurred. The LLP shield only applies to the liability of partners for the partnership obligations incurred while the partnership is an LLP.[932] For purposes of TBOC § 152.801 after 2011 S.B. 748, an

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926 2011 S.B. 748 § 66 (3) repealed old TBOC § 804 which required that an LLP maintain insurance or a segregated fund of at least $100,000 to provide for claims against the LLP.

927 TBOC § 152.801(d)(1) after 2011 S.B. 748.

928 TBOC § 152.801(d)(2) after 2011 S.B. 748.

929 TBOC § 152.801(d)(1) after 2011 S.B. 748 provides that the other LLP provisions do not affect "the liability of a partnership to pay its obligations from partnership property."

930 TEX. R. CIV. P. 28.

931 TRPA § 3.08(a)(3)(C) (Vernon Supp. 2010).

932 *See Elmer v. Santa Fe Properties, Inc.*, 2006 WL 3612359 (Tex. – San Antonio 2006, no pet.) (under Tex. LLP Stats. in effect prior to 2011 S.B. 748, 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).

obligation is incurred while a partnership is an LLP if: (i) the obligation relates to an action or omission occurring while the partnership is an LLP; or (ii) the obligation arises under a contract or commitment entered into while the partnership is an LLP.

The partners remain jointly and severally liable for all other partnership obligations. A partnership at any time may have both shielded and unshielded obligations.

The Tex. LLP Stats. do not deal with the right of a partnership to pay unshielded obligations before paying shielded obligations or whether partner contributions may be earmarked to cover particular unshielded obligations. These matters are left to fiduciary principles and laws pertaining to creditors rights.

6. 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,[933] perhaps in recognition that some malpractice claims could be pled in contract as well as in tort.[934] Under most LLP statutes, including that of Delaware,[935] 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.[936] 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.[937]

D. Post 2011 S.B. 748 Requirements for LLP Status. Each of the two 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.[938]

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933 *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).

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

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

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

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

938 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.

2. Filing with the Secretary of State of Texas. LLPs are considered to be non-filing entities under the TBOC.[939] Nonetheless, to achieve domestic LLP status, a partnership must file with the Secretary of State of Texas[940] an application accompanied by a fee for each partner of $200.[941] 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,[942] and (b) be executed by a majority in interest[943] 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.[944]

Compliance with the Texas name requirements by a law firm should not conflict with the misleading name prohibition in Rule 7.01 of Texas Disciplinary Rules of Professional Conduct, which provides in relevant part as follows:

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

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

939 *See* TBOC §§ 1.002(57), (34).

940 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.

941 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).

942 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.

943 "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.

944 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).

If the required information is supplied in the application and the fee is paid, the LLP registration becomes effective upon filing.[945] 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.[946]

Registration remains effective for a year,[947] regardless of changes in the partnership, unless the registration is earlier withdrawn or revoked or unless renewed.[948] Because the registration is a notice filing and no listing of partners is required in the application, partnership changes due to withdrawals or to admissions of new partners do not require any refiling with the Secretary of State until the next renewal filing.[949] 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.

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.

2. Texas Entity Taxes. As a species of general partnership, an LLP was not subject to the Texas franchise tax prior to the enactment of the Margin Tax in 2006.[950]

The Margin Tax is expressly imposed on LLPs.[951] 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.[952]

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.[953]

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945 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.

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

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

948 TRPA §§ 3.08(b)(6), (7); TBOC § 152.802(e).

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

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

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

952 TEX. TAX CODE ANN. § 171.0002(a); 2007 H.B. 3928 § 2; *see supra* notes 193-310 and related text.

953 *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 TC 137 (Feb. 9, 2011) (partners'distributive shares of the law firm's income found not to arise as a return on the partners' investment and were not "earnings which are basically of an investment nature;" the attorney partners' distributive shares arose from legal services they performed on behalf of the law firm and were held to be self-employment income); *see*

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.[954]

2. Assumed Name Certificate. Since an LLP is a species of general partnership, prior to House Bill 1239 ("1993 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")[955] like any other general partnership. 1993 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 documents on file in the office of the Secretary of State.[956] 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.[957] 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.[958] 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

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

954 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).

955 TEX. BUS. & COM. CODE § 71.001 *et seq.* (Vernon 2011).

956 *See also* TEX. BUS. & COM. CODE §§ 71.001-71.203 as amended in the 2009 Legislative Session by 2009 S.B. 1442.

957 TEX. BUS. & COM. CODE § 36.02(7) as amended in the 1993 Legislative Session by 1993 H.B. 1239.

958 TEX. BUS. & COM. CODE § 36.10 as amended in the 1993 Legislative Session by 1993 H.B. 1239.

Assumed Name Statute.[959] 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 an LLP.[960]

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.[961] 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,[962] 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.[963] Since the Tex. LLP Stats. shield protects partners only against liabilities incurred while the partnership is an LLP, attainment of LLP status has no effect on pre-existing partnership liabilities. In *Medical Designs, Inc. v. Shannon, Gracey, Ratliff & Miller, L.L.P.*,[964] 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

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

960 TBOC § 152.801(a); *see also* TRPA § 3.08(a)(1). This result is buttressed by the Bar Committee Bill Analysis of 1994 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."

961 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.).

962 *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).

963 *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).

964 922 S.W.2d 626 (Tex. App.—Fort Worth 1996, writ denied).

partnerships."[965] However, there is nothing in the court's opinion suggesting that registration as an LLP is enough to make the partnership a different partnership.[966]

5. Limited Partnership as LLP. A limited partnership can become an LLP simply by complying with the applicable LLP provisions, in which case it would be a "LLLP."[967] 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,[968] 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.,[969] and (iii) contains in its name[970] "limited liability partnership," "limited liability limited partnership" or an abbreviation thereof.[971]

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.[972] 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.[973]

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.[974] It seems inconsistent with the Tex. LLP Stats. to allow a partner to recover, directly or indirectly, from co-partners who are shielded from liability by the same statutes, absent a specific agreement of indemnification.[975] 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

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965 *Id.* at 629.

966 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.

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

968 TRPA § 3.08(b); TBOC § 152.802.

969 TRPA § 3.08(d); TBOC § 152.804.

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

971 TRLPA § 2.14; TBOC § 153.351.

972 TRLPA § 3.03; TBOC § 153.102.

973 TRLPA § 2.14(c); TBOC § 153.353.

974 TRPA § 3.08; TBOC § 152.801.

975 *See Henry v. Masson*, 333 S.W.3d 825 (Tex. App.—Houston [1st Dist.] 2010, no pet.), in which the Court held that the partnership agreement, which provided that if no partner agreed to lend funds needed to discharge the partnership's debts, obligations and liabilities as they came due, each partner was required to timely contribute the partner's proportionate share of funds needed applied in the winding up process and was not inconsistent with the LLP Provisions in TRPA.

authority that a partner who commits malpractice cannot recover from his or her non-negligent copartners.[976] 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,[977] a creditor could argue that the partnership agreement supersedes the shield afforded by the Tex. LLP Stats.[978] 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.[979] The LLP 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.

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

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

> The express negligence doctrine provides that parties seeking to indemnify the indemnitee from the consequences of its own negligence must express that intent in specific terms. Under the doctrine of express negligence, the intent of the parties must be specifically stated within the four corners of the contract. We now reject the clear and unequivocal test in favor of the express negligence doctrine. In so doing, we overrule [prior decisions] stating it is unnecessary for the parties to say, 'in so many words,' they intend to indemnify the indemnitee from liability for its own negligence.
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> * * *
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> The contract between Daniel and Ethyl speaks to 'any loss . . . as a result of operations growing out of the performance of this contract and caused by the negligence or carelessness of [Daniel]. . . .' Ethyl emphasizes the 'any loss' and 'as a result of operations' language to argue an intent to cover its own negligence. We do not find such meaning in those words. The indemnity provision in question fails to meet the express negligence test.

See also Dresser 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).

978 Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 BUS. LAW. 101, 118-120 (Nov. 1997).

979 *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,[980] 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.[981]

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*,[982] the court wrote:

> No one disputed that Archer, Sterquell, and Harris were partners. As such, they were involved in a fiduciary relationship which obligated each to act loyally towards one another and to fully disclose information affecting the partnership and their interests in same. [Citations omitted] So too were each prohibited from personally taking advantage of information unknown to the others but concerning partnership interests. *Id.* (each is a confidential agent of the other, each has a right to know all that the others know). Furthermore, in violating any of these fiduciary duties, the actor committed fraud. [Citations omitted]

9. Foreign LLP Qualification. A foreign LLP doing business in Texas[983] may qualify to do business in Texas like a foreign LLC[984] (the filing fee would be the lesser of

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

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

982 1997 WL 20881, 6 (Tex. App.—Amarillo 1997, writ denied) (not designated for publication).

983 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

(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.

[984] *See* TRPA article X; TBOC Chapter 9 and §§ 152.901-152.914 and 402.001(e).

$200 per resident partner[985] or $750); however, the failure of the foreign LLP to qualify would not affect its LLP shield in Texas.[986] 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.[987]

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.[988] 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."[989]

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,[990] 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.[991]

10. Bankruptcy. Section 723 of the Bankruptcy Code[992] 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

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985 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.

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

987 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.

988 TRPA § 10.01; TBOC §§ 1.101-1.105.

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

990 DEL. CODE ANN., tit. 6, §§ 15-1001–15-1004.

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

992 11 U.S.C. § 723, as amended by Pub.L. 103-394, Title II, § 212, Oct. 22, 1994, 108 Stat. 4125 (the "Bankruptcy Code").

uncertainty as to how this provision would be construed to apply with regard to LLPs which had been authorized by a number of states since the advent of the 1978 Bankruptcy Code, the 1994 amendments to the Bankruptcy Code clarified that a partner of an LLP would only be liable in bankruptcy to the extent that the partner would be personally liable for a deficiency according to the LLP statute under which the partnership was formed.[993]

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.[994] As a result, large accounting firms with offices in most states are likely beyond the reach of the diversity jurisdiction of the Federal courts.[995]

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.[996] The principal case that did not follow this doctrine was a 1938 Texas case, which has been effectively overturned by 1991 H.B. 278.[997] 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.[998]

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."[999]

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993 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.

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

995 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."

996 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).

997 *Means v. Limpia Royalties*, 115 S.W.2d 468 (Tex. Civ. App.—Ft. Worth 1938, writ dism'd).

998 *See* Herbert B. Chermside, Jr., Annotation, *Modern Status of the Massachusetts or Business Trust*, 88 A.L.R. 3d 704 (1978) ("In some jurisdictions a Massachusetts or business trust has been treated as a partnership for some purposes.").

999 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.[1000] 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.[1001] In *Means v. Limpia Royalties*,[1002] 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."[1003]

1000 TRPA § 1.05; TBOC §§ 1.101-1.105.

1001 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).

1002 115 S.W.2d 468, 475 (Tex. Civ. App.—Ft. Worth 1938, writ dism'd).

1003 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

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.[1004] The Bill Analysis[1005] used by the Legislature in connection with the consideration of 1991 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

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partners. Two years after the creation of the trust, but two years prior to the injury, three individuals withdrew from the arrangement by a document which purported to be an amendment to the venture's "agreement of general partnership" and an assumed name certificate was filed in which the defendants were listed as general partners. The court was not persuaded by the defendants' testimony that these actions were erroneous. In holding that the defendants were liable and that the trust was a partnership under Texas law, the court wrote:

> Article 6132b, the Texas Uniform Partnership Act, Section 6, defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit." Section 7 of this Act sets forth certain criteria for determining the existence of a partnership under the Act. Under this section it is provided that with the exception of certain circumstances not here existent, the receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner of the business. TEX. REV. CIV. STAT. ANN. art. 6132a, the Texas Uniform Limited Partnership Act, sets forth the method by which limited partners, who do not wish to be bound by the obligations of the partnership, may carry on a business as a limited partnership. TEX. REV. CIV. STAT. ANN. art. 6138a sets forth the requirements for creation of a Real Estate Investment Trust. Section 8 of that Act provides for limited liability of the shareholders of such a trust. Appellants here do not contend that there was compliance with the requisites of either of these statutes.
>
> Where two or more persons associate themselves as co-owners of a business for profit they become jointly and severally responsible for obligations incurred in the conduct of such business unless they have established, under some applicable statute, an association which the law recognizes as providing limited personal liability.

[1004] 1991 H.B. 278 § 46 Part Seven. Prior to the enactment of 1991 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.

[1005] Bill Analysis of H.B. 278 by Wolens at 10 (1991). *See* 1991 Bill Analysis Summary at 41.

entity affording limited liability, not entitled to qualify under another statute, whether or not characterized as a limited liability company.[1006]

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.[1007] The defendants entered into a contract of partnership in Cuba, which was then ruled by Spanish law. Under the contract, defendant Sarria became a special partner whose liability was expressly limited to a fixed amount. As a special partner under Spanish law, Sarria was entitled to participate in the profits of the partnership, but could not be made liable for its debts. The plaintiffs sought to recover from Sarria a sum of money due under a contract with the partnership.

The court held that the partnership agreement was governed by the laws of Spain[1008] and that the liability of Sarria and the extent of the authority of his partners to bind him[1009] were to be determined by those laws. The court stated:

[1006] "Foreign Limited Liability Company" is broadly defined in LLC Act § 1.02(9) as follows:

> (9) "Foreign Limited Liability Company" means an entity formed under the laws of a jurisdiction other than this state (a) that is characterized as a limited liability company by such laws or (b) although not so characterized by such laws, that elects to procure a certificate of authority pursuant to Article 7.01 of this act, that is formed under laws which provides [sic] that some or all of the persons entitled to receive a distribution of the assets thereof upon the entity's dissolution or otherwise or to exercise voting rights with respect to an interest in the entity shall not be liable for the debts, obligations or liabilities of the entity and which is not authorized to qualify to do business in this state under any other statute.

See also supra notes 867-874 and related text and TBOC §§ 9.001-9.003.

1991 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 1991 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.

[1007] *King v. Sarria*, 69 N.Y. 24 (N.Y. Ct. of App. 1877).

[1008] 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*, 288 U.S. 123 (1933); *Seidman & Seidman v. Wolfson*, 123 Cal. Rptr. 873 (Cal.

> [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.[1010]

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.[1011] However, in reaching this conclusion, the court noted that the Spanish statute resembled New York's own statute for the formation of limited partnerships.[1012]

The 1982 New York case of *Downey v. Swan*[1013] 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

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Ct. App. 1975) (California court held that New York law should determine the rights and obligations among partners in an accounting firm where the partnership agreement so provided); *Hill-Davis Co. v. Atwell*, 10 P.2d 463 (Cal. 1932) (a court will generally refer to the law of the state of the entity's organization to determine the precise nature of the powers or qualities enjoyed by such entity); *Gilman Paint & Varnish v. Legum*, 80 A.2d 906, 29 A.L.R. 2d 236 (Md. 1951) (the liability to third persons of a partner with limited liability is an issue to be determined under Maryland law where the partners were all from Maryland, the partnership agreement was made in Maryland, it was a Maryland partnership in its inception and no representations were made otherwise); *Froelich & Kuttner v. Sutherland*, 22 F.2d 870 (D.C. 1927) (where entity was organized under Philippine statutes, that country's laws determined whether the organization was a general partnership, limited partnership or a corporation).

1009 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.

1010 *Sarria*, 69 N.Y. at 34.

1011 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 (N.Y. Sup. 1918).

1012 The court indicated that the same reasoning would apply to contract and tort claims.

1013 *Downey v. Swan*, 454 N.Y.S. 2d 895 (N.Y. App. Div. 1982).

given full effect.[1014] 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.[1015]

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.*,[1016] although the court granted a motion to transfer a case to a federal court in Texas largely to avoid having to decide numerous questions about the effect of the Texas LLP status[1017]

[1014] *Cf. Schneider v. Schimmels*, 64 Cal. Rptr. 273 (Cal. Ct. App. 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).

[1015] *Cf. Abu-Nassar v. Elders Futures, Inc.*, 1991 U.S. Dist. LEXIS 3794 (S.D.N.Y. Mar. 28, 1991) (treating an LLC organized under Lebanese law as though it were a foreign corporation for purposes of analyzing choice of law and veil piercing liability).

[1016] *Liberty Mutual Insurance Co. v. Gardere & Wynne, L.L.P.*, 1994 WL 707133 (D. Mass. 1994).

[1017] *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;

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. Mfs. Co.*, 313 U.S. 487, 496, 61 S.Ct. 1020, 1021-22 (1941) (federal court in diversity case applies choice of law principles of state in which federal court is located). Thus, Texas law will apply to this question whether or not the case is transferred . . .[1018]

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.[1019] 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.

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(5) With respect to the individual defendants' claims of lack of personal jurisdiction, whether certain Gardere partners who had actually visited Massachusetts from time to time had been agents of other Gardere partners, by operation of general partnership law;

(6) Whether such presence by other Gardere partners constituted agency on behalf of the individual defendants when it occurred prior to the individual defendants' joining the Gardere firm; and

(7) If such agency occurred, whether it was effective with respect to an "income partner" such as Woods, who did not have an equity interest or many of the rights held by equity partners (assuming Woods actually became an income partner).

The court concluded that, despite the deference normally accorded to a plaintiff's choice of forum, the complicated issues stemming from Gardere's uncertain legal status under Massachusetts law, combined with the fact these issues would be moot if the case were transferred to Texas, compelled the court to transfer the litigation to a federal district court sitting in Texas. The court thus saved itself from resolving the many issues it had identified that were produced by the incompatibility of Texas and Massachusetts partnership law by transferring the case to Texas.

[1018] *Gardere & Wynne*, 1994 WL 707133 at *6 n. 7.

[1019] Elizabeth S. Miller, *Procedural and Conflict of Laws Issues Arising In Connection With Multi-State Partnerships*, ABA Bus. L. Sec. (1996 Spring Meeting).

E. Qualification as Foreign Entity and Other Ways to Reduce Extraterritorial Risk. Since all 50 states (including Texas) plus the District of Columbia now have LLC statutes, the LLC extraterritorial risk analysis requires analysis of the applicable LLC statute in each of the states in which the LLC contemplates doing business. Generally qualification as a foreign LLC in a jurisdiction will protect Members' limited liability, but failure to qualify may not result in the loss of limited liability, although it may result in the imposition of statutory penalties. The LLC statutes in Texas, New York and Delaware, which each contain provisions for the registration/qualification of foreign LLCs, expressly provide that the failure of a foreign LLC to so qualify shall not affect the limited liability of its members or managers, which shall be determined by the laws of the LLC's jurisdiction of organization.[1020] 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.[1021]

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.[1022]

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).

1020 LLC Act §§ 7.01, 7.02; N.Y. LLC Law §§ 801, 802 (2006); 6 DEL. CODE §§ 18-901, 18-902 (2013). 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.

1021 DEL. CODE ANN. tit. 6 § 15-1101 et seq (2013); 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.

1022 *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 Beverage Laws Enforcement Comm'n.*, 890 P.2d 1361 (Okla. Civ. App. 1995) (finding that an LLC is not permitted to hold liquor license).

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)[1023] or an LLC that elects to be taxed as a "C" corporation under the Check-the-Box Regulations.[1024] Such an LLC may be preferable to a corporation in closely held situations because of greater governance structuring flexibility.[1025]

If the owners do not want the entity's earnings to be taxed twice under the IRC, the entity selection process becomes more complicated,[1026] and the choices are:

- General partnership[1027]
- LLP[1028]
- Limited partnership[1029]
- LLC that elects to be taxed as a partnership under the Check-the-Box Regulations[1030]
- S-corporation[1031]

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.[1032]

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.[1033]

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,[1034] but has its own limitations:

1023 *See supra* notes 158-168, 360-366 and related text.

1024 *See supra* notes 158-168, 668-891 and related text.

1025 *See supra* notes 748-828 and related text.

1026 *See supra* notes 158-168 and related text.

1027 *See supra* notes 465-554 and related text.

1028 *See supra* notes 892-995 and related text.

1029 *See supra* notes 555-667 and related text.

1030 *See supra* notes 158-168, 668-891 and related text.

1031 *See supra* notes 367-380 and related text.

1032 *See supra* notes 465-554 and related text.

1033 *See supra* notes 892-995 and related text.

1034 *See supra* notes 555-667 and related text.

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;[1035]

2. Limited partners who participate in the management of the business may become liable as general partners, but the limited partnership statutes generally allow a degree of participation without general partner personal liability unless the creditor relied upon the limited partner as a general partner;[1036] 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.[1037]

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;[1038]

(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;[1039] 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.[1040]

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

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1035 *See supra* notes 158-168 and 574-582 and related text.

1036 *See supra* notes 158-168 and 574-582 and related text.

1037 *See supra* notes 193-310 and related text.

1038 *See supra* notes 193-307 and related text.

1039 *See supra* notes 698-710 and related text.

1040 *See supra* notes 996-1022 and related text.

Margin Tax, and there are limitations on its availability under the IRC.[1041] 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
   - Corporation (exception for "qualified subchapter S subsidiary").

IX. TAX COSTS IN CHOICE OF ENTITY DECISION.

A. Assumptions in Following Chart. The following chart compares the taxes that would be paid by different types of entities and their individual owners based on assumed gross receipts, gross margin and net income in 2013. 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 not investment income) and is distributed (after taxes) to its owners. It is also assumed that the individual owners will have earned income or wages in excess of the base amount for the tax year and will therefore be subject to only a 2.9% (3.8% on individual self employment income in excess of $200,000 [$250,000 in the case of a joint return; $125,000 in the case of a married taxpayer filing separately]) Medicare tax on all self employment income (there is no ceiling), and not the 12.40% social security equivalent tax to a base of $113,700 in 2013, which increases for subsequent years as disclosed in note (a) below.

B. 3.8% Unearned Income Medicare Contribution Tax. The following chart does not consider the Unearned Income Medicare Contribution Tax to which individuals, estates and trusts are subject to for tax years beginning after December 31, 2012 on the lesser of net investment income for the tax year or the excess of modified adjusted gross income ("MAGI") for the tax year over a threshold amount. Although the tax is an addition to regular federal income tax liability, it is taken into account for purposes of calculating estimated tax penalties of the individual, estate or trust. The Unearned Income Medicare Contribution Tax in the case of an individual is 3.8% of the lesser of (1) the taxpayer's net investment income for the tax year or (2) the excess of MAGI for the tax year over the threshold amount of $200,000 ($250,000 in the case of joint filers and surviving spouses, and $125,000 in the case of a married taxpayer filing separately). MAGI is the taxpayer's adjusted gross income increased by any foreign earned

[1041] *See supra* notes 367-384 and related text.

income excluded from gross income for the year, less any properly allocable deductions, exclusions or credits. Net investment income for purposes of the Unearned Income Medicare Contribution Tax is the sum of the following items (less any otherwise allowable deductions properly allocable thereto): (i) gross income from interest, dividends, annuities, royalties and rents other than such income derived in the ordinary course of a trade or business other than a passive trade or business; (ii) other gross income from a passive trade or business; and (iii) net gain which is included in computing taxable income of the taxpayer that is attributable to the disposition of property unless such property is held in a trade or business other than a passive trade or business. A passive trade or business for this purpose includes any trade or business of the taxpayer that is either a passive activity or consists of trading financial instruments or commodities. In the case of the disposition of an interest in a partnership or S-corporation, net gain or loss is considered net investment income only to the extent it would be taken into account by the partner or shareholder if all of the property of the partnership or S-corporation were sold at fair market value immediately before the disposition of the interest. Net investment income does not include any distribution from qualified employee benefit plans or arrangements. The Unearned Income Medicare Contribution Tax is not deductible in computing other federal income taxes.

Item	C-Corporation	S-Corp or Limited Liability Company[(b)]	General Partner in General or Limited Partnership[(b)]	Limited Partner in Limited Partnership[(b)]
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 [(c)]	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[(d)]	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[(e)]	2.90	0
Taxable Income of Owner	60.45	91.55[(f)]	91.55[(f)]	93.00
Fed. Tax on Dividends or Income Allocation (at 20%)	12.09	36.25	36.25	36.83
Amount Received After Taxes	**48.36**	**55.30**	**55.30**	**56.17**

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(a) Individuals are subject to a self-employment tax on self-employment income. For 2013 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 2013 contribution base of $113,700 (adjusted annually for inflation), plus (ii) a 2.9% (3.8% on individual self-employment income in excess of $200,000 [$250,000 in the case of a joint return; $125,000 in the case of a married taxpayer filing separately]) tax for hospital insurance ("Medicare") on all self-employment income (there is no ceiling). This self-employment tax is treated as part of the income tax and must also be taken into account for purposes of the estimated tax. A similar addition to Medicare tax applies for FICA purposes. If the taxpayer has wages subject to FICA, then the taxpayer's social security equivalent wage base would be reduced by amount of wages on which these taxes were paid. There is no cap on self-employment income subject to the Medicare tax.

(b) Assumes that the entity is treated as a partnership for federal income tax purposes.

(c) Assumes that (i) Margin Tax is applicable since gross receipts are all in 2013, (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 193-307 and related text. Assumes the business cannot take advantage of exclusions for businesses with $1,030,000 or less in total revenue. Tex. Tax Code § 171.002. Beginning in 2014 the Margin Tax will include an alternative minimum deduction of up to $1 million, and there are temporary rate reductions to .975% in 2014 and .950% in 2015 if certain state revenue targets are met.

(d) 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.

(e) 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 his share of its income but would be subject to employment tax on compensation received.

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

(g) Does not take into account the 3.8% Unearned Income Medicare Contribution Tax on net investment income discussed above under B. 3.8% Unearned Income Medicare Contribution Tax.

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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 applied 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

Texas Law Entity	*Check-the-Box*	*Federal Taxation*	*TX Franchise Tax until 1/1/07*[1042]	*TX Margin Tax 1/1/07*
Proprietorship	**Not Applicable**	**Form 1040, Schedule C or E**	**None**	**None**
LLC / single individual member	**Disregarded**[1043]	**Form 1040, Schedule C or E (Proprietorship)**	**Yes**	**Yes**
LLC / single entity member	**Disregarded**[2]	**Division of Member Entity**	**Yes**	**Yes**
General Partnership or LLP	**Partnership**[1044]	**Partnership**	**None**	**Depends**
General Partnership or LLP	**Corporation**	**C or S-Corp**[1045]	**None**	**Depends**
Limited Partnership	**Partnership**[3]	**Partnership**	**None**	**Yes**
Limited Partnership	**Corporation**	**C or S-Corp**[4]	**None**	**Yes**[1046]
LLC / multi-members	**Partnership**[3]	**Partnership**	**Yes**	**Yes**
LLC / multi-members	**Corporation**	**C or S-Corp**[4]	**Yes**	**Yes**
Corporation	**Not Applicable**	**C or S-Corp**[4]	**Yes**	**Yes**

1042 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 193-311 and related text.

1043 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.

1044 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* notes 158-172 and related text.

1045 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).

1046 Unless LP qualifies as a "passive" entity. Tex. Tax Code § 171.0003. *See supra* notes 207-213 and related text.

APPENDIX C

BUSINESS ORGANIZATIONS CODE
(As Amended through the 83rd Texas Legislature, 2013 Regular Session, and Effective September 1, 2013)

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Appendix D

JOINT VENTURE FORMATION

I. INTRODUCTION

The joint venture is a vehicle for the development of a business opportunity by two or more entities acting together,[1] and will exist if the parties have: (1) a community of interest in the venture, (2) an agreement to share profits; (3) an agreement to share losses, and (4) a mutual right of control or management of the venture.[2] A joint venture may be structured as a corporation, partnership, limited liability company (***"LLC"***), trust, contractual arrangement, or any combination of such entities and arrangements.[3] Structure decisions for a particular joint venture will be driven by the venturers' tax situation, accounting goals, business objectives and financial needs, as well as the venturers' planned capital and other contributions to the venture, and antitrust and other regulatory considerations.[4] Irrespective of the structure chosen, however, certain elements are must be considered in connection with structuring every joint venture.

Because a joint venture is commonly thought of as a limited duration general partnership formed for a specific business activity, the owners of a joint venture are sometimes referred to herein as ***"partners"*** or ***"venturers,"*** and the joint venture as the ***"entity," "partnership"*** or ***"venture,"*** in each case irrespective of the particular form of entity or other structure selected for the joint venture.

II. JOINT VENTURE FORMATION

A. Choice of Entity

A joint venture may take the form of:

(1) Contractual Relationship Not Constituting an Entity Recognized by Statute. The joint venturers may operate under a relationship such as a contractual revenue-sharing joint venture, a lease, a creditor/debtor relationship or some other relationship not constituting an entity. A risk to this 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 traditional definition of a partnership)

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1 *See* James R. Bridges and Leslie E. Sherman, *Structuring Joint Ventures*, 4 Insights 17 (Oct. 1990); David Ernst and Stephen I. Glover, *Combining Legal and Business Practices to Create Successful Strategic Alliances*, 11 Insights 6 (Oct. 1997); Stephen I. Glover, *Joint Ventures and Opportunity Doctrine Problems*, 9 Insights 9 (Nov. 1995); Warren S. de Wied, *Structuring Strategic Equity Investments*, 1 No. 8 M&A Law. 7 (Jan. 1998).

2 *Pitts & Collard, L.L.P. v. Schechter*, No. 01-08-00969-CV, 2011 WL 6938515, at *11 (Tex. App.—Hous. [1st Dist.] Dec. 29, 2011). For additional discussion of whether the agreement is, in fact, a joint venture, see *id.* at *11-12.

3 *See* JOINT VENTURE TASK FORCE OF NEGOTIATED ACQUISITIONS COMMITTEE, MODEL JOINT VENTURE AGREEMENT WITH COMMENTARY (Am. Bar Ass'n., 2006).

4 *See* Byron F. Egan, *Business Entities in Texas after 2011 Texas Legislature*, TexasBarCLE program on Legislative Changes Affecting Business Entities, July 13, 2011, *available at* http://images.jw.com/com/publications/1629.pdf ("***Business Entities Paper***")

regardless of how the venturers characterize and document their relationship.[5] In determining whether the relationship is a partnership, the following factors are considered:

- Receipt or right to receive a share of profits;
- Expression of an intent to be partners;
- Participation or right to participate in control of the business;
- Sharing or agreeing to share losses or liabilities; or
- Contributing or agreeing to contribute money or property to the business.[6]

A contract is sometimes used to establish the relationship among the venturers even though one of the entities referenced below may be the operating vehicle for the joint venture.

(2) General Partnership. A general partnership is an unincorporated association of two or more persons to operate a business as co-owners for profit that is not formed under another statute.[7] The definition of a partnership under Texas general partnership statutes includes a "joint venture" or any other named association that satisfies the definition of

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[5] In *Dernick Resources, Inc. v. Wilstein, et al*, 312 S.W.3d 864, 877 (Tex.App.-Hous. [1st Dist.] 2009, no pet.), 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.

[6] *See Brown v. Keel*, No. 01-10-00936-CV, 2012 WL 760933, at *4 (Tex. App.—Hous. [1st Dist.] March 8, 2012) (citing *Ingram v. Deere*, 288 S.W. 3d 886, 896 (Tex. 2009)); *Westside Wrecker Serv., Inc. v. Skafi*, ___ S.W. 3d ____, 2011 WL 5617748, at *9 (Tex. App.—Hous. [1st Dist.] Nov. 17, 2011); *Hoss v. Alardin*, 338 S.W.3d 635, 641-42 (Tex. App.—Dallas 2011). *See also* Business Entities Paper, *supra* note 4, at *76.

[7] Egan, supra note 4, at 78.

"partnership."[8] A joint venture may be legally nothing more than a limited purpose general partnership, although a joint venture may be organized as a corporation, limited partnership or LLC.[9] A general partnership may become a limited liability partnership (***"LLP"***), which is a general partnership in which the partners are not vicariously liable to third parties for some or all partnership obligations if it makes the requisite filings with the appropriate state secretary of state and complies with certain other state statutory requirements.[10]

(3) Limited Partnership. A limited partnership is a partnership having at least two partners including at least one limited partner and at least one general partner, and that files a certificate of limited partnership with the applicable state secretary of state.[11] A limited partnership can be structured in some states as a limited liability limited partnership (***"LLLP"***), which is a limited partnership in which general partners are not vicariously liable to third parties for some or all partnership obligations.[12]

(4) Limited Liability Company. A limited liability company (***"LLC"***) is an unincorporated organization formed by one or more persons filing a certificate of formation or articles of organization under a state limited liability company act.[13] None of the members of an LLC is personally liable to a third party for the obligations of the LLC solely by reason of being a member.[14]

(5) Corporation. A corporation is a business organization usually formed under a state corporation law, but occasionally is formed under federal law such as certain banking organizations.[15]

There are several factors typically considered in determining the appropriate form of entity or other structure for a joint venture. Key elements usually are:

- How the entity and the venturers will be taxed under federal and state law;[16] and

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8 Texas Business Organizations Code (***"TBOC"***) § 152.051(b); Texas Revised Partnership Act (***"TRPA"***) § 2.02.

9 *See* Alan R. Bromberg and Larry E. Ribstein, *Bromberg & Ribstein on Partnership*, § 2.06 (Aspen Publishers 2010).

10 Egan, supra note 4, at 147-162.

11 *Id.* at 88-105.

12 *Id.* at 164.

13 *Id.* at 106-147.

14 *Id.* at 106.

15 *Id.* at 52-75.

16 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"***) (Treasury Regulations §§ 301.7701-1, -2 and -3), 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, 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 a corporation is classified only as a corporation for IRC purposes, an LLC or

- 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).

Although these two considerations tend to receive the principal focus in the entity choice decision, other factors can be critical: (a) the application of non-tax laws and regulations to the venture and the venturers, (b) the ability of the venturers to order their duties and rights by agreement (e.g. limitation of fiduciary duties), (c) the venturers' exit strategies, (d) the manner in which the venturers will share the economic benefits of the venture, (e) the possible need for additional contributions by new and existing venturers, (f) the manner in which the venturers will make day-to-day and policy decisions of the venture, (g) the agency rules applicable to the venture and (h) particular requirements of the venture's business.

Increasingly, the LLC is the form of entity chosen for domestic joint ventures in the U.S.[17] 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. Owners of a properly structured LLC can obtain both a corporate-styled liability shield and the pass-through tax benefits of a partnership. All equity holders of an LLC have the limited liability of corporate shareholders even if they participate in the business of the LLC. 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.[18] An LLC is subject to Texas Margin Tax.

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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. *See* Byron F. Egan, *Business Entities in Texas after 2011 Texas Legislature*, Texas Bar CLE webcast on Legislative Changes Affecting Business Entities, Texas Bar CLE Webcast, July 13, 2011, at 15-19, *available at* http://images.jw.com/com/publications/1629.pdf.

In addition to federal tax laws, an entity and its advisors must comply with federal anti money laundering and terrorist regulations. 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 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 SND List and OFAC guidance are available on the OFAC website at http://www.ustreas.gov/offices/enforcement/ofac/.

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. 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.

[17] 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), *available at* http://www.abanet.org/dch/committee.cfm?com=CL590000.

[18] Egan, supra note 4, at 2.

An underlying premise of the Texas and Delaware LLC statutes 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.[19] Most of the provisions relating to the organization and management of an LLC and the terms governing its equity interests are contained in the LLC's company agreement, which will typically contain provisions similar to those in limited partnership agreements and corporate bylaws,[20] and may also constitute the joint venture agreement for a joint venture organized as an LLC.[21]

The identity of the specific entities through which the venturers will participate in the venture is another key initial decision. If the joint venture is structured as a partnership, special purpose subsidiaries will typically be used in order to insulate the venturers from liabilities incurred by the venture. A venturer may desire to use a special purpose subsidiary to facilitate a subsequent transfer of all or a portion of its interest in the venture. The use of special purpose subsidiaries may lead to requests for parent company guarantees of subsidiary obligations to other venturers and to the entity.

In addition to the form of entity or arrangement, the organizers need to choose the particular state laws that are to govern the entity. States like Delaware and Texas, which have well-developed statutes and case law relating to the relationship between owners of the joint venture and managers of the entity, are preferable to states where the law is not as well recognized. The state of organization also may affect where evidences of lien rights ("financing statements") need to be filed under Article 9 of the Uniform Commercial Code in secured lending arrangements, and where bankruptcy proceedings may be commenced.

B. Scope and Purpose

A central element of every joint venture is the scope of its business, both as to the types of products, services or technology which the venture is organized to provide, and as to the geographic area or markets in which they will be provided.[22] Where the business of the venture

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19 *Id.* at 114-117.

20 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).

21 *See* JOINT VENTURE TASK FORCE OF NEGOTIATED ACQUISITIONS COMMITTEE, *supra* note 3, at 38.

22 *Id.* at xv-xviii. The ABA Model Joint Venture Agreement was prepared based on an assumed fact pattern in which the proposed joint venture is a Delaware LLC with two members, one of whom has a 60% equity interest (***"Large Member"***) and one of which has a 40% equity interest (***"Small Member"***), and both of which are engaged in manufacturing and selling high tech equipment. They want to contribute their assets relating to existing products to the joint venture on its formation, and collaborate through the joint venture in developing and marketing the next generation of high tech equipment, which they know will have be smaller and more efficient. Although they are competitors, neither has a significant market share in their common products. Independently they will continue to manufacture and distribute other products. Based on this fact pattern, the ABA Model Joint Venture Agreement sets forth in recitals at the front definitions of the "Business" of the proposed joint venture and other terms that will be used throughout the Agreement to define the purposes of the joint venture, which in turn will be used to restrict other activities of the venturers elsewhere in the Agreement, as follows:

is similar to the existing business of one or more of the venturers, it may be necessary to contractually define the activities that may be conducted by the venturers only through the venture and those which the parties may conduct separately.[23]

A. Large Member, through its High Tech Division, and Small Member are each currently engaged in the research, development, manufacturing and distribution of _____ products ("Initial Products"), that each will manufacture on a toll basis for the joint venture and that will be distributed by the joint venture.

B. Large Member, through its High Tech Division, currently distributes its Initial Products in the United States and elsewhere in the world, and Small Member currently distributes its Initial Products in the United States.

C. Large Member and Small Member desire to form a joint venture as a Delaware limited liability company (the "Company") for the distribution of Initial Products and for the research, development, manufacture and distribution of _____ products that are not Initial Products ("New Products;" and with such activities as to the Initial Products and the New Products being the "Business").

[23] *Id.* at 182-86. Article 15 of the ABA Model Joint Venture Agreement prohibits a member from competing with the joint venture during the period it holds an interest therein, and for a specified period thereafter, as follows:

Article 15: Competition

15.1 Competition.

(a) *Generally*. Each Member will not, and will take all actions necessary to ensure that its Affiliates will not, engage in the activities prohibited by this Section 15.1. For purposes of this Section 15.1, the ''Restricted Period'' for a Member lasts for so long as it or any of its Affiliates owns any interest in the Company. In addition, in the case of a Member whose Member Interest is purchased pursuant to Article 10 (Buy-Sell in the Absence of Default) or pursuant to Article 11 (Buy-Sell Upon Default), the Restricted Period lasts until the last day of the 60th full calendar month following the date on which the purchase is closed. Further, in the case of a Member that does not continue the Company's Business following the dissolution of the Company in which the Company's Business is continued by the other Member or by a third party purchaser, the Restricted Period lasts until the last day of the 60th full calendar month following the date on which the Company is wound up.

(b) *Restricted Activities*. Neither the Member nor any of its Affiliates will:

(i) *Non-Competition*: during the Restricted Period, carry on or be engaged, concerned or interested directly or indirectly whether as shareholder, partner, director, employee, member, agent or otherwise in carrying on any business similar to or competing with the Business anywhere in the United States (other than as a holder of not more than five percent of the issued voting securities of any company listed on The Nasdaq Stock Market or any registered national securities exchange);

(ii) *Non-Solicitation of Customers*: during the Restricted Period, either on its own account or in conjunction with or on behalf of any other Person, solicit or entice away or attempt to solicit or entice away from the Company as a customer for the products or services of the Business any Person who is, or at any time within the prior 24 months has been, a customer, client or identified prospective customer or client of the Company;

(iii) *Non-Solicitation of Employees*: during the Restricted Period, either on its own account or in conjunction with or on behalf of any other Person, employ, solicit or entice away or attempt to employ, solicit or entice away from the Company, any Person who is or will have been at the date of or within 24 months before any solicitation, enticement or attempt, an officer, Manager, consultant or employee of the Company or of

A related issue is the extent of the exclusivity of the joint venture. What happens if the joint venture does not have the funds to pursue particular prospects, projects or opportunities within its scope. Further, where the joint venture has its own managers, what will happen if the managers decide not to pursue a particular project or market? Alternatives for dealing with these issues include: (i) make exclusivity absolute (e.g., even though the joint venture cannot or does not pursue a specific opportunity falling within its "scope," all participants are barred from doing so); (ii) allow each participant separately to pursue opportunities which are within the "scope" of the joint venture and which the joint venture management decides not to pursue; or (iii) where one or more participants, but not the required number of participants, vote for the venture to fund and pursue a particular opportunity, only those participants which voted in favor of pursuing the opportunity may pursue it if the venture does not. Where the parent company or any affiliates of a participant have the ability to compete with the joint venture, it may be necessary to get the agreement of such companies, or the covenant of the participant to cause such companies, not to compete with the joint venture.

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the other Member, whether or not that Person would commit a breach of contract by reason of leaving employment; *provided, however,* that the foregoing does not restrict a Member from employing a Manager or officer who was an employee of that Member while serving as a Manager or as an officer of the Company nor does it restrict a Member's general advertisements with respect to a position that are not directed to officers, Managers, consultants or employees of the Company, and *provided, further,* that the Members may agree from time to time that this Section does not apply to specified persons; and

(iv) *Restriction on Use of Trademark and Trade name*: at any time hereafter in relation to any trade, business or company use a name including the word [or symbol] [''_____''] or any similar word [or symbol] in a way as to be capable of or likely to be confused with the name of the Company.

15.2 Distribution. The Company may enter into distribution agreements with independent distributors who currently are distributing products manufactured by a Member. A Member whose products are distributed by an independent distributor after the Closing will not be considered to have breached its obligations under Section 15.1 by virtue of those distribution arrangements. Each Member hereby waives any claim it may have under existing distribution agreements with independent distributors that an independent distributor would have breached of its non-competition obligations under that existing distribution agreement by distributing Products under a distribution agreement with the Company.

15.3 Independent Agreements. The agreements set forth in this Article 15 (and in each Section or other part of this Article 15) are, will be deemed, and will be construed as separate and independent agreements. If any agreement or any part of the agreements is held invalid, void or unenforceable by any court of competent jurisdiction, then such invalidity, voidness or unenforceability will in no way render invalid, void or unenforceable any other part of the agreements; and this Article 15 will in that case be construed as if the void, invalid or unenforceable provisions were omitted.

15.4 Scope of Restrictions. While the restrictions contained in this Article are considered by the Members to be reasonable in all the circumstances, it is recognized that restrictions of the nature in question may not be enforced as written by a court. Accordingly, if any of those restrictions are determined to be void as going beyond what is reasonable in all the circumstances for the protection of the interest of the Members, but would be valid if restrictive periods were reduced or if the range of activities or area dealt with were reduced in scope, then the periods, activities or area will apply with the modifications as are necessary to make them enforceable.

Because common law "business opportunity" doctrines may impose fiduciary duties on the partners to offer business opportunities to the venture,[24] joint venture agreements typically define carefully the scope of the contemplated business of the venture and the extent to which partners may compete with the venture or pursue opportunities that the venture might undertake. Often these matters are dealt with in a separate business opportunity agreement.

C. Funding

Mechanisms should be established for funding the joint venture's activities – both for initial funding and for additional funding during the life of the joint venture. The joint venture's governing documents should state the participants' rights and obligations to make mandatory and optional cash contributions, as well as mandatory and optional loans to the joint venture entity.[25]

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[24] Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, University of Texas School of Law 34th Annual Conference on Securities Regulation and Business Law, Dallas, TX, February 10, 2012, at 78-82, *available at* http://images.jw.com/com/publications/1712.pdf; Byron F. Egan, *Good Faith, Fair Dealing and Other Contractual and Fiduciary Issues*, University of Texas School of Law 2009 Partnerships and LLCs Conference, Austin, TX, July 23, 2009, at 68-70, 78-85 and 102-11, *available at* http://images.jw.com/com/publications/1220.pdf; Kevin G. Abrams and Srinivas M. Raju, *Recent Developments in the Corporate Opportunity Doctrine Under Delaware Law*, 10 Insights 2 (1996).

[25] JOINT VENTURE TASK FORCE OF NEGOTIATED ACQUISITIONS COMMITTEE, *supra* note 3, at 59-64. Article 3 of the ABA Model Joint Venture Agreement provides for initial and additional capital contributions, as well as loans, by the venturers as follows:

> **Article 3: Capital Contributions**
>
> **3.1 Initial Capital Contributions.** Immediately after the completion of the capital contributions for which Section 2.8 (Closing Deliveries) provides, the parties agree that the Book Capital Account of each Member is as follows:
>
> | Name | Initial Book Capital Account |
> |---|---|
> | Large Member | $ |
> | Small Member | $ |
>
> **3.2 Additional Capital Contributions and Member Loans.**
>
> (a) *Mandatory Only If Included in Business Plan*. Each Member will make additional capital contributions (''Additional Capital Contributions'') or loans (''Member Loans'') to the Company in accordance with its Member Interest, but only in the amounts and at the times set forth in the Business Plan as it may be amended from time to time. Neither Member is otherwise required to contribute capital or make Member Loans to the Company.
>
> (b) *Procedure*.
>
> (i) *Generally*. All requirements or requests for Additional Capital Contributions or Member Loans will: (A) be in a notice delivered to each Member by the CEO stating that the Additional Capital Contribution has been approved by the Management Committee in accordance with Section 5.4 (Actions Requiring Management Committee Approval—Major); (B) state the aggregate amount of Additional Capital Contributions or Member Loans and the amount of each Member's share of such Additional Capital Contribution or Member Loan; and (C) specify the date that the Additional Capital

Contribution or Member Loan is to be made, which will not be sooner than twenty Business Days following the Member's receipt of the notice.

(ii) *Accompanying Certificate*. The Members will deliver certificates to the Company and to each other, dated as of the date the Additional Capital Contribution or Member Loan is to be made, that contain reasonable representations and warranties as to such matters as is appropriate (for example, to establish the ability of the Member to comply with its obligations under the Business Plan). In addition, if Additional Capital Contributions are to consist of property other than cash, such certificate will contain reasonable representations and warranties as to the ownership and condition of any such property.

(c) *The Member Loans*. Each Member Loan will be evidenced by a promissory note bearing interest at a fluctuating rate equal to six percentage points over the Prime Rate, but not in excess of any legally permitted rate of interest (the ''Specified Interest Rate''). ''Prime Rate'' means the prime rate as published in the ''Money Rates'' table of *THE WALL STREET JOURNAL* on the first publication day of the calendar quarter in which the loan was made and as adjusted as of the first publication day of each subsequent calendar quarter until paid. Each Member Loan will (i) be for such term and subject to such security, if any, as determined by the Management Committee, (ii) if necessary to secure financing for the Company, be subordinated to any other indebtedness of the Company or a portion of it, (iii) become due and payable in the event the Company is dissolved, (iv) rank pari passu with any and all other Member Loans and (v) be nonrecourse as to the other Member.

3.3 Failure of a Member to Make a Required Additional Capital Contribution or Make a Required Member Loan. If a Member (the ''Non-Contributing Member'') fails to make a required Additional Capital Contribution or make a required Member Loan when due, the other Member (the ''Other Member'') may exercise one or more of the following remedies (but shall not be entitled to any other remedy either in the name of the Other Member or in the name of the Company).

(a) *Proceeding to Compel*. Institute a proceeding either in the Other Member's own name or on behalf of the Company to compel the Non-Contributing Member to contribute the Additional Capital Contribution or Member Loan.

(b) *Loan by Other Member*. Loan to the Company on behalf of the Non-Contributing Member the amount of the Additional Capital Contribution or Member Loan due from the Non-Contributing Member (''Shortfall Loan''), in which case the Non-Contributing Member: (i) will be liable to the Other Member for the amount of such Shortfall Loan, plus all expenses incurred by the Other Member (not including any interest incurred by the Other Member in borrowing the funds used to fund the Shortfall Loan) and the Company in connection with such Shortfall Loan, including reasonable attorneys' fees, and interest at the Specified Interest Rate; and (ii) hereby grants the Other Member a lien on its Member Interest to secure repayment of the Shortfall Loan and constitutes the Other Member as its attorney in fact to file a financing statement on form UCC-1 to perfect such lien; *provided, however,* that the rights under such lien may be exercised by the Other Member only in connection with exercising its rights to purchase such Member's Member Interest in accordance with Section 8.2(a) (Material Default). The Non-Contributing Member will deliver to the Other Member the certificate representing its Member Interest as security for such lien. Any distributions otherwise due from the Company to the Non-Contributing Member will be applied as described in Section 4.4 (Payment of Distributions if Shortfall Loans Outstanding). The Non-Contributing Member will repay the Shortfall Loan in 20 equal quarterly installments plus interest at the Specified Interest Rate. The Non-Contributing Member's failure to make any such payment when due is a Material Default under Section 8.2(a).

(c) *Other Borrowings*. Borrow on behalf of the Company from a lender other than the Other Member the amount of the Additional Capital Contribution or Member

Typically, procedures will be put in place whereby the participants, either directly or through their representatives on the joint venture's board of directors or board of managers, agree upon an annual budget for the venture.[26] Cash required from the participants to fund the

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> Loan due from the Non-Contributing Member on such terms as the Other Member, in its sole discretion, may be able to obtain. In this case, the Non-Contributing Member will be liable to the Company for the principal amount of, and interest on, such borrowing, plus all expenses reasonably incurred by the Company in connection with such borrowing, including reasonable attorneys' fees (also a ''Shortfall Loan''). The Non-Contributing Member's failure to make any such payment when due is a Material Default under Section 8.2(a) (Material Default). The Non-Contributing Member does hereby grant to the Company a lien on its Member Interest to secure repayment of the Shortfall Loan and constitutes the Other Member as its attorney in fact to file a financing statement on form UCC-1 to perfect such lien. The Non-Contributing Member will deliver to the Company the certificate representing its Member Interest as security for such lien. Any distributions otherwise due from the Company to the Non-Contributing Member will be applied as described in Section 4.4 (Payment of Distributions if Shortfall Loans Outstanding).
>
> (d) *Refuse to Make Capital Contribution*. Refuse to make any Additional Capital Contributions or Member Loans to the Company without being in default of any provision of this Agreement.
>
> (e) *Exercise of Article 8 Rights*. Exercise its rights under Article 8 (Dis-solution and Other Rights upon Default).
>
> **3.4 No Withdrawal of or Payment of Interest on Capital.** No Member will have any right to withdraw or make a demand for withdrawal of all or any portion of its Book Capital Account. No interest or additional share of profits will be paid or credited to the Members on their Book Capital Accounts.

[26] *Id.* at 86-9. Section 5.8 of the ABA Model Joint Venture Agreement provides for business plans and budgets of the joint venture as follows:

> **5.8 Business Plan.**
>
> (a) *Initial Business Plan*. The initial business plan (''Business Plan'') attached as Exhibit One covers the first five years of the Company's proposed operations and identifies the items that (i) the Members deem to be critical to the Company's success (a ''Critical Target'') and (ii) if not met, will give one or both Members the rights described in Section 7.2(a) (Fundamental Failure). The Business Plan will include a budget prepared in accordance with Section 5.8(b). The Members intend that the Business Plan be reviewed or modified, as applicable, at least annually. At least 120 days before the beginning of each Fiscal Year, the CEO will deliver to the Management Committee any proposed modifications in the Business Plan.
>
> (b) *Budget Contents*. The budget will include:
>
> (i) a projected income statement, balance sheet and operational and capital expenditure budgets for the forthcoming Fiscal Year;
>
> (ii) a projected cash flow statement showing in reasonable detail: (A) the projected receipts, disbursements and distributions; (B) the amounts of any corresponding projected cash deficiencies or surpluses; and (C) the amounts and due dates of all projected calls for Additional Capital Contributions for the forthcoming Fiscal Year; and
>
> (iii) such other items requested by the Management Committee.
>
> (c) *Consideration of Proposed Plans*. Each proposal to continue or modify a Business Plan will be considered for approval by the Management Committee at least 90 days before the beginning of the Fiscal Year to which it pertains. The Management Committee may revise the proposed Business Plan or direct the CEO to submit revisions to the Management Committee.

venture's operations under the agreed budget is then frequently provided on the call of the venture's senior manager, based on an agreed schedule. An issue related to the cash funding of the joint venture is the contribution of services, technology, products, or other assets to the joint venture. To the extent that a participant will be making any such non-cash contributions, a procedure should be established at the outset of the venture for the valuation of such contributions.

D. Allocations and Distributions

Subject to various limitations imposed by tax laws, the participants have great flexibility in structuring the allocation and distribution of profits, losses and other items.[27] For example,

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(d) *Continuation of Existing Business Plan*. Until a revised Business Plan is approved, the Company will be managed consistently with the last Business Plan approved by the Management Committee, adjusted as necessary to reflect the Company's contractual obligations and other changes that result from the passage of time or the occurrence of events beyond the control of the Company.

[27] *Id.* at 64-9. Article 4 of the ABA Model Joint Venture Agreement provides for the allocation of profits and losses and distributions as follows:

Article 4: Allocation of Profits and Losses; Distributions

4.1 Shares of Profits and Losses. Each Member will share in the Company's profits and losses in accordance with its Member Interest. A Member's share of the taxable income or loss or other tax items of the Company will be determined in accordance with Attachment 12 (Tax Provisions).

4.2 Definitions.

(a) *Cash Flow from Operations*. ''Cash Flow from Operations'' means all cash available to the Company from its Ordinary Course of Business activities remaining after payment of current expenses, liabilities, debts or obligations of the Company (other than principal or interest on Member Loans).

(b) *Other Available Cash*. ''Other Available Cash'' means cash generated by the Company's activities outside its Ordinary Course of Business activities.

(c) *Tax Amount*. The ''Tax Amount'' is the product of (i) the Effective Tax Rate and (ii) the Company's Cumulative Net Taxable Income. The Tax Amount will not be in excess of the product of (A) the Effective Tax Rate and (B) the Company's taxable income for the Fiscal Year of the determination. For purposes of the foregoing:

(i) *Effective Tax Rate*. The ''Effective Tax Rate'' is the highest U.S. corporate income tax rate for that year plus the federal tax-effected state and local income tax rate in effect at the principal office of the Company.

(ii) *Cumulative Net Taxable Income*. The ''Cumulative Net Taxable Income'' is determined at the end of the Company's Fiscal Year with respect to which the Tax Amount is to be determined and is the sum of all taxable income for the current and all prior Fiscal Years reduced by the sum of all taxable losses for the current and all prior Fiscal Years.

4.3 Distributions. Distributions are made in the following priority:

(a) *Distribution of Tax Amount*. At least ten Business Days before each date when a U.S. corporate estimated income tax payment is due, the Company will distribute, from Cash Flow from Operations (or, if necessary, from Other Available Cash), to each Member its share of the Tax Amount estimated by the Company to have accrued during the estimated tax period before the distribution date. No later than 65 days after the end of the Company's Fiscal Year, the Company will distribute, from Cash Flow from

Operations (or, if necessary, from Other Available Cash), to each Member its share of any previously unpaid Tax Amount for such Fiscal Year.

(b) *Reserves*. The Management Committee will establish reserves from Cash Flow from Operations for:

(i) contingent or unforeseen obligations, debts or liabilities of the Company, as the Management Committee deems reasonably necessary;

(ii) amounts required by any Contracts of the Company; and

(iii) such other purposes as decided upon by the Management Committee.

(c) *Pay Member Loans*. Member Loans will be paid from Cash Flow from Operations (or, if necessary, from Other Available Cash) as follows:

(i) If the terms of Member Loans state the order of priority of payment of principal and interest, then those priority rules will apply.

(ii) Otherwise, the Company: (A) first will pay interest due on the Member Loans, on a proportionate basis without preference, in accordance with the total amount of interest outstanding on all Member Loans; and (B) then will pay the principal due on the Member Loans, on a proportionate basis without preference, in accordance with the total amount of principal outstanding on all Member Loans.

(d) *The Balance*. Subject to Section 4.4, the Company will distribute the balance, if any, of Cash Flow from Operations to the Members in accordance with their Member Interests within 90 days after the end of the Company's Fiscal Year.

(e) *Other Available Cash*. Distributions of Other Available Cash are to be made in such amounts and at such times as determined by the Management Committee, taking into account the needs of the Company and the distribution policy set forth in Section 4.8. If there is not enough Cash Flow from Operations to make all the distributions provided for in Sections 4.3(a) and 4.3(c), Other Available Cash will be used to make the distributions in the priority specified in such Sections.

4.4 Payment of Distributions if Shortfall Loans Outstanding. If a Shortfall Loan is outstanding, any distribution made pursuant to Section 4.3 to which the Non-Contributing Member otherwise would be entitled will be considered a distribution to the Non-Contributing Member. The distribution, however, will be paid directly to the Other Member if the other Member has made a Shortfall Loan. Such distribution will be applied first against interest and then against principal, until all accrued interest and principal of Shortfall Loans are repaid in full. The distribution then will be applied against expenses, in the same manner as provided in Section 3.3(c) (Other Borrowings). If there are two or more Shortfall Loans outstanding to the Non-Contributing Member, any distribution paid pursuant to this Section will be applied to such Shortfall Loans on a first-in, first-out basis. If the Company has borrowed money under Section 3.3(c) (Other Borrowings), the Non-Contributing Member's distribution will be used to pay principal and interest on such loans.

4.5 No Priority. Except as otherwise provided in this Agreement, no Member will have priority over any other Member as to the return of capital, allocation of income or losses, or any distribution.

4.6 Other Distribution Rules. No Member will have the right to demand and receive property other than cash in payment for its share of any distribution. Distribution of non-cash property may be made with the consent of both Members. The preceding sentence expressly overrides the contrary provisions of DLLCA § 18–605 as to non-cash distributions.

4.7 Liquidating Distribution Provisions. Subject to Section 4.4 (Payment of Distributions of Shortfall Loans Outstanding), distributions made upon liquidation of any Member Interest will be made in accordance with the positive Book Capital Account balance of the Member. These balances will be determined after taking into account all

where the joint venture entity in partnership form is expected to have substantial operating losses in its early years, the partners may allocate a disproportionate share of the losses to participants who have income against which to offset such losses, while allocating a disproportionate share of any other benefits or net income in future years to the other participants. The provisions of a venture's governing documents are typically structured in such a manner as to maximize all available financial benefits, whether they be in the form of income, gains, losses, deductions, tax credits or other items.

E. Governance and Management

The venture's governing documents (whether in the form of a shareholders agreement, partnership or LLC agreement or otherwise) usually specify the mechanics of the overall governance and the day-to-day management of the venture's affairs.[28] Typically, this will

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Book Capital Account adjustments for the Company's Fiscal Year during which the liquidation occurs.

4.8 Distribution Policy. The Members recognize the need for the Company to fund its own growth. Accordingly, funds of the Company will be retained for this purpose, and no distribution under Sections 4.3(d) (Balance) or 4.3(e) (Other Available Cash) will be paid to the Members, until and so long as the Company's Cash Flow from Operations net of reserves established pursuant to Section 4.3(b) (Reserves) exceeds the level required to be self-sustaining, without the need for further investment by the Members.

4.9 Limitation upon Distributions. No distribution will be made to Members if prohibited by DLLCA § 18–607 or other Applicable Law.

[28] *Id.* at 71-83. Sections 5.1 – 5.5 of the ABA Model Joint Venture Agreement provide for the governance of the LLC as follows:

5.1 Management Committee.

(a) *Managers*. The business and affairs of the Company will be managed exclusively by or under the direction of a committee (the ''Management Committee'') consisting of four individuals (each a ''Manager''). Except for the right to appoint a delegate in Section 5.2(f) (Delegation) and for the delegation of authority to Officers provided in Section 5.7 (Other Officers and Employees), no Manager may delegate his rights and powers to manage and control the business and affairs of the Company. The foregoing expressly override the contrary provisions of DLLCA § 18–407.

(b) *Initial Appointment; Replacement*. Each Member will appoint two Managers, unless otherwise provided by Section 8.3(c) (Management Changes). The initial appointments by each Member are as follows:

Large Member	Small Member
_____	_____
_____	_____

By written notice to the other Member and Managers, a Member may in its sole discretion remove and replace with or without cause either or both of its appointed Managers with other individuals. A Manager may be an officer or employee of a Member or of an Affiliate of a Member. Each Manager will serve on the Management Committee until his successor is appointed or until his earlier death, resignation or removal.

(c) *Compensation and Expenses of Managers*. Each Member will pay the compensation and expenses of the Managers it appoints.

(d) *Right to Rely on Manager Certificate*. Any Person dealing with the Company may rely (without duty of further inquiry) upon a certificate signed by any Manager as to (i) the identity of any Manager or Member, (ii) the existence or nonexistence of any fact or facts that constitute a condition precedent to acts by the Management Committee or that are in any other manner germane to the affairs of the Company, (iii) the Persons who are authorized to execute and deliver any instrument or document of the Company, or (iv) any act or failure to act by the Company or any other matter whatsoever involving the Company, any Manager or any Member.

(e) *Signing on Behalf of the Company*.

(i) *Generally*. Except as otherwise provided in Section 5.1(e)(ii) or as required by law but without limiting Section 5.6(c)(v) (CEO-Authority), the signature of any Manager (or other individual to whom the Management Committee has delegated appropriate authority) is sufficient to constitute execution of a document on behalf of the Company. A copy or extract of this Agreement may be shown to the relevant parties in order to confirm such authority.

(ii) *Deeds, Certain Promissory Notes, etc*. The signature of the Chair of the Management Committee is required (A) to convey title to real property owned by the Company or (B) to execute (1) promissory notes with respect to indebtedness for borrowed money in excess of $_____ and related trust deeds, mortgages and other security instruments and (2) any other document the subject matter of which exceeds $_____ or that binds the Company for a period exceeding one year.

(f) *No Authority of Members to Act on Behalf of the Company*. Except as otherwise specifically provided in this Agreement, no Member will act for, deal on behalf of, or bind the Company in any way other than through its representatives (acting as such) on the Management Committee.

5.2 Management Committee Meetings.

(a) *Meetings*. The Management Committee will hold regular meetings (at least quarterly) at such time and place as it determines. Any Manager or the Chair may call a special meeting of the Management Committee by giving the notice specified in Section 5.2(g).

(b) *Chair*. The chairperson of the Management Committee (''Chair'') will be one of the two Managers who are appointed by Large Member. The initial Chair is_____. The Chair will preside at all meetings of the Management Committee.

(c) *Participation*. Managers may participate in a meeting of the Management Committee by conference video or telephone or similar communications equipment by means of which all persons participating in the meeting can hear each other. Such participation will constitute presence in person at the meeting.

(d) *Written Consent*. Any action required or permitted to be taken at any meeting of the Management Committee may be taken without a meeting upon the written consent of the number and identity of Managers otherwise required to approve such matter at a Management Committee meeting. Each Manager will be given a copy of the written consent promptly after the last required signature is obtained. A copy of the consent will be filed with the minutes of Management Committee meetings.

(e) *Minutes*. The Management Committee will keep written minutes of all of its meetings. Copies of the minutes will be provided to each Manager.

(f) *Delegation*. Each Manager has the right to appoint, by written notice to the other Managers, any individual as his delegate. That delegate may attend meetings of the Management Committee on his behalf and exercise all of such Manager's authority for all purposes until the appointment is revoked.

(g) *Notice*. Written notice of each special meeting of the Management Committee will be given to each Manager at least five Business Days before the meeting and will identify the items of business to be conducted at the meeting. No business other

than those items listed in the notice may be conducted at the special meeting, unless otherwise expressly agreed by all the Managers. The notice provisions of this Section may be waived in writing and will be waived by a Manager's attendance at the meeting, unless the Manager at the beginning of the meeting or promptly upon his arrival objects to holding the meeting or transacting business at the meeting and does not thereafter vote for or assent to action taken at the meeting.

5.3 Voting of Managers; Quorum.

(a) *Generally*. Each Manager will have one vote, subject to Section 5.3(b). Except as otherwise provided in Section 5.4, all actions by the Management Committee will require the approval of a majority of the Managers present at a meeting at which a quorum exists.

(b) *Chair's Additional Vote*. If (i) Large Member is not a Defaulting Member (see Section 8.2) and (ii) there is a tie vote of the Managers on an action other than those described in Section 5.4, then the Chair will have an additional vote on such action.

(c) *Quorum*. Three Managers will constitute a quorum for the transaction of business, unless (i) a duly called meeting is adjourned because (A) neither of the Managers appointed by a Member attends that meeting and (B) neither of the Managers appointed by that Member attends a meeting duly called as to the same items of business of the adjourned meeting within thirty days after the adjournment of that first meeting and (ii) notice of both meetings complied with Section 5.2(g). In such event, two Members will constitute a quorum for the transaction of business.

5.4 Actions Requiring Management Committee Approval—Major.

The following actions require the approval of both (1) a majority of the Managers present at a meeting at which a quorum exists and otherwise in accordance with Section 5.3 and (2) at least one Manager appointed by each Member:

(a) amendment of this Agreement;

(b) admission of additional Members;

(c) approval of any new Business Plan or material modification of an existing Business Plan (for this purpose, any change by 10% or more during any Fiscal Year of any line item in the budget that is included in the Business Plan, any change in a Critical Target and any Additional Capital Contribution will be considered material);

(d) merger or combination of the Company with or into another Person;

(e) sale or other disposition of all or substantially all of the Company's assets;

(f) any material change in the Business, in particular, entering into the manufacture and/or sale of a new line of products or adopting a new line of business or a new business location;

(g) any material change in accounting or tax policies of the Company;

(h) conversion of the Company to another form of legal entity;

(i) entering into or amending the terms of any transaction or series of transactions between the Company and any Member, any Affiliate of a Member, or any Manager or Affiliate of a Manager; and

(j) amendment of any Related Agreement.

5.5 Actions Requiring Management Committee Approval—Other. The following actions require the approval of (1) a majority of the Managers present at a meeting at which a quorum exists and otherwise in accordance with Section 5.3 (Voting of Managers; Quorum) **but** (2) not the separate approval of at least one Manager appointed by each Member:

(a) any change in the Company's auditors (if the new auditor will be an independent, nationally recognized accounting firm);

involve a board of directors or managers of the joint venture entity on which each of the participants may have representation more or less proportional to its percentage interest in the joint venture. Sometimes, provision is made for an independent member of the board, appointed by the agreement of the participants, in order to protect against board deadlock over operational issues.[29]

Additionally, it is common to provide that certain key decisions may be made only with the unanimous, or a supermajority, approval of the board or the members. Such key decisions often include the following matters (often with materiality parameters): (1) capital expenditures in excess of specified amounts; (2) incurring indebtedness; (3) initiating or settling litigation; (4) entering into contracts involving more than an agreed sum; or (5) entering into contracts with a joint venture participant or any of its affiliates.

The venture's governing documents typically specify the types of officers and other managers who will conduct the day-to-day operations of the venture. Provision is also typically made for the removal and replacement, compensation and other benefits, and indemnification of board members, officers and other managers.

F. Restrictions on Transfer of Joint Venture Interests

Joint ventures are entered into between a limited number of parties (typically two) who respect each other and believe the others can contribute substance and funding to the venture over an extended period. As a result, provision is typically made to restrict the participants' transfer of their joint venture interests and for the admission and withdrawal of participants to the joint venture. Typically, a participant's ability to transfer its interest is restricted to transfers to wholly-owned subsidiaries (and perhaps other affiliates) and then only so long as the transfer

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(b) any change by less than 10% during any Fiscal Year of any line item in the budget that is included in the Business Plan or any other change in the Business Plan that does not require approval under Section 5.4(c);

(c) any establishment of reserves under Section 4.3(b) (Reserves) and other applicable provisions of this Agreement;

(d) the incurring of indebtedness for borrowed money in excess of $_____;

(e) the entering into of contracts, or series of related contracts, obligating the Company in excess of $_____;

(f) the acquisition or disposition of any interest in any other business or the participation in any increase or reduction of capital of any other business that is within the budget and consistent with the Business Plan;

(g) the purchase of real estate or other fixed assets or the sale and disposition of real estate or other fixed assets at a price of or valued at more than $_____;

(h) the lending or advancing of any monies, including the guaranteeing or indemnifying of any indebtedness, liability or obligation of any Person other than the granting of trade credit and other than in the Ordinary Course of Business as established in the then-current budget; and

(i) the creation of, the permitting to exist for more than 15 days of, or the assumption of any Encumbrance upon Company assets that have an aggregate value in excess of 10% of the aggregate value of the Company's total assets; *provided, however,* that the renewal of existing Encumbrances is not included in this limitation.

[29] *See* Stephen Glover, et al., *Recent Trends in Joint Venture Governance*, 26 INSIGHTS 2 (Feb. 2012).

causes no adverse tax consequences to the joint venture or any of the other participants. A transfer of an interest to a third party can make the other parties wish to dissolve the venture or at least have the right to approve their new partner, and ordinarily are more restricted. Sometimes such transfers are entirely prohibited, although such a provision may make it necessary for the participants to have the right to unwind the venture unilaterally. Alternatively, transfers to third parties may be permitted only where the other participants have a right of first refusal to buy the interest to be transferred. A right of first refusal may apply either from the inception of the venture or after a specified number of years during which no third-party transfers are permitted. To facilitate the right of first refusal mechanism, it may be helpful to require third-party transfers to be solely for cash consideration and separate and apart from transfers of other property. The ability to make transfers to third parties is also frequently limited by the establishment of specific objective criteria which a party must satisfy in order to qualify as an acceptable transferee. These criteria might include a required minimum net worth for a transferee, a requirement that the transferee not be a competitor of the non-transferring venturer, a requirement that the transferee not be owned or controlled by foreign persons (particularly if the venture has government contracts), or any number of other matters

When preparing transfer restriction provisions, indirect transfers by a change in control of a participant should be considered. A change in control may be defined to include (i) a transfer of stock in a venturer by its ultimate parent entity, (ii) a change in management in the venturer in which specified individuals cease to be in control or (iii) a change in control of an ultimate parent entity.

G. Defaults

Joint venture agreements often specify the events constituting an event of default by a venture participant and the remedies of the other participants upon a default.[30] The participants'

[30] Article 8 of the ABA Model Joint Venture Agreement defines and establishes remedial processes for defaults by venturers as follows:

> **Article 8: Dissolution and Other Rights Upon Default**
>
> **8.1 Applicability.** This Article applies only if (a) only one Member is a Defaulting Member, in which case the Non-Defaulting Member may elect to terminate the Company in accordance with Section 8.3 (Remedies Upon Default by One Member), or (b) both Members are Defaulting Members, in which case Section 8.4 (Remedies if Both Members are Defaulting Members) will apply.
>
> **8.2 Definitions—Defaulting Member and Non-Defaulting Member and Default Event.** ''Defaulting Member'' is a Member with respect to which any Default Event has occurred. A ''Non-Defaulting Member'' is a Member with respect to which no Default Event has occurred. Each of the following is a ''Default Event'':
>
> (a) *Material Default*. Any material default by the Member in the performance of any covenant in this Agreement or in the performance of any material provision of any Related Agreement, which default continues for a period of 30 days after written notice thereof has been given by the Non-Defaulting Member to the Defaulting Member. A ''material default'' under this Section includes (i) any failure to make when due an Additional Capital Contribution or to make a required Member Loan in accordance with Section 3.2 (Additional Capital Contributions and Member Loans), (ii) any failure to make any payment when due under a Member Loan (See Section 3.2(c)—The Member Loans), (iii) any failure to make any payment when due under a Shortfall Loan (See

Section 3.3(b)—Loan by Other Member) and (iv) a Critical Target Failure that is the result of a breach by a Member.

(b) *Material Breach*. A breach of any representation or warranty contained in Sections ____, ____ and ____ of Attachments 2.4-A or -B, any breach of which will be deemed to be a material breach for purposes of this Agreement.

(c) *Termination of Existence by a Member*. A Member commences any proceeding to wind up, dissolve or otherwise terminate its legal existence.

(d) *Termination of Existence by another Person*. Any Proceeding commenced against a Member that seeks or requires the winding up, dissolution or other termination of its legal existence; except if the Member defends or contests that Proceeding in good faith within 15 days of its commencement and obtains a stay of that Proceeding within 90 days of its commencement, a Default Event will not exist so long as the stay continues and the Member pursues the defense or contest diligently thereafter or the Proceeding is dismissed.

(e) *Dissociation*. The Member dissociates from the Company in violation of the prohibition against withdrawal in Section 2.3 (Term).

(f) *Prohibited Transfer*. The Member agrees to any transaction that would, if consummated, breach or result in a default under Section 6.1 (Restrictions on Transfer of Member Interests).

(g) *Change of Control*. There is a Change of Control of the Member or Person directly or indirectly controlling the Member, including a transfer pursuant to Section 6.2 (Assignment to Controlled Persons) (each a ''Target''). A ''Change of Control'' occurs when any of the following occurs:

(i) *Change in Ownership*. Any Person or group of Persons acting in concert acquires or agrees to acquire, directly or indirectly, either (A) that percent of the ownership interests of the Target that will provide the acquirer with a sufficient number of the Target's ownership interests having general voting rights to elect a majority of the directors or corresponding governing body or (B) in the case of a Target that has a class of securities registered under section 12 of the Securities Exchange Act of 1934, as amended, or that is subject to the periodic reporting requirements of that act by virtue of section 15(d) of that act, more than 30% of the Target's ownership interests having general voting rights for the election of directors or corresponding governing body.

(ii) *Board Approval of Acquisition*. The Target's board of directors or corresponding governing body recommends approval of a tender offer for 50% or more of the outstanding ownership interest of the Target.

(h) *Insolvency Proceeding*. If any of the following occurs: (i) the Member seeks relief in any Proceeding relating to bankruptcy, reorganization, insolvency, liquidation, receivership, dissolution, winding-up or relief of debtors (an ''Insolvency Proceeding''); (ii) the institution against the Member of an involuntary Insolvency Proceeding; *provided, however,* that if the Member defends or contests that Insolvency Proceeding in good faith within 15 days of its commencement and obtains a stay of that Proceeding within 90 days of its commencement, a Default Event will not exist so long as the stay continues and the Member pursues the defense or contest diligently thereafter or the Proceeding is dismissed; (iii) the Member admits the material allegations of a petition against the Member in any Insolvency Proceeding; or (iv) an order for relief (or similar order under non-U.S. law) is issued in any Insolvency Proceeding.

(i) *Appointment of a Receiver or Levy*. Either (i) a Proceeding has been commenced to appoint a receiver, receiver-manager, trustee, custodian or the like for all or a substantial part of the business or assets of the Member or (ii) any writ, judgment, warrant of attachment, warrant of execution, distress warrant, charging order or other similar process (each, a ''Levy'') of any court is made or attaches to the Member's Member Interest or a substantial part of the Member's properties; *provided, however,* that

if the Member defends or contests that Proceeding or Levy in good faith within 15 days of its commencement and obtains a stay of that Proceeding or Levy within 90 days of its commencement, a Default Event will not exist so long as the stay continues and it pursues the defense or contest diligently thereafter or the Proceeding is dismissed.

(j) *Assignment for Benefit of Creditors*. The Member makes a general assignment for the benefit of creditors, composition, marshalling of assets for creditors or other, similar arrangement in respect of the Member's creditors generally or any substantial portion of those creditors.

8.3 Remedies—Upon Default by One Member.

(a) *By Non-Defaulting Member*. A Non-Defaulting Member may, within 90 days of becoming aware of the occurrence of a Default Event, give notice of the Default Event (a ''Default Notice'') to the Defaulting Member. The Default Notice must specify one of the following remedies (which, together with Section 8.3(c) and subject to Section 8.3(b), are exclusive remedies):

(i) *Dissolution*. Dissolution of the Company in accordance with Article 9 (Dissolution Procedures).

(ii) *Right to Buy*. The purchase of the Defaulting Member's Member Interest for 90% of Fair Market Value and otherwise in accordance with Article 11 (Buy-Sell Upon Default). The Non-Defaulting Member must propose the Fair Market Value in the Default Notice, which must be accompanied by a deposit in immediately available funds equal to 25% of the Defaulting Member's Book Capital Account as reflected in the annual financial statements of the Company for the Fiscal Year immediately preceding the year in which the Default Notice is given.

(iii) *Right To Sell*. The sale of the Non-Defaulting Member's Member Interest to the Defaulting Member for 100% of Fair Market Value and otherwise in accordance with Article 11 (Buy-Sell upon Default). The Non-Defaulting Member must propose the Fair Market Value in the Default Notice.

(b) *Other Remedies*.

(i) *Generally*. The Non-Defaulting Member's election to dissolve the Company under Article 9 (Dissolution) will not preclude its exercise of whatever rights it may also have under Article 14 (Indemnification) or at law. However, the Non-Defaulting Member's election to purchase the Defaulting Member's Member Interest under Section 8.3(a)(ii) (Right To Buy) or to sell its Member Interest under Section 8.3(a)(iii) (Right To Sell) is the election of an exclusive remedy.

(ii) *Certain Other Rights*. Notwithstanding the foregoing, no election under Section 8.3(a) will preclude either (A) the appointment of additional Managers by Small Member under Section 8.3(c) if Small Member is the Non-Defaulting Member, (B) the recourse by either the Defaulting Member or the Non-Defaulting Member to whatever injunctive relief to which it may otherwise be entitled under this Agreement or any Related Agreement or (C) the recourse by the Non-Defaulting Member under § 2.11(b) (Actions by Company) to recover amounts owing to the Company that are not specifically taken into account in the determination of Fair Market Value.

(iii) *Legal Fees and Expenses*. The Non-Defaulting Member's legal fees and expenses will be deducted from any distribution otherwise to be made to the Defaulting Member and will be paid to the Non-Defaulting Member or, if the Non-Defaulting Member elects, will be paid by the Defaulting Member to the Non-Defaulting Member.

(c) *Management Changes*. In addition to other rights a Member may have under this Section 8.3:

(i) if Small Member is the Non-Defaulting Member and it elects in its Default Notice the remedy in Section 8.3(a)(ii) (Right To Buy), it may, by simultaneously giving notice to the Defaulting Member and each Manager, also (A) appoint that number of additional Managers that will give Small Member a majority of the members of the

obligations to each other and to the joint venture may extend beyond funding and non-competition to such things as the provision of goods, services or personnel to the venture. A default in any of these obligations may be deemed a default under the joint venture agreement.

The participants may desire to structure disincentives to default, such as liquidated damages or other penalty provisions. Moreover, it may provide the non-defaulting participants with the right to buy out the interest of a defaulting participant, or to cause the dissolution of the joint venture, in addition to any damages resulting from the default. A purchase price for a buy-out provision of this type may be a specified discount from the fair market value of the interest as determined by a pre-established formula, by agreement of the parties or through a determination by a third party.

Where the joint venture obligations of a participant are guaranteed through a parent or other affiliate guarantee, certain circumstances or events in respect of the guarantor may also be deemed a default by the participant under the joint venture agreement. For example, the

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Management Committee, (B) cause a simple majority of the members of the Management Committee to constitute a quorum, and (C) appoint the Chair of the Management Committee. Concurrently with that appointment, the appointee of Large Member will cease to be the Chair. However, in all cases the consent of at least one Manager appointed by each Member will continue to be required for the matters specified in Section 5.4 (Actions Requiring Management Committee Approval—Major); or

(ii) if the Non-Defaulting Member (which may be either Small Member or Large Member) elects in its Default Notice the remedy in Section 8.3(a)(i) (Dissolution), then concurrently with that notice and thereafter until the dissolution is completed or is terminated (A) the Non-Defaulting Member or its duly appointed representative will assume all of the powers and rights of the Management Committee and (B) its actions (1) will have the same effect as if taken by unanimous vote of the members of the Management Committee before the assumption and (2) will be deemed to include the consent of one Manager appointed by each Member to the matters specified in Section 5.4 (Actions Requiring Management Committee Approval—Major).

The management changes set forth in this Section 8.3(c) shall have effect only for so long as the Non-Defaulting Member is actively pursuing the remedy it elected under Section 8.3(a).

(d) *Effect of Notice*. If the Non-Defaulting Member elects in its Default Notice the remedy in Section 8.3(a)(i) (Dissolution), it will carry out that dissolution in accordance with Article 9 (Dissolution Procedures). If the Non-Defaulting Member elects in its Default Notice either to buy under Section 8.3(a)(ii) or to sell under Section 8.3(a)(iii) (and, in the former case, makes the required deposit), the Members will complete that purchase or sale, as applicable, in accordance with Article 11 (Buy-Sell Upon Default).

8.4 Remedies if Both Members are Defaulting Members. If both Members are, or become, Defaulting Members, simultaneously or sequentially, before a sale of a Member Interest under Section 8.3(a)(ii) or Section 8.3(a)(iii) has been completed, then notwithstanding any election previously made by a Non-Defaulting Member or steps taken to further such election, then (a) the Members and the Managers will proceed as expeditiously as possible to dissolve the Company in accordance with Article 9 (Dissolution Procedures) (other than Section 9.1(b)) as though such dissolution resulted from an election pursuant to Section 8.3(a)(i), and (b) both Defaulting Members will thereafter have whatever rights and remedies available to them under Article 14 (Indemnification) and under Applicable Law.

bankruptcy of a participant's guarantor may be deemed a default by the participant under the joint venture agreement.

H. Dispute Resolution

The joint venture agreement may provide for any number of dispute resolution mechanisms, including litigation, arbitration or other alternative forms of dispute resolution.[31] Whatever the mechanism provided, it is frequently provided that before any participant resorts to any such mechanism the dispute must be referred to specified senior level officers or managers of each participant for resolution. It is also important to provide for continued operation of the joint venture entity during the pendency of any dispute.

I. Termination

The joint venture governing documents typically specify the events, if any, which will cause a termination of the joint venture. Some agreements include a "termination for convenience" provision, under which any participant can force a termination of the joint venture, perhaps after a set period of time such as five years.[32] The joint venture agreements often

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[31] *Id.* at 89-91. Article 5.9 of the ABA Model Joint Venture Agreement establishes dispute resolution procedures for disagreements regarding modifications to the Business Plan or the failure to obtain requisite approvals for specified actions as follows:

> **5.9 Dispute Resolution Procedures.**
>
> (a) *Failure to Approve Actions Requiring Special Approval by Management Committee*. If the Management Committee has disagreed regarding (i) modifications to the then-current Business Plan and the disagreement has not been resolved at least ten Business Days before the beginning of the next Fiscal Year or (ii) any other action listed in Section 5.4 (Actions Requiring Management Committee Approval—Major) when properly submitted to it for a vote (either of which, a ''Business Dispute''), then the Managers will consult and negotiate with each other in good faith to find a mutually agreeable solution. If the Managers do not reach a solution within ten Business Days from the date the disagreement occurred and the failure to reach a solution, in a Member's judgment, materially and adversely affects the Company, then that Member may give notice to the other Member initiating the procedures under this Section (a ''Dispute Notice'').
>
> (b) *Consideration by Member Executives*. Within two Business Days after the giving of the Dispute Notice, the Business Dispute will be referred by the Managers to the senior executive of each Member to whom the respective Managers report (each a ''Member Executive'') in an attempt to reach resolution. If the Member Executives are unable to resolve the Business Dispute within ten Business Days after the date of the Dispute Notice, or such longer period as they may agree in writing, then they will refer the Business Dispute to the chief executive officer of each Member. The chief executive officers will meet, consult and negotiate with each other in good faith. If they are unable to agree within twenty Business Days of the date of the Dispute Notice, then they will adjourn such attempts for a further period of five Business Days during which no meeting will be held. On the first Business Day following such period, the chief executive officers of the Members will meet again in an effort to resolve the Business Dispute. If the chief executive officers are unable to resolve the Business Dispute within 48 hours after the time at which their last meeting occurred, then Section 7.2(b) (Unresolved Business Dispute) will apply.

[32] Article 8 of the ABA Model Joint Venture Agreement defines and establishes remedial processes for defaults by venturers and is set forth in note 30, *supra*. Article 7 of the ABA Model Joint Venture

include an affirmative obligation for each participant not to take any actions that would terminate the joint venture in violation of the other provisions of the joint venture agreement.

Rather than terminating the venture by terminating its business and winding up its affairs, provision may be included for a non-defaulting participant to purchase the interests of the other participants. One method of providing for such an alternative is a "Dutch-auction" provision under which a participant may place a value on the entire joint venture and offer to purchase the interests of the other participants for their pro-rata shares of that value. Within a specified period of time, each other participant must then elect to purchase its share of the offering participant's interest at the value established by the offering participant or, failing such an election, must sell its interest to the offering participant at the price offered.

Agreement defines the venturers exit rights, either by dissolution or by purchase of sale of member interests, in the absence of a default as follows:

Article 7: Dissolution or Buy-Sell—in the Absence of Default

7.1 Applicability. This Article applies only if neither Member is a Defaulting Member (as defined in Section 8.2 (Definitions—Defaulting Member and Non-Defaulting Member and Default Event).

7.2 Triggering Events—Absence of Default. Either Member may elect a remedy set forth in Section 7.3 upon the occurrence of either of the following events:

(a) *Fundamental Failure*. The Company fails to achieve a Critical Target at the time specified in the Business Plan (''Critical Target Failure'') that is not a result of a material breach by a Member and the Members fail to agree upon and implement a plan to remedy that failure within 30 days (or such longer period as may be agreed by the Members) after either Member or any Manager has given notice of the failure to the Members and to each Manager.

(b) *Unresolved Business Dispute*. The occurrence of a Business Dispute unresolved under Section 5.9(b) (Consideration by Member Executives).

7.3 Remedies—Absence of Default. A Member may, within 90 days of becoming aware of the occurrence of either of the events specified in Section 7.2, give notice of the event to the other Member. The notice must specify one of the following alternative remedies (which are exclusive remedies):

(a) *Dissolution*. Dissolution of the Company in accordance with Article 9 (Dissolution Procedures).

(b) *Mandatory Buy-Sell*. Initiation of the sale of its Member Interest or the purchase of the other Member's Member Interest by giving the notice specified in Section 10.1 (Offer to Buy or Sell).

If both Members give notices within that time period, the notice given first prevails.

7.4 Voluntary Buy-Sell. At any time after the third anniversary of the date of this Agreement (but not earlier), if no prior notice under Section 7.3 or Section 8.3 (Remedies—Upon Default of One Member) has rightfully been given, either Member may give a written notice to the other offering to purchase the other Member's Member Interest or sell its Member Interest to the other Member in accordance with Article 10 (Buy-Sell in Absence of Default).

J. Antitrust

HSR Filing Requirements. Pre-merger notification filings under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (***"HSR"***) are generally required if all three of the following tests are met:[33]

(1) *The Commerce Test:* If either the acquiring and acquired person[34] is "engaged in commerce or any activity affecting commerce…."[35]

(2) *The Size-of-Person Test:* (i) One person in the transaction has a net sales or total assets of at least $141.8 million in sales or total assets, **and** (ii) the other party has at least $14.2 million in sales or total assets.[36]

(3) *The Size-of Transaction Test:* As a result of the transaction, (i) the acquiring person will hold an aggregate amount of stock and assets of the acquired person valued at least $70.9 million[37], **or** (ii) the acquiring person will hold an aggregate amount of voting securities[38] and assets of the acquired person valued at more than $283.6 million.[39]

In the case of a joint venture, even though the persons contributing to the formation of the unincorporated entity and the unincorporated entity itself may, in the formation transaction, be both acquiring and acquired persons within the meaning of HSR, for the above tests, the contributors are deemed acquiring persons only and the joint venture is deemed the acquired person only.[40]

If an HSR filing were required, there could be a waiting period of at least 30 days before the joint venture could be consummated unless "early termination" were granted.[41]

Under current HSR rules, the formation of a "non-corporate entity" - including joint ventures - is reportable if the above tests are satisfied and a party gains "control" of the entity as a result of the transaction.[42] The HSR rules define a "non-corporate interest" as "an interest in any unincorporated entity which gives the holder the right to any profits of the entity or in the

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33 Clayton Act 7A, 15 U.S.C. § 18a (2006). The thresholds are adjusted each year based on the percentage change in the U.S. gross national product for the fiscal year. The most recent adjustment for 2013 appeared at 78 Fed. Reg. 2406 (Jan. 11, 2013), and was effective on February 11, 2013.

34 16 C.F.R. § 801.2 (Jan. 11, 2006).

35 16 C.F.R. § 801.1(l) and § 801.3 (Jan. 11, 2006).

36 78 Fed. Reg. 2406 (Jan. 11, 2013), effective February 11, 2013, available at http://www.ftc.gov/os/2013/01/130110claytonact7afrn.pdf.

37 78 Fed. Reg. 2406 (Jan. 11, 2013), effective February 11, 2013, available at http://www.ftc.gov/os/2013/01/130110claytonact7afrn.pdf.

38 16 C.F.R. § 801.10 (Jan. 11, 2006).

39 78 Fed. Reg. 2406 (Jan. 11, 2013), effective February 11, 2013, available at http://www.ftc.gov/os/2013/01/130110claytonact7afrn.pdf.

40 16 C.F.R. § 801.50(a) (Jan. 11, 2006).

41 Stephen M. Axinn et al, *Acquisitions under the Hart-Scott-Rodino Antitrust Improvements Act: A Practical Analysis of the Statute & Regulations* 1-14 (New York: Law Journal Press 3d ed. 2008).

42 16 C.F.R. § 801.1(a)(1) (Jan. 11, 2006).

event of dissolution of that entity the right to any of its assets after payment of its debts."[43] These unincorporated entities include, but are not limited to, joint ventures, general partnerships, limited partnerships, limited liability partnerships, limited liability companies, cooperatives and business trusts. The HSR rules also provide that "control" is held by a person or entity with rights to 50% or more of the profits of the entity, or 50% or more of the assets upon the entity's dissolution.[44]

HSR Filing Fee Thresholds. The HSR filing fee thresholds, as of February 11, 2013, are as follows:[45]

Filing Fee	**Value of Transaction ($ millions)**
$45,000	More than $70.9 but less than $141.8
$125,000	$141.8 to less than $709.1
$280,000	$709.1 or more

General Antitrust Considerations. Whether or not pre-merger notification is required, the prospective joint venturers need to analyze whether the joint venture will be considered unlawful under antitrust law. While there is no clear test, a number of legal standards in the relevant case law as well as agency opinions, consent orders, guidelines and speeches are summarized in the Federal Trade Commission (***"FTC"***) and U.S. Department of Justice (***"DOJ"***) Antitrust Guidelines for Collaborations Among Competitors, available at http://www.ftc.gov/os/2000/04/ftcdojguidelines.pdf. In addition, if the joint venture is sufficiently similar to a horizontal merger, then the DOJ/FTC Horizontal Merger Guidelines, http://www.ftc.gov/bc/docs/horizmer.shtm may apply.

K. Intellectual Property

Under federal law, intellectual property rights are not assignable, even indirectly as part of a business combination transaction among affiliated parties, unless the owner has agreed otherwise. This presumption of non-assignability is based on the concept that allowing free assignability would undermine the reward for invention. Where patent or copyright licenses constitute material assets to be contributed to a joint venture, the due diligence review should take into consideration not only the language of the license agreements, but also the federal law presumption against assignability of patent or copyright licenses.

In *Cincom Systems, Inc. v. Novelis Corp.*,[46] the U.S. Court of Appeals for the Sixth Circuit held that an internal forward merger between sibling entities constitutes an impermissible

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43 16 C.F.R. § 801.1(f)(1)(ii) (Jan. 11, 2006).

44 16 C.F.R. § 801.1(b) (Jan. 11, 2006).

45 *Filing Fee Information*, FEDERAL TRADE COMMISSION, http://www.ftc.gov/bc/hsr/filing2.shtm (last visited March 27, 2012).

46 581 F.3d 431 (6th Cir. 2009).

software license transfer, notwithstanding a state corporation statute that provides that a merger vests title to assets in the surviving corporation without any transfer having occurred.[47] The reasoning in the *Cincom* case follows that of *PPG Industries, Inc. v. Guardian Industries Corp.*,[48] which held that, although state law provided for the automatic transfer and vesting of licenses in the successor corporation in a merger without any transfer having occurred, an intellectual property license, based on applicable federal law, is presumed to be non-assignable and nontransferable in the absence of express provisions to the contrary in the license. *PPG* held the state merger statute was preempted and trumped by this federal law presumption of non-transferability.

III. TRANSFERRING ASSETS TO A JOINT VENTURE

Transferring assets to a joint venture, including a division or a subsidiary, revolves around a purchase agreement between the buyer (the joint venture) and the selling entity (one of the joint venture parties) and sometimes its owners.[49] 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.[50]

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47 The *Cincom* case involved Cincom's non-exclusive license of software to Alcan Rolled Products Division ("Alcan Ohio"), a corporation wholly owned by Alcan, Inc. The license agreement required Alcan Ohio, as licensee, to obtain Cincom's written approval prior to any transfer of its rights or obligations under the agreement. As part of an internal corporate restructuring, Alcan Ohio eventually merged into Novelis Corp., another subsidiary of Alcan, Inc. This forward merger caused the software to be owned by a different entity, but it remained on the same computer specified by the license agreement and its use of the software by the surviving entity was unchanged. Cincom was not asked to, and did not, consent to the merger.

In addition to showing that the operation of the software was unaffected, Novelis Corp. claimed the intent of the license agreement demonstrated no concern with preventing internal corporate reorganizations. Further, Novelis Corp. argued that Ohio substantive corporate law required the court to find no transfer occurred as a result of the internal merger.

After considering these arguments, the Sixth Circuit found that the merger was a transfer in breach of the express terms of Cincom's license and held that software licenses did not vest with the surviving entity formed as part of a corporate restructuring. The court reached this conclusion notwithstanding Ohio's merger law that automatically vests assets with the surviving entity. Relying instead on federal common law, the court aligned itself with the presumption that, in the context of intellectual property, a license is non-transferable unless there is an express provision to the contrary.

48 597 F.2d 1090 (6th Cir. 1979), *cert. denied* 444 U.S. 930 (1979).

49 For a detailed discussion of asset purchase transactions, *see* Bryon F. Egan, *Asset Acquisitions: Assuming and Avoiding Liabilities*, 116 PENN ST. L. REV. 913 (2012).

50 These drafting and legal issues are dealt with from a United States (***"U.S."***) law perspective in the *Model Asset Purchase Agreement with Commentary*, which was published by the Negotiated Acquisitions

Committee of the American Bar Association (***"ABA"***) in 2001 (the ***"Model Asset Purchase Agreement"*** or the ***"Model Agreement"***). In recognition of how mergers and acquisitions (***"M&A"***) have become increasingly global, the Model Agreement was accompanied by a separate ABA Negotiated Acquisitions Committee volume in 2001 entitled *International Asset Acquisitions*, which included summaries of the laws of 33 other countries relevant to asset acquisitions, and in 2007 was followed by another ABA Negotiated Acquisitions Committee book, which was entitled *International Mergers and Acquisitions Due Diligence* and which surveyed relevant laws from 39 countries.

APPENDIX E

CONFIDENTIALITY AGREEMENTS ARE CONTRACTS WITH LONG TEETH

By Byron F. Egan[1]

I. Confidentiality Agreements And Their Effects Are Evolving

A confidentiality agreement (also sometimes called a non-disclosure agreement or "*NDA*") is typically the first stage for the due diligence process in a business combination or joint venture transaction (collectively, "*M&A*") as parties generally are reluctant to provide confidential information to the other side without having the protection of an NDA. The target typically proposes its form of NDA,[2] which may provide that it makes no representations regarding any information provided, and a negotiation of the NDA ensues. Some NDAs contain covenants restricting activities of the buyer after receipt of confidential information.[3]

The recent cases discussed below highlight that possible consequences of an agreement to maintain the confidentiality of information can be far reaching and are evolving. These cases also teach that, in addition to the importance of having contractual provisions sufficient to accomplish the intended objectives, director awareness of the effects of provisions in NDAs their companies enter into can have fiduciary duty implications. Thus, the lessons of these recent

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[2] A seller's form of confidentiality agreement is attached as Appendix B to Byron F. Egan, *Acquisition Structure Decision Tree*, TexasBarCLE & Business Law Section of State Bar of Texas, Choice & Acquisition of Entities in Texas Course, San Antonio, TX, May 24, 2013, http://www.jw.com/publications/article/1844. *See also* Article 12 of the ABA Model Asset Purchase Agreement (2001) and the Model Confidentiality Agreement accompanying the ABA Model Public Company Merger Agreement (2011).

[3] *See*, *e.g.*, *Goodrich Capital, LLC and Windsor Sheffield & Co., Inc. v. Vector Capital Corporation*, 11 Civ. 9247 (JSR) (S.D.N.Y. June 26, 2012) (confidentiality agreement prohibited use of confidential information solely to explore the contemplated business arrangement and not to minimize broker's role or avoid payment of its fees; a prospective bidder used information provided about other comparable companies to acquire one of the other companies; broker's lawsuit against that prospective bidder for breach of contract for misusing confidential information survived motion to dismiss); *In re Del Monte Foods Company Shareholders Litigation*, C.A. No. 6027-VCL, 2011 WL 532014 (Del. Ch. Feb. 14, 2011), (confidentiality agreement restricted bidders from entering into discussions or arrangements with other potential bidders; in temporarily enjoining stockholder vote on merger because target was unduly manipulated by its financial adviser, Delaware Vice Chancellor Laster faulted bidders' violation of the "no teaming" provision in the confidentiality agreement and the target's Board for allowing them to do so). *See* discussion of *Del Monte* case at then *see* Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, University of Texas School of Law 35th Annual Conference on Securities Regulation and Business Law, Austin, TX, Feb. 8, 2013, 252-55 nn.779-781, http://www.jw.com/publications/article/1830.

cases should be considered by counsel and discussed with the client before an NDA is entered into for a significant transaction.

II. No Representations

In *RAA Management, LLC v. Savage Sports Holdings, Inc.*,[4] the Delaware Supreme Court held that non-reliance disclaimer language in a confidentiality agreement was effective to bar fraud claims by a prospective buyer. The prospective buyer had been told by seller during early discussions that seller had no significant unrecorded liabilities, but due diligence showed otherwise. The confidentiality agreement provided that seller made no representations regarding any information provided and that buyer could only rely on express representations in a definitive acquisition agreement, which was never signed. The non-reliance provision in the NDA at issue in the *RAA* case provided as follows:

> You [RAA] understand and acknowledge that neither the Company [Savage] nor any Company Representative is making any representation or warranty, express or implied, as to the accuracy or completeness of the Evaluation Material or of any other information concerning the Company provided or prepared by or for the Company, and none of the Company nor the Company Representatives, will have any liability to you or any other person resulting from your use of the Evaluation Material or any such other information. Only those representations or warranties that are made to a purchaser in the Sale Agreement when, as and if it is executed, and subject to such limitations and restrictions as may be specified [in] such a Sale Agreement, shall have any legal effect.

After deciding not to pursue a transaction, the buyer sued seller to recover its due diligence and other deal costs. In affirming the Superior Court's dismissal of the buyer's complaint, the Delaware Supreme Court in *RAA* wrote:

> Before parties execute an agreement of sale or merger, the potential acquirer engages in due diligence and there are usually extensive precontractual negotiations between the parties. The purpose of a confidentiality agreement is to promote and to facilitate such precontractual negotiations. Non-reliance clauses in a confidentiality agreement are intended to limit or eliminate liability for misrepresentations during the due diligence process. The breadth and scope of the non-reliance clauses in a confidentiality agreement are defined by the parties to such preliminary contracts themselves. In this case, RAA and Savage did that, clearly and unambiguously, in the NDA.
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> The efficient operation of capital markets is dependent upon the uniform interpretation and application of the same language in contracts or other documents. The non-reliance and waiver clauses in the NDA preclude the fraud claims asserted by RAA against Savage. Under New York and Delaware law, the

[4] 45 A3d 107 (Del. 2012).

reasonable commercial expectations of the parties, as set forth in the non-reliance disclaimer clauses in Paragraph 7 and the waiver provisions in Paragraph 8 of the NDA, must be enforced. Accordingly, the Superior Court properly granted Savage's motion to dismiss RAA's Complaint.

The *RAA* holding was consistent with other cases upholding non-reliance provisions under Delaware law. In *ABRY Partners V, L.P. v. F&W Acquisition LLC*,[5] a stock purchase agreement included a merger clause or a "buyer's promise" that it was not relying upon any representations and warranties not stated in the contract, and the Delaware Chancery Court wrote that such provisions are generally enforceable:

> When addressing contracts that were the product of give-and-take between commercial parties who had the ability to walk away freely, this court's jurisprudence has . . . honored clauses in which contracted parties have disclaimed reliance on extra-contractual representations, which prohibits the promising party from reneging on its promise by premising a fraudulent inducement claim on statements of fact it had previously said were neither made to it nor had an effect on it.
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> The teaching of this court . . . is that a party cannot promise, in a clear integration clause of a negotiated agreement, that it will not rely on promises and representations outside of the agreement and then shirk its own bargain in favor of a "but we did rely on those other representations" fraudulent inducement claim. The policy basis for this line of cases is, in my view, quite strong. If there is a public policy interest in truthfulness, then that interest applies with more force, not less, to contractual representations of fact. Contractually binding, written representations of fact ought to be the most reliable of representations, and a law intolerant of fraud should abhor parties that make such representations knowing they are false.
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> Nonetheless, . . . we have not given effect to so-called merger or integration clauses that do not clearly state that the parties disclaim reliance upon extra-contractual statements. Instead, we have held . . . that murky integration clauses, or standard integration clauses without explicit anti-reliance representations, will not relieve a party of its oral and extra-contractual fraudulent representations. The integration clause must contain "language that . . . can be said to add up to a clear anti-reliance clause by which the plaintiff has contractually promised that it did not rely upon statements outside the contract's four corners in deciding to sign the contract." This approach achieves a sensible balance between fairness and equity — parties can protect themselves against unfounded fraud claims through explicit anti-reliance language. If parties fail to

[5] 891 A.2d 1032 (Del. Ch. 2006).

include unambiguous anti-reliance language, they will not be able to escape responsibility for their own fraudulent representations made outside of the agreement's four corners.

In *Abry*, however, the Court allowed a fraud claim to proceed where, notwithstanding a clear anti-reliance provision, the plaintiff alleged that the defendant had intentionally lied within the four corners of the agreement.[6]

In *Pyott-Boone Electronics Inc., etc. v. IRR Trust for Donald L. Fetterolf Dated December 9, 1997*,[7] a diversity action involving the sale of a Virginia business, the disappointed buyer sued for damages for breach of the purchase agreement as well as for related tort claims and claims for breach of the Virginia Securities Act based on information that was furnished to buyer pursuant to a due diligence request months before the purchase agreement was signed. In dismissing the complaint the Court, applying Delaware law pursuant to the agreement's choice of law clause, found that plaintiff's breach of contract claim was founded on an impossibly broad interpretation of a provision to the effect that all representations and warranties in the agreement were correct and did not misstate or omit to state any material fact. The Court stated that "to reach the conclusion that the plaintiff advocates, the warranties contained in [that representation] would effectively encompass every statement any of the defendants ever made to the plaintiff regarding the sale throughout months of negotiations." In construing the provision, the Court was influenced by the purchase agreement's entire agreement provision which provided:

> This Agreement, including the Schedules and Exhibits hereto, together with the Confidentiality Agreement constitutes the entire agreement of the parties hereto respecting its subject matter and supersedes all negotiations, preliminary agreements and prior or contemporaneous discussions and understandings of the parties hereto in connection with the subject matter hereof. There are no restrictions, promises, representations, warranties, agreements or undertakings of any party hereto with respect to the transactions contemplated by this Agreement, the Confidentiality Agreement, or the Transaction Documents, other than those set forth herein or therein or in any other document required to be executed and delivered hereunder or thereunder.

The Court held that "[t]he plain language of [the entire agreement provision] states that the parties made no representations beyond those specifically included in the agreement. If the

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[6] *See* Glenn D. West & W. Benton Lewis, Jr., *Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the "Entire" Deal?*, 63 Bus. Law. 999 (August 2009). *Cf. OverDrive, Inc. v. Baker & Taylor, Inc.*, 2011 WL 2448209 (Del.Ch. June 17, 2011), which arose out of a joint venture agreement providing that "[n]either party is relying on any representations, except those set forth herein, as inducement to execute this Agreement," and in which the plaintiff alleged that defendant intentionally lied about specific provisions in the joint venture agreement by failing to reveal plans to use confidential information received from plaintiff in arrangements with competitors; in denying defendant's motion to dismiss, Chancellor Chandler wrote that "[u]nder the teaching of *ABRY Partners V, L.P. v. F&W Acquisition LLC*, use of an anti-reliance clause in such a manner is contrary to public policy if it would operate as a shield to exculpate defendant from liability for its own intentional fraud—'there is little support for the notion that it is efficient to exculpate parties when they lie about the material facts on which a contract is premised.'"

[7] ____ F. Supp. 3d ____ (No. 1:12CV00048 Jan. 15, 2013).

plaintiff wished to rely upon the [information furnished during the due diligence process], it should have negotiated for its explicit inclusion in the [purchase agreement]." Thus, the Court gave effect to the bargain the parties made as set forth in their contract.

Texas courts have dealt with non-reliance provisions outside of the M&A arena and have imposed conditions to their enforceability not found in Delaware cases. In *Italian Cowboy Partners, Ltd. v. Prudential Ins. Co.*,[8] the Texas Supreme Court held that a merger clause does not waive the right to sue for fraud should a party later discover that the representations it relied upon before signing the contract were fraudulent, unless the clause also disclaims reliance on representations (thus negating an essential element of a claim for fraudulent inducement) and it is insufficient to merely state that promisor has not made any representations or promises except as expressly set forth in the agreement.

Italian Cowboy was influential in *Allen v. Devon Energy Holdings, L.L.C. F/K/A Chief Holdings, L.L.C. and Trevor Rees-Jones*,[9] in which Allen alleged that Chief and Trevor Rees-Jones, Chief's manager and majority owner, fraudulently induced him to redeem his interest two years before the company sold for almost 20 times the redemption sales price to Devon Energy Production Company, L.P. The defense focused on disclaimers and release provisions in the redemption agreement, which it contended barred Allen's fraud claims by negating reliance or materiality as a matter of law. The Court of Appeals held that the redemption agreement did not bar Allen's claims, and that fact issues existed as to fraud and the existence of a fiduciary relationship, in reversing the trial court's summary judgment for the defense and for such purpose assuming the correctness of the facts alleged by Allen below.

Allen and Rees-Jones served together as partners at a prominent Dallas law firm. Allen was an oil and gas transactions lawyer, and Rees-Jones was a bankruptcy lawyer before leaving the firm to go into the oil and gas business. Allen was one of Chief's early investors, and relied on investment advice from Rees-Jones.

In November 2003, Rees-Jones decided to redeem the minority equity interests in Chief. He sent to the minority members a letter explaining the reasons for and terms of the redemption offer, to which he attached (1) an independent valuation firm's opinion on Chief's market value and (2) an appraisal of Chief's existing gas reserves and future drilling prospects. The valuation report included discounts for the sale of a minority interest and for lack of marketability. The letter also included Rees-Jones's pessimistic assessment of a number of facts and events that could negatively impact Chief's value in the future.

The redemption proposal languished for seven months until June 2004 when Rees-Jones notified the minority members that Chief was ready to proceed with the redemption. Three of the minority members (including Allen) accepted the redemption offer, and four others chose to retain their interests. There were positive developments in the Barnett Shale area where Chief operated and within Chief in the seven months between the November 2003 offer and the June

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[8] 341 S.W.3d 323 (Tex. 2011).

[9] 367 S.W.3d 355 (Tex. App.—Houston [1st Dist.] March 9, 2012; case settled in 2013 while writ of error pending).

2004 redemption, and Allen asserts that these events, which Allen claimed were not disclosed to him and would have materially impacted his decision to redeem his interest.

Chief provided Allen with a written redemption agreement for the first time in June 2004, and "insisted" that the contract be signed by the end of the month. The parties did not exchange drafts, and Allen stated that he had only three days to review the agreement before signing because, as he was on vacation for much of the time.

The redemption agreement contained several release clauses which are discussed below, including an "independent investigation" paragraph, a general "mutual release," and a merger clause which defendants claimed barred Allen's fraud claims negating reliance or materiality as a matter of law. The "independent investigation" paragraph provided that (1) Allen based his decision to sell on his independent due diligence, expertise, and the advice of his own engineering and economic consultants; (2) the appraisal and the reserve analysis were estimates and other professionals might provide different estimates; (3) events subsequent to the reports might "have a positive or negative impact on the value" of Chief; (4) Allen was given the opportunity to discuss the reports and obtain any additional information from Chief's employees as well as the valuation firm and the reserve engineer; and (5) the redemption price was based on the reports regardless of whether those reports reflected the actual value and regardless of any subsequent change in value since the reports. The independent investigation paragraph also included mutual releases "from any claims that might arise as a result of any determination that the value of [Chief] . . . was more or less than" the agreed redemption price at the time of the closing.

In a separate paragraph entitled "mutual releases" each party released the other from all claims that "they had or have arising from, based upon, relating to, or in connection with the formation, operation, management, dissolution and liquidation of [Chief] or the redemption of" Allen's interest in Chief, except for claims for breach of the redemption agreement or breach of the note associated with the redemption agreement. Another paragraph contained a "merger clause" stating that the redemption agreement "supersedes all prior agreements and undertakings, whether oral or written, between the parties with respect to the subject matter hereof."

Allen argued that fraudulent inducement invalidates the release provisions in the redemption agreement as "fraud vitiates whatever it touches," citing *Stonecipher v. Butts*.[10] In rejecting that argument but holding that the release provisions in the redemption agreement were not sufficiently explicit to negate Allen's fraud in the inducement claims, the Court of Appeals wrote:

> The threshold requirement for an effective disclaimer of reliance is that the contract language be "clear and unequivocal" in its expression of the parties' intent to disclaim reliance. [citations omitted] In imposing this requirement, the Texas Supreme Court has balanced three competing concerns. First, a victim of fraud should not be able to surrender its fraud claims unintentionally. [citations omitted] Second, the law favors granting parties the freedom to contract knowing that courts will enforce their contracts' terms, as well as the ability to

[10] 591 S.W.2d 806, 809 (Tex. 1979).

> contractually resolve disputes between themselves fully and finally. [citations omitted] Third, a party should not be permitted to claim fraud when he represented in the parties' contract that he did not rely on a representation . . .

The Court then said that in view of these competing concerns, Texas allows a disclaimer of reliance to preclude a fraudulent inducement claim only if the parties' intent to release such claims "is clear and specific." Among the failings the Court found with the disclaimer language in the redemption agreement were: (i) it did not say none of the parties is relying upon any statement or any representation of any agent of the parties being released hereby; (ii) the broad language releasing "all claims, demands, rights, liabilities, and causes of action of any kind or nature" did not specifically release fraudulent inducement claims or disclaim reliance on Rees-Jones and Chief"s representations (although it did release claims "of any kind or nature" (which necessarily includes fraudulent inducement), the elevated requirement of precise language requires more than a general catch-all--it must address fraud claims in clear and explicit language); (iii) the merger clause stated that the contract is the "final integration of the undertakings of the parties hereto and supersedes all prior agreements and undertakings," but did not include clear and unequivocal disclaimer of reliance on oral representations; (iv) the redemption agreement failed to state that the only representations that had been made were those set forth in the agreement; (v) it did not contain a broad disclaimer that no extra-contractual representations had been made and that no duty existed to make any disclosures; (vi) it did not provide that Allen had not relied on any representations or omissions by Chief; or (vii) it did not include a specific "no liability" clause stating that the party providing certain information will not be liable for any other person's use of the information.

The Court was careful to state it was not requiring that the words "disclaimer of reliance" must be stated in order for a disclaimer to preclude a fraudulent inducement claim or that each one of these issues must be addressed in every disclaimer. Rather, the Court stated that the redemption agreement lacked the following: "(1) an all-embracing disclaimer that Allen had not relied on any representations or omissions by Chief; (2) a specific 'no liability' clause stating that the party providing certain information will not be liable for any other person's use of the information; and (3) a specific waiver of any claim for fraudulent inducement based on misrepresentations or omissions."

Although the independent investigation clause stated that Allen "based his decision to sell" on (1) his own independent due diligence investigation, (2) his own expertise and judgment, and (3) the advice and counsel of his own advisors and consultants, the Court found that the statement of reliance on the identified factors did not clearly and unequivocally negate the possibility that Allen also relied on information he had obtained from Chief and Rees-Jones, and consistent with the terms of the redemption agreement, Allen could have relied on both. The Court found it incongruous to state that Allen could not rely on the information he was given, and noted the absence of the words "only," "exclusively," or "solely" are of critical importance in this case.

Rees-Jones and Devon argued that the redemption agreement contained language that released Allen's claims against them and that this language shows that the parties agreed broadly to disavow the factual theories he now asserts in his lawsuit. Although the redemption agreement released the parties from claims that arise from a determination that the redemption

price did not reflect Chief's market value at closing, it did not negate Allen's claims that Rees-Jones made misrepresentations and omissions concerning Chief's future prospects. Further the release disclaimed any claim by Allen based on a change in value from the 2003 appraisal to the date of redemption only, but the language did not cover Allen's claims that Rees-Jones and Chief withheld information relating to Chief's future prospects and potential value.

The Court further wrote, citing *Forest Oil Corp. v. McAllen*,[11] that even a clear and unequivocal disclaimer of reliance may not bar a fraudulent inducement claim unless (1) the terms of the contract were negotiated or boilerplate; (2) the complaining party was represented by counsel; (3) the parties dealt with each other at arm's length; and (4) the parties were knowledgeable in business matters. The Court found for defendants on two of the factors (Allen as an oil and gas attorney could not complain that he was not represented by counsel and was not knowledgeable). The Court, however, found fact issues as to the other two factors (whether the contract was negotiated and whether the parties dealt with each other at arm's length) and declined to grant Defendant's motion for summary judgment. The Court declined to say whether all four tests must be satisfied for an otherwise clear and unequivocal disclaimer of reliance to be enforceable.

In *Staton Holdings, Inc. v. Tatum, L.L.C.*,[12] a Texas Court of Appeals held, as a matter of first impression, that an express-intent requirement, under which a release of liability is enforceable only if the intent to grant such a release is expressed in specific terms within the four corners of the contract, applies to prospective releases of future breaches of warranty in service transactions. In so holding, the Court wrote:

> We begin by reviewing Texas's express-negligence jurisprudence. Under Texas law, certain kinds of contractual provisions that call for an extraordinary shifting of risk between the parties are subject to the fair-notice doctrine. *See Dresser Indus., Inc. v. Page Petroleum, Inc.*, 853 S.W.2d 505, 508 (Tex. 1993). In *Dresser Industries*, the Texas Supreme Court held that a release of liability for future negligence is enforceable only if it comports with both prongs of the fair-notice doctrine: the conspicuousness requirement and the express-negligence test. Id. at 509. Under the express-negligence test, a release of future negligence is enforceable only if the intent to grant such a release is expressed in specific terms within the four corners of the contract. *Id.* at 508; *see also Ethyl Corp. v. Daniel Constr. Co.*, 725 S.W.2d 705, 708 (Tex. 1987) (adopting the express-negligence test in the context of indemnity clauses). If a similar express-intent rule applies to breach-of-warranty claims, the release involved in this case is suspect because it does not expressly state that Staton is waiving claims for future breaches of warranty.
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> The Texas Supreme Court has extended the express-negligence test to some claims besides negligence. In 1994, the supreme court held that an indemnity agreement will not be construed to indemnify a party against statutorily imposed strict liability unless the agreement expressly states the parties' intent to

[11] 268 S.W.3d 51 (Tex. 2008).

[12] 345 S.W.3d 729 (Tex.App.—Dallas 2011).

provide for indemnification of such claims. *Houston Lighting & Power Co. v. Atchison, Topeka & Santa Fe Ry. Co.*, 890 S.W.2d 455, 458-59 (Tex. 1994). The court indicated that the same express-intent rule would apply to claims for strict products liability.

* * *

After considering the reasons supporting *HL & P's* extension of the express-intent rule to strict liability, we conclude the express-intent rule applies to breach-of-warranty claims.

* * *

The release involved in this case does not expressly release claims for future breaches of warranty, so it does not bar Staton's breach-of-warranty claims . . .

The *Staton Holdings* case is another example of a Texas court acknowledgement that Texas law respects freedom of contract, including the right of parties to contractually limit their tort and other liabilities arising in respect of contracts, but that the Texas courts regard such a shifting of liability as so extraordinary that they require it to be clear, unequivocal and conspicuous in the contract so that there is no question that the parties knowingly bargained for that outcome. In that respect *Staton Holdings* is consistent with the results in *Italian Cowboy* and *Allen*, although the application of express negligence principles is new and an extension. These three 2011 cases suggest that the following principles should be considered when attempting to contractually limit liabilities under Texas law:

- Do not appear to use boilerplate provisions, however comprehensive, and tailor the limitation of liability provision for each transaction in a way that shows that it has been specifically negotiated and is not merely a boilerplate provision.

- Expressly disclaim reliance on any representations that are not embodied in the four corners of the agreement, and perhaps even in particular enumerated sections thereof.

- Expressly state that no reliance is being placed on any statements (i) by any representative of any of the parties whose liability is limited or (ii) in the dataroom (if such is the case).

- Expressly state that fraud in the inducement claims are being released.

- Expressly state that no reliance has been placed on any prior representations.

- Include both broad inclusive words of limitation of liability and then specifically address the particular kinds of representations not being relied upon.

- Put the limitation of liability provision in italics, bold face or other conspicuous type.[13]

A non-reliance provision based on those Texas principles might read as follows:

____ Entire Agreement, Non-reliance, Exclusive Remedies and Modification

(a) This Agreement supersedes all prior agreements, whether written or oral, between the parties with respect to its subject matter (including any letter of intent and any confidentiality agreement between Buyer and Seller) and constitutes (along with the Disclosure Letter, Exhibits and other documents delivered pursuant to this Agreement) a complete and exclusive statement of the terms of the agreement between the parties with respect to its subject matter. This Agreement may not be amended, supplemented or otherwise modified except by a written agreement executed by the party to be charged with the amendment.

(b) Except for the representations and warranties contained in Article 3 [the representations and warranties section of the Agreement], none of Seller or any Shareholder has made any representation or warranty, expressed or implied, as to Seller or as to the accuracy or completeness of any information regarding Seller furnished or made available to Buyer and its representatives, and none of Seller or any Shareholder shall have or be subject to any liability to Buyer or any other Person resulting from the furnishing to Buyer, or Buyer's use of or reliance on, any such information or any information, documents or material made available to Buyer in any form in expectation of, or in connection with, the transactions contemplated by this Agreement.

(c) Following the Closing, the sole and exclusive remedy for any and all claims arising under, out of, or related to this Agreement, or the sale and purchase of the Seller, shall be the rights of indemnification set forth in Article 11 [the indemnification section of the Agreement] only, and no person will have any other entitlement, remedy or recourse, whether in contract, tort or otherwise, it being agreed that all of such other remedies, entitlements and recourse are expressly waived and released by the parties hereto to the fullest extent permitted by law.

(d) The provisions of this Section 13.7 [the entire agreement provision] and the limited remedies provided in Article 11, were specifically bargained for between Buyer and Sellers and were taken into account by

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[13] *See* Comment to Section 11.11 on pp 259-262 of Byron F. Egan, *Acquisition Structure Decision Tree*, TexasBarCLE & Business Law Section of State Bar of Texas, Choice & Acquisition of Entities in Texas Course, San Antonio, TX, May 24, 2013, http://www.jw.com/publications/article/1844, regarding the express negligence doctrine.

Buyer and the Sellers in arriving at the Purchase Price. The Sellers have specifically relied upon the provisions of this Section 13.7 and the limited remedies provided in Article 11 in agreeing to the Purchase Price and in agreeing to provide the specific representations and warranties set forth herein.[14]

(e) All claims or causes of action (whether in contract or in tort, in law or in equity) that may be based upon, arise out of or relate to this Agreement, or the negotiation, execution or performance of this Agreement (including any representation or warranty, whether written or oral, made in or in connection with this Agreement or as an inducement to enter into this Agreement), may be made only against the entities that are expressly identified as parties hereto. No Person who is not a named party to this Agreement, including without limitation any director, officer, employee, incorporator, member, partner, stockholder, Affiliate, agent, attorney or representative of any named party to this Agreement ("Non-Party Affiliates"), shall have any liability (whether in contract or in tort, in law or in equity, or based upon any theory that seeks to impose liability of an entity party against its owners or affiliates) for any obligations or liabilities arising under, in connection with or related to this Agreement or for any claim based on, in respect of, or by reason of this Agreement or its negotiation or execution; and each party hereto waives and releases all such liabilities, claims and obligations against any such Non-Party Affiliates. Non-Party Affiliates are expressly intended as third party beneficiaries of this provision of this Agreement.

(f) This Agreement may not be amended, supplemented or otherwise modified except by a written agreement executed by the party to be charged with the amendment.

While the foregoing provision is lengthy and is intended to address the concerns expressed by the courts in the *Italian Cowboy*, *Allen* and *Staton Holdings* cases, circumstances and future cases will no doubt suggest revision of the foregoing in particular cases.

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[14] This alternative is derived from the Model Provisions suggested in Glenn D. West and W. Benton Lewis, Jr., *Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the "Entire" Deal?*, 64 Bus. Law. 999, 1038 (Aug. 2009), as well as the *Italian Cowboy*, *Allen* and *Staton Holdings* discussed above; *see* Byron F. Egan, Patricia O. Vella and Glenn D. West, *Contractual Limitations on Seller Liability in M&A Agreements*, University of Texas School of Law 7th Annual Mergers and Acquisitions Institute, Dallas, TX, October 20, 2011, at Appendix B, *available at* http://images.jw.com/com/publications/1669.pdf.

III. De Facto Standstill

In *Martin Marietta Materials, Inc. v. Vulcan Materials Co.*,[15] the Delaware Supreme Court upheld a pair of NDAs and temporarily enjoined Martin Marietta Materials from prosecuting a proxy contest and proceeding with a hostile bid for its industry rival Vulcan Materials Company. After years of communications regarding interest in a friendly transaction, Vulcan and Martin Marietta in the spring of 2010 executed two NDAs to enable their merger and antitrust discussions, each governed by Delaware law:

- A general non-disclosure agreement requiring each party to use the other's confidential information "solely for the purpose of evaluating a Transaction," which was defined as "a possible business combination transaction . . . between" the two companies, and prohibiting disclosure of the other party's evaluation material and of the parties' negotiations except as provided in the agreement, which had a term of two years.

- A joint defense and confidentiality agreement, intended to facilitate antitrust review signed about two weeks after the non-disclosure agreement requiring each party to use the other's confidential information "solely for the purposes of pursuing and completing the Transaction," which was defined as "a potential transaction being discussed by" the parties, and restricting disclosure of confidential materials.

Neither NDA contained an express standstill provision. When the agreements were signed, both parties were seeking to avoid being the target of an unsolicited offer by the other or by another buyer. Accordingly, the agreements protected from disclosure the companies' confidential information as well as the fact that the parties had merger discussions.

After its economic position improved relative to Vulcan, Martin Marietta decided to make a hostile bid for Vulcan and also launched a proxy contest designed to make Vulcan more receptive to its offer. The Court found that Martin Marietta used protected confidential material in making and launching its hostile bid and proxy contest.

The Court then construed the language of the NDAs to determine that Martin Marietta had breached those agreements by (1) using protected information in formulating a hostile bid, since the information was only to be used in an agreed-to business combination; (2) selectively disclosing protected information in one-sided securities filings related to its hostile bid, when such information was not disclosed in response to a third-party demand and when Martin Marietta failed to comply with the agreements' notice and consent process; and (3) disclosing protected information in non-SEC communications in an effort to "sell" its hostile bid. The Court emphasized that its decision was based entirely on contract law, and its reasoning did not rely on any fiduciary principles.

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[15] No. 254,2012, C.A. No. 7102 (Del. July 10, 2012), affirming *Martin Marietta Materials, Inc. v. Vulcan Materials Co.*, C.A. 7102-CS (Del. Ch. May 4, 2012). *See* XVII Deal Points (The Newsletter of the Mergers and Acquisitions Committee of the ABA Bus. L. Sec.) at 23-26 (Summer 2012).

The Court held that, although the NDAs did not expressly include a standstill provision, Martin Marietta's breaches entitled Vulcan to specific performance of the agreements and an injunction. The Court therefore enjoined Martin Marietta, for four months, from prosecuting a proxy contest, making an exchange or tender offer, or otherwise taking steps to acquire control of Vulcan's shares or assets.

IV. Express Standstill and "Don't Ask, Don't Waive" Provisions

Some NDAs do contain express standstill provisions that (i) prohibit the bidder from making an offer for the target without an express invitation from its Board and (ii) preclude the bidder from publicly or privately asking the Board to waive the restriction.[16] Such provisions in NDAs, which are sometimes referred to as "Don't Ask, Don't Waive" provisions, are designed to extract the highest possible offer from the bidder because the bidder only has one opportunity to make an offer for the target unless the target invites the bidder to make another offer *sua sponte*.[17] Bidders who do not execute NDAs with "Don't Ask, Don't Waive" provisions generally are not precluded from submitting multiple offers for the company, even after a winning bidder emerges from an auction.[18]

The legitimacy of "Don't Ask, Don't Waive" provisions was recognized in *In re Topps Co. Shareholders Litigation*,[19] in which Chancellor (then Vice Chancellor) Strine enjoined a stockholder vote on a merger until the target waived a standstill agreement. The target's Board had refused to waive the standstill in order to permit a strategic rival to make a tender offer on the same terms it had proposed to the Board and to communicate with Topps stockholders in connection with the vote on the proposed transaction the Board had approved with a private equity investor. In holding that the Board was misusing the standstill agreement solely in order to deny its stockholders the opportunity to accept an arguably more attractive deal and to preclude them from receiving additional information about rival's version of events, the Court wrote that standstill agreements can have legitimate purposes, including in the final round of an auction where a Board in good faith seeks to extract the last dollar from the remaining bidders, but can be subject to abuse:

> "Standstills serve legitimate purposes. When a corporation is running a sale process, it is responsible, if not mandated, for the board to ensure that confidential information is not misused by bidders and advisors whose interests are not aligned with the corporation, to establish rules of the game that promote an orderly auction, and to give the corporation leverage to extract concessions from the parties who seek to make a bid.

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16 Peter J. Walsh, Jr., Janine M. Salomone and David B. DiDonato, *"Don't Ask, Don't Waive" Standstill Provisions: Impermissible Limitation on Director Fiduciary Obligations or Legitimate, Value-Maximizing Tool?*, ABA Business Law Section, Business Law Today (January 23, 2013), http://apps.americanbar.org/buslaw/blt/content/2013/01/delawareinsider.shtml.

17 *Id.*

18 *Id.*

19 *In re Topps Company Shareholders Litigation*, 926 A.2d 58 (Del. Ch. 2007); *see also* Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, University of Texas School of Law 35th Annual Conference on Securities Regulation and Business Law, Austin, TX, Feb. 8, 2013, 198-203 nn.641-648, http://www.jw.com/publications/article/1830.

> "But standstills are also subject to abuse. Parties like Eisner often, as was done here, insist on a standstill as a deal protection. Furthermore, a standstill can be used by a target improperly to favor one bidder over another, not for reasons consistent with stockholder interest, but because managers prefer one bidder for their own motives."[20]

Later in *In re Celera Corp. Shareholder Litigation*,[21] Vice Chancellor Parsons held that although in isolation the "Don't Ask, Don't Waive" provisions arguably fostered the legitimate objectives set forth in *Topps*, when viewed with the no-solicitation provision in the merger agreement, a colorable argument existed that the collective effect created an informational vacuum, increased the risk that directors would lack adequate information, and constituted a breach of fiduciary duty. The Court commented that the "Don't Ask, Don't Waive" standstill provisions blocked certain bidders from notifying the Board of their willingness to bid, while the no-solicitation provision in the merger agreement contemporaneously blocked the Board from inquiring further into those parties' interests, and, thus, diminished the benefits of the Board's fiduciary-out in the no-solicitation provision and created the possibility that the Board would lack the information necessary to determine whether continued compliance with the merger agreement would violate its fiduciary duty to consider superior offers.

In late 2012, two Chancery Court opinions, *In re Complete Genomics, Inc. Shareholder Litigation*[22] and *In re Ancestry.com Inc. Shareholder Litigation*,[23] considered the propriety of a target company's inclusion in standstill agreements of a "Don't Ask, Don't Waive" provision which became the "emerging issue of December of 2012," in the words of Chancellor Strine. In *Complete Genomics* the Board of a company in financial straits decided to explore "all potential strategic alternatives," including initiation of a process to find a buyer. Prospective bidders were required to sign confidentiality agreements, some of which included standstill provisions that prohibited the bidders from launching a hostile takeover and prohibited the prospective bidders from *publicly* asking the Board to waive the standstill restrictions, but one also forbade the prospective bidder from making a *nonpublic* request for such a waiver.[24] In a bench ruling, Vice Chancellor Laster analogized the "Don't Ask, Don't Waive" provision (at least insofar as it prohibited *nonpublic* waiver requests) to "bidder-specific no-talk" clauses criticized by the Court of Chancery in previous cases as being violative of the Board's "duty to take care to be informed of all material information reasonably available," rendering it the "legal equivalent of willful blindness" to its fiduciary duties.[25] The Vice Chancellor commented that while "a board doesn't

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[20] 926 A.2d at 91 (Del. Ch. 2007).

[21] C.A. No. 6304-VCP (Del. Ch. Mar. 23 2012) (Transcript), *aff'd in part rev'd in part on other grounds*, 2012 WL 6707746 (Del. Dec. 27, 2012).

[22] Telephonic Oral Argument and the Court's Ruling, *In re Complete Genomics, Inc. S'holder Litig.*, C.A. No. 7888-VCL (Del. Ch. Nov. 27, 2012).

[23] The Court's Ruling on Plaintiffs' Motion for Preliminary Injunction, *In re Ancestry.com Inc. S'holder Litig.*, C.A. No. 7988-CS (Del. Ch. Dec. 17, 2012).

[24] Robert S. Reder, *Delaware Chancellor Weighs in on "Don't Ask, Don't Waive" Provision of Standstill Agreement*, Bloomberg BNA Corporate Practice Library, 28 CCW 24 (2013).

[25] The Vice Chancellor wrote:

> In my view, a Don't Ask, Don't Waive Standstill resembles a bidder-specific no-talk clause. In *Phelps Dodge Corporation v. Cyprus Amax* [1999 WL 1054255, at *2 (Del. Ch. Sept. 27,

necessarily have an obligation to negotiate," it "does have an ongoing statutory and fiduciary obligation to provide a current, candid and accurate merger recommendation," which encompasses "an ongoing fiduciary obligation to review and update its recommendation," and a "Don't Ask, Don't Waive" provision in a standstill is "impermissible" to the extent it limits a board's "ongoing statutory and fiduciary obligations to properly evaluate a competing offer, disclose material information, and make a meaningful merger recommendation to its stockholders." These are ongoing obligations no matter how pristine the process adopted by the Board in making its initial decision to approve a transaction and recommend it to stockholders.

In *Ancestry.com*, the bidders in an auction initiated by the target were required to sign confidentiality agreements containing standstill restrictions that included "Don't Ask, Don't Waive" provisions.[26] The ultimate winner in this process was a private equity firm which did not "demand an assignment" of the provision in the merger agreement, thereby leaving it within the target's discretion whether or not to allow unsuccessful bidders to make unsolicited topping bids prior to receiving stockholder approval. Chancellor Strine generally praised the process followed by the Ancestry Board, noting that the Board was "trying to create a competitive dynamic" and the process "had a lot of vibrancy and integrity to it … ." With respect to the "Don't Ask, Don't Waive" provision, the Chancellor noted that while it "is a pretty potent provision," he was aware of "no statute" or "prior ruling of the Court" that rendered such provisions "per se invalid," and wrote that a "Don't Ask, Don't Waive" provision actually may be used by a "well-motivated seller … as a gavel" for "value-maximizing purposes" by communicating to bidders that "there really is an end to the auction for those who participate," creating an incentive for bidders to "bid your fullest because if you win, you have the confidence of knowing you actually won that auction at least against the other people in the process," which may attract prospective bidders to a process that has "credibility so that those final-round bidders know the winner is the winner, at least as to them."

The Chancellor was, however, troubled by the target's failure to disclose in proxy materials sent to stockholders the potential impact of the "Don't Ask, Don't Waive" provision on the bidding process, warned that directors "better be darn careful" in running an auction process to be sure that "if you're going to use a powerful tool like that, are you using it consistently with your fiduciary duties, not just of loyalty, but of care." Chancellor Strine faulted the lack of proxy statement disclosures regarding the "Don't Ask, Don't Waive" provision as "probabilistically in violation of the duty of care" since the Board was "not informed about the potency of this clause," and it "was not used as an auction gavel." Once the winning bidder "did not demand an assignment of it," the Board did not "waive it in order to facilitate those bidders which had signed up the standstills being able to make a superior proposal." The Chancellor "enjoin[ed] the deal subject to those disclosures being promptly made."

1999)], Chancellor Chandler considered whether a target board had breached its fiduciary duties by entering into a merger agreement containing a no-talk provision. Unlike a traditional no-shop clause, which permits a target board to communicate with acquirers under limited circumstances, a no-talk clause -- and here I'm quoting from the Chancellor -- "not only prevents a party from soliciting superior offers or providing information to third parties, but also from talking to or holding discussions with third parties."

[26] Robert S. Reder, *Delaware Chancellor Weighs in on "Don't Ask, Don't Waive" Provision of Standstill Agreement*, Bloomberg BNA Corporate Practice Library, 28 CCW 24 (2013).

V. Lessons from the Cases

The cases discussed above teach that even a simple agreement to maintain the confidentiality of information can be enforced in ways that can change the course of a major transaction. Further, the emphasis placed by the Courts on the directors understanding the power of NDA provisions suggests that counsel should consider the implications thereof on the fiduciary duties of directors and help their clients understand them.

APPENDIX F

DISSIDENT DIRECTOR WHO HARMS CORPORATION TO FURTHER PERSONAL OBJECTIVES VIOLATES DUTY OF LOYALTY

By Byron F. Egan

I. Director Duty of Loyalty

Directors owe fiduciary duties to a corporation on whose Board of Directors ("*Board*") they serve and effectively to all of its stockholders.[1] The fiduciary duty of loyalty dictates that directors act in good faith and not allow their personal interests to prevail over those of the corporation.[2] Thus, a director may not use confidential company information, or disclose it to third parties, for personal gain without authorization from his fellow directors.[3] This principle is often memorialized in corporate policies.[4]

II. Duty of Loyalty Breached by Leaking Confidential Information

In *Shocking Technologies, Inc. v. Michael*,[5] a director ("*Michael*") of a privately held Delaware corporation in dire financial straits who was on the Board as the representative of two series of preferred stock, was sued by the corporation for breaching his duty of loyalty by leaking negative confidential information to another preferred shareholder considering an additional investment in the company. The Delaware Court of Chancery found that Michael disclosed the confidential information (i) to encourage the potential investor to withhold funds the corporation desperately needed, thereby making the company accommodating to the governance changes sought by Michael, or (ii) if the investor nevertheless decided to invest, to help the investor get a "better deal" which would include Board representation for such investor (thereby changing the balance of power on the Board in Michael's favor). In holding that Michael had violated his duty of loyalty, the Chancery Court explained:

> "The fiduciary duty of loyalty imposes on a director 'an affirmative obligation to protect and advance the interests of the corporation' and requires a director 'absolutely [to] refrain from any conduct that would harm the corporation'. Encompassed within the duty of loyalty is a good faith aspect as well. 'To act in good faith, a director must act at all times with an honesty of purpose and in the best interest and welfare of the corporation. **A director acting in subjective good faith may, nevertheless, breach his duty of loyalty. The 'essence of the duty of loyalty' stands for the fundamental proposition that a director, even if he is a shareholder, may not engage in conduct that is 'adverse to the interests of [his] corporation**.' [Emphasis added]

The *Shocking Technologies* case involved a dissident director who was the sole Board representative of two series of preferred stock. Over time, significant disagreements between Michael and the other Board members arose over executive compensation and whether there

should be increased Board representation for the preferred stock. Michael argued that the company's governance problems would need to be resolved before it could attract additional equity funding. The other directors believed, however, that these disagreements were a pretext for Michael's desire to increase his influence and control over the Board at a time when the company faced financial difficulties.

As the disagreements escalated, Michael contacted another holder of preferred stock who represented the company's only remaining source of capital to discourage the holder from exercising its warrants to purchase additional shares of the company's stock. Michael also told the potential investor that the company was in a dire financial situation, that the investor was the only present source of financing, and that the investor should use this leverage to negotiate for more favorable terms, such as a lower price or Board representation. The Court found that Michael shared this confidential information with the potential investor because Michael anticipated that he would be more likely to achieve his goals if the investor either (i) withheld any additional investment in the company, thereby leaving the company desperate for funding,[6] or (ii) used the confidential information to get better deal terms, which Michael believed would undercut the authority of the balance of the Board.

In rejecting Michael's argument that his efforts were intended to "better the corporate governance structure" of the company and "reduce [the CEO's] domination" of the Board, the Court wrote:

> "Michael may, for some period of time, have been motivated by idealistic notions of corporate governance. It was no doubt convenient that his corporate governance objectives aligned nicely with his self-interest.[7] When he and his fellow B/C [series of preferred stock] investors bought into Shocking, they did so knowing that they collectively only had one out of six board slots. Apparently, Michael came to regret that decision and worked to avoid the deal that he made. He contrasted the one out of six board seats designated by the B/C investors with B/C investors' substantial shares of all funds invested in Shocking.[8] That disparity annoyed him, but it was the board representation which he negotiated. In the abstract, his argument that board representation should be more proportional to investment is plausible. To describe it as a matter of good corporate governance—something that he may have believed or rationalized in contravention of the investment commitments that he made—strikes an observer from a distance as somewhere between disingenuous and self-righteous self-interest.
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> * * *
>
> "Regardless of how one might prioritize Michael's corporate governance concepts, those objectives would not justify pushing the Company to the brink of—or beyond—a debilitating cash shortfall. It is not an act of loyalty for a director to seek to impose his subjective views of what might be better for the Company by exercising whatever power he may have to threaten the Company's survival. In short, even if Michael had reasonable goals, he chose improper means, including disclosure of confidential information, in an attempt to achieve them.

> "Michael's conduct had a foreseeable (and intended) consequence: depriving the Company of a cash infusion necessary for its short-term survival. It turns out that a predictable result of his actions did not occur. In these circumstances, a director may not put the existence of a corporation at risk in order to bolster his personal views of corporate governance. The lesson to be learned from these facts must be carefully confined, however. First, fair debate may be an important aspect of board performance. A board majority may not muzzle a minority board member simply because it does not like what she may be saying. Second, criticism of the conduct of a board majority does not necessarily equate with criticism of the corporation and its mission. The majority may be managing the business and affairs of the corporation, but a dissident board member has significant freedom to challenge the majority's decisions and to share her concerns with other shareholders. On the other hand, internal disagreement will not generally allow a dissident to release confidential corporate information. Fiduciary obligations are shaped by context. A balancing of the various conflicting factors will be necessary, and sometimes the judgments will be difficult. Here, the most logical objective of Michael's actions—strangling the Company with a potentially catastrophic cash shortfall—cannot be reconciled with his 'unremitting' duty of loyalty. Thus, Michael did breach his fiduciary duty of loyalty to Shocking."

III. Director Debate Has Limits

The Court recognized that the crucible of director debate can be good for the corporation, albeit frustrating to the protagonists:

> "Shareholders and directors, sometimes to the chagrin of a majority of the board of directors, may seek to change corporate governance ambiance and board composition. That is not merely permitted conduct; such efforts may be entitled to affirmative protection as part of the shareholder franchise. Michael's objectives as to his corporate governance agenda were not proscribed. They may have been prudent, or they may have been irresponsible. Nonetheless, it was his right to make such policy choices.
>
> "The steps that a shareholder-director may take to achieve objectives are not without limits. A director may not harm the corporation by, for example, interfering with crucial financing efforts in an effort to further such objectives. Moreover, he may not use confidential information, especially information gleaned because of his board membership, to aid a third party which has a position necessarily adverse to that of the corporation."[9]

The Court in *Shocking Technologies,* however, found that the director went too far in pursuing his objective by his disclosure of confidential information to a third party dealing with the corporation:

> "Michael may have hoped that his disclosure of confidential information to Dickinson [the investor] would have ultimately resulted in better corporate governance practices for Shocking [the corporation]. That hope, however, cannot

> outweigh or somehow otherwise counterbalance the foreseeable harm that he would likely cause Shocking. Notwithstanding his good intentions, his taking steps that would foreseeably cause significant harm to Shocking amounts to nothing less than a breach of the fiduciary duty of loyalty."

The Court, however, did not award damages to the corporation as it did not find that there were any material damages suffered by the corporation and found that the director did not manifest the "subjective bad faith" required for an award of attorney's fees to the corporation. The Court appeared concerned that shifting fees may be too much of a penalty for a dissident director, and may make it too easy for the majority to use as a "hammer" to silence those members of the Board who dissent, explaining: "The line separating fair and aggressive debate from disloyal conduct may be less than precise."

IV. Lessons from *Shocking Technologies*

The *Shocking Technologies* case illustrates the risk that a director takes when he leaks confidential information to achieve his objectives, however laudable he may believe them to be. The case also shows the difficulties corporations face when dealing with directors who will take steps that may damage the corporation to achieve their personal objectives.

ENDNOTES

[1] Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, University of Texas School of Law 35th Annual Conference on Securities Regulation and Business Law, Austin, TX, Feb. 8, 2013, http://www.jw.com/publications/article/1830.

[2] *Gearhart Indus., Inc. v. Smith Int'l., Inc.*, 741 F.2d 707, 719 (5th Cir. 1984); *Kahn v. Kolberg Kravis Roberts & Co., L.P.*, 23 A.3d 831 (Del. 2011); *Solash v. Telex Corp.,* 1988 WL 3587 at *7 (Del. Ch. 1988).

[3] *Hollinger Intern., Inc. v. Black*, 844 A.2d 1022, 1062 (Del Ch., 2004); *Agranoff v. Miller*, 1999 WL 219650, at *19 (Del. Ch. Apr. 12, 1999), aff'd as modified, 737 A.2d 530 (Del. 1999).

[4] *See Disney v. Walt Disney Co.*, C.A. No. 234-N (Remand Opinion June 20, 2005), discussing a written confidentiality policy of The Walt Disney Company that bars present and former directors from disclosing information entrusted to them by reason of their positions, including information about discussions and deliberations of the Board). *See* The Walt Disney Company Code of Business Conduct and Ethics for Directors available at http://thewaltdisneycompany.com/content/code-business-conduct-and-ethics-directors.

[5] C.A. No. 7164-VCN (Del. Ch. Oct. 1, 2012), *available at* http://courts.delaware.gov/opinions/download.aspx?ID=179010.

[6] The company alleged that Michael was seeking to force the company into a new down round share issuance in which Michael could purchase shares on the cheap and dilute the other stockholders.

[7] *See City Capital Assocs. Ltd. P'ship v. Interco. Inc.*, 551 A.2d 787, 796 (Del. Ch. 1988) ("human nature may incline *even one acting in subjective good faith* to rationalize as right that which is merely personally beneficial").

[8] Michael believed that the B/C series investors had contributed 70% of the capital paid in to the company.

[9] *Cf. Sherwood v. Chan Tze Ngon*, 2011 Del. Ch. LEXIS 202 (Dec. 20, 2011), which involved an action over disclosures about a Board's decision not to renominate a director for election at the company's annual meeting, and in which the Court found that the plaintiff had adequately alleged disclosure claims where the proxy statement suggested that the director's "questionable and disruptive personal behavior was the only reason that motivated the

board to remove him from the Company's slate." The Court commented that it is "important that directors be able to register effective dissent" and that "[a] reasonable shareholder likely would perceive a material difference between, on the one hand, an unscrupulous, stubborn and belligerent director as implied by the Proxy Supplement and, on the other hand, a zealous advocate of a policy position who may go to tactless extremes on occasion."

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APPENDIX G

AN INTRODUCTION TO THE TEXAS BUSINESS LAW FOUNDATION (2013)

The Texas Business Law Foundation is a non-profit corporation organized in 1988 and supported by businesses, law firms, professors of business law and individuals throughout Texas. The Foundation's objective is to promote a favorable business climate in Texas through the maintenance of a modern system of business laws. To achieve this goal, the Foundation sponsors Texas legislation that advances the law and solves problems, monitors state legislative and administrative proposals of interest to Foundation members, endorses or opposes those proposals and serves as a source of advice and consultation to the legislative, judicial and executive branches of Texas government.

Whether sponsoring a uniform state business statute or a modernization of usury and organizational laws, the Foundation can be relied on to provide a package of progressive and sound business law legislation at each biennial session of the Texas Legislature. The Foundation has also been vigilant in monitoring bills that are adverse to the interests of business in Texas and in mobilizing opposition where appropriate. Among the proposed laws successfully opposed by the Foundation were those that would regulate the compensation of management, impose at a state level regulations similar to but beyond those in the Sarbanes-Oxley Act of 2002, and void certain indemnification arrangements. Your contribution to the Foundation assures your firm or company a voice in the future direction of Texas business law and the chance to participate in promoting an environment that is advantageous to your company or clients.

In supporting or opposing legislation, the Foundation has both acted as the primary advocate or opponent and partnered with or provided support to other like-minded organizations in its effort to achieve the desired outcome. The Foundation avoids active sponsorship of legislation that is not viewed favorably by its members or that is more high profile and controversial (for example, tort reform). In addition to its legislative efforts, the Foundation has drafted and filed amicus briefs and position papers with the courts and regulatory bodies in support of or opposition to litigation, regulation or legislation.

The directors of the Foundation are lawyers in private practice, general counsels of major corporations, and distinguished professors of law and corporate executives who concentrate on governmental relations and public affairs. The current officers of the Foundation and their affiliations are as follows:

Chairman: Byron F. Egan, Jackson Walker L.L.P., Dallas
Vice Chairman: Scott G. Night, Haynes and Boone, LLP, Dallas
Secretary-Treasurer: Michael L. Laussade, Jackson Walker L.L.P., Dallas

The Foundation's Sustaining and Contributing Members include:

Americredit/GMFinancial
Andrews Kurth LLP
Atkins, Hollmann, Jones, Peacock, Lewis & Lyon, Inc.
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Vinson & Elkins, L.L.P.
Weil, Gotshal & Manges LLP

For further information regarding the purposes, history and successes of the Foundation, see 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 Texas Journal of Business Law 41 (Spring 2005), available at http://www.jw.com/site/jsp/publicationinfo.jsp?id=1239.

For more information on how to join the Foundation and to assist in its efforts, please contact:

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LEGISLATION SPONSORED BY TEXAS BUSINESS LAW FOUNDATION
83RD TEXAS LEGISLATURE (2013)

The Texas Business Law Foundation sponsored and shepherded the following bills through the 83rd Texas Legislature, which commenced January 11, 2013 and adjourned on May 27, 2013, from their introduction through their passage:

1. Updating Corporate Statutes. S.B. 847 by Sen. John J. Carona amended the Texas Business Organizations Code ("*TBOC*") to update its provisions relating to corporations, partnerships and LLCs, including (i) simplification of the required contents for amended and restated certificates of formation, (ii) requiring limited partnerships to give winding up notices to potential claimants much like corporations are currently required to do, (iii) clarifying that the governing documents of partnerships and LLCs may eliminate monetary liability of their governing persons to the same extent that a corporate certificate of formation can do so for directors and to the further extent permitted by the specific partnership and LLC provisions of the TBOC, (iv) clarification that partnership agreements and LLC company agreements may provide rights to persons who are not parties thereto (e.g., officers, managers or creditors), and (v) clarification of the powers of an LLC series and that a series is not a separate entity. S.B. 847 also amended Section 24.003 of the Texas Business and Commerce Code ("*TB&CC*") to eliminate a subsection that provided that a general partner's nonpartnership assets are considered in determining the solvency of the partnership for fraudulent transfer purposes. Available at http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=SB847.

2. Social Purposes in For-Profit Corporations. S.B. 849 by Sen. John J. Carona amended the TBOC to allow for-profit corporations to include "social purposes" in their certificates of formation and to specify that their governing persons are entitled to consider those social purposes in making decisions on behalf of the corporations. Available at http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=SB849.

3. Finance Code. H.B. 1979 by Rep. Mike Villarreal amended Section 306.003 of the Finance Code to allow parties to commercial loans to agree that (i) interest is to be computed on the basis of actual days over a year of 360 days or twelve 30-day months and (ii) accrued interest may be paid on a periodic basis (not more often than monthly) by adding it to the principal balance of the loan. H.B. 1979 also confirmed that the provisions in Chapter 306 are meant to be safe harbors and do not create a negative implication for other transactions. Available at http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=HB1979.

4. Amendments to Section 4A.108, Texas Business & Commerce Code. S.B. 230 by Sen. John J. Carona amended TB&CC Section 4A.108 so that international consumer wire transfers will remain covered by TB&CC Section 4A.108. The amendment was necessitated by an amendment to the federal Electronic Funds Transfer Act effected by the Dodd-Frank Wall Street Reform and Consumer Protection Act that would have removed the statutory framework for such transfers. Available at http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=SB230.

5. Amendments to Section 9.516(b), Texas Business & Commerce Code. SB 474 by Sen. John J. Carona amended TB&CC Section 9.516(b) to eliminate organization information from

financing statements that is not otherwise required by the TB&CC. Available at http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=SB474.

6. Uniform Trade Secrets Act. SB 953 by Sen. John J. Carona enacted the Uniform Trade Secrets Act ("*UTSA*") to generally modernize existing Texas common law relating to misappropriation of trade secrets, but made the following changes from the UTSA: (i) does not require that information have been in "continuous use", resulting in a broader class of trade secrets, (ii) provides that injunctive relief is a proper remedy, (iii) provides that attorneys' fees are available to a plaintiff where misappropriation was willful and malicious, and are available to a defendant where a claim of misappropriation was made in bad faith, and (iv) provides that damages for misappropriation can include both actual loss and unjust enrichment, or alternatively imposition of a reasonable royalty, plus exemplary damages not exceeding twice any damage award. The UTSA has been adopted in 46 other states. Available at http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=SB953.

We also contributed to changes in the course or content of, or the demise of, several bills that were introduced by others in the Regular Session and affected statutes that have traditionally been of interest to the Foundation, including:

(i) Assumed Name Filings. Chapter 71 of the TB&CC requires a filing entity to file an assumed name certificate if it conducts business in Texas in a name other than the one in its certificate of formation on file with the Secretary of State and include certain information. S.B 699 by Sen. John J. Carona at the request of the Secretary of State amended TB&CC Section 71.102 to eliminate the requirement that an assumed name certificate include the entity's registered office (as it is already in another filing with the Secretary of State) and simplified the information required in connection with a principal office. Available at http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=83R&Bill=SB699.

(ii) Series LLC Name Filing. H.B. 1624 by Rep. Philip Cortez was initially proposed as an amendment to TBOC Section 101.601 adding a requirement that an LLC establishing a series shall name the series with a name that contained the name of the LLC followed by the word "series" and a unique identifying number. The bill was reworked into a simple amendment to the TB&CC Section 71.002(2) to require an assumed name filing for an LLC series established by its company agreement. H.B. 1624 as passed did not contain any requirements as to the naming of any series. Available at http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=83R&Bill=HB1624.

(iii) Powers of Attorney. H.B. 2918 by Rep. Senfronia Thompson, as passed and effective January 1, 2014, changed the current statutory durable power of attorney form in Estates Codes Section 752.051 from an "opt-out" form to an "opt-in" form (i.e. from a form in which powers are granted unless expressly excluded to one in which powers are not granted unless affirmatively so provided) and added wording regarding the fiduciary duties and other legal responsibilities of an agent appointed pursuant to a statutory durable power of attorney. Foundation representatives monitored the bill so that it did not end up containing provisions that would have applied to powers of attorney in entity organization and governance documents, financing documents and other commercial documents. Available at http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=83R&Bill=HB2918.

(iv) Banks. S.B. 804 by Sen. John J. Carona revised provisions in certain laws governing certain banks and trust companies in Texas to conform to changes in terminology made by the TBOC. This legislation was prepared by the Department of Banking and primarily substitutes the term "certificate of formation" for the term "articles of association." Available at http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=83R&Bill=SB804.

(v) Bank Regulation. H.B. 1664 by Rep. Mike Villarreal amended provisions of the Finance Code relating to the subpoena and other regulatory powers of state bank and trust company regulators, the opening of state bank deposit or loan production offices, limitations on the providing by a state bank or trust company of confidential information to its advisory directors, meetings of the board of directors of a state bank, holding real estate and mineral royalty interests, and other matters relating to the regulation of state banks, trust companies and bank holding companies. Available at http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=83R&Bill=HB1664.

LEGISLATION SPONSORED BY TEXAS BUSINESS LAW FOUNDATION 82ND TEXAS LEGISLATURE (2011)

The Texas Business Law Foundation sponsored and shepherded the following bills through the 82nd Texas Legislature, which convened on January 11, 2011 and adjourned on May 30, 2011, from their introduction through their passage:

1. LLC Veil Piercing Limits. Senate Bill 323 amended the Texas Business Organizations Code ("TBOC") to provide that the TBOC provisions limiting the liability of shareholders of Texas corporations apply equally to managers and members of Texas limited liability companies ("LLCs") if or to the extent LLC veil piercing becomes recognized in Texas. SB 323 is available at: http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=HB521.

2. Derivative Plaintiff Qualification. Senate Bill 1568 deleted a TBOC provision that was ambiguous and inconsistent with other TBOC provisions and court holdings relating to standing to bring a derivative action on behalf of a corporation after a merger. Now it is clear that a derivative plaintiff must own stock at the time of the act complained of and continuously to the completion of the lawsuit. SB 1568 is available at: http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB1568.

3. Business Entity Statute Updating. Senate Bill 748 is a 58-page package of amendments to the corporation, non-profit corporation, partnership and LLC provisions of the TBOC that addresses issues that have arisen in recent experience under the TBOC and makes the statute more user friendly for Texas entities. SB 748 is available at: http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB748.

4. More Flexibility to Choose Law Applicable to Large Transactions. House Bill 2991 amended chapter 271 of the Texas Business and Commerce Code to add additional flexibility in choosing the law of a particular jurisdiction to govern large business transactions. HB 2991 is available at: http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=HB2991.

5. Secured Transactions. Senate Bill 782 amended Texas Business and Commerce Code Chapter 9 to adopt changes approved and recommended by the National Conference of Commissioners on Uniform State Laws for enactment in all states. The majority of the changes are for enhanced clarity or to reflect advances in technology or changes in business practice. SB 782 is available at: http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB782.

In 2011 the Foundation also successfully opposed proposed legislation that, if enacted, would have been generally unfavorable to the conduct of business. Among the bills the Foundation opposed in 2011 that did not pass were bills restricting the choice of foreign law and adding requirements for powers of attorney that could affect commercial transactions.

OTHER LEGISLATION SPONSORED BY TEXAS BUSINESS LAW FOUNDATION

During its history, the Texas Business Law Foundation has been extremely successful in obtaining the passage of its legislative program by the Texas Legislature. Most of the laws that the Foundation has sponsored and passed are listed below:

Amendments to Texas Business Corporation Act in 1985, 1989, 1991, 1993, 1995, 1997, 2003 and 2005

Revised Limited Partnership Act of Texas in 1991, and amendments in 1993, 1995, 1997, 2003 and 2005

Revised Partnership Act of Texas, and amendments in 2003 and 2005

Limited Liability Partnership Amendments to Uniform Partnership Act and to Revised Partnership Act of Texas

Limited Liability Company Act of Texas in 1991, amendments in 1993, 1995, 1997, 2003, 2005, and 2007

Business and Commerce Code Amendments (i.e., Revised UCC Articles 1, 2A, 3, 4, 4A, 5, 6, 7, 8 and 9) in 1991, 1995, 1997, 1999, 2003 and 2005, technical amendments to UCC Article 9 in 2001, 2003, and 2007, and amendments to UCC Articles 3 and 4 in 2005

Uniform Unincorporated Non-Profit Association Act in 1995

Amendments to Non-Profit Corporation Act in 1993 and 1995

Texas Environmental and Safety and Health Audit Privilege Act in 1995

Amendments to Real Estate Investment Trust Act in 1995 and 1997

Contractual Choice of Law in 1993

Covenants Not to Compete Amendments in 1989, 1991 and 1993

Professional Service Negligence Bill in 1995

Usury Reform Amendments in 1993, 1997, 1999 and 2005

Contractual Choice of Venue Bill in 1999
Euro Conversion Bill in 1999

Uniform Electronic Transactions Act in 2001

Texas Business Organizations Code in 2003, and amendments thereto in 2005, 2007 and 2009.

Anti-Botnet Bill in 2009

Amendments to Certificate of Title Statutes in 2009

In addition, the Foundation has in each legislative session monitored and either endorsed or opposed any number of other bills, all from the standpoint of their benefit to the conduct of business in the State of Texas. The Foundation's efforts have also resulted in the modification of legislation to reduce its negative effect on business.

TEXAS BUSINESS LAW FOUNDATION
Sustaining Membership Form

The Texas Business Law Foundation is a non-profit organization dedicated to the improvement and implementation of laws favorable to organizations doing business in the State of Texas. The Foundation's activities include the drafting and support of pro-business legislation, the filing of amicus briefs and position papers with the courts and regulatory bodies on significant issues affecting Texas businesses and other activities associated with the enactment of pro-business legislation and regulations.

Membership dues are used to further the mission of the Foundation and are used primarily to pay lobbying expenses. Dues and other contributions to the Foundation are not deductible as charitable contributions for federal income tax purposes. In addition, the Foundation estimates that approximately 100 percent of the dues collected by the Foundation will be allocable to the Foundation's activities with respect to "influencing legislation," as the term is defined in section 162(e) of the Internal Revenue Code, and thus will not be deductible as a trade or business expense under section 162(a) of the Internal Revenue Code. No funds are used for political contributions.

Membership may be either on an individual basis or through an organization. Dues are payable annually at $2,500 a year for sustaining members and cover the fiscal year period from September 1 to August 31. We also have participating organizational memberships for small law firms and small businesses (called Contributing Memberships).

Sustaining members will receive regular updates on the Foundation's legislative, judicial and other efforts and will also be entitled to the appointment of a director to the Board of Directors of the Foundation.

Please complete the following and return this form and your check payable to The Texas Business Law Foundation at the address provided below:

Membership:	Sustaining Membership	$2,500
Name/Organization:		
Organizational Contact:		
Address:		
Telephone Number:		
Fax Number:		
Email Address:		

TEXAS BUSINESS LAW FOUNDATION
Michael L. Laussade, Secretary/Treasurer
c/o Jackson Walker L.L.P.
901 Main Street, Suite 6000
Dallas, Texas 75202
Telephone: 214-953-5805
mlaussade@jw.com

TEXAS BUSINESS LAW FOUNDATION
Membership Form

The Texas Business Law Foundation is a non-profit organization dedicated to the improvement and implementation of laws favorable to organizations doing business in the State of Texas. The Foundation's activities include the drafting and support of pro-business legislation, the filing of amicus briefs and position papers with the courts and regulatory bodies on significant issues affecting Texas businesses and other activities associated with the enactment of pro-business legislation and regulations.

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Membership may be either on an individual basis or through an organization. Dues are payable annually and cover the fiscal year period from September 1 to August 31. Individual memberships are $100 per year (called "Fellows") and organizational memberships are $2,500 per year (called "Sustaining Memberships"). We also have participating organizational memberships for small law firms and small businesses (called "Contributing Memberships") for $1,000 per year.

All members will receive regular updates on the Foundation's legislative, judicial and other efforts. Sustaining members will also be entitled to the appointment of a director to the Board of Directors of the Foundation.

Please complete the following and return this form and your check payable to Texas Business Law Foundation at the address provided below:

Membership:	[_____] Sustaining Membership	$2,500
	[_____] Contributing Membership	$1,000
	[_____] Fellow Membership	$ 100
Name/Organization:		
Organizational Contact:		
Address:		
Telephone Number:		
Fax Number:		
Email Address:		

TEXAS BUSINESS LAW FOUNDATION
Michael L. Laussade, Secretary/Treasurer
c/o Jackson Walker L.L.P.
901 Main Street, Suite 6000
Dallas, Texas 75202

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 approximately 300 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/attyinfo.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. 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" – prepared for a May 24, 2013 program in San Antonio at the TexasBarCLE & Business Law Section of State Bar of Texas Choice and Acquisition of Entities in Texas Course. Published on the Jackson Walker L.L.P. ("JW") website and full text available at: http://www.jw.com/publications/article/1846

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 *"Legislative Update: Business Law"* – prepared for a July 2, 2013 TexasBarCLE Webcast on Legislative Update: Business Law. Published on the JW website and full text available at: http://www.jw.com/publications/article/1871.

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 were required to conform to TBOC from and after January 1, 2010, but could 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.

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 *"How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations"* – prepared for a February 8, 2013 program in Austin at the University of Texas School of Law 35th Annual Conference on Securities Regulation and Business Law. Published on the JW website and full text available at: http://www.jw.com/publications/article/1830.

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.

3.
MERGERS & ACQUISITIONS

EXCERPTED FROM: "Acquisition Structure Decision Tree" – prepared for a May 24, 2013 program in San Antonio at the TexasBarCLE & Business Law Section of State Bar of Texas Choice and Acquisition of Entities in Texas Course. Published on the JW website and full text available at: http://www.jw.com/publications/article/1844

Key Issues Covered:

- Alternative structures for sales of businesses
- Successor liability
- Form of asset purchase agreement with commentary

See also:

◆*"Private Company Acquisitions: A Mock Negotiation"* – 116 Penn State Law Review 743 (2012)

◆*"Asset Acquisitions: Assuming and Avoiding Liabilities"* – 116 Penn State Law Review 913 (2012)

◆*"Joint Venture Formation"* – 44 Texas Journal of Business Law 129 (2012)

◆*"Contractual Limitations on Seller Liability in M&A Agreements"* – prepared for an October 18, 2012 program in Dallas at the University of Texas School of Law 8th Annual Mergers and Acquisitions Institute. Published on the JW website and full text available at: http://images.jw.com/com/publications/1790.pdf

Buying or selling a business, 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 acquisition 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.
- Forms of confidentiality agreement and letter of intent.

- 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.

- Joint venture formation overview.

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 M&A Professionals After the Sarbanes-Oxley and Dodd-Frank Acts"* – prepared for a November 5, 2010 program in Las Vegas at the ABA 15th Annual National Institute on Negotiating Business Acquisitions. Published on the JW website and full text available at: http://images.jw.com/com/publications/1498.pdf

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.

Byron F. Egan is a partner of Jackson Walker L.L.P. in Dallas, Texas, where he practices corporate, financing, mergers and acquisitions, and securities law.

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.