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Corporations and Limited Liability Companies

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CORPORATIONS AND LIMITED LIABILITY COMPANIES

*Alan W. Tompkins**
*Ted S. O'Neal***

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I. INTRODUCTION

The most significant changes to Texas business corporation and limited liability company law during the Survey period¹ arose from the activities of the 75th Texas Legislature. The passage of Senate Bill 555² brought numerous changes to the Texas Business Corporation Act³ (TBCA), the Texas Miscellaneous Corporation Laws Act⁴ (TMCLA), and the Texas Limited Liability Company Act⁵ (TLLCA), and House Bill 1507⁶ provided a welcome limitation of civil liability for attorneys, accountants, and consultants who work on small business securities offerings.⁷ In addition, Texas courts decided a number of interesting corporate and securities law cases during the period. Section II of this article highlights the most significant amendments to the Texas corporation, limited liability company, and securities statutes, Section III focuses on the more interesting judicial decisions, and Section IV summarizes certain significant federal income tax developments relating to business corporations and limited liability companies.

1. The Survey period runs from October 1, 1996 through September 30, 1997.

2. See Act of May 13, 1997, 75th Leg., R.S., ch. 375, 1997 Tex. Sess. Law Serv. 1516 (Vernon) [hereinafter S. B. 555].

3. TEX. BUS. CORP. ACT ANN. arts. 1.01-13.08 (Vernon 1980 & Supp. 1998).

4. TEX. REV. CIV. STAT. ANN. arts. 1302-1.01-7.07 (Vernon 1997 & Supp. 1998).

5. TEX. REV. CIV. STAT. ANN. art. 1528n, Arts. 1.01-11.07 (Vernon 1997 & Supp. 1998).

6. See Act of May 21, 1997, 75th Leg., R.S., ch. 638, 1997 Tex. Sess. Law Serv. 2184 (Vernon) (to be codified as an amendment to TEX. REV. CIV. STAT. ANN. art. 581-33) [hereinafter H. B. 1507].

7. Both bills became effective on September 1, 1997.

II. STATUTORY AMENDMENTS

A. TEXAS BUSINESS CORPORATION ACT

1. *Conversions*

Probably the most significant amendment to the TBCA as a result of Senate Bill 555 is the addition of new articles 5.17 to 5.20, which provide for the conversion of a Texas corporation into a foreign corporation or other entity without interruption or the necessity of a merger or other transfer of assets.⁸ A Texas corporation may adopt a plan of conversion if (1) the plan is approved by the shareholders in the same manner as a merger in which the corporation is the surviving entity; (2) the conversion is permitted by, or not inconsistent with, the laws of the jurisdiction in which the converted entity is to be incorporated, formed, or organized and the incorporation, formation, or organization is effected in compliance with those laws; (3) at the time the conversion becomes effective, each shareholder of the converted corporation (other than those who receive payment for their shares pursuant to the dissenters' rights provisions of TBCA article 5.12) will, unless otherwise agreed, own an equity interest or other ownership or security interest in, and be a shareholder, partner, member, owner, or other security holder of, the converted entity; (4) no shareholder of the converting corporation will, as a result of the conversion, become personally liable for any liability or obligation of the converted entity without that shareholder's consent; and (5) the converted entity is incorporated, formed, or organized as a part of the plan of conversion.⁹ A foreign corporation or other entity (such as a Texas partnership or limited liability company) may convert into a Texas corporation if (1) the conversion is permitted by the laws of the foreign jurisdiction, in the case of a foreign corporation; (2) the conversion is permitted by the laws under which the other entity is formed or organized or by such entity's constituent documents, in the case of another entity; and (3) the converting entity takes all actions required under applicable law to effect the conversion.¹⁰

Once a conversion has been approved, the converting entity must file articles of conversion with the Texas Secretary of State which include either (1) a copy of the plan of conversion or (2) certain statements certifying the identity of the converting entity, the approval of the plan, that a copy of the plan is on file at the entity's principal office, and that a copy of the plan will be provided to any shareholder of the converted or converting entity upon written request.¹¹ The articles of conversion must also include certain statements regarding the number of outstanding shares that were and were not entitled to vote on the plan and the results

8. See S. B. 555, *supra* note 2, § 32 (adding TEX. BUS. CORP. ACT ANN. arts. 5.17-5.20).

9. See *id.* (adding TEX. BUS. CORP. ACT ANN. art. 5.17, § A).

10. See *id.* (adding TEX. BUS. CORP. ACT ANN. art. 5.17, § B).

11. See *id.* (adding TEX. BUS. CORP. ACT ANN. art. 5.18, § A(1)).

of that vote, if the converting entity was a Texas corporation, or a statement that the conversion was duly authorized by all required action, if the converting entity was a foreign corporation or other entity.¹² Unless the articles of conversion provide for a delayed effective date, the conversion will be effective upon the filing of the articles and the issuance of a certificate of conversion by the Texas Secretary of State.¹³ When the conversion takes effect, the converting entity will continue to exist, without interruption, but in the form of the converted entity rather than the prior organizational form.¹⁴ All of the converting entity's rights to property, as well as its liabilities, will continue as the rights and liabilities of the converted entity, and all rights of creditors or third parties against the prior interest holders of the converted entity will continue as if the conversion had not occurred.¹⁵

2. *Mergers and Share Exchanges*

a. Authority to Treat Shareholders Differently in Mergers and Share Exchanges

The question has long existed under Texas law as to whether holders of the same class or series of shares could be treated differently than other holders of the same class or series in a merger or share exchange transaction. That question has been answered in the affirmative, at least with respect to future transactions, by the Texas Legislature. Article 5.01 of the TBCA, dealing with mergers, now provides that if the shares of any holder of a class or series of shares (or other evidences of ownership) will be converted in a manner or basis that is different from the treatment afforded to other holders of shares of that same class or series, then the manner and basis of such conversion must be specified in the plan of merger.¹⁶ Article 5.02 of the TBCA, dealing with share exchange transactions, now provides a similar disclosure requirement with respect to plans of exchange.¹⁷

b. Dissenters' Rights

Senate Bill 555 effected two significant limitations to the dissent and appraisal rights provisions of TBCA article 5.11. The first is a denial of the right of dissent and appraisal to the holders of shares of a class or series that is not entitled to vote on a particular sale, lease, exchange, or other disposition of all (or substantially all) of the property and assets of the corporation.¹⁸ This change makes the dissent and appraisal rights applicable to an asset sale transaction consistent with the rights applicable

12. *See id.* (adding TEX. BUS. CORP. ACT ANN. art. 5.18, § A(2)-(3)).

13. *See id.* (adding TEX. BUS. CORP. ACT ANN. art. 5.19).

14. *See id.* (adding TEX. BUS. CORP. ACT ANN. art. 5.20, § A(1)).

15. *See id.* (adding TEX. BUS. CORP. ACT ANN. art. 5.20, § A(2)-(4)).

16. *See id.* § 24 (amending TEX. BUS. CORP. ACT ANN. art. 5.01, § B(3)).

17. *See id.* § 25 (amending TEX. BUS. CORP. ACT ANN. art. 5.02, § B(3)).

18. *See id.* § 29 (amending TEX. BUS. CORP. ACT ANN. art. 5.11, § A(2)).

in the case of a merger,¹⁹ i.e., a shareholder must be entitled to vote on the transaction before he is entitled to dissent and appraisal rights with respect to that transaction.

The second change expands the universe of shares exempt from statutory dissent and appraisal rights. Prior to amendment, article 5.11, section B(1) provided that shares that were either (1) listed on a national securities exchange, such as the New York Stock Exchange or the American Stock Exchange, or (2) held of record by at least 2,000 holders on the record date of the vote on the plan of merger were exempt from statutory dissent and appraisal rights.²⁰ Senate Bill 555 added to the list of exempt securities those shares listed on the NASDAQ Stock Market (or successor quotation system) or designated as a national market security on an interdealer quotation system by the National Association of Securities Dealers, Inc., or its successor.²¹ The statutory language is not clear as to whether the term "NASDAQ Stock Market" includes the NASDAQ Small-Cap Market System or only the NASDAQ National Market System (the reference to designation as a national market security seems to indicate the latter); therefore, an issue may arise as to whether shares traded on the NASDAQ Small-Cap Market System are subject to statutory dissent and appraisal rights.

c. Filing Statement in Lieu of Plan of Merger or Exchange

Article 5.04 of the TBCA previously provided that the plan of merger or exchange be set forth in the articles of merger or exchange filed with the Texas Secretary of State. The TBCA has been amended to simplify the filing process and eliminate the filing of a voluminous plan.²² In lieu of filing the plan of merger or exchange, a statement may be filed certifying (1) the name and state of incorporation or organization of each constituent entity; (2) that a plan has been approved; (3) any amendments to the articles of incorporation of any surviving Texas corporations, or if no such amendments are made, a statement to that effect; (4) that the articles of incorporation of any new Texas corporation created pursuant to the merger are being filed with the Secretary of State with the articles of merger or exchange; (5) that a copy of the plan is on file at the surviving or new entity's principal office; and (6) that the plan will be furnished to any shareholder of any corporation that is a party to the merger upon written request.²³

19. See TEX. BUS. CORP. ACT ANN art. 5.11, § A(1) (Vernon Supp. 1998).

20. See *id.* art. 5.11, § B.

21. See S. B. 555, *supra* note 2, § 29 (amending TEX. BUS. CORP. ACT ANN. art. 5.11, § B).

22. See *id.* § 27 (amending TEX. BUS. CORP. ACT ANN. art. 5.04).

23. See *id.* (amending TEX. BUS. CORP. ACT ANN. art. 5.04, § A(1)).

d. Short-Form Mergers with Other Entities

The short-form merger provision of the TBCA, article 5.16, which provides for short-form mergers between parent corporations and their ninety-percent-owned subsidiaries, has been expanded to permit short-form mergers between Texas corporations and other types of entities, foreign or domestic, provided that the ninety ownership requirement is met and that such mergers are permitted by the laws applicable to the constituent entities.²⁴ The procedural formalities for short-form mergers were not altered.

3. *Amendments Specifically Relating to Directors*

a. Consideration of Corporate and Shareholder Long-Term Interests

Prior to amendment, the TBCA did not specifically address whether directors could consider the long-term interests of the corporation and its shareholders when evaluating transactions such as mergers, tender offers, and other business combinations. New article 13.06 remedies this situation by providing that directors may, in the discharge of their duties, consider both the long-term and short-term interests of the corporation and its shareholders, and specifically permits directors to consider the possibility that those interests may be best served by the continued independence of the corporation.²⁵

b. Interested Director and Officer Transactions

Prior to amendment, TBCA article 2.35-1 provided that interested director or officer transactions were not void or voidable solely because the director or officer was present at or participated in the meeting of the board (or committee thereof) in which the contract or transaction was approved, so long as certain disclosure or fairness standards were met.²⁶ Article 2.35-1 has been amended to more strongly favor the validity of such contracts and transactions. As amended, article 2.35-1 generally provides that an otherwise valid contract or transaction will be valid regardless of whether the director or officer is present at or participates in the meeting at which the contract or transaction is authorized, or whether his or her votes are counted for such purpose, provided that: (1) the material facts of the director's or officer's relationship to the contract or transaction are disclosed or known to the board (or committee thereof) and the board or committee authorizes the contract or transaction by the affirmative vote of a majority of the disinterested directors (even though such directors may not constitute a quorum); (2) the material facts of the director's or officer's relationship to the contract or transaction are disclosed to the shareholders and the contract or transaction is approved by

24. *See id.* § 31 (amending TEX. BUS. CORP. ACT ANN. art. 5.16).

25. *See id.* § 47 (adding TEX. BUS. CORP. ACT ANN. art. 13.06).

26. *See id.* § 13 (amending TEX. BUS. CORP. ACT ANN. art. 2.35-1).

a vote of the shareholders; or (3) the contract or transaction is fair to the corporation when it is authorized, approved, or ratified by the board or the shareholders.²⁷

c. Removal of Classified Directors Only for Cause

TBCA article 2.33 provides that the board of a Texas corporation may be divided into two or three classes with staggered terms.²⁸ This arrangement helps maintain a degree of consistency in the composition of the board in the event of a change of corporate control. The ability to maintain consistency has been strengthened by an amendment to article 2.32, which now provides that unless otherwise permitted by the articles of incorporation, classified directors may be removed only for cause.²⁹

4. Amendments Specifically Relating to Shareholders

a. Shareholder Agreements

New article 2.30-1 provides the authority for shareholders to enter into an agreement that is effective as to the shareholders and the corporation and which substantially modifies (or eliminates) the traditional corporate governance structure established in the TBCA.³⁰ Such a shareholder agreement must comply with the procedural requirements set forth in article 2.30-1 and, in order to do so, it must be:

- (1) set forth (a) in the articles of incorporation or bylaws and approved by all persons who are shareholders at the time of the agreement, or (b) in a written agreement that is signed by all the persons who are shareholders at the time of the agreement and is made known to the corporation;
- (2) subject to amendment only by all persons who are shareholders at the time of the amendment, unless the agreement provides otherwise; and
- (3) valid for 10 years, unless the agreement provides otherwise.³¹

A shareholder agreement which complies with article 2.30-1 can effect any of the following arrangements:

- (1) restricts the discretion or powers of the board of directors;
- (2) eliminates the board of directors and permits 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) establishes 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;

27. See *id.*

28. TEX. BUS. CORP. ACT ANN. art. 2.33 (Vernon 1980).

29. See S. B. 555, *supra* note 2, § 12 (amending TEX. BUS. CORP. ACT ANN. art. 2.32).

30. See *id.* § 10 (adding TEX. BUS. CORP. ACT ANN. art. 2.30-1).

31. *Id.* (adding TEX. BUS. CORP. ACT ANN. art. 2.30-1, § B).

(4) governs the authorization or making of distributions whether in proportion to ownership of shares, subject to the limitations in Article 2.38 [of the TBCA], or determines the manner in which profits and losses [are] apportioned;

(5) governs, 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) establishes the terms and conditions of any agreement for the transfer or use of property or the provision of services between the corporation and any shareholder, director, officer, or employee of the corporation, or other person or among any of them;

(7) authorizes arbitration or grants 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) requires dissolution of the corporation at the request of one or more of the shareholders or on 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 Article 6.02 [of the TBCA]; or

(9) otherwise governs the exercise of corporate powers, the management of the business and affairs of the corporation, or the relationship among the shareholders, the directors, and the corporation, 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.³²

The existence of the agreement must be noted conspicuously on the front or back of each of the corporation's share certificates (or on the information statement required for uncertificated shares by TBCA article 2.19), and such notation must state that the "shares are subject to the provisions of a shareholders' agreement that may provide for management of the corporation in a manner different than in other corporations and may subject a shareholder to certain obligations or liabilities not otherwise imposed on shareholders in other corporations."³³ If the corporation has shares outstanding represented by certificates at the time the agreement is made, it must recall the outstanding certificates and issue substitute certificates that comply with the requirements of article 2.30-1, section C; however, the failure to note the existence of the agreement on the certificate will not affect the validity of the shareholder agreement or any action taken pursuant to it.³⁴

Any purchaser of shares who, at the time of purchase, did not have knowledge of the existence of a shareholder agreement authorized by article 2.30-1 is entitled to rescind their purchase of the shares.³⁵ A pur-

32. *Id.* (adding TEX. BUS. CORP. ACT ANN. art. 2.30-1, § A).

33. *Id.* (adding TEX. BUS. CORP. ACT ANN. art. 2.30-1, § C).

34. *See id.*

35. *See id.* § 10 (adding TEX. BUS. CORP. ACT ANN. art. 2.30-1, § D).

chaser will be deemed to have knowledge of the agreement if it is noted on the certificate or information statement for the shares (as required by article 2.30-1, section C) and, if the shares are not represented by a certificate, the information statement noting the existence of the agreement is delivered to the purchaser at or prior to the time of purchase.³⁶ "An action to enforce the right of rescission . . . must be commenced within the earlier of 90 days after discovery of the existence of the agreement or two years after . . . the purchase of the shares."³⁷

A shareholder agreement authorized by article 2.30-1 that limits the discretion or powers of the board of directors (or supplants the board of directors) will relieve the directors of, and impose on the persons in whom the discretion or powers of management of the corporation are vested, liability for actions or omissions imposed by the TBCA or other law on directors to the extent that the discretion or powers of the directors are limited or supplanted by the agreement.³⁸ The existence or performance of the 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: "(1) treats the corporation as if it were a partnership or in a manner that otherwise is appropriate only among partners; (2) results in the corporation being considered a partnership for purposes of taxation; or (3) results in failure to observe the corporate formalities otherwise applicable to the matters governed by the agreement."³⁹

b. Limitations on Corporate Shareholder and Affiliate Liability

The 75th Texas Legislature has amended TBCA article 2.21 in yet another effort to curb the creativity of the bench and the bar in holding shareholders liable for corporate obligations.⁴⁰ As amended, article 2.21 now provides that no shareholder *or affiliate* will be liable for any contractual obligation of the corporation "*or any matter relating to or arising from the [contractual] obligation*" under such theories as alter ego or constructive fraud unless an actual fraud which directly benefits the shareholder or affiliate is proven.⁴¹ These changes provide protection for corporate affiliates, such as brother/sister corporations, and restrict plaintiffs from seeking to recover against corporate shareholders through tort claims arising from the contractual relationship (rather than from the contract). In addition, the prohibition against shareholder liability result-

36. *See id.*

37. *Id.*

38. *See id.* (adding TEX. BUS. CORP. ACT ANN. art. 2.30-1, § F).

39. *Id.* (adding TEX. BUS. CORP. ACT ANN. art. 2.30-1, § G).

40. For a more thorough discussion of the Texas Legislature's efforts to limit shareholder liability through TBCA article 2.21, see John D. Jackson & Alan W. Tompkins, *Corporations and Limited Liability Companies: Annual Survey of Texas Law*, 47 SMU L. REV. 901, 918 (1994) [hereinafter Jackson & Tompkins].

41. S.B. 555, *supra* note 2, § 7 (amending TEX. BUS. CORP. ACT ANN. art. 2.21, § A) (emphasis added).

ing from the corporation's failure to follow corporate formalities has been expanded to include *all* obligations of the corporation, rather than only contractual obligations.⁴²

c. Quorum Requirements

Prior to amendment, TBCA article 2.28, dealing with the determination of a quorum at a meeting of shareholders, provided for the determination of a quorum on a matter-by-matter basis.⁴³ As amended, article 2.28 provides that a quorum is established for the meeting in general.⁴⁴ The amendments further provide that a matter (other than the election of directors) that is subject to a vote will be determined on the basis of the votes actually cast for, against, or expressly abstained with respect to the matter, rather than on the basis of the shares represented at the meeting in person or by proxy.⁴⁵

5. Shareholder Derivative Proceedings

TBCA article 5.14, dealing with shareholder derivative proceedings, was extensively amended by Senate Bill 555. As amended, article 5.14 provides that no shareholder has standing to commence or maintain a derivative action unless the shareholder:

(1) was a shareholder of the corporation at the time of the act or omission complained of or became a shareholder by operation of law from a person that was a shareholder at that time; and (2) fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.⁴⁶

The demand requirement of article 5.14 now provides that no shareholder can commence a derivative action until:

(1) a written demand is filed with the corporation setting forth with particularity the act, omission, or other matter that is the subject of the claim or challenge and requesting that the corporation take suitable action; and (2) 90 days have expired from the date the demand was made, unless the shareholder [is sooner] notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation is being suffered or would result [from the 90-day delay].⁴⁷

A written demand filed with the corporation pursuant to TBCA article 5.14, section C will toll the statute of limitations on the claim on which demand is made for the lesser of (1) ninety days or (2) thirty days after the corporation advises the shareholder that the demand has been rejected or the review of the demand has been completed.⁴⁸

42. *See id.*

43. *See id.* § 8 (amending TEX. BUS. CORP. ACT ANN. art. 2.28).

44. *See id.* § 8 (amending TEX. BUS. CORP. ACT ANN. art. 2.28, § A).

45. *See id.* (amending TEX. BUS. CORP. ACT ANN. art. 2.28, § B).

46. *Id.* § 30 (amending TEX. BUS. CORP. ACT ANN. art. 5.14, § B).

47. *Id.* (amending TEX. BUS. CORP. ACT ANN. art. 5.14, § C).

48. *See id.* (amending TEX. BUS. CORP. ACT ANN. art. 5.14, § E).

If the corporation commences an inquiry into the allegations made in a demand or petition and a group of disinterested directors or other persons are conducting an active review of the allegations in good faith, the action will be stayed until the review is completed and a determination is made by the group as to what further action, if any, should be taken.⁴⁹ Under article 5.14, section F, the court must dismiss the derivative action on a motion by the corporation if a group of disinterested directors or other persons determines in good faith, after conducting a reasonable inquiry and based on the factors deemed appropriate under the circumstances, that the continuation of the action is not in the best interests of the corporation.⁵⁰ However, no derivative action can be discontinued or settled without court approval.⁵¹ If the court finds that a proposed discontinuance or settlement may substantially affect the interests of other shareholders, the court will require that notice be given to the affected shareholders.⁵²

6. *Business Combination Law*

Another significant amendment to the TBCA was the addition of the new business combination law.⁵³ In general, the law provides for a three-year moratorium on mergers and share exchanges between issuing public corporations (those with publicly-traded or registered shares or more than 100 shareholders) and their affiliates or affiliated shareholders (i.e., a person who directly or indirectly controls, or is under common control with, the issuing public corporation).⁵⁴ More particularly, issuing public corporations are prohibited, directly or indirectly, from entering into or engaging in a business combination with an affiliated shareholder, or any affiliate or associate of the affiliated shareholder, during the three-year period immediately following the affiliated shareholder's share acquisition date unless: (1) the combination or the purchase or acquisition of shares is approved by the board of directors of the corporation before the affiliated shareholder's share acquisition date; or (2) the combination is approved, by the affirmative vote of the holders of at least two-thirds of the outstanding voting shares of the corporation not beneficially owned by the affiliated shareholder (or an affiliate or associate of the affiliated shareholder), at a meeting of shareholders (and not by written consent) duly called for that purpose not less than six months after the affiliated shareholder's share acquisition date.⁵⁵ A number of exceptions to the application of the three-year moratorium are set forth in TBCA article 13.04.⁵⁶

49. *See id.* (amending TEX. BUS. CORP. ACT ANN. art. 5.14, § D).

50. *See id.* (amending TEX. BUS. CORP. ACT ANN. art. 5.14, § F).

51. *See id.* (amending TEX. BUS. CORP. ACT ANN. art. 5.14, § I).

52. *See id.*

53. *See id.* § 47 (adding TEX. BUS. CORP. ACT ANN. arts. 13.01-13.08).

54. *See id.* (adding TEX. BUS. CORP. ACT ANN. art. 13.03).

55. *See id.*

56. *See id.* (adding TEX. BUS. CORP. ACT ANN. art. 13.04).

B. TEXAS MISCELLANEOUS CORPORATION LAWS ACT

Prior to their respective amendments, section A of TMCLA article 1302-2.06, dealing with the types of consideration that could be exchanged for indebtedness, was consistent with the requirement in the Texas Constitution that the consideration received in exchange for shares or indebtedness consist of money paid, labor done, or property actually received.⁵⁷ The Texas Constitution was amended to eliminate that requirement in 1993,⁵⁸ and Senate Bill 555 eliminated that requirement from article 1302-2.06.⁵⁹ As amended, article 1302-2.06 now provides that a corporation may incur indebtedness for any consideration that it deems to be appropriate, including real, personal, or intangible property, contracts to receive such property, debt or equity securities of any domestic or foreign corporation, or any other direct or indirect benefit received by the corporation.⁶⁰ Further, a corporation may issue and incur indebtedness without the receipt of any consideration as a result of the authorization or payment of a distribution.⁶¹

Section B of article 1302-2.06 provides that a corporation may guaranty indebtedness if the guaranty is reasonably expected to be of direct or indirect benefit to the guarantor corporation.⁶² Prior to amendment, section C provided a safe harbor of power and authority for the guaranty of the indebtedness of subsidiary, parent, or affiliated corporations, but required that each such relationship meet a one hundred percent share ownership test.⁶³ The safe harbor in section C was amended by Senate Bill 555 to cover those subsidiary, parent, and affiliate relationships with corporations or other entities (such as limited liability companies or partnerships) that result from an ownership of at least fifty percent of the voting interests of the subsidiary, parent, or affiliated corporation or other entity.⁶⁴ This amendment significantly expands the range of entities and affiliate relationships covered by the statutory safe harbor.

C. TEXAS LIMITED LIABILITY COMPANY ACT

1. Conversions

Part Ten of the TLLCA was amended by Senate Bill 555 to add new articles 10.08-10.11, which provide the authority for Texas limited liability companies to engage in conversion transactions.⁶⁵ The TLLCA conver-

57. See TEX. REV. CIV. STAT. ANN. art. 1302-2.06 (Vernon 1997).

58. See Jackson & Tompkins, *supra* note 40, at 922 (addressing the amendment to art. XIII, § 6 of the Texas Constitution).

59. See S. B. 555, *supra* note 2, § 48 (amending TEX. REV. CIV. STAT. ANN. art. 1302-2.06, § A).

60. See *id.*

61. See *id.*

62. See TEX. REV. CIV. STAT. ANN. art. 1302-2.06, § B (Vernon 1997).

63. See *id.* art. 1301-2.06, § C.

64. See S. B. 555, *supra* note 2, § 48 (amending TEX. REV. CIV. STAT. ANN. art. 1302-2.06, § C).

65. See *id.* § 79 (adding TEX. REV. CIV. STAT. ANN. art. 1528n, Arts. 10.08-10.11).

sion provisions are substantively equivalent to the provisions set forth for corporations in new TBCA articles 5.17-5.20, which are addressed extensively in Section II.A.1 of this Article.⁶⁶

2. Amendments to Articles of Organization

Prior to amendment, the vote of a majority of the members of a Texas limited liability company was required to amend the company's articles of organization.⁶⁷ That is still the case if no capital has been paid into the company,⁶⁸ but if any capital has been paid into the company, the vote or approval of all members is now required to amend the company's articles of organization.⁶⁹ This new requirement for unanimous approval can be altered by the company's articles of organization or regulations⁷⁰ and, in most cases, practitioners would be well advised to provide for approval of amendments by a lesser number of company members.

3. Adoption of Regulations

Article 2.09 of the TLLCA required that the regulations of a limited liability company be adopted by the initial manager or managers named in the articles of organization, if any, or by the initial members named in the articles of organization.⁷¹ This requirement for the adoption of regulations by the *initial* managers or members has been eliminated,⁷² but new TLLCA article 2.09, section B requires that any adoption, alteration, amendment, or repeal of the company's regulations be done with the affirmative vote, approval, or consent of *all* the managers or members (unless otherwise provided in the articles of organization or regulations).⁷³

4. Liability of Non-Qualified Foreign LLC Members

Prior to amendment, TLLCA article 7.13, section B provided that the failure of a foreign limited liability company to qualify to do business in Texas would not impair the validity of any contract or other act of the company or prevent the company from defending any action, suit, or proceeding in a Texas court.⁷⁴ In addition, article 7.13, section B now provides that the failure to qualify to do business in the state will not cause any member or manager of the company to be liable for the debts or obligations of the company.⁷⁵

66. See *supra* notes 8-15 and accompanying text.

67. See TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 2.23, § D (Vernon 1997).

68. See S. B. 555, *supra* note 2, § 60 (adding TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 2.23, § G).

69. See *id.* (adding TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 2.23, § H).

70. See *id.*

71. See TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 2.09, § A (Vernon 1997).

72. See S. B. 555, *supra* note 2, § 53 (amending TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 2.09, § A).

73. See *id.* (adding TEX. REV. CIV. STAT. ANN. art. 1528n, Arts. 2.09, § B-C).

74. See TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 7.13, § B (Vernon 1997).

75. See S. B. 555, *supra* note 2, § 73 (amending TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 7.13, § B).

D. THE SECURITIES ACT

In an effort to encourage lawyers, accountants, and consultants to assist small businesses with their securities offerings, the Texas Legislature made a welcome change to the Securities Act.⁷⁶ The Securities Act now provides that unless intentional wrongdoing is involved, the amount that may be recovered from persons who provide services relating to an offering of securities in the aggregate amount of \$5,000,000 or less by a small business issuer⁷⁷ is limited to three times the fee paid for the services.⁷⁸ The limitation applies to any action or series of actions under section 33 of the Securities Act, which sets forth, among other things, civil penalties for securities registration and anti-fraud violations.⁷⁹ The issuer must provide written disclosure of the limitation to the prospective purchasers of the securities and must obtain a signed acknowledgment that the disclosure was provided.⁸⁰

III. JUDICIAL DEVELOPMENTS

A. LEITCH V. HORNSBY

One of the most significant cases of the year involved the reversal of a terrible precedent set by the San Antonio Court of Appeals in 1994. On December 13, 1996, the Texas Supreme Court reversed the holding in *Leitch v. Hornsby*,⁸¹ an opinion that was considered to be the "most troubling opinion of the year" in the 1995 edition of this Survey.⁸² Grady Hornsby was employed by Pro Com Marketing Services, Inc. (Pro Com) as a cable installer. Hornsby sued Pro Com for damages relating to a back injury he suffered while lifting a reel of wire. Hornsby joined Russell Leitch and Hal Crews, the officers, directors, and stockholders of Pro Com, as defendants. The trial court rendered judgment in Hornsby's favor on a jury verdict against Pro Com, Leitch, and Crews, jointly and severally, for nearly \$700,000. In affirming the judgment, the San Antonio Court of Appeals noted that the jury found both Leitch and Crews guilty of negligence and concluded that an officer can be personally liable for the corporation's wrongdoing when the officer actively participates in the tortious conduct or when the officer has actual or

76. See TEX. REV. CIV. STAT. ANN. art. 581, §§ 1-42 (Vernon 1964 & Supp. 1998).

77. A "small business issuer" has annual gross revenue of no more than \$25,000,000 at the time of the offering and does not have a class of equity securities registered (or required to be registered) under the Securities Exchange Act of 1934, 15 U.S.C. § 78l (1995). See H. B. 1507, *supra* note 6, § 1 (adding TEX. REV. CIV. STAT. ANN. art. 581, § 33N(1)).

78. See *id.* § 1 (adding TEX. REV. CIV. STAT. ANN. art. 581, § 33N(1)-(4)). The statutory language limiting liability to three times the fee *paid* may prove to be particularly beneficial to those lawyers, accountants, and consultants who occasionally collect less than they bill on securities offering projects.

79. See *id.*

80. See *id.*

81. 885 S.W.2d 243 (Tex. App.—San Antonio 1994), *rev'd*, 935 S.W.2d 114 (Tex. 1996).

82. Alan W. Tompkins, *Corporations and Limited Liability Companies: Annual Survey of Texas Law*, 48 SMU L. REV. 1019, 1020 (1995).

constructive knowledge of the conduct.⁸³

Leitch and Crews appealed to the Texas Supreme Court on the basis that they owed no individual duty to Hornsby, an employee of Pro Com. The Texas Supreme Court stated that “[w]hen the employer is a corporation, the law charges the corporation itself, not the individual corporate officer, with the duty to provide the employee a safe workplace.”⁸⁴ The Court reasoned that although a corporate officer can be individually liable to others, including corporate employees, for his or her own negligence, personal liability will arise “only when the officer or agent owes an independent duty of reasonable care to the injured party apart from the employer’s duty.”⁸⁵ The Court noted that without a finding that an officer or agent is the corporation’s alter ego, “corporate officers and agents are subject to personal liability for their actions within the employment context only when they breach an independent duty of care.”⁸⁶ In this case, even though Pro Com, Leitch, and Crews were each found to be negligent and responsible for Hornsby’s injury, the jury did not find that Leitch or Crews was an alter ego of Pro Com.⁸⁷ As a result, the Texas Supreme Court reversed the holding of the San Antonio appellate court and rendered judgment that Hornsby take nothing.⁸⁸ Although the result in this case may seem harsh, the analytical approach employed by the Texas Supreme Court provides a welcome margin of comfort for the directors, officers, and agents of Texas corporations.

B. UTAIC v. MACKEEN & BAILEY, INC.

In a case primarily dealing with a claim by an insurance company against its actuary for breach of fiduciary duties, the Fifth Circuit noted an important caveat to the corporate opportunity doctrine.⁸⁹ United Teacher Associates Insurance Company (UT) hired Duncan MacKeen (MacKeen) to provide actuarial services for UT in 1984. Based on his advice, UT bought blocks of insurance business with surplus reserves. For a time, MacKeen operated as a partner with two UT principals, and later was paid a retainer by UT for assisting with the acquisitions. The retainer agreement between MacKeen’s business and UT specified that Texas law controlled.

In 1991, MacKeen examined National Foundation Life (National) in connection with a prospective acquisition by UT. While negotiations between National and UT continued for some time without resulting in an acquisition, National retained MacKeen to provide actuarial services. While a principal of UT gave permission for MacKeen to work with National, UT was not aware of the broad scope of activities for which

83. See *Leitch*, 885 S.W.2d at 250.

84. See *Leitch v. Hornsby*, 935 S.W.2d 114, 117 (Tex. 1996).

85. *Id.*

86. *Id.*

87. See *id.*

88. See *id.* at 120.

89. See *UTAIC v. MacKeen & Bailey, Inc.*, 99 F.3d 645 (5th Cir. 1996).

MacKeen had been retained. MacKeen's activities for National included secretly recalculating National's reserves, which UT was still considering purchasing. In March of 1992, MacKeen also began purchasing stock in the parent of National. About two weeks later, and based upon public disclosure of MacKeen's increased reserve recalculations, National's stock rose significantly. Additionally, a short time later, MacKeen, acting as an advisor to UT, directed UT away from another potential acquisition which he ultimately convinced National to consummate. UT sued MacKeen and his actuarial firm for a variety of causes, including breach of fiduciary duty. The district court found that a fiduciary relationship existed between MacKeen and UT, that MacKeen had breached that relationship, and that MacKeen had usurped a corporate opportunity belonging to UT when he purchased stock in National's parent without notifying UT.⁹⁰

The Fifth Circuit, in reviewing the district court findings, held that a fiduciary duty did exist between UT and MacKeen and that the district court's finding that MacKeen had breached his fiduciary relationship with UT was not clearly erroneous.⁹¹ The Fifth Circuit then reviewed the corporate opportunity doctrine in Texas, noting that the doctrine applies "where a corporation has a legitimate interest or expectancy in, and the financial resources to take advantage of, a particular business opportunity. When a corporate officer or director diverts a corporate opportunity to himself, he breaches his fiduciary duty of loyalty to the corporation."⁹² While MacKeen had argued in the district court that the doctrine did not apply to him because he was not a corporate officer or director, the district court found that the doctrine applied and could be used to disgorge interests improperly acquired by any fiduciary of the corporation.⁹³

The Fifth Circuit held that, under Texas law, the corporate opportunity doctrine does not apply to all corporate fiduciaries, but rather is limited to officers, directors, and major shareholders who are fiduciaries.⁹⁴ In reaching this conclusion, the court stated that while many Texas courts have used the term corporate fiduciary loosely, no Texas cases have applied the corporate opportunity doctrine to any person other than an officer, director, or major shareholder.⁹⁵ While the court noted that there was no evidence that UT ever considered buying the stock of National's parent, thus raising the question of whether it was truly a corporate opportunity, it held that MacKeen could not be liable for usurping the opportunity since he was not an officer, director, or major shareholder of

90. *See id.* at 650.

91. *See id.*

92. *Id.* at 650-51, (citing *In re Safety International, Inc.*, 775 F.2d 660, 662 (5th Cir. 1985)).

93. *See id.* at 651.

94. *See id.*

95. *See id.*

UT.⁹⁶

C. NORDAR HOLDINGS, INC. V. WESTERN SECURITIES (USA) LTD.

In a well-reasoned opinion, Judge Barefoot Sanders summarized the state of Texas law with respect to the corporate disregard doctrines.⁹⁷ The facts of this case involve the now familiar scenario of the attempt by a successor to the Resolution Trust Corporation (RTC) to recover on a guaranty of a promissory note. Plaintiff Nordar Holdings, Inc. (Nordar) acquired the note in question from Commerce Savings Association (CSA), which originally held the note when CSA was placed into receivership in 1991. The suit was based on two related transactions.

In 1987, Western USA (USA) executed a promissory note secured by certain real estate in favor of CSA. In 1988, USA conveyed the land securing the note to its wholly-owned subsidiary, Western Properties (Western). In 1991, in settlement of separate litigation with the RTC, Western executed a second promissory note, renewing and extending the original note. As part of this renewal, USA, as Western's parent, executed a limited guaranty in the amount of \$1.1 million. Western Securities Limited (WSL), the Canadian corporation which was the ultimate corporate parent of both USA and Western, never executed a note related to these transactions or owned the real property securing the debt.

Western defaulted on the note. Nordar foreclosed on the real property, but was left a deficiency of approximately \$1.8 million. Nordar sued Western as the maker of the note and USA as guarantor. Nordar also sued WSL, claiming that WSL's corporate fiction should be disregarded so that WSL could be held liable for the obligations of its subsidiaries. Pursuant to the parties' agreement, the court dismissed Western as a defendant and entered summary judgment against USA for \$1.1 million (based on the guaranty).⁹⁸ Nordar then sought to establish that WSL should be jointly and severally liable for the \$1.1 million judgment based upon the alter ego doctrine and single business enterprise theory.

In finding that Nordar's claim against WSL failed, Judge Sanders reviewed the state of the single business enterprise and alter ego doctrines. Noting that Texas law on piercing the corporate veil has undergone substantial change in the last ten years, Judge Sanders recalled that the Texas Supreme Court has set out six situations in which Texas courts may pierce the corporate veil and find shareholders liable for corporate obligations.⁹⁹

96. *See id.*

97. *Nordar Holdings, Inc. v. Western Securities (USA) Ltd.*, 969 F. Supp. 420 (N.D. Tex. 1997).

98. *See id.* at 422.

99. *See Castleberry v. Branscum*, 721 S.W.2d 270, 272 (Tex. 1986), stating that the Court will disregard the corporate fiction:

(1) when the fiction is used as a means of perpetrating fraud; (2) where a corporation is organized and operated as a mere tool or business conduit of another corporation; (3) where the corporate fiction is resorted to as a means of evading an existing legal obligation; (4) where the corporate fiction is employed to achieve or perpetuate monopoly; (5) where the corporate fiction is

The Fifth Circuit has articulated three instances in which Texas law allows piercing of the corporate veil, and those are when the corporation (1) is the alter ego of its shareholders; (2) is used for illegal purposes; and (3) is used as a sham to perpetrate a fraud.¹⁰⁰ Although the Texas Supreme Court held that the theory of using a corporation as a sham to perpetrate a fraud required only proof of constructive fraud in *Castleberry*,¹⁰¹ the Texas Legislature amended the TBCA in 1989 to provide that, in contract cases and under the theory of sham to perpetrate a fraud, proof of actual fraud for the direct benefit of the shareholder is required.¹⁰² In 1991, the Texas Legislature again amended TBCA article 2.21 to provide that proof of actual fraud also applied to the alter ego doctrine or other "similar theor[ies]."¹⁰³ Therefore, Judge Sanders concluded that Texas law requires proof of actual fraud to pierce the corporate veil under the alter ego doctrine or any similar theory.¹⁰⁴

Judge Sanders also noted that the single business enterprise doctrine is separate and distinct from the theories permitting the piercing of the corporate veil. The single business enterprise doctrine allows a court to impose joint liability on two corporations when they are not operated as separate entities and their resources are used for a common purpose.¹⁰⁵ The court concluded that while the single enterprise doctrine is not explicitly mentioned in article 2.21, it constitutes a "similar theory" to which the requirement of a showing of actual fraud under TBCA article 2.21 is applicable.¹⁰⁶

After reaching the conclusion that actual fraud was a required element of Nordar's case, the court found the evidence presented wholly inadequate to prove that fraud was perpetrated against CSA.¹⁰⁷ There was no evidence of any false representations made by Western, USA, or WSL to CSA that were relied upon by CSA. Although Nordar alleged that the fraud consisted of WSL's and USA's failure to inform CSA that USA had insufficient assets to meet a \$1.1 million obligation, there was no evidence that Western, USA, or WSL had materially misled CSA.¹⁰⁸ Thus, judgment was entered in favor of WSL.

used to circumvent a statute; and (6) where the corporate fiction is relied upon as a protection of crime or to justify wrong.

Id. For a recent discussion of the corporate disregard theory, see Alan W. Tompkins & Theodore S. O'Neal, *Corporations: Annual Survey of Texas Law*, 50 SMU L. REV. 1047, 1047-55 (1997).

100. See *Villar v. Crowley Maritime Corp.*, 990 F.2d 1489, 1496 (5th Cir. 1993), *cert. denied*, 510 U.S. 1044 (1994).

101. See *Castleberry*, 721 S.W.2d at 272.

102. See *Nordar Holdings*, 969 F. Supp. at 422; see also TEX. BUS. CORP. ACT ANN. art. 2.21, § A.

103. *Nordar Holdings*, 969 F. Supp. at 422.

104. See *id.*

105. See *id.* (citing *Old Republic Ins. Co. v. Ex.-Im. Servs. Corp.*, 920 S.W.2d 393, 395-96 (Tex. App.—Houston [1st Dist.] 1996, no writ).

106. See *id.* at 422-23.

107. See *id.* at 423.

108. See *id.*

D. BEEBE V. COMPAQ COMPUTER CORPORATION

Bret and Luann Beebe were hired by Compaq Computer Corporation (Compaq) in the early 1980s. In 1985, Compaq introduced a non-qualified stock option plan (Plan). In 1987, and later in 1988, the Beebes signed agreements entitling them to receive options under the Plan. In 1991, the Beebes requested a leave of absence to attend to family matters. During the course of discussions about their leave of absence, the issue arose of whether their option vesting would continue during their leave. Before the couple left, Compaq presented them with an agreement stating that vesting would cease during their leave. The Beebes refused to sign the agreement and began their leave of absence.

During their leave, Compaq continued to send the documents to the Beebes for their signature, but the couple refused to sign. Finally, Compaq notified the Beebes that if they failed to sign, their leave would be terminated and they would have one year to exercise all outstanding options. The Beebes refused to sign, and Compaq terminated their leave. When the Beebes later attempted to exercise their options, they were prohibited from exercising options that would have vested during the term of their leave. The Beebes sued, but the lower court granted summary judgment in favor of Compaq on the Beebes' claims of breach of contract, fraud, and violation of state securities laws.

In reviewing the lower court's decision, the appellate court affirmed the findings relating to breach of contract and fraud¹⁰⁹ and then addressed the allegation that Compaq had violated section 33 of the Securities Act,¹¹⁰ which provides that a person who offers or sells a security by means of an untrue statement or omission of material fact is liable to the person buying the security.¹¹¹ The court found no Texas case law on the issue of anti-fraud liability under the Securities Act in the context of employee stock options, but noted that analogous cases under the federal securities laws¹¹² have not imposed liability in similar situations.¹¹³ The court noted that while the cases dealing with the federal securities laws were not dispositive with respect to Texas law, the cases could provide some persuasive guidance on this issue.¹¹⁴

In one such case, an employee took a short-term disability leave at the suggestion of his employer.¹¹⁵ When his stock options did not vest while he was on leave, he sued his employer on the basis of the employer's misrepresentations regarding the circumstances under which his options would vest and alleged violations of the federal securities laws. The

109. *See* *Beebe v. Compaq Computer Corp.*, 940 S.W.2d 304, 307 (Tex. App.—Houston [14th Dist.] 1997, no writ).

110. TEX. REV. CIV. STAT. ANN. art. 581, §§ 1-42 (Vernon 1964 & Supp. 1998).

111. *See id.* § 33A(2).

112. *See* 15 U.S.C. § 78j(b) (1994).

113. *See Beebe*, 940 S.W.2d at 306-07.

114. *See id.* at 307.

115. *See Gurwara v. Lymphomed, Inc.*, 739 F. Supp. 1162 (N.D. Ill. 1990), *aff'd*, 937 F.2d 380 (7th Cir. 1991).

Beebe court found that (1) the alleged deceptions were not material, (2) because the options never vested, the plaintiff had never made an investment decision regarding the purchase or sale of securities, and (3) this was an employment dispute that the securities laws should not be expanded to embrace.¹¹⁶ In reviewing the Beebes' situation, the court of appeals found that because they ceased to be employees under the terms of the Plan, they never made any investment decision regarding the purchase or sale of securities.¹¹⁷ Hence, the anti-fraud provisions of the Securities Act were not applicable to the Beebes' case, and the judgment of the lower court was affirmed.¹¹⁸

IV. FEDERAL INCOME TAX DEVELOPMENTS

A. SUBCHAPTER S CORPORATION SUBSIDIARIES

The Small Business Job Protection Act of 1996¹¹⁹ modified Section 1361 of the Internal Revenue Code¹²⁰ (Code) to permit an S corporation to own a qualified subchapter S subsidiary (QSSS).¹²¹ A QSSS is not treated as a separate corporation for federal income tax purposes; rather, all the QSSS assets, liabilities, income, deductions, and credits are treated as those of the parent S corporation.¹²² This statutory amendment, along with the concurrent increase in the number of permissible S corporation shareholders from 35 to 75, has made the S corporation significantly more attractive as a small business entity. The legislation did not, however, provide guidance as to how an S corporation should make a QSSS election. Temporary guidance was later provided by the IRS in Notice 97-4, issued on December 20, 1996, indicating that a QSSS election will be deemed to be a liquidation of the subsidiary corporation for federal income tax purposes.¹²³ Notice 97-4 states that in order to make the election, the parent corporation should file a Corporate Dissolution or Liquidation Form 966 for the subsidiary with the appropriate IRS Service Center.¹²⁴ Detailed instructions for completing Form 966 in the QSSS context are set forth in Notice 97-4. Although a QSSS is usually required to file a short-period tax return for the year in which it goes out of existence,¹²⁵ no short-period return is necessary for a newly-formed subsidiary for which an immediate QSSS election is made.

116. See *Beebe*, 940 S.W.2d at 307 (citing *Gurwara*, 739 F. Supp. at 1166-69).

117. See *id.*

118. See *id.*

119. Pub. L. No. 104-188 § 1308, 110 Stat. 1755, 1782.

120. I.R.C. §§ 1-9722 (1994).

121. A QSSS is essentially a wholly-owned subsidiary of an S corporation for which a QSSS election has been made. See I.R.C. § 1361(b)(3)(B).

122. See I.R.C. § 1361(b)(3)(A)(ii).

123. See I.R.S. Notice 97-4, 1997-2 I.R.B. 24.

124. See *id.* at 25.

125. See *id.*

B. ENTITY CLASSIFICATION REGULATIONS

The long-awaited "check-the-box" Treasury Regulations regarding the classification of business entities for federal income tax purposes were issued effective as of January 1, 1997,¹²⁶ thus making the prior four-factor entity classification framework (dealing with the corporate characteristics of limited liability, free transferability of interests, centralized management, and continuity of life) under section 7701 of the Code obsolete.¹²⁷ The new regulations are vastly superior to the old regulatory framework with respect to simplicity and classification certainty. The new regulations provide that a business entity which is not classified as a corporation (as defined in Treasury Regulation 301.7701-2) and which has at least two members can elect to be taxed as a partnership or as an association taxable as a corporation.¹²⁸ Further, a business entity that is not classified as a corporation and that has only one member can elect to either be disregarded entirely for federal income tax purposes or be taxed as an association taxable as a corporation.¹²⁹ The new regulations establish a default classification scheme for newly-formed domestic eligible entities which provides that the entity will be taxed as a partnership if it has at least two members, or will be disregarded as an entity separate from its owner if it has a single owner.¹³⁰ Existing entities which do not file an election will retain the classification they claimed under the old regulations.¹³¹ The new classification structure is particularly advantageous for those individuals who wish to conduct business through a single-member Texas limited liability company because no separate federal income tax return is required for the entity.¹³²

C. CONVERSION TAX ISSUES

Although the ability to convert entity forms is a welcome and convenient addition to Texas business entity law,¹³³ a conversion should not be undertaken without careful consideration of the tax consequences of the transaction. For example, one type of conversion that may initially appear to be attractive is the conversion of an existing S corporation into a limited liability company (or other entity taxed as a partnership) so that the number and type of owners of the entity will not be subject to the restrictions imposed by subchapter S of the Code. If the corporation has appreciated assets, however, the conversion will result in the immediate

126. See Treas. Reg. §§ 301.7701-1, 301.7701-2, 301.7701-3 (as amended in 1996).

127. See I.R.S. Notice 97-1, 1997-2 I.R.B. 22 (making the existing IRS Revenue Rulings and Revenue Procedures obsolete to the extent they use the prior regulatory framework to determine whether an entity is taxable as a corporation or a partnership).

128. See Treas. Reg. § 301.7701-3(a) (as amended in 1996). The election is made on IRS Form 8832, Entity Classification Election. See *id.* § 301.7701-3(c).

129. See *id.* § 301.7701-3(a).

130. See *id.* § 301.7701-3(b).

131. See *id.*

132. The individual must, of course, report the profit or loss from their business on Schedule C of their personal Form 1040.

133. See *supra* notes 8-15 and accompanying text.

recognition of the gain in the assets (with the exception of installment receivables) without any actual distribution of cash or other assets to stockholders to cover the resulting income tax liability. This situation arises because the conversion of the S corporation will constitute a liquidation of the corporation for federal income tax purposes with a corresponding constructive distribution of the assets (valued at fair market value) to the stockholders. The liquidation of the corporation triggers the recognition of the gain in the assets and the resulting pass-through income tax liability for the stockholders. The assets are then deemed to have been contributed to the capital of the new entity (at fair market value) by the former stockholders of the corporation, with a corresponding increase in the basis of their new partnership interests. The increased basis will probably be of little comfort, however, to those former stockholders who were not aware of or warned about being required to recognize the income tax liability resulting from the liquidation of the S corporation.

In the right situation, however, conversions can be useful in reducing tax liabilities. For example, the Texas franchise tax is presently levied only on corporations and limited liability companies.¹³⁴ Limited liability companies taxed as partnerships under federal income tax law may, if appropriate for the situation, convert into a limited partnership (or perhaps a limited liability partnership) in order to maintain limited liability for the interest owners and to operate in a form that is not subject to the Texas franchise tax. Such a conversion will not usually have any significant federal income tax consequences (unless there is a change in the allocation of certain liabilities among the partners) because the entity should continue to be taxed as a partnership in its post-conversion forms. The conversion may, however, have other practical implications that should be considered before the transaction is undertaken.

134. See TEX. TAX CODE ANN. § 171.001(a) (Vernon 1992).