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CORPORATIONS AND LIMITED LIABILITY COMPANIES

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Alan W. Tompkins**

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I. INTRODUCTION

THE most noteworthy changes to Texas business corporation and limited liability company law during the Survey period¹ arose from the activities of the Seventy-Third Texas Legislature. The passage of House Bill 1239, which became effective on September 1, 1993, brought numerous changes to the Texas Business Corporation Act (TBCA) and the Texas Limited Liability Company Act (TLLCA).² The Texas and federal courts also decided a number of interesting corporation law issues during the period. Section II of this article addresses the more interesting judicial decisions and legislative actions affecting Texas corporation law; Section III fo-

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¹ October 1, 1992 through September 30, 1993.
² See Act of May 7, 1993, 73d Leg., R.S., ch. 215, 1993 Tex. Sess. Law Serv. 420, 461 (Vernon). The changes in House Bill 1239 were recommended by the Texas Business Law Foundation, a group that suggests improvements in and changes to the Texas business laws in order to "enhance the state's business climate and economic development." HOUSE RESEARCH ORGANIZATION, DAILY FLOOR REPORT, Tex. H.B. 1239, at 23 (Apr. 13, 1993). The legislature also made significant amendments to the Texas Non-Profit Corporation Act. See Act of May 24, 1993, 73d Leg., R.S., ch. 733, 1993 Tex. Sess. Law Serv. 2876 (Vernon). Although the non-profit corporation statute is not addressed in this article, practitioners who deal with such entities are encouraged to review the amendments in detail.
cuses on the substantial amendments to the TLLCA as well as related federal income tax and foreign-state qualification issues.

II. CORPORATIONS

Several decisions handed down during the survey period dealt with matters of corporate disregard, the individual liability of shareholders, directors, and officers, the business judgment rule, the right to appeal after dissolution, and federal class actions. These decisions are discussed in Part A below. Part B summarizes the more significant amendments to the TBCA as a result of the passage of House Bill 1239.\(^3\) Readers should keep in mind that the cases discussed in this article were all decided prior to the effective date of the 1993 amendment to TBCA Article 2.21, dealing with the liability of subscribers and shareholders for corporate contractual obligations.\(^4\)

A. JUDICIAL DEVELOPMENTS

1. Corporate Disregard

_Houston Cable TV, Inc. v. Inwood W. Civic Ass'n\(^5\) involved a review of whether the trial court correctly determined that four cable television companies were, as a matter of law, the alter egos of one another. The court of appeals affirmed, noting that the evidence established that the companies acted as one entity in dealing with customers.\(^6\) The court pointed out that the different bases for disregard of the corporate fiction involved fact questions ordinarily determined by a jury, but where the material facts are undisputed, the application of the alter ego doctrine becomes a question of law.\(^7\)

Seventeen homeowner associations brought suit against Houston Cable TV, Inc., Warner Cable Communications, Inc., Warner Cable Communications of Harris County, Inc., and Warner Communications, Inc. (collectively, Houston Cable) for breach of contract, fraud, tortious interference, and other causes of action. The facts showed that, beginning in 1979, Houston Cable executed right-of-way agreements with approximately 150 associations to allow cable lines to be laid on their easements. As consideration, Houston Cable agreed to pay the associations two to three percent of gross revenues. In 1986, Houston Cable decided that it no longer wanted to pay the amounts due under the agreements because the expense exceeded $300,000 per year. To avoid a confrontation with the associations, Houston Cable sent letters falsely stating that recent federal legislation precluded the distribution of further payments. Seventeen of the associations discovered the truth and brought suit.

On appeal, Houston Cable asserted that the associations did not exclu-
sively establish that the Houston Cable entities were the alter egos of one another. The court stated that Houston Cable not only breached the contracts but committed a tort in the process; thus, “special circumstances” existed to support the trial court’s application of the alter ego doctrine as a matter of law.

The record indicated that Houston Cable TV, Inc. was a wholly owned subsidiary of Warner Cable Communications, Inc., which was a wholly owned subsidiary of Warner Communications, Inc. Houston Cable TV represented to certain of the homeowner groups that it was affiliated with Warner Communications. Further, letters sent to the associations showed the company name as Houston Cable TV, Inc./Warner-Amex. One Warner Cable executive testified that Warner Cable was involved in the day-to-day operations of Houston Cable TV, Inc. He answered questions in the context of “Warner Cable” as if the Warner Cable and Houston TV corporations were one entity. Further, he testified that “there’s an awful lot of companies involved here and I’m unclear as to them.” In addition, the president and general manager of Warner Cable testified that “we operate under Warner Cable. It’s not a legal entity.” He further stated that Warner Cable “is the umbrella of the operation, whatever legal entity it is.”

The associations presented evidence that they thought they were dealing with one Warner Cable entity, and the testimony of the cable executives proved that the associations were correct. The trial court determined that because the companies were the alter egos of one another, a judgment against one constituted a judgment against all; thus, separate jury findings against each company were not necessary. The court of appeals agreed.

Interestingly, the reported decision did not make reference to which of the corporations executed the contracts in question or which entity received the gross revenues used to calculate the $300,000 annual payment due the homeowner associations.

In *Subway Equipment Leasing Corp. v. Sims*, the Fifth Circuit addressed whether the debtors of three related corporations could use the alter ego theory, alleging that the corporations were not separate entities for bankruptcy filing purposes, to block the corporations’ efforts to put the debtors into involuntary bankruptcy. The three related corporations filed petitions instituting separate involuntary proceedings against Earl Sims and his wife Dorothy (the Debtors), the owners of four sandwich shop franchises. The couple moved to dismiss the petitions on the basis of bad faith filing. The bankruptcy court faced the issue of whether the creditor corporations had

8. *Id.*
9. *Id.* at 501.
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.* at 502.
14. *Id.*
15. *Id.*
16. 994 F.2d 210 (5th Cir. 1993).
17. *Id.* at 218.
satisfied the requirements of Section 303(b)(1) of the United States Bankruptcy Code, providing that if a debtor has twelve or more creditors, an involuntary petition may be filed by three or more entities that hold bona fide, non-contingent claims against the debtor. The Debtors contended that the three corporations were the alter egos of the franchisor, Doctor's Associates, Inc. (DAI), and thus should qualify as only one entity for purposes of Section 303.

The bankruptcy court denied Debtors' motions to dismiss and entered orders for relief in both proceedings. Debtors appealed to the United States District Court for the Eastern District of Louisiana, which reversed the bankruptcy court. The creditor corporations then appealed the district court decision to the Fifth Circuit, which reversed and held that the bankruptcy court had correctly concluded that the creditor corporations were not the alter egos of DAI.

In addressing the alter ego issue, the Fifth Circuit found that the Bankruptcy Code was silent as to whether the separate identity of a corporate creditor should be disregarded for purposes of Section 303, and found no cases in which the separate identity of a petitioning corporate creditor had been disregarded. After reviewing the few cases it found to have addressed the issue, the court concluded that "ordinary principles of corporation law apply in determining whether related entities will be combined for Bankruptcy Code § 303(b)(1) purposes."

The court noted that one of the fundamental purposes for the creation of a corporation is to provide an entity separate from its owners, thus limiting the personal liability of those owners. Further, the court wrote that the various theories for piercing the corporate veil have been created for the purpose of disregarding that separate legal identity in situations where equity demands it, such as when the owners have misused the corporate form, or have established it for a fraudulent purpose or to commit an illegal act. Another exception arises where a parent company totally dominates and controls its subsidiary, operating the subsidiary as its business conduit or agent.

The court stated that "the alter ego doctrine and piercing of the corporate veil are truly exceptional doctrines" which should be reserved for cases where the officers, directors, or stockholders used the corporation as "a sham to perpetuate a fraud, to shun personal liability, or to encompass other truly unique situations."

The Fifth Circuit noted that in determining whether the three creditor corporations were the alter egos of DAI, the district court had applied the

19. 994 F.2d at 222.
20. Id. at 215.
21. Id. at 217.
22. See id.
23. Id. at 217-18 (citation omitted).
24. Id. at 218.
25. Id.
"laundry list" of factors enumerated in United States v. Jon-T Chemicals, Inc. The court found that the district court had failed to consider crucial distinctions between the instant case and Jon-T, and held that the district court had inappropriately applied the Jon-T analysis. The distinctions articulated by the court were that the Debtors were not seeking to hold DAI liable for any debts owed to them by the creditor corporations, and that "in contract cases, fraud is an essential element of an alter ego finding." The Fifth Circuit concluded that in the absence of a finding of fraud, "the alter ego doctrine is inapplicable in a case in which the claims sound in contract rather than tort."29

In Kern v. Gleason, a mandamus proceeding before the Amarillo Court of Appeals, discovery of a shareholder's personal financial information was limited even though the claimants sought recovery of exemplary damages based on theories of corporate disregard. The court noted that "piercing the corporate veil is not a separate cause of action but a means of imposing individual liability where it would not otherwise exist" and that the various corporate disregard theories are only remedial measures for expanding potential sources of recovery.

In the underlying action, two sisters brought suit against Texas Health Enterprises, Inc. (Texas Health), the operator of several nursing homes. They alleged that in November 1987, while residents of a nursing home operated by Texas Health, they were attacked by a former employee who had previously been convicted of a felony. Plaintiffs sought damages arising from Texas Health's negligence, intentional torts, deceptive trade practices, and breach of a duty of good faith, and plead for exemplary damages under several theories. Further, they alleged that Texas Health was synonymous with Peter Kern, the sole shareholder on the date of the alleged attack, and

26. 768 F.2d 686 (5th Cir. 1985). The factors used in Jon-T for evaluating whether the corporate form should be disregarded included whether:
   (1) the parent and the subsidiary have common stock ownership;
   (2) the parent and the subsidiary have common directors or officers;
   (3) the parent and the subsidiary have common business departments;
   (4) the parent and the subsidiary file consolidated financial statements and tax returns;
   (5) the parent finances the subsidiary;
   (6) the parent caused the incorporation of the subsidiary;
   (7) the subsidiary operates with grossly inadequate capital;
   (8) the parent pays the salaries and other expenses of the subsidiary;
   (9) the subsidiary receives no business except that given to it by the parent;
   (10) the parent uses the subsidiary's property as its own;
   (11) the daily operations of the two corporations are not kept separate; and
   (12) the subsidiary does not observe the basic corporate formalities, such as keeping separate books and records and holding shareholder and board meetings.

    Id. at 691-92.

27. 994 F.2d at 219.

28. Id. at 218.

29. Id. at 219. Thus, federal common law on the alter ego issue appears to be fundamentally consistent with TBCA Article 2.21 § A, as amended. See infra text accompanying notes 153-165.


31. Id. at 736.
requested that the separate identity of the corporation be disregarded.\textsuperscript{32}

The trial court entered an order compelling Kern to produce numerous records reflecting his personal financial condition since January 1, 1987, including federal income tax returns and supporting schedules. Kern and Texas Health petitioned the court of appeals for mandamus relief, requesting that the trial judge be directed to set aside the discovery order. Kern attacked the discovery order on the grounds that its requests were irrelevant, overly broad, unduly burdensome, harassing, duplicitous, and not calculated to lead to the discovery of admissible evidence.\textsuperscript{33} He further asserted that production of such sensitive financial information would invade his privacy.\textsuperscript{34} The court granted the relief, reasoning that Kern had no adequate remedy on appeal because once the records were inspected and reproduced, a subsequent holding that the trial court had mistakenly issued the order would not cure the error.\textsuperscript{35}

The record indicated that Kern was the sole shareholder of Texas Health on the day the plaintiffs were attacked, and that he owned about 120 nursing home leaseholds through various corporations. He also owned majority interests in several health management corporations, one of which performed accounting and payroll functions for the nursing homes. Kern testified that the nursing home administrators and field personnel managed the homes on a day-to-day basis.\textsuperscript{36}

In analyzing the case, the court found that the sisters correctly contended that they were entitled to discover evidence of net worth because they alleged grounds for the recovery of exemplary damages.\textsuperscript{37} The sisters further contended that because Kern might be liable for exemplary damages along with Texas Health, discovery of his net worth, as well as that of Texas Health, was appropriate.\textsuperscript{38} Because the record established that Kern was not involved in the daily operations of the nursing home where the attack occurred and had committed no acts or omissions outside his corporate pos-

\textsuperscript{32} \textit{Id.} at 732. Plaintiffs alleged that the separate identity of Texas Health should be disregarded because:

(a) Texas Health was the alter ego of Peter Kern;
(b) Texas Health had been used as a sham to perpetuate actual or constructive fraud;
(c) Texas Health was being used as a means for evading existing legal obligations;
(d) Texas Health was relied upon to justify a wrong;
(e) Texas Health was inadequately capitalized;
(f) Kern had denuded Texas Health for his personal gain;
(g) Kern was directly liable to the sisters under the trust fund doctrine; and
(h) Kern's total personal control over the operations of Texas Health lead to the conclusion that he knowingly participated in the tortious and fraudulent acts giving rise to the action.

\textit{Id.}

\textsuperscript{33} \textit{Id.} at 734.

\textsuperscript{34} \textit{Id.}

\textsuperscript{35} \textit{Id.}

\textsuperscript{36} \textit{Id.} at 735.

\textsuperscript{37} \textit{Id.} at 736.

\textsuperscript{38} \textit{Id.}
tion with respect to the sisters, the court held that he could not be liable for any tort, deceptive trade practice, or breach of good faith. The court stated that if the plaintiffs succeeded in their causes of action, the liability would be that of the corporation, not Kern.

The sisters argued that their request to discover evidence of Kern's net worth was permissible to prove that the corporate veil of Texas Health should be pierced. The court responded that the sisters were "fishing in the wrong hole," and pointed out that Kern received income from several sources unrelated to Texas Health. Thus, his net worth was immaterial to whether Texas Health's corporate character should be disregarded. In weighing the need for Kern's tax returns against his right to privacy, the court held that the sisters should first examine the corporation's records for the evidence they sought.

The sisters also claimed that under the trust fund theory, whereby a constructive trust is imposed on distributed corporate assets, the location and nature of Kern's assets were relevant to determining whether such assets had been acquired with funds belonging to Texas Health. The court wrote that the trust fund doctrine "permits an unpaid creditor of a dissolved corporation to pursue assets distributed to its shareholders or third parties on the theory that an equitable lien will burden the transferred property." Since Texas Health had not been dissolved and the sisters were not yet creditors, the court held that the sisters could not rely on the trust fund doctrine to secure the information they sought.

2. Individual Liability of Shareholders, Directors, and Officers

In Portlock v. Perry the Dallas Court of Appeals considered whether summary judgment evidence established that the non-physician president of a radiological diagnostic corporation could be held personally liable for damages resulting from the lethal administration of sedatives by corporate employees. The court concluded that the officer could not be held liable, based on the pleadings and evidence presented.

Four-year-old Erica Portlock was taken by her parents to the Duncanville Diagnostic Center (DDC) for a routine radiological examination. After she

39. Id.
40. Id. The court and the parties appeared to treat all of the sisters' claims as theories of corporate disregard. The court did not address the issue of whether some of the sisters' allegations constituted separate causes of action. See, e.g., Castleberry v. Branscum, 721 S.W.2d 270, 271 n.1 (Tex. 1986) (stating that doctrines similar yet distinct from theories of corporate disregard include fraudulent conveyance, the trust fund doctrine, and the denuding theory).
41. 840 S.W.2d at 737.
42. Id.
43. Id.
44. Id.
45. Id. at 738.
46. Id. For a discussion of the trust fund doctrine and its development under Delaware law, see Alan W. Tompkins, Directors' Duties to Corporate Creditors: Delaware and the Insolvency Exception, 47 SMU L. Rev. 165, 171 (1993).
47. Id.
became anxious, the DDC radiologist ordered the radiological technicians to sedate her with chloral hydrate. The dosage was miscalculated and excessive; Erica died later that day. Erica’s parents sued DDC, the radiologist, and the technicians on theories of negligence and medical malpractice. The Portlocks later amended their petition to include Kenneth Perry, the president of DDC, as an individual defendant. The Portlocks alleged, among other things, that Perry failed to ensure that adequate safety procedures were in place for the supervision of DDC employees administering dangerous narcotics and that Perry was negligent in hiring certain DDC managerial employees. The two employees in question were responsible for the daily operations of the center, but neither was licensed as a physician nor experienced in providing patient-care services.

The Portlocks settled their claims against the radiologist, and the court dismissed DDC and the technicians from the lawsuit. Perry moved for summary judgment, arguing that because he was an officer of the corporation, he could not be held personally liable for Erica’s death. The trial court granted Perry’s motion. On appeal, the Portlocks contended that summary judgment was inappropriate because Perry’s failure to institute safety policies and procedures at DDC, as well as his affirmative acts of negligently hiring inexperienced managerial personnel, constituted direct participation in Erica’s death because such actions proximately caused her death.

The Dallas Court of Appeals affirmed the summary judgment for Perry and held, as a matter of law, that he had no duty to institute safety policies and procedures at DDC. The court so held because nothing in the record indicated that Perry undertook an affirmative act to institute such policies and procedures, nor was otherwise required to do so, as an officer of the corporation. Absent any such duties, Perry’s omissions did not constitute participation in the child’s death. The court concluded that there was “no causal connection between Perry’s negligent hiring, if any, of [the management personnel] and Erica Portlock’s death because the Portlocks neither pled nor offered summary judgment proof that [the radiologist] or the technologists who administered the drug were negligently hired.” Further, the court found that Perry could not have anticipated the dangers to the Portlocks by hiring the DDC management personnel because he did not hire them to provide medical services to patients.

This holding provoked a sharp dissent. Justice Maloney noted that the record indicated that Perry approved the hiring of the full-time on-site manager even though he knew nothing of the manager’s background and never inquired as to whether he had any health care expertise. Further, evidence had been introduced indicating that Perry had the ultimate authority to

49. Id. at 582.
50. Id.
51. Id.
52. Id.
53. Id. at 583.
54. Id.
55. Id. at 586.
make decisions for DDC, but that neither Perry nor the managers had ever inquired as to whether adequate safety procedures existed. Maloney argued that a properly instructed jury could have found that Perry's actions were a proximate cause of Erica's injuries, and concluded that the majority had decided issues as a matter of law which were "precisely the issues that should be resolved by a trier of fact."57

In Holloway v. Skinner58 a corporate officer, director, and shareholder was held personally liable for tortious interference in certain contracts breached by the corporation. In 1981, Skinner, the owner of a sandwich-shop franchise, agreed to contribute his business to a new corporation to be owned by him, Holloway, and Holloway's father-in-law. In return, Skinner received a job, a promissory note, and the right to certain royalty payments from the corporation. Holloway served as president of the corporation and owned approximately forty percent of its outstanding shares.

From 1981 to 1984, the corporation paid Skinner only a portion of the amounts owed to him and, predictably, relations between Skinner and Holloway deteriorated. When Skinner quit his job with the corporation in 1984, Holloway's annual salary was $24,000; by 1986, Holloway's annual salary exceeded $44,000. During the period in which Holloway's salary was increasing at such a brisk pace, the corporation defaulted on its obligations to Skinner. Skinner sued for breach of contract and secured a favorable judgment in June, 1986, but the judgment remained unsatisfied because the corporation filed for bankruptcy shortly thereafter.

Skinner then sued Holloway, claiming that he had tortiously interfered with Skinner's contracts with the corporation and forced the entity to default. The jury found for Skinner, awarding actual and punitive damages.59 Holloway appealed, contending that, as the president, a director, and a shareholder of the corporation, he could not have interfered with the contracts as a matter of law.60 Alternatively, Holloway argued that he was immune from personal liability because of his status as an agent of the corporation.61

The Austin Court of Appeals cited Maxey v. Citizens Nat'1 Bank62 for the proposition that "an officer or director may not be held liable in damages for inducing the corporation to violate a contractual obligation, provided that the officer or director acts in good faith and believes that what he does is for the best interests of the corporation."63 The court of appeals inferred from that language that when a corporate officer or director acts against the interests of the corporation, for their own pecuniary benefit, or with an intent to harm the plaintiff by inducing the breach of a contract, that officer or direc-

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56. Id.
57. Id.
58. 860 S.W.2d 217 (Tex.App.—Austin 1993, writ requested).
59. Id. at 219.
60. Id. at 220.
61. Id.
62. 507 S.W.2d 722, 726 (Tex. 1974).
63. 860 S.W.2d at 220.
tor can be held liable to the injured party for tortious interference with a contractual relationship.\textsuperscript{64}

After acknowledging that Texas courts have allowed absolute immunity for officers and directors whose interests are so closely aligned with those of the corporation as to be "incapable of separation,"\textsuperscript{65} the court held that Holloway, as a forty-percent shareholder, "lacked that unity of financial interest which would warrant considering him the same entity as [the corporation],"\textsuperscript{66} and denied his claim for immunity.\textsuperscript{67} The court confirmed that corporate agents who "knowingly participate in a tortious act may be held individually liable without the need to pierce the corporate veil."\textsuperscript{68}

Holloway also contended that even if he had interfered with the corporation's contracts with Skinner, he was, as a matter of law, privileged in doing so as a bona fide exercise of his rights as president, director, and shareholder of the corporation.\textsuperscript{69} The court noted that once a plaintiff has established a prima facie case of tortious interference, the burden shifts to the defendant to show that the conduct was justified.\textsuperscript{70} Holloway had received an adverse jury finding as to the justification for his conduct;\textsuperscript{71} thus, the court of appeals reviewed the record for evidence tending to support that finding.\textsuperscript{72} The court found that the substantial increase in Holloway's salary, at the time of the corporation's default on other obligations, could be evidence to support an inference that Holloway used his position in the corporation to "derive a direct, personal, pecuniary benefit at the expense of the corporation's existing financial obligations to a creditor."\textsuperscript{73} The court also noted that although the weight of a defendant's burden is slight in showing that the breach of a corporate obligation was in good faith, "Holloway failed to meet that burden."\textsuperscript{74}

Holloway relied on his status as an agent of the corporation, rather than on evidence that he acted in good faith, to justify his inducement of the corporation's breach of its contracts as a matter of law.\textsuperscript{75} The court noted that "the only status that can assure immunity from tortious-interference liability is defendant's total ownership of the corporation,"\textsuperscript{76} and deferred to the jury's determination that the evidence did not support Holloway's claim of legal justification.\textsuperscript{77}

Another case involving the tortious conduct of corporate officers was \textit{State
v. Malone Service Co., which involved an action by the Texas attorney general against Malone Service Company (MSC) for alleged violations of the Texas Water Code. MSC, a Texas corporation, operated a hazardous waste disposal plant under a permit issued pursuant to the terms of the Texas Water Code. MSC's president and plant manager were also named as individual defendants in the action. At trial, the jury assessed more than $3 million in penalties against the defendants for groundwater contamination and the unauthorized dumping of hazardous wastes.

On appeal, MSC contended that because it was the owner of the permit, rather than the individual defendants, the individuals could not be held personally liable. MSC argued that the relevant provision of the Water Code does not impose liability on a "person" who does not own the permit, even though such person acts as an agent or abettor in the violation. MSC relied upon a case in which the term "person" was interpreted to impose liability only on "principals" in the context of the Texas usury statute.

The court rejected this argument, stating that "[w]hile usury has 'a contractual flavor,' an environmental tort is more analogous to a situation in which a corporate officer who participates in or directs the commission of a tort may be held personally liable." The court cited a number of federal environmental cases which applied the "personal participation" doctrine to persons who are not permit holders, and held that the individual defendants were liable as a result of their actions rather than their status as agents of the corporation.

Davis v. State involved a suit by the Texas attorney general to recover unpaid franchise taxes, penalties, and interest from the sole shareholder and

78. 853 S.W.2d 82 (Tex. App.—Houston [14th Dist] 1993, writ denied).
79. Id. at 83.
80. Id.
81. Id. at 84.
82. See TEX. WATER CODE ANN. § 27.101(a) (Vernon 1988). This section provides that "[a] person who violates any provision of . . . a permit issued under this chapter shall be subject to a civil penalty in any sum not exceeding $5,000 for each day of noncompliance and for each act of noncompliance." Id.
83. 853 S.W.2d at 85. The usury statute provides that any person who contracts for, charges or receives interest greater than what is authorized by statute shall forfeit an amount equal to three times the amount of the usurious interest. See TEX. REV. CIV. STAT. ANN. art. 5069-1.06 (Vernon 1988). The case cited for the proposition that the liability of a "person" should be limited to "principals" only was Wartman v. Empire Loan Co., 101 S.W. 499, 500-01 (Tex. Civ. App.—Dallas 1909, no writ).
84. 853 S.W.2d at 85. Cases decided during the survey period confirmed that a corporation may be held liable for exemplary or punitive damages when (1) it authorizes the performance of a tortious act, (2) it recklessly employs an unfit person who commits such an act, (3) it ratifies or approves such an act, or (4) a managerial employee commits such an act in the scope of employment. See Borden, Inc. v. Rios, 850 S.W.2d 821 (Tex. App.—Corpus Christi 1993, writ dism'd by agr.) (holding that an exemplary damage award of more than $3 million in favor of defamed former employee was not excessive); Browning-Ferris Indus., Inc. v. Lieck, 845 S.W.2d 926 (Tex. App.—Corpus Christi 1992, writ granted) (affirming damage award for malicious prosecution).
85. 846 S.W.2d 564 (Tex. App.—Austin 1993, no writ).
director of Ad Agency, Inc. (AAI). The Texas Tax Code provides that when corporate privileges are forfeited for the failure to file a report or pay a tax or penalty, each director and officer is liable for the debts of the corporation which arise after the date the report, tax, or penalty was due and before the date on which the corporate privileges are revived. Such liabilities include franchise taxes and penalties which become due and payable after the date of forfeiture.

The State sought to hold Davis personally liable for AAI's tax debt by alleging that Davis was the alter ego of AAI, that Davis operated AAI as a sham to perpetrate a fraud on creditors, and that Davis, as a director of the corporation, was liable under the Tax Code provisions referenced above. After limited discovery, both Davis and the State moved for summary judgment. The trial court granted the State's motion and awarded joint and several relief from AAI and Davis.

Davis appealed, arguing that there was no summary judgment proof that AAI was his alter ego or that he operated the corporation as a sham to perpetrate a fraud. The State admitted in its brief that its summary judgment motion had not been based on either theory; thus, the appellate court noted that the Tax Code provided the only basis under which Davis could be held personally liable.

In his motion for summary judgment, Davis alleged that AAI's corporate privileges were forfeited on June 24, 1985. The court of appeals held the allegation to be a formal judicial admission, conclusively establishing the date of forfeiture. As proof for its summary judgment motion, the State had attached a certified claim for Texas franchise taxes from the comptroller. The claim recited that AAI failed to pay franchise taxes when due, that its privileges had been forfeited, that taxes were due for an audit covering the years 1983-1986, and that the claim's tax summary was "for the year 1986." Importantly, the claim did not recite the date on which the franchise taxes were due.

Noting that two annual tax periods were included within the calendar year 1986, the Austin Court of Appeals found the term "1986," as used in the comptroller's claim, to be susceptible to more than one meaning. The statutory tax period ran from May 1 through April 30; franchise taxes for the 1986 period came due on March 15, 1985. Thus, a portion of the taxes for the calendar year 1986 came due on March 15, 1985, and the remainder were due on March 15, 1986. Because AAI's corporate privileges were forfeited more than three months after the date on which the 1986 franchise taxes came due, the court noted that Davis could not be held personally liable for the 1986 statutory tax period liability. Further, because it could

89. Id.
90. 846 S.W.2d at 568.
91. Id.
92. Id.
93. Id. nn.7-8.
94. Id. at 568-69.
not be determined whether the 1986 tax summary contained in the comptroller's claim referred to a statutory or calendar period, the court found that a genuine issue of material fact existed.95

Next, the State argued that a jeopardy determination notice issued to AAI in October 1987 established, as a matter of law, that the tax liability for the 1983-1986 audit period became due in 1987—two years after AAI's privileges were forfeited.96 Under this approach, Davis could be held personally liable for the debt.97 The court rejected this argument, noting that "statutes making directors and officers liable for corporate debts must be strictly construed and cannot be extended beyond the clear meaning of their language."98

The current jeopardy determination provision of the Tax Code became effective on July 21, 1987; in Davis, the State sought to apply the statute to taxes due prior to its effective date.99 The court pointed out that laws may not operate retroactively to deprive or impair vested substantive rights under existing laws,100 and held that a jeopardy determination may not be retroactively applied to establish a franchise tax due date causing director or officer liability to arise when it did not otherwise exist.101 Based on the failure of the State's jeopardy argument and the ambiguity of the tax summary, that portion of the trial court judgment holding Davis personally liable was reversed and remanded.102

3. The Texas Business Judgment Rule in Federal Court

Most of the recent decisions dealing with directors' fiduciary duties and the business judgment rule are part of the "long line of many 'second-tier' asset recovery cases brought by the FDIC in its efforts to resolve the nationwide banking crisis."103 Such actions usually involve tort claims by the FDIC alleging malfeasance by directors, officers, employees, and professional service providers, such as lawyers and accountants.104 In one such case, the Fifth Circuit reviewed jury instructions on the fiduciary duty owed by directors and officers of a financial institution and the availability of the business judgment rule as a defense to claims of breach of duty.105 The

95. Id. at 569.
96. Id. Section 111.022 of the Tax Code provides that if the comptroller believes that collection of a tax required to be paid to the state is jeopardized by delay, the comptroller must issue a determination stating the amount of the tax and that collection is in jeopardy. See Tex. Tax Code Ann. § 111.022 (West 1992). The amount determined is due and payable immediately. Id.
97. 846 S.W.2d at 569.
98. Id. at 570.
99. Id. at 569.
100. Id. at 570.
101. Id. at 571.
102. Id. at 572.
103. FDIC v. Niblo, 821 F. Supp. 441, 449 (N.D. Tex. 1993). "First tier" recovery usually involves actions against the makers of notes and against collateral pledged, seeking satisfaction of the original debt. Id. n.13.
104. Id.
court considered whether the instructions accurately stated the law and did not mislead the jury. The court found that the instructions were "

106 lucid and accurate on the duty question, and . . . [contained] the business judgment rule and its effect on the FDIC's case." 108

In FDIC v. Brown 109 the United States District Court for the Southern District of Texas considered whether the business judgment rule protected former directors of RepublicBank-Houston against the FDIC's allegations of negligence, gross negligence, and the abdication of duty. After an extensive review of the history of the business judgment rule in Texas, 110 the court concluded that a director's gross negligence is exempt from the protection of the rule. 111 Further, the court concluded that the rule does not protect a director if he abdicated his responsibility and failed to exercise any judgment, 112 noting that the rule necessarily presumes that directors have exercised their judgment. 113 In dicta, the court stated that although the nineteenth-century origin of the rule may make it "appear anachronistic or at least counter-intuitive to some notions of director liability . . . [it] remains a viable part of Texas jurisprudence and has been applied in the context of a modern publicly held corporation." 114 Continuing, the court noted that the business judgment rule

still furthers the public policy of encouraging citizens to serve as corporate directors by immunizing them from acts and omissions that in hindsight proved to be wrong, as long as the directors were not personally interested in the transaction or did not act fraudulently or contrary to their lawful authority. 115

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106. The pertinent parts of the instructions were as follows:

Directors and officers of a bank owe a fiduciary duty to the bank, its shareholders, depositors, and creditors. As fiduciaries, directors and officers have a duty to act with the highest degree of loyalty, trust, and allegiance toward the bank, and with the utmost candor, unselfishness and good faith. Directors and officers of a bank are held to a higher standard of fair-dealing than a person not in a fiduciary position because they are responsible for other people's money.

A breach of fiduciary duty consists of any failure of a director or officer to comply with such standards.

A director or officer of a bank shall not be held liable if his conduct falls within the business judgment rule . . . [A] director or officer of a bank shall not be liable for claims against him if, in the discharge of his duties, he exercised ordinary care and acted in good faith and honestly exercised his best business judgment within the limits of the actual authority of his position with the bank.

A director or officer of a bank shall not be held liable for honest mistake of judgment if he acted with due care, in good faith, and in furtherance of a rational business purpose.

Id. at 130-31 n.13.
107. Id. at 130.
108. Id.
110. Id. at 723-24.
111. Id. at 725.
112. Id. at 726.
113. Id.
114. Id. at 723.
115. Id.
In *FDIC v. Niblo*\(^{116}\) the corporation moved to strike the business judgment rule as an affirmative defense of the defendant directors. The court held that the rule was an affirmative defense within the meaning of Rule 8(c),\(^{117}\) that it precluded judicial interference with the business judgment of directors absent a showing of fraud or an ultra vires act, and that it raised issues of fact to be determined at trial.\(^{118}\) Thus, the rule was not stricken as a defense.\(^{119}\)

4. Appeal after Dissolution

The case of *Vanscot Concrete Co. v. Bailey*\(^{120}\) presented the Supreme Court of Texas with the question of whether a corporation which has ceased to exist under law may appeal a trial court’s judgment against it.\(^{121}\) On July 2, 1986, Vanscot Concrete Company (VCC) merged into Tarmac Texas, Inc. (TTI), and articles of merger were properly filed with the Secretary of State. Three months later, Bailey was injured by concrete poured from a truck bearing the name “Express Pennington,” which had been an assumed name of VCC. Bailey sued VCC for his personal injuries. At trial, VCC moved for a summary judgment on the basis of its merger with TTI and the acquisition by TTI of the assumed name “Express Pennington.” The motion was denied, and the trial court found for Bailey.\(^{122}\)

In the Fort Worth Court of Appeals, VCC contended that it was not liable for Bailey’s injuries, as a matter of law, because it did not exist on the date of injury.\(^{123}\) The court agreed and dismissed the appeal without addressing VCC’s points of error.\(^{124}\) VCC appealed to the Supreme Court. The Court applied and affirmed the reasoning of *Texas Trunk Co. v. Jackson*,\(^{125}\) holding that corporations have the same right to have judgments revised on appeal as do persons, and that even extinguished corporations are entitled to a hearing before the appellate courts.\(^{126}\) The Court held that VCC was entitled to bring an appeal and have the merits of its case addressed, and remanded the case for further consideration.\(^{127}\)

5. Federal Class Actions

Under the Federal Rules of Civil Procedure, a shareholder seeking to bring a derivative action on behalf of a corporation must “fairly and ade-


\(^{117}\) FED. R. CIV. P. 8(c); see 821 F. Supp. at 458.

\(^{118}\) Id. at 458.


\(^{120}\) 853 S.W.2d 525 (Tex. 1993).

\(^{121}\) Id. at 526.

\(^{122}\) Id.


\(^{124}\) Id. at 195.

\(^{125}\) 85 Tex. 605, 22 S.W. 1030 (1893).

\(^{126}\) 853 S.W.2d at 526.

\(^{127}\) Id. at 527.
quately represent the interests of the shareholders . . . similarly situated in enforcing the right of the corporation." 128 In *Smith v. Ayres* 129 the Fifth Circuit reviewed the district court's determination of whether Andrew Smith, the holder of one of the 10,000,000 outstanding shares of Smith Protective Services (SPS), could maintain a shareholder derivative action against Ayres, the general counsel of the corporation.

The Fifth Circuit characterized the case as "but another chapter in a protracted internecine feud among Coralie Smith (mother of Andrew, Clayton, and Mark), Andrew Smith, Clayton Smith, and Mark Smith, principals or former principals of [SPS]." 130 Andrew had acquired his one share of SPS, an assignment of all claims which SPS had against Ayres, and the right to sue Ayres as part of a settlement agreement with the corporation. Because Andrew was restricted from voting his stock and was obligated to reconvey the share to SPS if it became unnecessary for maintaining the derivative action against Ayres, the court concluded that Andrew had been granted the stock for the sole purpose of generating federal standing for his action against Ayres. 131

The court noted that Andrew's stake in SPS was "infinitesimal" and that he received no cooperation from his brothers, the two remaining shareholders of SPS, in the litigation. 132 In fact, Mark and Clayton denied the essential allegations that formed the basis of the suit. In reviewing the facts, the court pointed out that Andrew "has an unmistakable personal and professional dispute with Ayres," 133 that Andrew's brief was "peppered with vituperative epithets, pugilistic metaphors, and descriptions of Ayres as 'satanic' and 'evil'," 134 and that the "catalog of the various lawsuits between these two parties and their affiliates would consume well over a full page." 135

Andrew argued that the test of adequate representation was not whether he would adequately represent all shareholders, but rather those similarly situated to himself. Because Mark and Clayton were not similarly situated, Andrew claimed that he was in a class of one. The court pointed out that only in the rarest circumstances may a shareholder derivative action proceed with a class of one, and distinguished the present case from one in which such circumstances were manifest. 136

In determining that the district court did not abuse its discretion in concluding that Andrew was not an adequate representative, 137 the Fifth Circuit found that the district court properly considered the degree of support the

129. 977 F.2d 946 (5th Cir. 1992).
130. Id. at 947.
131. Id. at 948.
132. Id.
133. Id. at 949.
134. Id.
135. Id.
136. Id. at 948 (discussing Larson v. Dumke, 900 F.2d 1363 (9th Cir. 1990), in which the original owner of a franchise operation, who had retained a 25% interest in the corporation and opposed an action by the new owners, was allowed to proceed with a derivative action).
137. 977 F.2d at 949.
would-be plaintiff would receive from other shareholders, the amount of plaintiff's stake in the corporation as balanced against his interest and how the litigation might affect his personal interests, and the degree of plaintiff's vindictiveness toward the defendant. The court noted that a shareholder plaintiff owes the corporation undivided loyalty, must not have ulterior motives, must not be pursuing an external personal agenda, and should not be allowed to proceed with a derivative action which could be used as "leverage" in other litigation. Next, the court addressed Andrew's claim of standing based on the express assignment of SPS's right to sue Ayres. In what the court considered to be a novel claim, Andrew argued that the generally accepted rule of non-assignability of Rule 10b-5 claims was not applicable to his case because he received an express assignment and did not rely on an automatic assignment which "travel[ed] with his single share of stock." Ayres responded that to accept Andrew's approach and allow such an assignment to create standing would "presage the development of a futures market in Rule 10b-5 claims."

In evaluating Andrew's claim, the court relied heavily on the holding of Blue Chip Stamps v. Manor Drug Stores that Rule 10b-5 actions are restricted to persons who are either purchasers or sellers of securities. The court noted that the Blue Chip Stamps decision was intended to tightly restrict the availability of Rule 10b-5 actions, and was based on two policy considerations which guided the decision in the instant case. The first consideration was the Congressional intent behind the enactment of section 10(b) of the Securities Exchange Act of 1934, which has been interpreted as an effort to eliminate blackmail, nuisance, and strike suits. The second consideration was the evidentiary problems inherent in allowing a non-purchaser or non-seller to bring a Rule 10b-5 action.

The district court had been particularly concerned that the "derivative action will be used as a weapon in Andrew's arsenal rather than a device for the protection of all shareholders," and that "Andrew's personal antagonisms are a major motivation behind this lawsuit." The Fifth Circuit found that the suit bore "all the hallmarks of a strike or nuisance suit, the very actions which the Blue Chip Stamps decision [sought] to reduce or elim-
inates,” and held that the district court did not err in dismissing the claim. 151

B. LEGISLATIVE AND CONSTITUTIONAL HIGHLIGHTS

1. Shareholder Liability for Contractual Obligations

The Seventy-Third Legislature addressed one of the most uncertain areas of Texas corporation law by again trying to clarify the circumstances under which a shareholder may be held liable for a corporation's contractual obligations. This area has been of great concern to practitioners since the Texas Supreme Court decision in Castleberry v. Branscum, 153 which resulted in aggressive actions by claimants seeking to reach shareholder assets in satisfaction of corporate debts.

In 1989, the legislature addressed the Castleberry decision by limiting the circumstances under which shareholders could be held liable for corporate obligations. 154 As reflected in the 1993 Survey article 155 and in the text above, courts continued to have difficulty with corporate disregard issues as the creativity and persuasiveness of the bar led to inconsistent judicial conclusions. 156

Accordingly, the legislature attempted to further clarify the limited circumstances under which a shareholder will be liable for the contractual obligation of a corporation. 157 As revised, Section A of Article 2.21 provides that a holder of shares, an owner of any beneficial interest in shares, or a subscriber shall be under no obligation to the corporation or to its obligees with respect to . . . any contractual obligation of the corporation on the basis that the holder, owner, or subscriber is or was the alter ego of the corporation, or on the basis of actual fraud or constructive fraud, a sham to perpetrate a fraud, or other similar theory, unless the obligee demonstrates that the holder, owner, or subscriber caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder, owner, or subscriber . . . . 158

Section B now states that the "liability of a holder, owner, or subscriber of shares . . . for an obligation that is limited by Section A . . . is exclusive and preempts any other liability imposed on a holder, owner, or subscriber . . . for that obligation under common law or otherwise," 159 unless that person has

151. Id.
152. Id. at 951.
153. 721 S.W.2d 270 (Tex. 1986).
154. See TEX. BUS. CORP. ACT ANN. art. 2.21, § A (Vernon Supp. 1993).
156. See text accompanying notes 5-47.
158. TBCA Amendments, supra note 3, § 2.05 (amending TEX. BUS. CORP. ACT ANN. art. 2.21, § A(2)) (emphasis added).
159. Id. (amending TEX. BUS. CORP. ACT ANN. art. 2.21, § B) (emphasis added).
agreed to be liable for the obligation or is otherwise liable under the TBCA or other applicable statute.\textsuperscript{160}

One commentator has written that the 1989 amendments to TBCA Article 2.21, made in response to \textit{Castleberry}, resulted in the lower courts "show[ing] an inclination to avoid the clear language and intent of the statute and allow contract claims against shareholders in the absence of actual fraud."\textsuperscript{161} The 1993 amendment to Article 2.21 was an effort to "reverse this trend by making it unambiguously clear that contractual claims against a corporation may only be pursued against shareholders in the circumstances stated."\textsuperscript{162}

Although such clarity was intended, the result may have fallen short. Rather than to simply state that the circumstances set forth in Section A provide the exclusive bases for pursuing contractual claims against shareholders, Section B states that "[t]he liability of a [shareholder] . . . for an obligation that is limited by Section A . . . is exclusive and preempts any other liability . . . ."\textsuperscript{163} A literal interpretation gives the conclusion that a shareholder's liability precludes any other liability, begging the question of how a shareholder who is not liable for an obligation under Section A can be protected against other theories of liability by Section B.\textsuperscript{164} Even though the statutory language of Section A has been tightened, it still may be possible for courts which seek to find a shareholder personally liable to construe the language of Section B in a manner which achieves the desired result.

Likewise, encouraging judicial interpretation of the phrase "or other similar theory"\textsuperscript{165} may test the creativity of practitioners seeking to circumvent the obvious intention of the legislature. The amendment does not address non-contractual corporate obligations, however, and thus leaves the corporate disregard doctrines viable for use by tort claimants and those seeking recovery based on other equitable theories.

2. Right of Directors to Examine Corporate Records

The TBCA amendments confirm that a director is entitled to examine the

\textsuperscript{160} Id.
\textsuperscript{161} Id.
\textsuperscript{162} Id.
\textsuperscript{163} TBCA Amendments, supra note 3, § 2.05 (amending \textbf{TEX. BUS. CORP. ACT ANN. art. 2.21, § B}) (emphasis added).
\textsuperscript{164} For example, suppose a defendant is sued for a corporate obligation under the alter ego theory but plaintiff cannot prove an element required for recovery under TBCA Article 2.21 § A. Suppose further, however, that the plaintiff is successful in convincing the court that the "denuding" theory (wherein a stockholder deprives the corporation of assets for personal gain) is not "similar" to the alter ego theory for purposes of that statutory section. In such a situation, Section B may not exclude liability under the denuding theory because the obligation is not one for which the shareholder was liable under Section A. Although such a holding seems unlikely, this example illustrates a gap between the legislature's apparent intent and the resulting language.
\textsuperscript{165} TBCA Amendments, supra note 3, § 2.05 (amending \textbf{TEX. BUS. CORP. ACT ANN. art. 2.21, § A(2)})
corporation’s books and accounting records, share transfer records, and corporate minutes for any purpose reasonably related to his service as a director. A statutory cause of action is provided whereby a court may compel the corporation to open its books and records for inspection by the director upon a showing that he is a director, he demanded to inspect the corporate books and records, his purpose for inspecting the books and records was reasonably related to his service as a director, and his right of access was denied by the corporation. The court can award attorneys’ fees and any other relief deemed to be just and proper.

The House Committee Report states that TBCA Article 2.44, as amended, "[c]larifies that a director of a corporation has the right of access to the corporation’s books and records for any purpose reasonably related to his service as a director." Prior to amendment, however, Article 2.44 addressed only the rights of shareholders, not the rights of directors. One reported decision addressed the issue of directors’ rights to corporate information, with the conclusion that because the TBCA charged directors with responsibility for managing the affairs of the corporation, the right of a director to inspect corporate information was absolute. Although no guidance is offered as to whether the amendment was thought to clarify an implied statutory right or to codify a common-law principle, the result is a clearly beneficial change.

3. Reorganization Under Federal Law

With respect to a corporation being reorganized pursuant to a federal statute, the TBCA now authorizes the trustee, the designated officers of the corporation, or any other individual appointed by the court to make certain fundamental changes to the corporation without approval by either the board of directors or the shareholders. The changes authorized under revised Article 4.14 include amending the articles of incorporation or by-laws, merging or engaging in a share exchange, selling or disposing of substantially all of the assets, fixing the terms of bonds and debentures, classifying the board of directors, removing or appointing new directors, changing the registered office or registered agent of the corporation, and dissolution. These amendments were intended to resolve "possible problems presented in the consummation of a plan of reorganization under federal bankruptcy law in connection with possible mergers, sales of assets, or disso-

167. Id.
168. Id.
171. Chavco Investment Co. v. Pybus, 613 S.W.2d 806, 810 (Tex. Civ. App.—Houston [14th Dist.] 1981, writ ref’d n.r.e.).
173. Id.
lution," and should reduce the time necessary for Texas corporations to emerge from bankruptcy proceedings.

4. Investment Companies

The TBCA has been amended to include references to corporations licensed under the Investment Company Act of 1940 (Investment Companies). The board of an open-end Investment Company may establish classes and series of unissued shares by determining the relative rights of such shares to the same extent that such authority is set forth in the company’s articles of incorporation. The board may also increase or decrease the number of shares which the corporation has the authority to issue, unless a contrary provisions appears in the articles of incorporation.

Article 2.21 of the TBCA has been amended by the addition of Section D, providing that if the articles of incorporation or bylaws of an Investment Company so provide, the corporation is not required to hold an annual meeting of shareholders or to elect directors if not required to do so by the Investment Company Act. Directors of an Investment Company may, unless removed in accordance with the articles of incorporation or bylaws of the corporation, hold office for the term elected or until a successor is elected and qualified.

5. Benefits for Directors

Article 2.02 of the TBCA, dealing with general corporate powers, has been amended to clarify that a corporation may pay pensions and establish pension plans, pension trusts, profit sharing plans, stock bonus plans, or other incentive plans for its directors as well as for its officers and employees.

6. Interest on Dissenter’s Shares

As amended, Article 5.12 of the TBCA provides that interest on shares which have been valued in a judicial appraisal proceeding will begin to accrue on the 91st day after the corporate action from which the shareholder elected to dissent.

7. Merger Approval

Article 5.03, dealing with the approval requirements for mergers, has been amended to clarify that the only action which is required to effect a merger

175. 15 U.S.C. § 80a-1 - 64 (1981); see TBCA Amendments, supra note 3, § 2.01 (amending Tex. Bus. Corp. Act Ann. art. 1.02(11)).
177. Id. § 2.06 (adding Tex. Bus. Corp. Act Ann. art. 2.24, § D).
179. Id. § 2.02 (amending Tex. Bus. Corp. Act Ann. art. 2.02, § A(17)).
permitted without shareholder approval under Article 5.03(G) is the adoption of a resolution of the board approving the plan of merger. 181

8. Amendment to Texas Constitution

In 1991, Article 2.16 of the TBCA was amended to add the following language:

Subject to any provision of the Constitution of the State of Texas to the contrary, the board of directors may authorize shares to be issued for consideration consisting of any tangible or intangible benefit to the corporation, including cash, promissory notes, services performed, contracts for services to be performed, or other securities of the corporation. 182

The language of Article 2.16 which required that the "consideration paid for the issuance of shares shall consist of money paid, labor done, or property actually received" was deleted. 183

This change had no effect, however, because the Texas Constitution limited the consideration for which shares could be issued. 184 A Constitutional amendment was submitted to and approved by Texas voters on November 2, 1993. 185 Therefore, the language of Article 2.16, as amended in 1991, now has legal effect. TBCA Article 3.05 still provides, however, that a corporation must receive $1,000 of consideration, consisting of "money, labor done, or property actually received," before any business may be conducted. 186 Thus, although shares may now be issued for any consideration of tangible or intangible benefit, such consideration may not be adequate to meet the requirements of Article 3.05.

III. LIMITED LIABILITY COMPANIES

The national trend toward acceptance of the limited liability company (LLC) as a viable business entity has picked up great speed since the Texas Legislature enacted the Texas Limited Liability Company Act (TLLCA) on May 25, 1991. Twenty-nine states have adopted LLC statutes since that time, bringing the total number of such states to thirty-seven as of November 4, 1993. 188


183. See id.


Although no cases were reported during the survey period construing the provisions of the TLLCA, the legislature made a number of amendments which clarify and enhance the usefulness of the statute. The most significant changes are discussed in Part A below. Part B provides an overview of recent federal income tax developments which may be of interest to practitioners involved in the formation and operation of LLCs. Finally, because the four states surrounding Texas have all enacted LLC statutes in recent months, Part C provides a summary of the statutory registration requirements affecting Texas LLCs which do business in those surrounding states.

A. LEGISLATIVE AMENDMENTS TO THE TLLCA

1. One-Member LLCs

Prior to amendment, the TLLCA was not clear as to whether a Texas LLC could be formed with only one member. Practitioners and commentators had generally concluded that one-member LLCs were permitted under the statute because it provided that (i) only one organizer was needed to form the company and (ii) an LLC could avoid dissolution if at least one remaining member continued the business of the company after the termination of another member's membership. Support was inferred for this proposition from the fact that the TLLCA, based on the Colorado LLC Act explicitly requiring two members for formation, was silent as to the number of members required for formation. The legislature ended the uncertainty on this issue by amending Article 4.01 to clarify that an LLC “may have one or more members.”

2. LLC Name

Article 2.03 of the TLLCA required each LLC name to include either “Limited,” “Ltd.,” or “L.C.” in order to denote the limited liability nature of the entity. The amendments add the option of using the words “Limited Liability Company” or “Limited Company,” as well as the abbreviations “L.L.C.,” “LLC,” “LC,” and “LTD.” LLCs formed before September 1, 1993 which complied with the TLLCA on the date of formation are not required to change their names in order to conform to the
amended statute. No certificate of authority will be issued to a foreign LLC unless its name complies with the requirements set forth above, but foreign LLCs which complied with the TLLCA and procured a certificate of authority prior to September 1, 1993 will not be required to change their names in order to conform to the TLLCA as amended.

3. Period of Duration

Article 3.02 of the TLLCA, which originally restricted the period of duration of an LLC to 30 years, has been amended to allow the articles of organization of an LLC to provide for perpetual duration. Before providing for perpetual duration, however, practitioners should consider the effect such a choice will have on the entity's classification for federal income tax purposes.

4. Allocations of Profit and Loss

The TLLCA, prior to amendment, did not specify how the profits and losses of an LLC should be allocated among its members. Newly enacted Article 5.02-1 directs that profits and losses are to be allocated in the manner set forth in the LLC's regulations, if any method is provided. In the absence of such a provision, profits and losses should be allocated among the members in accordance with their then-current percentage interests in the company, as specified in the accounting records of the company. This amendment was intended to conform the TLLCA to Section 5.03 of the Texas Revised Limited Partnership Act, and strengthens the LLC's resemblance to the partnership form for tax purposes.

5. Management

Unless an LLC's management powers were reserved to its members in the regulations, the TLLCA dictated that such powers would be exercised under the authority of the entity's managers. Despite this default provision, the TLLCA required each LLC to include a statement in its articles of organization that the company was to be managed by a manager or managers (along with the names and addresses of such managers) or, if management was reserved to the members, the names and addresses of such members.

The amendments clarify that if the management of an LLC is fully re-

197. Id.
198. Id. § 1.24 (amending TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 7.03, § A(1)).
199. Id.
200. Id. § 1.12 (amending TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 3.02, § A(2)).
201. See Treas. Reg. § 301.7701-2(b). See also infra text accompanying notes 290-310.
202. TLLCA Amendments, supra note 189, § 1.18 (adding Art. 5.02-1 to TEX. REV. CIV. STAT. ANN. art. 1528n).
203. Id.
206. Id. Art. 3.02, § A(5).
served to its members, the LLC need not have managers at all. Each LLC’s articles of organization must now affirmatively state whether the LLC will or will not have managers. The power to manage the company can be reserved to its members either in the regulations or the articles of organization, and the powers, rights, and duties of any manager (or group of managers) can be enlarged or restricted by the articles or the regulations. Further, if management of the company is reserved in whole or in part to its members, the provisions of the TLLCA dealing with interested manager transactions, management committees, management meetings, and indemnification apply to the members to the same extent as those provisions would otherwise apply to the managers.

The initial managers of an LLC previously held office until the first annual meeting of members and until their successors were elected and qualified. Managers were thereafter elected at each annual meeting, unless the LLC’s regulations provided for the managers to be divided into two or three classes with one- to three-year staggered terms. Each manager may now be elected for a specified term or until that manager’s death, resignation, or removal. Managers may be divided into any number of classes to serve for any term specified in the regulations. The regulations may also allow for any particular group of members to elect one or more managers who shall hold office for such term as specified in the regulations or until removal.

The amendments restricted the authority of committees of managers by providing that unless the articles of organization, regulations, or resolution designating the particular committee expressly so provides, no committee of managers may authorize or make a distribution of LLC cash or property to the members or authorize the issuance of interests in the company.

6. Officers and Agents

The TLLCA previously provided that the managers of an LLC could designate one or more persons as non-manager officers of the company.

208. Id. § 1.12 (amending Tex. Rev. Civ. Stat. Ann. art. 1528n, Art. 3.02, § A(5)).
209. Id.
211. Id. Art. 2.18.
212. Id. Art. 2.19.
213. Id. Art. 2.20.
216. Id.
217. See id. Art. 2.14, § A.
Each manager and officer was deemed to be an agent of the company for the purposes of carrying on company business and binding the company, unless the manager or officer lacked authority to act for the company and the person with whom the manager or officer was dealing had knowledge of that fact.\(223\)

As amended, the TLLCA provides that the group in which management power is vested (either managers or members) may designate one or more persons, whether or not such persons are managers or members, as officers of the company.\(224\) The amendments have clarified the agency authority of each member, manager, and officer by specifying that, for the purposes of conducting company business, authorized agents shall consist of (a) officers or other agents to the extent of their actual or apparent authority, (b) each manager, to the extent that management of the LLC is vested in that manager, and (c) each member, to the extent that management of the company is reserved to that member.\(225\) Each officer, agent, manager, and member of the LLC, as among themselves and the company, has the authority and may perform the duties provided for in the regulations or as determined by resolution of the group in which management power is vested.\(226\) An act by any officer, agent, manager, or member of the company binds the company unless such person lacks the authority to act for the company and the person with whom the officer, agent, manager, or member is dealing has knowledge of such lack of authority.\(227\)

7. Voting

With regard to voting and quorum requirements applicable to LLC members, the TLLCA deferred to the regulations of the company\(228\) and, as a default, relied upon the provisions of the Texas Business Corporation Act.\(229\) The amendments add new Article 2.23, which provides that “a majority of the members, managers, or members of any committee constitutes a quorum for the transaction of business at any meeting” of such group, unless otherwise provided in the TLLCA or the articles of organization or regulations of the company.\(230\) The act of a majority of the members entitled to vote, man-

\begin{itemize}
\item \textit{Id.}
\item \textit{Id.} § 1.10 (adding Art. 2.21, § C to Tex. Rev. Civ. Stat. Ann. art. 1528n); see also Tex. Rev. Civ. Stat. Ann. art. 1528n, Art. 2.10, § A (original provision of the TLLCA regarding the authority to contract debts and obligations on behalf of the entity).
\item \textit{Id.} § 1.10 (adding § D to Tex. Rev. Civ. Stat. Ann. art. 1528n, Art. 2.21).
\item Article 8.12 provides, in part, as follows:
To the extent this Act contains no provision with respect to one of the matters provided for in the TBCA or the Texas Miscellaneous Corporation Laws Act . . . the provisions of the TBCA and the Texas Miscellaneous Corporation Laws Act shall supplement the provisions of this Act to the extent they are not inconsistent with the provisions of this Act.
\end{itemize}
agers, or committee members present at a meeting at which a quorum is present constitutes the act of the members, managers, or the committee. The term “majority” means “more than one-half, by number, of all the members, managers, or committee members, as the case may be.”

The TLLCA now provides that, unless otherwise specified in the articles of organization or regulations of the company, “the affirmative vote, approval, or consent of a majority of all members [not merely those present at a meeting at which a quorum is present] is required to amend the articles of organization or regulations,” change the company from a member-managed LLC to a manager-managed LLC or vice versa, issue additional membership interests, approve any merger, consolidation, share exchange or interest exchange, voluntarily cause the dissolution of the company, authorize any transaction which is unrelated to the purpose of the company or contrary to its regulations, or authorize any act which would make it impossible for the company to carry on its ordinary business.

Article 2.23 has particular significance for LLC members in that it vests equal voting power in each member, regardless of their respective interests in the company. Under this one-member, one-vote concept, control of a three-member LLC (of which one member owns 80% and the other two each own 10%) can rest with two members owning only a minimal interest in the company. Persons expecting to own a majority interest in a newly-formed LLC should be advised to take advantage of their statutory right to provide for interest-based voting in the LLC’s articles of organization or regulations. Majority-interest owners of existing LLCs with articles or regulations which do not provide for proportional-interest voting should consider amending the governance documents at their earliest convenience.

Other changes brought about by new Article 2.23 include an express authorization for members, managers, and committees to take action without a meeting, if a written consent form is signed by the number of persons as would have been required to consent at a meeting called for such purpose, and to conduct meetings by conference telephone or similar communications equipment.

8. Merger

Prior to the 1993 amendments, the TLLCA did not explicitly address

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231. Id.
232. Id. § 1.11 (adding TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 2.23, § F).
233. Id. § 1.11 (adding TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 2.23, § D(1)) (emphasis added).
234. Id. § 1.11 (adding TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 2.23, § D(2)).
235. Id. § 1.11 (adding TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 2.23, § D(3)).
236. Id. § 1.11 (adding TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 2.23, § D(4)).
237. Id. § 1.11 (adding TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 2.23, § D(5)).
238. Id. § 1.11 (adding TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 2.23, § D(6)).
239. Id. § 1.11 (adding TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 2.23, § D(7)).
240. Id. § 1.11 (adding TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 2.23, § B).
241. Id. § 1.11 (adding TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 2.23, § C).
whether an LLC could merge with another entity. It dealt with the merger issue by providing that:

to the extent this Act contains no provision with respect to one of the matters provided for in the TBCA or the Texas Miscellaneous Corporation Laws Act . . . the provisions of the TBCA and the Texas Miscellaneous Corporation Laws Act shall supplement the provisions of this Act to the extent they are not inconsistent with the provisions of this Act . . . Article 5 of the TBCA [dealing with mergers] shall supplement the provisions of this Act and a limited liability company shall be an "other entity" as that term is defined in the TBCA . . . . 242

Based on the quoted language, it was clear that a Texas LLC could participate in, and be the surviving entity of, a merger with a domestic corporation.243 What was not clear was whether the LLC could merge with anything other than a domestic corporation.244 This question was answered by the 1993 amendments, which provide that domestic LLCs may adopt a plan of merger and merge with domestic or foreign LLCs or other entities.245 These new merger provisions were modeled after section 2.11 of the Texas Revised Limited Partnership Act and, with respect to new TLLCA Article 10.05, Article 5.16 of the TBCA.246 The term "merger" is defined to include:

(a) the division of a domestic [LLC] into two or more new domestic [LLCs] or into a surviving [LLC] and one or more new domestic or foreign [LLCs] or other entities, or (b) the combination of one or more domestic [LLCs] with one or more foreign or domestic [LLCs] or other entities . . . . 247

Before an LLC may merge with another entity, a written plan of merger must be adopted by each constituent entity.248 The plan of merger must be approved by a majority of the respective members of each domestic LLC, unless the regulations or articles of organization of each LLC specifies otherwise.249 If a foreign LLC or other entity is a party to the merger, the merger must be consistent with, in compliance with, and permitted by the laws of its home state, its organizational documents, and the laws of the State of Texas.250 No merger may cause any member of a participant LLC, without such members' consent, to become personally liable for the debts or obligations of any other person as a result of the merger.251

The plan of merger must include the name and state of domicile of each

243. See Keatinge, supra note 190, at 394 n.126; Ray, supra note 190, at 853.
244. Id.
245. TLLCA Amendments, supra note 189, § 1.28 (adding Art. 10.01, § A to TEX. REV. CIV. STAT. ANN. art. 1528n).
247. TLLCA Amendments, supra note 189, § 1.01 (adding Art. 1.02, § A(10) to TEX. REV. CIV. STAT. ANN. art. 1528n).
248. Id. § 1.28 (adding Art. 10.01, § A to TEX. REV. CIV. STAT. ANN. art. 1528n).
249. Id. § 1.28 (adding Art. 10.01, § A(1)(a) to TEX. REV. CIV. STAT. ANN. art. 1528n).
250. Id. § 1.28 (adding Art. 10.01, § A(1)(b) to TEX. REV. CIV. STAT. ANN. art. 1528n).
251. Id. § 1.28 (adding Art. 10.01, § A(2) to TEX. REV. CIV. STAT. ANN. art. 1528n).
limited liability company or other entity which is involved in the merger,\textsuperscript{252} the name of the entity which will survive the merger,\textsuperscript{253} and the name and state of domicile of each new entity which will be created pursuant to the plan of merger.\textsuperscript{254} The plan must include the terms and conditions of the merger including, if more than one entity will survive, the manner and basis of allocating and vesting all property, liabilities, and obligations of the constituent entities.\textsuperscript{255} The plan must specify the manner and basis of converting the ownership interests or shares of the constituent entities into the ownership interests, shares, or other obligations of the surviving entity or entities.\textsuperscript{256} The plan must also include the articles of organization and other organizational documents of each new LLC or other entity to be created by the merger.\textsuperscript{257}

After the plan of merger has been approved by each of the entities which are a party thereto, articles of merger must be executed by each domestic LLC\textsuperscript{258} and filed with the Secretary of State.\textsuperscript{259} Such articles of merger must include the plan of merger\textsuperscript{260} and, for each entity which is a party thereto, a statement that the plan was authorized by all action required by the laws under which it was formed or organized or by its constituent documents.\textsuperscript{261} Unless a delayed effective date is specified, the merger is effective on the issuance of a certificate of merger by the Secretary of State.\textsuperscript{262}

When the merger takes effect, the separate existence of each non-surviving entity ceases.\textsuperscript{263} Additionally, the ownership interests or shares which are to be converted into other interests, shares, or securities pursuant to the plan of merger are so converted.\textsuperscript{264} Further, all property rights, liabilities, and obligations of the participant entities are allocated to and vested in the surviving entity (or entities) as provided by the plan of merger without further action.\textsuperscript{265} Any proceeding pending by or against an LLC that is a party to the merger may be continued as if the merger had never occurred.\textsuperscript{266}

The amendments to the TLLCA permit the merger of parent and subsidiary entities on the basis of at least 90% ownership by the parent of the outstanding membership interests, shares of stock, or other ownership interests in the subsidiary entity.\textsuperscript{267} Further, one or more LLCs or other entities may now adopt a plan of exchange whereby an acquiring entity acquires all the

\textsuperscript{252} Id. § 1.28 (adding Art. 10.02, § A(1) to TEX. REV. CIV. STAT. ANN. art. 1528n).
\textsuperscript{253} Id. § 1.28 (adding Art. 10.02, § A(2) to TEX. REV. CIV. STAT. ANN. art. 1528n).
\textsuperscript{254} Id. § 1.28 (adding Art. 10.02, § A(3) to TEX. REV. CIV. STAT. ANN. art. 1528n).
\textsuperscript{255} Id. § 1.28 (adding Art. 10.02, § A(4) to TEX. REV. CIV. STAT. ANN. art. 1528n).
\textsuperscript{256} Id. § 1.28 (adding Art. 10.02, § A(5) to TEX. REV. CIV. STAT. ANN. art. 1528n).
\textsuperscript{257} Id. § 1.28 (adding Art. 10.02, § A(6), (7) to TEX. REV. CIV. STAT. ANN. art. 1528n).
\textsuperscript{258} Id. § 1.28 (adding Art. 10.03, § A to TEX. REV. CIV. STAT. ANN. art. 1528n).
\textsuperscript{259} Id. § 1.28 (adding Art. 10.03, § B to TEX. REV. CIV. STAT. ANN. art. 1528n).
\textsuperscript{260} Id. § 1.28 (adding Art. 10.03, § A(1) to TEX. REV. CIV. STAT. ANN. art. 1528n).
\textsuperscript{261} Id. § 1.28 (adding Art. 10.03, § A(2) to TEX. REV. CIV. STAT. ANN. art. 1528n).
\textsuperscript{262} Id. § 1.28 (adding Art. 10.03, § C to TEX. REV. CIV. STAT. ANN. art. 1528n).
\textsuperscript{263} Id. § 1.28 (adding Art. 10.04, § A(1) to TEX. REV. CIV. STAT. ANN. art. 1528n).
\textsuperscript{264} Id. § 1.28 (adding Art. 10.04, § A(2) to TEX. REV. CIV. STAT. ANN. art. 1528n).
\textsuperscript{265} Id. § 1.28 (adding Art. 10.04, § A(3) to TEX. REV. CIV. STAT. ANN. art. 1528n).
\textsuperscript{266} Id. § 1.28 (adding Art. 10.04, § A(4) to TEX. REV. CIV. STAT. ANN. art. 1528n).
\textsuperscript{267} Id. § 1.28 (adding Art. 10.05 to TEX. REV. CIV. STAT. ANN. art. 1528n).
outstanding interests of one or more LLCs, or all of the outstanding stock, partnership interests, or other interests of another type of entity, in return for the cash or securities of the acquiring entity.\textsuperscript{268}

9. Dissolution and Winding Up

The amendments clarify the conditions upon which an LLC may avoid dissolution after (a) the expiration of its period of duration, (b) the occurrence of an event causing dissolution, as specified in the articles of organization or regulations, or (c) the expulsion, withdrawal, bankruptcy, or dissolution of a member.\textsuperscript{269} If one of these events occurs, the LLC will not be dissolved so long as there is at least one remaining member and the business of the company is "continued by the vote of the members or class as stated in the articles of organization or regulations of the [LLC], or if not so stated, by all remaining members."\textsuperscript{270} An election to continue the business of the company must be made within 90 days after the occurrence of the event of dissolution, unless otherwise provided in the articles or regulations.\textsuperscript{271} If such an election is made, it is not effective unless the company amends its articles during the three-year period following the event of dissolution to either extend its period of duration or delete the event specified in the articles which caused the dissolution, as applicable.\textsuperscript{272}

The TLLCA has also been amended to allow the appointment of any person designated by the LLC's articles of organization, regulations, or resolution of the members or managers to effect the winding-up of the company after dissolution.\textsuperscript{273} This expands the group of persons which may be designated to wind up the affairs of the company beyond the members and managers, as previously required.\textsuperscript{274}

10. Professional LLCs

The Seventy-Third Legislature made the LLC form expressly available to persons offering professional services through the addition of Part Eleven of the TLLCA.\textsuperscript{275} One or more persons may now organize a "professional limited liability company," for the purpose of offering one specific type of professional service, by filing articles of organization with the Secretary of State in accordance with Part Three of the TLLCA.\textsuperscript{276} The company name must include the words "Professional Limited Liability Company" or the abbreviations "P.L.L.C." or "PLLC."\textsuperscript{277} A "professional service" is defined as any type of personal service that requires the obtaining of a license, permit, cert-

\textsuperscript{268} Id. § 1.28 (adding Art. 10.06, § A to TEX. REV. CIV. STAT. ANN. art. 1528n).
\textsuperscript{269} See id. § 1.20.
\textsuperscript{270} Id. § 1.20 (adding TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 6.01, § B).
\textsuperscript{271} Id.
\textsuperscript{272} Id.
\textsuperscript{273} Id. § 1.21 (amending TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 6.03, § A).
\textsuperscript{274} See TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 6.03, § A (Vernon Supp. 1993).
\textsuperscript{275} See TLLCA Amendments, supra note 189, § 1.28 (adding Arts. 11.01-.07 to TEX. REV. CIV. STAT. ANN. art. 1528n).
\textsuperscript{276} Id. § 1.28 (adding Art. 11.01, § A to TEX. REV. CIV. STAT. ANN. art. 1528n).
\textsuperscript{277} Id. § 1.28 (adding Art. 11.02, § A to TEX. REV. CIV. STAT. ANN. art. 1528n).
tificate of registration, or other legal authorization as a condition precedent to the rendering of the service.278 According to the statute, persons offering professional services include architects, attorneys, public accountants and certified public accountants, dentists, doctors, physicians, surgeons, and veterinarians.279

Only persons who are licensed or otherwise authorized to perform the professional service of the PLLC may become members, managers, or officers of the company.280 If a member, manager, or officer becomes legally disqualified to render the professional services of the company, such person must sever all employment and immediately terminate all financial interest in the company.281 The company is obligated by statute to purchase the membership interest owned by a disqualified member on terms specified in the company's articles of organization, regulations, or other agreements.282 If the company has only one member, the disqualified professional may continue to act as a member, manager, or officer only for the purposes of the winding-up and dissolution of the company.283

Part Eleven expressly states that it does not alter or affect the relationship between any person rendering professional services and any person receiving such services.284 The existence of a PLLC does not diminish any legal rights which a person may have against the professional for errors, omissions, negligence, incompetence, or malfeasance.285 Under the statute, the company and the specific members, managers, officers, employees, or other agents rendering the professional service in the course of their employment are held jointly and severally liable for any liability resulting therefrom.286 The members, managers, officers, employees, or agents of the company which did not render the services in question are expressly exempted from personal liability by the statute.287

The sale, issuance, or offering of membership interests in a PLLC is expressly exempt from all state laws providing for the supervision, regulation, or registration of securities.288 The sale, issuance, or offering of PLLC interests to persons permitted to own such interests is deemed to be legal without any action or approval by any state regulatory agency authorized to regulate, license, or supervise the sale, issuance, or offering of securities.289

B. Federal Income Tax Developments

The Internal Revenue Service (I.R.S.) issued a number of Revenue Proce-
dures and Revenue Rulings during 1992 and 1993 which clarified and interpreted the tax classification of LLCs under Treasury Regulation § 301.7701-2. In addition, a private letter ruling was issued which dealt with the appropriate accounting method for a professional firm operating as an LLC. These are addressed below.

1. Revenue Procedures

Rev. Proc. 92-33\textsuperscript{290} offered definitive guidance on the issue of whether a partnership has the corporate characteristic of "free transferability of interests"\textsuperscript{291} by indicating that the I.R.S. will rule that a partnership lacks that characteristic "if, throughout the life of the partnership, the partnership agreement expressly restricts . . . the transferability of partnership interests representing more than 20% of all interests in partnership capital, income, gain, loss, deduction, and credit."\textsuperscript{292} Rev. Proc. 92-35\textsuperscript{293} expanded the range of instances in which the I.R.S. will rule that an organization lacks the corporate characteristic of "continuity of life."\textsuperscript{294} Rev. Proc. 89-12\textsuperscript{295} indicates that the I.R.S. will not rule that a limited partnership lacks the characteristic of continuity of life if, in the case of a removal of the general partner, the partnership agreement permits less than a majority in interest of the limited partners to continue the partnership. Rev. Proc. 92-35 supplements Rev. Proc. 89-12 by stating that the I.R.S. will not rule that a limited partnership possesses continuity of life if, under the partnership agreement, the bankruptcy or removal of a general partner will cause a dissolution of the partnership "unless the remaining general partners or at least a majority in interest of all remaining partners agree to continue the partnership."\textsuperscript{296}

Rev. Procs. 92-87\textsuperscript{297} and 92-88\textsuperscript{298} provided clarification regarding when, for purposes of rulings and determination letters, limited partnerships (or-

\textsuperscript{290} 1992-1 C.B. 782.
\textsuperscript{291} See Treas. Reg. § 301.7701-2(e)(1). The regulations provide that: [a]n organization has the corporate characteristic of free transferability of interests if each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves . . . a person who is not a member of the organization. In order for this power of substitution to exist . . . the member must be able, without the consent of other members, to confer upon his substitute all the attributes of his interest in the organization.

\textit{Id.}

\textsuperscript{292} Rev. Proc. 92-33, 1992-1 C.B. 782.
\textsuperscript{293} 1992-1 C.B. 790.
\textsuperscript{294} See Treas. Reg. § 301.7701-2(b)(1). The regulations provide that: [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 . . . If the retirement, death, or insanity of a general partner of a limited partnership causes a dissolution of the partnership, unless the remaining general partners . . . or unless all remaining members agree to continue the partnership, continuity of life does not exist.

\textit{Id.}

\textsuperscript{295} 1989-1 C.B. 798.
\textsuperscript{297} 1992-42 I.R.B. 38.
organized under a state limited partnership act corresponding to the Uniform Limited Partnership Act) will be treated as lacking the corporate characteristics of continuity of life and limited liability and thus will not ordinarily need to request an entity classification ruling.

2. Revenue Rulings

The most surprising ruling to date dealing with the tax classification of an LLC, Rev. Rul. 93-6, centered on the existence of the corporate characteristic of centralized management. In Rev. Rul. 93-6, the I.R.S. considered the classification of a Colorado LLC and held that the entity would be taxed as a partnership for federal income tax purposes. The regulations dealing with centralized management provide that an organization has that characteristic if any person (or group of persons that does not include all the members) has continuing authority to make the decisions necessary to conduct the business of the organization. The LLC in question had five members who were each elected as a manager of the company. In spite of the fact that management was centralized in a group which included all the members, the I.R.S. ruled that the characteristic of centralized management existed because the authority to make management decisions rested with the members in their capacity as managers, rather than as members. This ruling should serve as a warning to practitioners to take special care in drafting LLC articles and regulations in order to avoid causing the entity to possess the characteristic of centralized management.

Rev. Rul. 93-38 dealt with the classification of two LLCs organized under the Delaware LLC statute. The first LLC considered in the ruling was structured to avoid taxation as an association, and the I.R.S. so ruled. The governance documents of the second LLC provided that (a) the company would be managed by managers, (b) the company would continue under all circumstances, without the prior approval of any member or manager, and (c) the company's interests could be assigned without consent from any member or manager, and that the assignee would acquire all the attributes of the member's interest in the company. The LLC was found to possess all four corporate characteristics, and thus was classified as an association for federal income tax purposes.

Other rulings which may be of interest include Rev. Ruls. 93-30 and

299. See Treas. Reg. § 301.7701-2(b), (d).
301. Id.
304. Id. For a more thorough discussion of Rev. Rul. 93-6, as well as an exhaustive listing of rulings and procedures affecting LLCs, see R. Brent Clifton, Update Of The Tax Classification Of LLCs, STATE BAR OF TEXAS SECTION OF TAXATION NEWSLETTER, Feb. 1993, at 4.
306. Id.
307. Id.
308. Id.
in which LLCs organized under the Nevada and Virginia statutes, respectively, were classified as partnerships for federal tax purposes.

3. Tax Accounting Methods of PLLCs

The amendments to the TLLCA expressly authorized the formation of PLLCs, through which doctors, lawyers, accountants, architects, and others may practice their profession and reduce the risk of personal liability arising from the torts of their colleagues. Professionals currently practicing in general partnership form who wish to convert to a PLLC should, however, carefully evaluate the federal income tax implications of such a conversion. Commentators have recently noted that the Internal Revenue Code may dictate a change from the cash method of accounting, commonly used by professionals, to the accrual method of accounting upon a conversion from general partnership form to PLLC. This change could force the acceleration of a substantial amount of taxable income into the year of conversion as a result of the valuation of accounts receivable. Depending upon the amount and anticipated collection dates of the accounts receivable and the liquidity of the PLLC members, such a recognition of income could have potentially catastrophic consequences.

The I.R.S. has issued one private letter ruling which indicates that professionals may be able to retain the cash method of accounting after conversion to a PLLC. The facts upon which the ruling was based are highly specific and apply only to the firm under consideration, however, and a number of significant questions on the issue of the appropriate tax accounting method still remain unanswered.

C. Qualification of Texas LLCs in the Adjoining States

All four states bordering Texas have recently enacted an LLC statute of one form or another. Texas businesses which operate as LLCs and transact business in one of the surrounding states should consider whether qualifying in that state is appropriate. The following paragraphs summarize the qualifi-

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311. See supra text accompanying notes 275-89.
312. Sheldon I. Banoff et al., Tax Trap For Professionals Forming LLCs, J. TAX'N, July 1993, at 63.
313. See id.
315. Among other things, the law firm represented that all LLC members would continue in the active practice of law and would participate in the management of the firm. Id.
316. See Sheldon I. Banoff, New IRS Ruling Encourages Professionals to Form Limited Liability Companies, J. TAX'N, August 1993, at 68. Mr. Banoff raises a number of troubling questions for practitioners in connection with the issuance of Priv. Ltr. Rul. 9321047. For example, would the ruling have been issued if less than all the members of the law firm were involved in all the major activities and decisions? Id. at 70. Would a favorable ruling be precluded if the firm consisted of two or more tiers of partners with differing voting interests? Id. Does the ruling imply that the cash method is not available in a situation where all the members of an LLC are not actively engaged in the day-to-day practice of the profession? Id. at 71.
ocation requirements for Texas LLCs operating in Oklahoma, Arkansas, New Mexico, and Louisiana.

1. Oklahoma

Before a Texas LLC may lawfully transact business in Oklahoma, it must register with the office of the Oklahoma Secretary of State. Under Oklahoma statute, any Texas LLC which owns income-producing real or tangible personal property in Oklahoma (which is not otherwise exempted by statute) is considered to be transacting business in the state. Registration involves the payment of a $300 fee and the filing of an original certificate from the office of the Texas Secretary of State attesting to the LLC's organization under the laws of the State of Texas. LLCs must also submit two copies of an application for registration, signed by a manager, member, or other person, stating the LLC's name, date and state of organization, registered agent for service of process in Oklahoma, and related information.

An LLC may not register to transact business in Oklahoma if its name does not satisfy the requirements of the Oklahoma Limited Liability Company Act. The Oklahoma statute requires that the name of each LLC contain either the words “limited liability company” or the abbreviations “L.L.C.” or “L.C.” This requirement is more restrictive than the Texas statute which, as amended, also allows the use of “Limited Company,” “Limited,” “Ltd.,” “LTD,” “LLC,” and “LC.” Thus, a Texas LLC using these additional words or abbreviations may be required to select a designated name which satisfies the requirements of Oklahoma law before a certificate of registration will be granted.

A Texas LLC which has not registered in Oklahoma may not maintain an action, suit, or proceeding in an Oklahoma court until the statutory registration requirements are met. By transacting business in Oklahoma without registration, the Texas LLC appoints the Oklahoma Secretary of State as its agent for service of process for actions arising out of transactions in the state. The failure of the LLC to register does not affect the validity of any act which it may have taken or contract to which it may have been a party. No member or manager of a Texas LLC becomes liable for the debts and obligations of the entity solely because it transacted business in the State of Oklahoma without first complying with the registration

318. Id. § 2049(B).
319. Id. § 2055(9).
320. Id. § 2043(2).
321. Id. § 2043(3).
322. Id. § 2045.
323. Id. § 2008(1).
324. See TLLCA Amendments, supra note 189, § 1.02 (amending Tex. Rev. Civ. Stat. Ann. art. 1528n, Art. 2.03, § A(1)).
326. Id. § 2048(A).
327. Id. § 2048(C).
328. Id. § 2048(B).
requirements.329

2. Arkansas

Before a Texas LLC may lawfully transact business in Arkansas, it must register with the office of the Arkansas Secretary of State.330 Registration involves the payment of a $300 fee331 and the filing of two copies of an application for registration, signed by a person with authority to do so under Texas law, stating the LLC’s name, date and state of organization, registered agent for service of process in Arkansas, and related information.332 No certificate of registration will be issued unless the name of the LLC satisfies the requirements of Arkansas law.333 The Arkansas statute permits the use of all the same words and abbreviations in an LLC name as are permitted by the TLLCA, with the exception that “LTD” is not specifically authorized as an abbreviation for the word “Limited.”334

A Texas LLC which has not registered in Arkansas may not maintain an action, suit, or proceeding in an Arkansas court until it has registered in the state.335 By transacting business in Arkansas without registration, the Texas LLC appoints the Arkansas Secretary of State as its agent for service of process for actions arising out of transactions in the state.336 The failure of the LLC to register does not affect the validity of any act which it may have taken or contract to which it may have been a party.337 No member or manager of a Texas LLC becomes liable for the debts and obligations of the entity solely because it transacted business in the State of Arkansas without first complying with the registration requirements.338

3. New Mexico

Before a Texas LLC may transact business in New Mexico, it is required to register with the New Mexico State Corporation Commission.339 Registration involves the submission of two copies of an application for registration, executed by a person with authority to do so under Texas law, stating the LLC’s name, date and state of organization, registered agent for service in New Mexico, the identity of persons in whom the management of the LLC is vested, and related information.340

329. Id. § 2048(D).
331. Id. § 1302(a)(xiii) (to be codified at ARK. CODE ANN. § 4-32-1301).
332. Id. § 1002(a)-(f) (to be codified at ARK. CODE ANN. § 4-32-1002).
333. Id. § 1004 (to be codified at ARK. CODE ANN. § 4-32-1004).
334. See id. § 103 (to be codified at ARK. CODE ANN. § 4-32-103); TLLCA Amendments, supra note 189, § 1.02 (amending TEX. REV. CIV. STAT. ANN. art. 1528n, Art. 2.03, § A(1)).
336. Id. § 1007(c).
337. Id. § 1007(b).
338. Id. § 1007(g).
340. Id. at 2807-08.
The name of the Texas LLC must be one which would be permitted by the New Mexico Limited Liability Company Act.\textsuperscript{341} The Act requires that each LLC name include the words "limited liability company" or "limited company," the words "limited" and "company" may be abbreviated as "ltd." and "co.," respectively.\textsuperscript{342} This requirement is more restrictive than the Texas statute which, as amended, also allows the use of "Limited," "LTD," "L.L.C.,” “LLC,” and "LC.”\textsuperscript{343}

A Texas LLC which has not registered in New Mexico may not maintain an action, suit, or proceeding in a New Mexico court until it has registered in the state.\textsuperscript{344} By transacting business in New Mexico without registration, the Texas LLC appoints the New Mexico Secretary of State as its agent for service of process for actions arising out of transactions in the state.\textsuperscript{345} The failure of the LLC to register does not affect the validity of any act which it may have taken or contract to which it may have been a party.\textsuperscript{346} No member or manager of a Texas LLC becomes liable for the debts and obligations of the entity solely because it transacted business in the State of New Mexico without first complying with the registration requirements.\textsuperscript{347}

4. \textit{Louisiana}

No Texas LLC shall have the right to transact business in Louisiana until it has procured a certificate of authority from the Louisiana Secretary of State.\textsuperscript{348} Registration involves the payment of a $100 fee\textsuperscript{349} and the filing of two copies of an application for registration, signed by a member (or a manager, if management of the LLC is vested in one or more managers), stating the LLC's name, date and state of organization, period of duration, registered agent for service of process in Louisiana, nature of business to be transacted in Louisiana, and related information.\textsuperscript{350}

No certificate of authority will be issued to a Texas LLC if its name does not satisfy the requirements of Louisiana law.\textsuperscript{351} The Louisiana statute requires that the name of each LLC contain either the words "limited liability company" or the abbreviations "L.L.C." or "L.C."\textsuperscript{352} This requirement is more restrictive than the Texas statute which, as amended, also allows the use of "Limited Company," "Limited," "Ltd.," "LTD," "Ltd," "LLC," and

\textsuperscript{341} Id. § 50, at 2809 (to be codified at N.M. Stat. Ann. § 53-19-50).
\textsuperscript{342} Id. § 3, at 2756 (to be codified at N.M. Stat. Ann. § 53-19-3).
\textsuperscript{343} See \textit{TLLCA Amendments, supra} note 189, § 1.02 (amending Tex. Rev. Civ. Stat. Ann. art. 1528n, Art. 2.03, § A(1)).
\textsuperscript{345} Id.
\textsuperscript{346} Id.
\textsuperscript{347} Id. at 2814.
\textsuperscript{348} \textit{LA. REV. STAT. ANN.} § 12:1342 (West Supp. 1993).
\textsuperscript{349} Id. § 12:1364(B)(1).
\textsuperscript{350} Id. § 12:1345(A), (B).
\textsuperscript{351} Id. § 12:1344.
\textsuperscript{352} Id. § 12:1306(A)(1).
Thus, a Texas LLC using these additional words or abbreviations may be required to modify its name before a certificate of authority will be granted.\textsuperscript{354}

A Texas LLC which has not procured a certificate of authority in Louisiana will not be permitted to present a judicial demand before any court of that state.\textsuperscript{355} The failure of the LLC to obtain a certificate does not affect the validity of any act which the LLC may have taken or contract to which it may have been a party.\textsuperscript{356} No member or manager of a Texas LLC is liable for the obligations of the entity solely as a result of the failure to obtain a certificate of authority.\textsuperscript{357}

\textsuperscript{353} See TLLCA Amendments, supra note 189, § 1.02 (amending Tex. Rev. Civ. Stat. Ann. art. 1528n, Art. 2.03, § A(1)).
\textsuperscript{355} Id. § 12:1354(A).
\textsuperscript{356} Id. § 12:1354(B).
\textsuperscript{357} Id.