DISSECTING LLC COMPANY AGREEMENTS

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LEGAL EXPERIENCE

***ScottHulse PC*, El Paso, Texas and Las Cruces, New Mexico**.
Shareholder – January 2001 to present; Associate – September 1995 to December 2000.
Practice includes estate planning, asset protection, probate and contested estates. Experience includes eleven years of pure trial practice in employment, commercial and general litigation. Licensed in Texas and New Mexico and admitted to the federal courts in the Western District of Texas, the District of New Mexico and the United States Court of Appeals for the Fifth Circuit.

***United States District Court for the Western District of Texas*, El Paso, Texas.**
Law Clerk for Chief Judge Harry Lee Hudspeth – August 1994 to August 1995.

***Supreme Court of the State of Texas*, Austin, Texas.**
Intern for Justice Lloyd Doggett – January 1994 to May 1994.

ARTICLES AND SPEECHES

- Author and Speaker: 24th Annual Estate Planning Institute. Community Foundation of Southern New Mexico. *2016 Legislative Changes Affecting the New Mexico Estate Planning and Probate Practice*, October 27-28, 2016, Las Cruces, New Mexico.
- Author and Speaker: 26th Annual Estate Planning & Probate Drafting Course. State Bar of Texas. *Drafting and Exercising Powers of Appointment*, October 8-9, 2015, Houston, Texas.
- Author: "Federal Transfer Taxes for International Clients", The Texas Tax Lawyer, Vol. 42, No. 1 (Fall 2014).
- Author and Speaker: 38th Annual Advanced Estate Planning & Probate Course. State Bar of Texas. *Administration of the Estate with Cross Border Issues*, June 10-12, 2014, San Antonio, Texas.
- Author and Speaker: 21st Annual Estate Planning Institute. Community Foundation of Southern New Mexico. *The Nuts and Bolts of a New Mexico Will*, October 24-25, 2013, Las Cruces, New Mexico.
- Author and Speaker: Houston Attorneys in Tax and Probate Luncheon. *International Estate Planning*, March 5, 2013, Houston, Texas.
- Author and Speaker: El Paso Estate Planning Council Luncheon. *Business Succession Planning*, December 19, 2012, El Paso, Texas.
- Author and Speaker: 20th Annual Estate Planning Institute. Community Foundation of Southern New Mexico. *A Stroll Through the Uniform Probate Code*, November 1-2, 2012, Las Cruces, New Mexico.
- Author and Speaker: 19th Annual Estate Planning Institute. Community Foundation of Southern New Mexico. *Business Succession Planning*, November 3-4, 2011, Las Cruces, New Mexico.
- Speaker: 2011 Southwest Regional Conference. American Society of Women Accountants. *Estate and Trust Accounting Under the Uniform Probate and Trust Codes*, May 20, 2011, Las Cruces, New Mexico.
- Author and Speaker: 2011 Tax Considerations in Estate Planning Course. State Bar of New Mexico. *The Federal Estate Tax – A Primer*, April 27-28, 2011, Albuquerque, New Mexico.
- Course Director and Speaker: 2nd through 10th Annual New Mexico State University Estate Planning Conference for Women, 2009 – 2017, Las Cruces, New Mexico.
- Author: "Key Points as EGTRRA's Sunset Looms", Texas Lawyer, Vol. 26, No. 34 (November 22, 2010).
- Author and Speaker: 18th Annual Estate Planning Institute. Community Foundation of Southern New Mexico. *Planning in Uncertain Times: Bypass (or Credit Shelter) and Marital Deduction Trusts in 2011 and Beyond*, November 4-5, 2010, Las Cruces, New Mexico.

- Author and Speaker: 2010 Advanced Estate Planning and Probate Course. State Bar of Texas. *International Issues in Estate Administration*, June 22-24, 2010, San Antonio, Texas.
- Speaker: El Paso Chapter, Texas Society of CPAs. *Estate Planning for 2010 & Beyond, or Be Careful of What You Wish for*, April 27, 2010, El Paso, Texas.
- Author and Speaker: 2009 Advanced Drafting: Estate Planning & Probate Course. State Bar of Texas. *Drafting for Non-Citizens and Non-Residents*, October 29-30, 2009, Dallas, Texas.
- Author and Speaker: 16th Annual Estate Planning Institute. Community Foundation of Southern New Mexico. *Planning with Irrevocable Life Insurance Trusts*, November 6-7, 2008, Las Cruces, New Mexico.
- Author and Speaker: 19th Annual Advanced Drafting: Estate Planning and Probate Course. State Bar of Texas. *Drafting for the Settlement of Estates and Trusts*, October 30-31, 2008, Austin, Texas.
- Author and Speaker: 15th Annual Estate Planning Institute. Community Foundation of Southern New Mexico. *Advanced Planning Techniques with Incapacity in Mind*, November 1-2, 2007, Las Cruces, New Mexico.

EDUCATION

University of Texas School of Law, J.D. with honors, Order of the Coif – May 1994.

Texas A & M University, B.A. in Economics, *magna cum laude* – May 1990.

AWARDS AND CIVIC AND RELIGIOUS INVOLVEMENT

- *State Bar of Texas, Tax Section, Estate and Gift Tax Committee*. Vice-Chair – 2014 to 2016.
- *Texas Super Lawyers, Estate Planning and Probate*. 2014--2016.
- *State Bar of New Mexico, Real Property, Trust and Estate Section Board of Directors*. Budget Officer – 2011 to 2013, *Member* – 2011 to 2013.
- *Southern New Mexico Estate Planning Council.* President – 2011 to 2012, 1st Vice-President – 2010 to 2011, Member – 2006 to present.
- *El Paso Estate Planning Council.* Board Member – 2014 to 2016, Member – 2005 to present.
- *Rio Grande Professional Advisor of the Year*. Community Foundation of Southern New Mexico. April 2009.
- *Leadership El Paso Class XXIX*, The Greater El Paso Chamber of Commerce, El Paso, Texas. Participant – 2007.
- *Insights El Paso Science Museum*, El Paso, Texas. Board Member – July 2006 to May 2008; Vice President – June 2004 to June 2006; Board Member – June 2002 to June 2004.
- *Beth El Bible Evangelical Free Church*, El Paso, Texas. Elder – December 2001 to May 2008; Member – 1995 to present.

FAMILY

Married to Laura B. Davis with five daughters: Emma (17), Audrey (15), Camille (13), Julia (13) and Charlotte (7).

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I. INTRODUCTION

A. The Problem

Lawyers in the estate planning and probate area of practice will invariably advise clients regarding limited liability companies ("LLCs") that the lawyer did not establish. While the fundamental concepts behind LLCs are relatively understandable, LLCs in practice can be very complex. At one end of the spectrum, the subject company can be a single member LLCs without any written company agreement. But at the other end of the spectrum, the LLC may have several hundred members, each of whom has a different economic interest and a different level of management rights. Complex companies also tend to have managers and officers who manage the day to day activities of the company, while the members may be for most intents and purposes, silent investors. In all instances, the manner in which a particular LLC is governed is informed by the governing law, the formation document (in Texas – the certificate of formation), and the agreement between the company and its members (in Texas – the company agreement).

At some point in each attorney's career, the attorney will become comfortable with his or her own forms and how they affect the legal relationships of the members and the company. But a lawyer's model agreement likely provides little practical assistance in understanding documents prepared by other attorneys. The lawyer will likely have made choices in preparing his or her own model form between a handful of options without documenting those choices in the form. Consequently, the lawyer is forced to reconsider all of the various options and the consequences of each while at the same time considering other new options presented by the other lawyer's agreement.

B. Scope of Paper

The goal of this paper is to establish a framework to assist attorneys in reviewing and understanding company agreements prepared by other lawyers. Perhaps, the paper also will assist attorneys in dissecting their own model agreements. But the paper does not attempt to provide a model agreement. Instead, the author refers the reader to such papers as: 1) Ernst, Cliff and Elizabeth S. Miller, *Model Company Agreements for Simple LLCs*, LLCs, LPs and Partnerships Course, University of Texas School of Law Continuing Legal Education, July 14-15, 2016, Austin, Texas (hereafter "*Model Company Agreements*"); and 2) Jones, Bernard E., The Annotated LP/LLC Agreement: A New Paradigm for Unified/"Plug & Play" Drafting, 23rd Annual Estate Planning & Probate Drafting Course, State Bar of Texas, Oct. 18-19, 2012, Dallas, Texas.

This is an intermediate course. Given that LLCs can become quite complex, some limits must be placed on the depth to which the paper discusses each issue. For example, it will not discuss most issues in detail and particularly will avoid discussions of complex equity structures and taxation. The paper also will not discuss due diligence matters that a client should consider before joining a company with other persons. Finally, this is a Texas law seminar. Accordingly, the paper will address only Texas LLCs.

II. DOCUMENTS TO GATHER

A. Draft LLCs

In the context of an LLC that has not yet been formed, the attorney should gather the following documents for review, all of which, hopefully, will be drafts:

- *Certificate of formation*. All terms that may be included in a company agreement may also be alternatively placed in the certificate of formation (the "certificate"). TEX. BUS. ORG. CODE (hereafter, the "BOC") § 101.051(a). In the BOC, references to an LLC's company agreement therefore includes any provision found in the certificate.[1] *Id*. § 101.051(b). Further, the certificate also governs certain matters with respect to the company. For example, whether the company is managed by managers or its members must be stated in the certificate. *Id*. §§ 3.010, 101.251.
- *Company agreement*. Technically, an LLC does not require a company agreement. In the absence of a company agreement (or the absence of a provision in the company agreement), the Business Organizations Code governs. BOC § 101.052(b). Further, the company agreement may alter the application of the BOC with respect to most matters. *Id*. § 101.052(c). The agreement also may contain any other matters not inconsistent with the BOC. *Id*. § 101.052(d) (section 101.054 specifies those provisions that may not be modified). Note that a company agreement may be oral and is not unenforceable simply because the company only has one member. *Id*. § 101.001(a).

[1] Despite that the term "company agreement" incorporates both the certificate and the company agreement for purposes of the BOC, this paper will refer to the two documents separately. A reference to the LLC's "governing documents" incorporates both the certificate and the company agreement.

- *All schedules and exhibits*. Many company agreements refer to schedules and exhibits. Significant examples may include the schedules that identify the members and their respective interests in the company and schedules that identify each member's contributions to the company.
- *Organizational minutes or consents*. Actions not in the ordinary course of the company and fundamental business transactions require votes by the company's governing persons or members, or both. BOC § 101.356(b), (c). These documents typically adopt the proposed certificate and company agreement, and appoint managers, officers, and the like. Note that an LLC is not required to keep copies of its minutes unless its company agreement requires such preservation. *Id*. § 3.151(c).
- *Transfer documents*. If members are expected to contribute property other than cash, the attorney should review the documents by which such property will be assigned to the LLC to ensure the transfers take place properly.

B. Existing LLCs

For existing LLCs, the attorney should gather all of the documents listed above, which in this case should be fully executed and, if relevant, any filed documents. Additionally, the attorney should gather:

- *All amendments and restatements*. Both certificates of formation and company agreements may be amended or restated. The company is required to keep copies of all such documents. BOC § 101.501(a)(3), (4).
- *Any addendum agreements*. Depending on the terms of the company agreement, new members may execute an addendum agreement or some other document reflecting an agreement to be bound by the existing company agreement. Such an agreement may be incorporated in another document, such as an assignment.
- *Current schedules*. LLCs are required to keep current lists of members and their respective interests in the company. BOC § 101.501(a)(1). They also must keep a list of all contributions to the company. *Id*. § 101.501(a)(7). Information regarding members and contributions may be found, however, in the company agreement. *Id*. § 101.501(b).
- *Any agreements with third parties that affect control*. Sometimes, lending agreements impose restrictions upon changes of control or changes of ownership of the company. The LLC also may be a member or partner of another entity, which includes transfer restrictions of a similar sort. For example, members of an LLC may enter a written voting trust. *See id*. § 6.251.
- *Voting agreements*. Any one or more of the members may enter voting agreement that can affect control of the entity. *See id*. § 6.252.
- *Minutes and consents*. The company's minutes and consents may reflect changes in the company's governing documents not apparent elsewhere. For example, they will show changes in managers and officers. They also will reflect changes in members and contributions. Interestingly, the BOC does not require LLCs to maintain records of its minutes unless the company agreement so requires. BOC § 3.151(c); *cf. id*. § 101.501 (listing other documents an LLC is required to maintain).
- *Tax returns*. Tax returns are important to verify how the LLC is taxed. They also should identify how ownership has been reported to the IRS. The author is constantly amazed how often the ownership information appearing on the tax returns is inconsistent with the LLC's own records, especially in the context of gifted interests to family members. The company is required to maintain and make available (to certain persons) copies of its last six years of returns. BOC § 101.501(a)(2).

III. THE CERTIFICATE OF FORMATION DOCUMENTS TO GATHER

A. Compliance with the Law

The first step in reviewing the certificate is to determine whether it complies with the law. Certificates of LLCs (and all other Texas entities) are governed by the general provisions of the BOC. Filing of the certificate is required to form the entity and the entity's existence commences upon the effectiveness of the filing. BOC § 3.001(a), (c). A filed certificate is conclusive evidence that (1) the entity is formed and exists; (2) all conditions precedent to the formation have been satisfied; and (3) the entity has authority to transact business in Texas. *Id*. § 3.001(d). When reviewing draft certificates, the attorney should verify that it contains the following information, all of which are required by the BOC:

- The name of the LLC;
- That an LLC (as opposed to some other type of entity) is being formed;

- The LLC's purpose or purposes, which may be stated as simply as "to be or to include any lawful purpose;"
- The LLC's initial registered office and the name of the LLC's initial registered agent at that office;
- The name of the organizer;
- Whether the LLC will have managers, and if so, the names and addresses of the managers; and
- If the LLC will not have managers, the names and addresses of all the initial members.

BOC §§ 3.005(a), 3.010. If, on the other hand, the LLC is formed to provide professional services such as medicine or law, the certificate must state the type of professional service to be provided as the LLC's purpose and that the LLC is a "professional limited liability company." *Id.* § 3.014. Finally, if the LLC is organized as a series LLC, its certificate must also provide the statutory notices of limitations of liability found in Section 101.602(a). *Id*. § 101.602(b)(3). The requirements with respect to series LLCs will be discussed in further detail below in Section VI(F).

The certificate must be signed by the organizer, who may be virtually anyone. BOC § 3.004. There is no requirement in the BOC that the organizer be associated with the company after its formation. The organizer must, however, have the capacity to contract and be authorized by the company to sign the certificate. *Id*. §§ 3.004(a) (capacity), 4.001(a)(1) (authorization). Finally, all the organizers of the company must sign the certificate. *Id*. § 3.004(b).

B. Optional Provisions in the Certificate

The certificate generally only contains that information which is required by the BOC. S*ee* 19 TEX. PRAC., BUSINESS ORGANIZATIONS (hereafter "TEX. PRAC. SERIES") § 19:1 (3d ed.). All other terms governing the relationship of the members, managers, if any, and the company are typically found in the company agreement. But as pointed out above, the certificate may contain any terms that might otherwise be found in the company agreement. BOC § 101.051(a). The certificate also governs in cases of inconsistency between the certificate and the company agreement. *Id*. § 101.052(d); *Pinnacle Data Servs., Inc. v. Gillen*, 104 S.W.3d 188, 195 (Tex. App.—Texarkana 2003, no pet.) (company's articles of organization controlled over company's regulations), *disapproved on other grounds by Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014). Therefore, the attorney should carefully review the certificate and determine how it might alter either the BOC or the company agreement itself.

C. Amendments and Restatements of Certificates

Unless the certificate or the company agreement provides otherwise, all members must approve, "by affirmative vote" any amendment of the certificate and any restatement that amends the certificate. BOC §§ 3.052(a) (Title 3 of the BOC, which relates to LLCs, governs how an LLC amends its certificate), 101.356(d) (requiring an "affirmative vote" of all members for amendments to the certificate). The certificate of amendment must be signed by an authorized officer, manager, or member of the company. *Id*. § 101.0515. The identity of the exact person who is authorized to sign should be found in the relevant consent or minutes (if such documents still exist).

IV. THE COMPANY AGREEMENT IN GENERAL

A. Validity

The term "company agreement" means any agreement among the members of the company "concerning the affairs or the conduct of the business" of the company. BOC § 101.001(a). The term necessarily includes the company's certificate of formation. *Id*. § 101.051(b) (any reference in the BOC to "company agreement" includes any provisions found in the certificate). In particular, the company agreement governs the relations among the members, managers, officers, assignees of membership interests, and the company itself. *Id*. § 101.052(a)(1). It also governs the internal affairs of the company. *Id*. § 101.052(a)(2). Written company agreements are not required. Rather and in the absence of an agreement, the default company agreement is composed of the provisions of the BOC. *See id*. § 101.052(b) (to the extent a company agreement does not alter the BOC, the BOC governs the internal affairs of the company). Also, company agreements may be oral. *Id*. § 101.001(a).

The written company agreement typically is signed by the members and managers, if any. But the BOC would allow for a company agreement that is never signed by the members. For example, the BOC allows for an LLC with managers to operate for a reasonable period between the date it is formed and the date the first member is admitted to the company. BOC § 101.101(b). During that period, the company may act without the approval of any members. *Id*. § 101.356(e). Therefore, the managers could establish the company agreement and the members would consent to the agreement as they are admitted.

While the best practice would be to require all members to sign some document by which they accept the company agreement, consent to the agreement can also be established by (1) the member failing to object to the company agreement in a timely fashion, if the

member has full knowledge of the agreement, (2) the member consenting to the agreement in some writing other than the agreement itself, or (3) any other means reasonably evidencing consent. BOC § 101.359(2). The members also could adopt the written company agreement at a member meeting at which all of the members voted. *Id*. § 101.359(1). In the latter case, there may be no minutes evidencing the affirmative vote, unless the company agreement otherwise requires such records to be kept. *Cf. id*. § 3.151(c) (LLCs are not required to maintain records of its minutes).

B. Amendments and Restatements

Unless the company agreement provides otherwise, all members must consent to an amendment of the company agreement. BOC § 101.053. That all members must consent to the amendment does not require, however, that all members must sign the amendment. An amendment to the company agreement (as opposed to the certificate) may be oral. *See id*. § 101.001(a) (the company agreement may be oral). That a company agreement and amendments to the company agreement may be oral certainly is problematic, especially when a dispute is on the horizon. If there is a necessary provision in all company agreements, it is that all amendments to the agreement be in writing.

V. MISCELLANEOUS INTRODUCTORY PROVISIONS

A. Exordium clause

Most company agreements start with the exordium or introductory clause. There are two primary purposes of the exordium clause in the context of a company agreement. It typically identifies the parties to the agreement and the effective date of the agreement. The exordium clause is not necessary, however.

B. Definitions

Many company agreements (and other agreement prepared by lawyers) place the definitions section near the beginning of the agreement. Other lawyers place definitions of terms in a section near the end. Of course, the attorney reviewing the company agreement must be aware that the agreement likely will contain other defined terms throughout the agreement that are not necessarily found in the definitions section. Well drafted agreements will use capitalized terms (or a different font) for those words that have supplied definitions. But invariably, there are mistakes and the reviewing attorney must be careful to determine which words have supplied meanings.

The attorney also should be aware that many definitions found in company agreements may go beyond merely defining a word by including substantive provisions with the definition.

1. Restricted Definitions

One also should ensure that the company agreement does not go too far in its definitions. The BOC prohibits changing the definitions as found in Chapter 1 of the BOC if the statutory definition is used to interpret or define a word or phrase found in any section of the BOC listed in Section 101.054(a). BOC § 101.054(a)(3). After a considerable amount of page flipping in a copy of the BOC, the author was finally able to determine that some of the relevant definitions are as follows:[2]

- *Contribution*, which means a tangible or intangible benefit that a person transfers to an entity in consideration for an ownership interest in the entity or otherwise in the person's capacity as an owner or a member. The benefit includes cash, services rendered, a contract for services to be performed, a promissory note or other obligation of a person to pay cash or transfer property to the entity, or securities or other interests in or obligations of an entity, but does not include cash or property received by the entity: (A) with respect to a promissory note or other obligation to the extent that the agreed value of the note or obligation has previously been included as a contribution; or (B) that the person intends to be a loan to the entity. BOC §§ 1.002(9) (defining the term), 101.054(a)(2) (limiting modification of certain provisions of Title 3 of the BOC), 101.151 (using the term), 101.501 (using the term).
- *Manager*, which means a person designated as a manager of a limited liability company that is not managed by members of the company. *Id*. §§ 1.002(51) (defining the term), 101.054(a)(2) (limiting modification of certain provisions of Title 3 of the BOC), 101.101 (using the term).
- *Member*, which means, with respect to an LLC, a person who is a member or has been admitted as a member in the limited liability company under its governing documents. *Id*. §§ 1.002(53)(A) (defining the term), 101.054(a)(2) (limiting modification of certain provisions of Title 3 of the BOC), 101.101 (using the term), 101.206 (using the term), 101.501 (using the term), 101.613 (using the term).

[2] The list is by no means exhaustive.

- *Membership interest*, which means a member's interest in an entity. With respect to a limited liability company, the term includes a member's share of profits and losses or similar items and the right to receive distributions, but does not include a member's right to participate in management. *Id*. §§ 1.002(54) (defining the term), 101.054(a)(2) (limiting modification of certain provisions of Title 3 of the BOC), 101.206 (using the term), 101.501 (using the term), 101.613 (using the term).
- *Person*, which means an individual or a corporation, partnership, limited liability company, business trust, trust, association, or other organization, estate, government or governmental subdivision or agency, or other legal entity. *Id*. §§ 1.002(69-b) (defining the term), 101.054(a)(2) (limiting modification of certain provisions of Title 3 of the BOC), 101.151 (using the term), 101.501 (using the term).
- *Writing* or *written*, which means an expression of words, letters, characters, numbers, symbols, figures, or other textual information that is inscribed on a tangible medium or that is stored in an electronic or other medium that is retrievable in a perceivable form. Unless the context requires otherwise, the term: (A) includes stored or transmitted electronic data, electronic transmissions, and reproductions of writings; and (B) does not include sound or video recordings of speech other than transcriptions that are otherwise writings. *Id*. §§ 1.002(89) (defining the term), 101.054(a)(2) (limiting modification of certain provisions of Title 3 of the BOC), 101.151 (using the term).

2. Optional Definitions

Most definitions in any company agreement will be agreement specific. Some common definitions will be considered in connection with substantive provisions in the company agreement.

VI. COMPANY PURPOSE, POWERS, ETC.

A. Company Purpose

The company's certificate is required to state the company's purpose. BOC § 3.005(a)(3). That statement may be as broad as "to be or include any lawful purpose." *Id*. Depending on the exact wording as found in the certificate, the company agreement may limit the company's purpose. *Id*. § 101.052(d) (the certificate governs in cases of conflict with the company agreement). Therefore, if the company's certificate simply states that the company's purpose is to conduct any lawful business, then the company agreement likely cannot restrict that broad purpose. On the other hand, if the certificate states the purpose is to conduct any lawful business as further stated or limited by the LLC's company agreement, the company agreement may limit the purpose.

Generally, an LLC (as well as any other domestic entity) may have any lawful purpose or purposes. BOC § 2.001. Of course, the LLC's governing documents may limit those purposes. *Id*. § 2.005. An LLC also may be a professional LLC, which is an LLC formed to provide a professional service and which is governed as a professional entity under Title 7, chapters 301 and 304 of the BOC. *Id*. § 301.003(6). A professional LLC must state in its certificate that its purpose it to provide the professional service it intends to provide. *Id.* § 3.104.

But not all purposes are lawful. Beyond the obvious unlawful purposes such as operating a criminal enterprise, LLCs also may not operate as a bank, trust company, savings association, insurance company, cemetery organization (with certain exceptions), or abstract or title company. BOC § 2.003(2). Also, LLCs are prohibited from engaging in an activity in which it "cannot lawfully be engaged ... under state law." *Id*. § 2.003(1)(B). This catch all provision is intended to address those industries regulated by some other statute and which might only allow certain specified types of entities to participate. TEX. PRAC. SERIES § 19:15. The author is unaware, however, whether there is still such an industry (except those already listed).

If the LLC is a professional entity, the LLC may, in most instances, engage in only one type of professional service and such services as are ancillary to the professional service rendered by the LLC in question. BOC § 2.004.

In some situations, the company's purpose can be somewhat important. For example, a minority member may be outvoted with respect to a new business or some course of action the majority wishes to pursue. The power of an LLC and its "managerial officials" to act is limited to that manner which is consistent with those purposes expressed in the company agreement. BOC § 2.113(a). On the other hand, the concept of ultra vires, which protects minority rights in a corporation, might not apply to LLCs. *Compare id*. §§ 2.113(a) (limiting the power to act with respect to both corporations and LLCs) and 20.002 (codifying ultra vires for corporations, but not LLCs). Breach of contract theories, however, might apply to protect the minority member if the company agreement adequately limits the company's purposes. Also, a court may order that an LLC wind up its affairs and terminate if the LLC "has continued to transact business beyond the scope of the purpose" of

the entity as expressed in its certificate. *Id*. § 11.301(a)(4).

The company's purpose also may help define the relationships among the LLC, its managers, if any, and the members, especially in the context of the pursuit of new business either through the new LLC or independent of the LLC and other members. This issue will be discussed further, below in Section XV(A)(1), below, in connection with modifications of the duties and liabilities of the parties to each other as permitted by BOC section 101.401 and that may be found in a company agreement.

Finally, and in the context of family LLCs, a company's purpose statement may assist in documenting legitimate and nontax reasons for the LLC's structure and thereby providing some defense against government attacks that the LLC transaction does not meet the bona fide sale exception for lifetime transfers in which the transferor retained an income interest. *See* 26 U.S.C. (hereafter "IRC") § 2036(a) (providing for the bona fide sale transaction to life estates); *Bongard v. Commissioner*, 124 T.C. 95, 118 (2005) ("the bona fide sale exception is not applicable where the facts fail to establish that the transaction was motivated by a legitimate and significant nontax purpose"). Some suggested purposes include providing an efficient means for:

- Maintaining control of family assets;
- Consolidating fractional interests in and avoiding further fractionalization of assets such as real property;
- Capital and operating funds to maintain legacy properties, which are not available through fractional ownership;
- Continued family ownership of the property and the construction of barriers to third-party interests;
- Asset protection from creditors and divorcing spouses; and
- Dispute resolution among family members such as mandatory mediation and arbitration.

See ACTEC Model LLC Operating Agreement, Updated through January 2008, n. 11 (available at http://www.americanbar.org).

Note that an LLC that has been established as a series LLC may have separate series with separate business purposes or investment objectives. BOC § 101.601(a)(2).

B. Company Powers

The concept of company powers is closely related to the company's purpose. Under the BOC, an LLC automatically has most if not all the powers necessary for it to achieve its stated purpose. BOC § 2.101 (an LLC "has the same powers as an individual to take action necessary or convenient to carry out its business and affairs"). Because the LLC's broad powers are enumerated in the BOC, restating those powers in the company agreement probably is redundant. *See id*. § 2.112 (an LLC "is not required to state any of the powers provided to the entity … in its governing documents").

The owners of an LLC may limit the LLC's powers by limiting either the company's purpose or its powers in either the certificate or the company agreement. BOC § 2.113(a) (the LLC may not exercise a power in a manner inconsistent with a limitation upon the LLC's purpose or powers as found in the company agreement). Review of enumerated powers in a governing document may require attention to detail. One should always wonder whether a deviation from the statutorily enumerated powers was intended to modify the powers found in the statute or was simply an attempt to say the same thing in a manner more pleasing to the drafter. On the other hand, all of the enumerated powers might be inappropriate in certain situations. Accordingly, attorneys should be familiar with the powers that are granted by default. Unless modified in the governing documents, any LLC has the power to:

- sue, be sued, and defend suit in the LLC's business name;
- have and alter a seal and use the seal or a facsimile of it by impressing, affixing, or reproducing it;
- acquire, receive, own, hold, improve, use, and deal in and with property or an interest in property;
- sell, convey, mortgage, pledge, lease, exchange, and otherwise dispose of property;
- make contracts and guarantees;
- incur liabilities, borrow money, issue notes, bonds, or other obligations, which may be convertible into, or include the option to purchase, other securities or ownership interests in the LLC, and secure its obligations by mortgaging or pledging its property, franchises, or income;
- lend money, invest its funds, and receive and hold property as security for repayment;
- acquire its own bonds, debentures, or other evidences of indebtedness or obligations;
- acquire its own ownership interests, regardless of whether redeemable, and hold the ownership interests as treasury ownership interests or cancel or dispose of the ownership interests;

- be a promoter, organizer, owner, partner, member, associate, or manager of an organization;
- acquire, receive, own, hold, vote, use, pledge, and dispose of ownership interests in or securities issued by another person;
- conduct its business, locate its offices, and exercise the powers granted by [the BOC] to further its purposes, in or out of this state;
- lend money to, and otherwise assist, its managerial officials, members, or employees as necessary or appropriate if the loan or assistance reasonably may be expected to benefit, directly or indirectly, the entity;
- elect or appoint officers and agents of the entity, establish the length of their terms, define their duties, and fix their compensation;
- pay pensions and establish pension plans, pension trusts, profit-sharing plans, bonus plans, and incentive plans for managerial officials, members, or employees or former managerial officials, members, or employees;
- indemnify and maintain liability insurance for managerial officials, members, employees, and agents of the entity or the entity's affiliate;
- adopt and amend governing documents for managing the affairs of the entity subject to applicable law;
- make donations for the public welfare or for a charitable, scientific, or educational purpose;
- voluntarily wind up its business and activities and terminate its existence;
- transact business or take action that will aid governmental policy;
- renounce, in its certificate of formation or by action of its governing authority, an interest or expectancy of the entity in, or an interest or expectancy of the entity in being offered an opportunity to participate in, specified business opportunities or a specified class or category of business opportunities presented to the entity or one or more of its managerial officials or owners; and
- take other action necessary or appropriate to further the purposes of the entity.

BOC § 2.101.

The BOC expounds on an LLC's powers related to indebtedness and guaranties. BOC §§ 2.103, 2.104. Specifically, and unless the governing documents state otherwise, the LLC may incur indebtedness in exchange for any consideration it considers appropriate, including indirect benefits to the LLC. *Id*. § 2.103(a). The consideration also may be received indirectly by the LLC, such as through an entity wholly or partially owned, directly or indirectly, by the LLC. *Id*. § 2.103(c). The LLC's judgment as to the value of the consideration received is conclusive, absent fraud in the transaction. *Id*. § 2.103(b). A silent investor or a person loaning money to the LLC might insist upon changes in the company's power to incur indebtedness to protect their respective interests.

Under certain circumstances, an LLC also may execute guaranties on behalf of itself and its parents, subsidiaries, and affiliates, unless otherwise provided in the governing documents. BOC § 2.104(b)(1). In this context, a "guaranty" means a guaranty, mortgage, pledge, security agreement, or other agreement by which the LLC or its assets are liable for another person's liabilities. *Id*. § 2.104(a). The LLC may make a guaranty for the indebtedness of another person "if the guaranty may reasonably be expected directly or indirectly to benefit" the LLC. *Id*. § 2.104(b)(2). Generally, the LLC's determination that it may reasonably expect benefit from the guaranty is conclusive. *Id*. § 2.104(c). Again, silent investors and creditors of the LLC may want to ensure that an LLC's power to make guaranties is modified. On the other hand, those who control the LLC's majority interest and who appreciate the default power to make guaranties may want to include a provision in the company agreement that modifies the ability of the members to seek an injunction against a particular guaranty. *See id*. § 2.014(c)(2) (giving members the right to seek an injunction on the ground that the guaranty "cannot reasonably be expected to benefit" the LLC); 101.054(a)(4) (providing authority for the modification). The same majority owners, and the managers, if any, also might want to ensure that the company agreement modifies the right of the LLC (and its receiver or trustee) to sue those persons who approved a guaranty on the ground that the guaranty could not "be reasonably expected to benefit" the LLC. *See id*. § 2.104(c)(3) (giving the LLC the right to sue the managers and members who approve such a guaranty); 101.054(a)(4) (providing authority for the modification).

C. Principal Office

Company agreements typically state the LLC's principal office. The principal office may be different from its registered office. *See* BOC § 5.201(c) (the registered office is the location of the entity's registered agent for service of process). Beyond setting expectations for the members of the LLC as to where business will be conducted, other purposes of stating the principal office include:

- Establishing the default place for member meetings of a manager-managed LLC. BOC § 6.001(b);
- Establishing the place where the company's records must be kept and made available. *Id.* § 101.501(a) (requiring records to be kept and made available at the principal office);
- Establishing the place where a member or assignee may send written requests for copies of the LLC's certificate, company agreement, and tax returns. *Id.* § 101.502(b) (note that the company agreement may provide for a different address for such written notices); and
- Establishing the company's principal office for purposes of venue.[3] *See* TEX. CIV. PRAC. & REM. CODE § 15.002(a)(3) (setting the principal office as one of two options for venue with respect to defendants who are not "natural persons").

D. Registered Agent and Registered Office

The company's initial registered agent and registered office must be stated in the certificate. BOC § 3.005(a)(5). The registered agent is the person on whom third parties may serve any process, notice, or demand that is required by law to be served on the entity. *Id.* § 5.201(b)(1). The registered agent may be either an individual residing in the state or another organization registered and authorized to do business in Texas. *Id.* § 5.201(b)(2). In both instances, the individual or organization must consent in writing to serve as registered agent for the entity. *Id.*

The company agreement cannot change either the identity of the registered agent or the location of the registered office. Rather changes as to both must be accomplished through statements filed with the Secretary of State. BOC § 5.202. Upon filing and acceptance by the Secretary of State, the statement operates as an amendment to the certificate. *Id.* § 5.202(c).

The main purpose of including a provision in the company agreement relating to the registered agent and the registered office likely is to establish an agreed procedure for changing them. Unless the company agreement provides otherwise, all members must consent to an amendment of the certificate. BOC § 101.053. Therefore, unless the company agreement establishes some other procedure for changing the registered agent and registered office, all members must consent to the change. *See* Sections III(C) and IV(B), above, for a more detailed discussion regarding amendments to the LLC's governing documents.

E. Term of Existence

Unless otherwise provided in the LLC's governing documents, the company will have a perpetual existence. BOC § 3.003. Historically and between 1991 and 1993, Texas law limited the existence of LLCs to 30 years. Act of May 25, 1991, 72d Leg., R.S., ch. 901, § 46, 1991 TEX. GEN. LAWS 3161, 3192-3216; TEX. PRAC. SERIES § 19:14. Since that time, the trend has been to establish companies with a perpetual existence. TEX. PRAC. SERIES § 19:14. Beginning in 2021, however, Texas LLCs formed before 1993 may start to expire if they have not already changed their term of existence. TEX. PRAC. SERIES § 19:14.

A member might want a limited existence to ensure eventual liquidity of the member's investment. Unless the right of withdrawal is granted in the company agreement, members have no right to withdraw. BOC § 101.107. Limited existence may also be appropriate in the context of a joint venture that is anticipated to be of limited duration.

Limited existence may, on the other hand, cause unintended consequences, primarily related to the members simply forgetting that the company automatically terminates at some point in the formerly distant future. For example, the termination of the LLC's period of duration may require it to wind up its affairs if it does not affirmatively "cancel" the termination by amending its governing documents within 3 years of the automatic expiration. BOC §§ 11.051(1) (requiring winding up), 11.152(b) (allowing for cancellation of the termination within 3 years). Depending on how the LLC is subject to income taxation, the winding up also may cause adverse income tax consequences to the members.

F. Limited Liability

Some company agreements include statements regarding the limited liability of the company's members and managers, if any. The statement will usually contain a list of matters for which the members and managers are not responsible in connection with the LLC, simply by being associated with the company. The statement probably is unnecessary. Under the BOC, members are not proper parties in any action by or against an LLC unless the action relates to the member's rights against or liabilities to the LLC. BOC § 101.113. Further, the

[3] While the declaration of the LLC's principal office may be a factor in determining venue, the actual facts likely are more important. *See* TEX. CIV. PRAC. & REM. CODE § 15.001(a) (defining "principal office" as the place where "the decision makers for the organization … conduct the daily affairs of the organization"). Whether this definition actually applies to an LLC might be debatable as it does not refer to LLCs. *Id.* (the definition applies to corporations, unincorporated associations, and partnerships).

BOC specifically states that both members and managers have no liability for any of the LLC's liabilities. *Id.* § 101.114. The statute states, in relevant part:

> [A] member or manager is not liable for a debt, obligation, or liability of a limited liability company, including a debt, obligation, or liability under a judgment, decree, or order of a court.

Id. To the extent the company agreement makes any comments regarding the liability of a member or manager, the reviewing attorney should ensure the provision does not alter the default rule under the BOC. The BOC specifically makes the limited liability provision subject to change in the company agreement. *Id.* Also by default, a member's judgment creditors have a single remedy with respect to his or her membership interest: a charging order. *Id.* § 101.112. Care should be taken to avoid somehow amending this default rule.

Note that the BOC includes one chink in a member's armor that is otherwise provided by the LLC format. If the member has executed an enforceable writing to make a contribution to the company, a creditor of the company may enforce that obligation under certain conditions. BOC § 101.155. The creditor's rights to enforce a promise to make a contribution should be considered while reviewing any "cash call" or "capital call" requirements found in a company agreement. Most cash call provisions are drafted such that creditors cannot enforce them as against the members, but sloppy drafting might cause problems. *See id.* § 101.156 (conditional obligations to make contributions are enforceable only if the condition has been satisfied or waived).

If the LLC is established as a series LLC, however, the company agreement must contain a statement listing the limitations of liability found in Section 101.602(a). BOC § 101.602(b)(2). The required statements are:

> [T]he debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to a particular series shall be enforceable against the assets of that series only, and shall not be enforceable against the assets of the limited liability company generally or any other series; and
>
> [N]one of the debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to the limited liability company generally or any other series shall be enforceable against the assets of a particular series.

Id. The same statements must be included in the certificate as well. *Id.* § 101.602(a)(3). Members and managers of both the company and the series are not liable for the liabilities of the series. *Id.* § 101.606(a). Again, the company agreement may alter the limitation of liability for both members and managers with respect to a series. *Id.* § 101.606(b).

VII. MEMBERS, MEMBERSHIP INTERESTS & VOTING

There are several issues to resolve with respect to members of an LLC. Those issues include their identities and their various rights in connection with the company.

A. Generally

LLCs generally must have at least one member.[4] BOC § 101.101(a). This statutory requirement may not be waived or modified by the governing documents. *Id.* § 101.054(a)(2). Otherwise and under state law, there is no limit on the number of members. Of course, the company agreement may limit the number of members. Federal tax law also imposes a restriction on the number of members if the company elects to be taxed as an S corporation. IRC § 1361(b)(1)(A).

Generally, any person may be a member of an LLC, as long as the person has capacity apart from the BOC. BOC § 101.102(a). For purposes of the BOC, a person means an individual, corporation, partnership, limited liability company, business trust, trust, association, or other organization, estate, government or governmental subdivision or agency, or other legal entity. *Id.* § 1.002(69-b). In the context of a professional entity that has been formed as an LLC, however, each member must be licensed to provide the professional services provided by the LLC. *Id.* § 301.007(a) (limiting ownership, ultimately, to such persons). Again, federal tax law restricts who may be a member of an LLC that has elected to be taxed as an S corporation. IRC § 1361(b)(1). In the context of an LLC taxed as an S corporation, members must be U.S. persons, individuals, grantor trusts, or trusts that qualify as electing small business trusts or qualified small

[4] Manager-managed LLCs may, for a short and reasonable period, have no members during that time between the filing of the certificate and the admission of the first member. BOC § 101.101(b). Both member-managed and manager-managed LLCs also might not have any members during that period after the LLC's last member ceases to be a member and the date an agreement to continue the LLC is executed. *Id.* § 101.101(c).

business trusts. *Id.*

B. Identity

Member-managed LLCs must identify their initial members in the certificate. BOC § 3.010(3). The certificate likely will not, however, identify the membership interests each initial member holds. *See id*. (only requiring that the initial members be identified). Otherwise, well-drafted company agreements will identify the company's initial members and their respective interests in the company. Addendums or amendments of the company agreement admitting new members should identify the new members and their respective interests. If the agreement does not identify the members, the company should have a current list identifying both the members and their respective interests in the company. *See id*. § 101.501(a)(1) (requiring LLCs to maintain such a current list). The reviewing attorney should verify that the LLC's lists correspond with the entity's tax returns. *See id*. § 101.501(a)(3) (requiring the LLC to maintain six years of returns). For closely held LLCs, especially those held among family members and in which gifts have been made, the attorney also should consider collecting and reviewing all gift assignments, again to verify that all records match.

C. Admission as Member

The effective date of membership affects many membership rights and liabilities, especially with respect to allocation of profits and losses, distributions, voting rights, and possible liability for obligations to the company. Unless otherwise addressed in the governing documents, members identified in the certificate become members as of the date the company is formed. BOC § 101.103(a). Initial members who are not identified in the certificate become members as of the date of the later of (1) the company's formation; (2) the date stated in the company's records; or (3) the date membership is first reflected in the company's records. *Id.* § 101.103(b). Note that in each instance, membership is not contingent upon the member making a contribution to the company or otherwise giving consideration for being admitted as a member. *Id.* § 101.102(b).

Unless there is a written agreement to make a contribution, neither the LLC nor the other members (who have made a contribution to the company) have any way to enforce a promise to make a contribution. BOC § 101.151 (requiring that promises to make a contribution or otherwise pay cash or transfer property to the LLC be in writing and signed by the promisor). Fortunately, the member who has failed to make a contribution has no rights to be allocated a share of the LLC's profits and losses, or receive distributions (unless the poorly drafted company agreement ignores the issues regarding contributions and provides such rights). *Id.* §§ 101.201 (allocation of profits and losses), 101.203 (distributions). On the other hand, and unless otherwise addressed in the company agreement, the member nevertheless has an equal vote with all the other members. *Id.* § 101.354. The company agreement that failed to address contributions may therefore nevertheless avoid the voting problem by basing voting rights on the members' respective membership interests.[5] To add insult to injury, the member who has failed to make the contribution also may not be expelled, again, unless the company agreement addresses the issue. *Id.* § 101.107.

New members, however, are admitted only upon approval or consent of all the existing members. BOC §§ 101.103(c), 101.105. Similarly, assignees may be admitted as members upon the approval of all members. *Id.* § 101.109(c). The statute also seems to remove the problem associated with initial members who fail to make a contribution with respect to new members. Even if the new member is admitted, if the new member "fails to acquire a membership interest," the person does not become a member without the approval or consent of all the other members. *Id.* § 101.103(c); *cf. id*. § 101.102(c) (the company agreement may provide that a new member may be admitted without acquiring a membership interest).

Even if all the members agree and are excited that a new member is joining the company, the date on which the new member is admitted itself also may cause several unanticipated practical issues, especially if the relative membership interests change as a result of the admission. For example, profits and losses are allocated based on the members' respective membership interests. BOC § 101.201. The LLC may have a difficult time changing the allocation if the effective date happens in the middle of a month. Distributions also are dependent on the relative membership interests. *Id.* § 101.203. While these issues can be addressed at the time of the admission of the new member, many company agreements address the issue in a variety of ways, including by establishing an effective date of all admissions as occurring at the end of the month in which the admission took place, or by establishing a record date for allocations and distributions. *See id*. § 101.208 (specifically providing for record dates if adopted in the company agreement); *cf. id*. § 6.302 (the default record dates for other entities do not apply to LLCs unless they are adopted in the LLC's governing

[5] "Membership interest" is defined as a member's share of profits and losses and the right to receive distributions. BOC § 1.002(54).

documents).

A well-drafted company agreement is therefore quite important to establish when and upon what circumstances a person is admitted as a member (both initial and new members) of the LLC. To avoid the problems discussed above, company agreements should state the conditions for membership as including an actual contribution to the LLC. *Cf.* BOC § 101.102(b) (default rule is that membership is not contingent upon a contribution). The company agreement also should state the effective date of admission, keeping in mind the allocation and distribution issues discussed above. Alternatively, the company agreement may establish a record date for such issues. *Id.* § 101.208.

D. Withdrawal Rights

Members do not have the right to withdraw from the LLC without being granted that right in the company agreement. BOC § 101.107. But if the member is granted a right to withdraw, the member will have a right to receive the "fair value" of the member's membership interest determined as of the date of the withdrawal within a reasonable time after the withdrawal. *Id.* § 101.205. Consequently and if members are granted the right of withdrawal, the company agreement should contain provisions designed to anticipate the payment of "fair value" in a manner that does not hurt the continued viability of the company. Those provisions also should address how the "fair value" is to be determined and how payment will be made.

E. Rights to Expel a Member

Members also may not be expelled, unless the company agreement so provides. BOC § 101.107. The inability to expel a member for cause may create a great deal of conflict. Many company agreements provide that the other members may expel another member under such circumstances such as (1) material breach of the company agreement, (2) fraud, theft, or gross negligence in connection with the LLC, (3) wrongful conduct towards third parties that injures the LLC, (4) convictions of crime, and (5) insolvency and bankruptcy.[6] Depending on how the company agreement is drafted, minority members might be able to expel a majority member for such reasons. The company agreement should carefully set out those factors that constitute cause to expel a member, the votes that are required, and the consequences to the expelled member's economic interests (that is, his or her membership interest) in the company.

[6] *See* Section VIII(B), below, for a discussion of the impact that a member's bankruptcy may have on the LLC. It may be that the bankruptcy trustee may ignore any attempt to expel a bankrupt member.

F. Membership Interest

A membership interest is the member's share of profits and losses and the right to receive distributions. BOC § 1.002(54). That share is dependent upon the agreed value of the contributions made to the company by each member. *Id.* §§ 101.201 (allocation of profits and losses), 101.203 (allocation of distributions). An agreed value is easy to determine when the members contribute money to the LLC in exchange for their membership interests (assuming records of those contributions are kept). When one or more members contribute something else, such as real property, intellectual property, services, or the like, it is critical for the members to reach a written agreement as to value.[7]

Ultimately, the membership interest is a percentage share of the economic interest in the company, but may be expressed in a variety of ways. Common methods include describing the membership interest as percentages, units, and shares. Given that LLCs are essentially a hybrid entity composed of ideas behind both corporations and partnerships, the variety of ways to describe a membership interest is not surprising. The less complicated method is probably to define the membership interest in terms of percentages. As the members' contributions to the company relative to other members changes, the percentage membership interests automatically change.[8] For those companies that chose to describe membership interests in terms of units or shares, appropriate provisions tying the units or shares to changes in contributions should be included. Of course, the company agreement could prohibit further contributions, but such a provision may significantly reduce the flexibility of the company to address unforeseen events.

Membership interests may be certificated, that is, they may be represented by a piece of paper, but generally are not. *See* BOC § 3.201(e). If the company agreement elects to certificate its membership interests, it should consider adopting the

[7] The contribution of property likely carries with it all sorts of future income tax consequences, a discussion of which is beyond the scope of this paper. At least with respect to the contribution of appreciated property in exchange for membership interests, the contributor does not recognize gain or loss. IRC § 721(a). On the other hand, members should be aware that the agreed value of a member's future services contributed in exchange for a membership interest typically constitutes ordinary income for the contributing member. *See* IRC § 61(a)(i); Regs. § 1.721-1(b)(1).

[8] A member's right to be allocated profits and losses, and to receive a share of distributions is dependent upon the relative value of the member's contributions to the company, as reflected in the company's records. *See* BOC §§ 101.201, 101.203.

provisions of the BOC relating to the form and validity of certificates as such provisions do not apply to LLCs unless they are adopted in the company agreement. *Id*. § 3.201(d). The company agreement also should incorporate provisions addressing logistical issues surrounding certificates similar to those found in corporate bylaws for lost certificates and requirements for transfer.

Under the Texas Uniform Commercial Code (the "UCC"), membership interests are not subject to Chapter 8 of the UCC, which governs securities for state law purposes, unless the company agreement so provides or the interest is traded on a securities exchange or market. TEX. BUS. & COM. CODE § 8.103(c) (exempting, generally, LLC membership interests from application of Chapter 8). If the LLC elects to have its membership interests treated as securities under Chapter 8 of the UCC, the membership interests will be treated as "investment property" for purposes of perfection under Chapter 9 of the UCC, regardless of whether the membership interest is certificated. *Id.* § 9.102(a)(49) (defining "investment property").

By default, a membership interest is personal property and gives the member no interest in any specific assets of the company. BOC § 101.106(a), (b). See Section XII, below for a discussion of the rights a member has with respect to distributions.

Note that a membership interest may be community property if the member is married at the time the membership interest is acquired. BOC § 101.106(a-1). Accordingly, and regardless of whether any individual member is married, the company agreement should address his or her current and future spouse's community property interest in that member's membership interest.[9] A typical method of handling this issue is to include provisions in the company agreement that obligate the non-member spouse in some fashion to force divestment in the case of divorce. To be enforceable, the spouse probably must be a party to the company agreement. For current separate property interests, the company agreement might include a warranty from the member that his or her membership interest is his or her separate property and an agreement not to convert the property to community property without the written approval of all the other members. Otherwise, the company and its other members may find that the ex-spouse of a former member has acquired an interest in the company much to the chagrin of all parties involved (except the ex-spouse). Fortunately, a member's right to participate in the LLC's management and conduct of the business is not community property. *Id.* § 101.106(a-2). Accordingly and in the worst case scenario, the ex-spouse should be unable to assert control over the entity.

G. Determination of Voting Rights

The default rule under the BOC is that members have equal per capita voting rights on all issues. BOC § 101.354. Such an arrangement may be fine in the case of a single member LLC. The arrangement also might suffice for an LLC in which all of the members make equal contributions and the relative economic interests of the parties are not expected to change over time. But the assumption that the economic interests will not change probably is unrealistic or at least probably not safe. There is no prohibition in the BOC against a member making additional contributions to the company. Also, the company may require additional infusions of capital and not all members may contribute. Such circumstances will change the relative membership interests in the company and distort the default one member one vote rule in favor of those with less economic interest in the company.

A more realistic approach to voting rights is to tie votes to the members' respective membership interests. Many times, such a voting scheme is stated in terms of percentages. For example, a member with a 25% membership interest in the company will have an equivalent weighted vote. If that member contributes additional capital to the company while other members do not, the member's percentage membership interest will increase proportionately.

The problem with the realistic approach is twofold. The author has found that most clients, especially in the context of family LLCs, do not understand that contributions of additional property to an LLC affect the members' respective membership interests. The second problem is record keeping. The books of the LLC might reflect a non-proportional contribution to the company, but the LLC and its members fail to carry that change through to the membership interests for purposes of voting. Also, it is not always clear whether a cash infusion is a contribution or a loan. One way of clearing up these issues is to require in the company agreement that all contributions be approved in writing by the members and be accompanied by an agreed adjustment to the members' respective membership interests. To address the likely confusion surrounding percentage membership interests and the manner in which they change, many commentators also recommend including appropriate definitions in the agreement. *See Model Company Agreements* at Appendix A, pp.

[9] Even if all membership interests are clearly separate property at the time of acquisition, the members may agree in writing with his or her current or future spouse to convert the property into community property, thus exposing the other members to the problem without their consideration of the issue.

22-23 (providing such an example).

Note that some company agreements might deprive a member of voting rights entirely, or with respect to certain decisions if the member, for example, fails to satisfy some obligation to the company.

H. Classes of Members and Membership Interests

As discussed above, the default structure of an LLC is that it has members who have equal per capita voting rights and membership interests based on the members' relative contributions to the company. But the company agreement may create separate classes of both members and membership interests. BOC § 101.104. The separate classes may have separate rights, powers, duties, and voting rights relative to other classes. *Id.* § 101.104(a). The rights of one also may be senior to the rights of other classes. *Id.* § 101.104(d).

These provisions allow for a significant degree of freedom and complexity in structuring the entity. A simple divergence from the default structure would be to emulate the structure of a typical limited partnership and establish two classes of members: voting and non-voting, leaving the membership interests alone. Economically, the voting members would have a small membership interest in the company (similar to the typical structure of a general partner's interest in the limited partnership). The non-voting members would have the majority membership interest but no voting rights (similar to the limited partners).

Complex structures with respect to the membership interests allow for any manner of preferred returns on capital and the like. For example, the company agreement may establish a distribution dependent equity structure that either provides for (1) the return of capital followed by a preferred return, (2) preferred return followed by a return of capital, or (3) an investment rate of return. Any further discussion of this topic is outside the scope of this paper. The author has found that the following paper is a helpful introduction to the topic: Borden, Bradley T., *Equity Structure of Noncorporate Entities*, LLCs, LPs and Partnerships Course, University of Texas School of Law Continuing Legal Education, July 14-15, 2016, Austin, Texas.

I. Series LLCs

Series LLCs allow for even more flexibility with respect to classes of members and membership interests. If the company is established as a series LLC, the company agreement may provide for one or more separate "series" of members and membership interests with respect to specified property or assets. BOC § 101.601(a). Series LLCs also may have separate classes or groups of members associated with each series, changing the relative rights, voting rights, powers, and duties for each series. *Id.* § 101.607. Given the breadth of possibilities, one can only say that a reviewing attorney should carefully review any company agreement involving series LLCs.

J. A Member's Degree of Control

In the context of any LLC with multiple members, a major issue to consider is control. That is, which member, or potential group of members, may control the LLC's management and business decisions. By default, the BOC provides that the LLC's governing authority manages and directs the business and affairs of the company, subject to the LLC's governing documents. BOC § 3.101. The governing authority for a member-managed LLC is its members, while the governing authority for a manager-managed LLC is its managers.[10] *Id.* § 101.251.

1. Majority of the Quorum

For all decisions apparently for carrying out the ordinary business of the company, a majority of the members present at a meeting at which a quorum is present constitutes an act of the governing authority (the "majority of the quorum rule"). BOC §§ 101.355, 101.356(a). A quorum, by default, is a majority of the governing persons. *Id.* § 101.353. Other decisions that fall under the majority of the quorum rule include:

- Interim distributions. BOC § 101.204;
- Removal of managers, if any. *Id.* § 101.034;
- Appointment of a manager to fill a newly created position. *Id.* § 101.305(a)(2); and
- Indemnification of a person. *Id.* § 101.402.

The consequence of the majority of the quorum structure is that a minority of the governing members may make a binding decision for the LLC. A simple example illustrates the result. Consider an LLC with ten members, each of whom has an equal vote. A quorum consists of six members (a majority of all the members). At a meeting of six members, four members constitute the majority required to carry the decision. If four members vote in favor of a proposition, then only 40% of the members will have bound the LLC on behalf of all the members.

Note that in the context of an LLC which adopts the default equal vote rule under BOC § 101.354, the majority of the quorum problem only arises if there

[10] Manager-managed LLCs will be discussed in detail in Section VIII, below.

are four or more members. For four total members, a quorum is composed of three members. At a meeting of three members, a majority is two members, which is less than a majority of all the members. But if there are only three members, a quorum is composed of at least two members. When there are only two members, the majority vote rule requires unanimity of the quorum. The result is that a majority of the three members will have to act together to make decisions on behalf the LLC.

In the context of an LLC that bases voting on the members' respective membership interests, the result of the majority of the quorum rule is that the member with more than 50% of the membership interests controls the company for most decisions. That member will constitute a quorum regardless of how many other members there might be. On the other hand, a similar result as illustrated above could result in this context, depending on the percentage membership interests held by each member. Consider an LLC with three members, whose membership interests are as follows: 40%, 40%, and 20%. A meeting of either of the 40% members together with the 20% member would constitute a quorum under the default rule. At such a meeting, the 40% member would have the majority vote. Consequently, either of the 40% members could make a decision on behalf of the LLC as long as the 20% member was present at the meeting.

The consequences of the majority of the quorum rule is tempered some by the notice requirements for meetings. Notice must be provided to all members of any member meeting. BOC § 101.352(a). But the BOC does not require, by default, much content in the notice.[11] *Id.* § 6.051(a). Therefore, careful consideration should be given as to what the company agreement may or may not require in notices of company meetings. The attorney reviewing a company agreement also should be on the lookout for a blanket waiver of notice in the company agreement (or in some other writing). *See id*. § 6.052(a) (providing for waivers of meeting notices). Such waivers may be made before a meeting and are not required to state the business to be transacted. *Id.* §§ 6.052(b), (c).

Written consents in lieu of meetings should not pose the same problem seen in the majority of the quorum rule. The BOC allows written contents for all LLC company actions. BOC § 101.358 (governing less than unanimous written consents for LLCs); *cf. id*. §§ 6.201 and 6.202 (governing consents in general under the BOC). All such consents must be signed by at least the requisite number of members or members with the requisite membership interests that would be necessary if all members attended a meeting. *Id.* § 101.358(b). Therefore, for votes requiring a majority of the members, a majority of the members must sign the consent for it to be effective.

2. Affirmative Voting Standards

Not all decisions under the BOC relating to the LLC are made according to the majority of the quorum rule. *See* BOC § 101.356. Instead, many decisions require the affirmative vote of a majority of all the members or governing persons.

Fundamental business transactions and actions that would make it impossible for the LLC to carry out its ordinary business must be approved by the affirmative vote of at least a majority of all of the members. *Id.* § 101.356(c). A "fundamental business transaction" is a merger, interest exchange, conversion, or sale of all or substantially all of the LLC's assets. *Id.* § 1.002(32). All members also must approve by majority vote a decision to voluntarily wind up the company or to revoke such a decision. *Id*. § 101.552(a)(1), (2). A majority vote of all members also is required to approve the reinstatement of a terminated LLC under Section 11.202. *Id.* § 101.552(a)(3). Note that all of the members must vote regarding fundamental business transactions and those actions that would render further business impossible regardless of whether the governing authority of the LLC happens to be its managers. *Id.* § 101.356(c).

Finally, the governing authority must approve, by affirmative vote, all actions "not apparently for carrying out the ordinary course of business of the company." BOC § 101.356(b).

Note that there is a complicated standard of approval of contracts and transactions involving interested governing persons. BOC § 101.255(b). There is a second complicated standard of affirmative voting with respect to an LLC's response to derivative actions brought by members. *Id*. § 101.454(a).

3. Unanimous consent required

Many decisions require unanimous consent or approval by default.[12] They include:

- Amendments to the company agreement. BOC § 101.053;
- Amendments to the company's certificate. *Id.* § 101.356(d);
- Admission of new members. *Id.* §§ 101.103(c), 101.105;
- Admission of assignees. *Id.* § 101.109(c);

[11] *See* Section IX, below, for further details regarding notices of member meetings.

[12] *See* Sections IV(A) and (B), above, for a discussion as to how a member may consent to an action in a manner that is not an affirmative vote.

- Release of a member's obligation to the company, including an obligation to make a contribution. *Id.* § 101.154; and
- Cancellation of an event requiring a winding up of the LLC as provided under Section 11.152. *Id.* § 101.552(b).

4. Proxy Voting, Voting Trusts, and Voting Agreements

Members may vote by written proxy unless the company agreement provides otherwise. BOC § 101.357(a). Members also may enter voting trusts and voting agreements that might affect control of the LLC. *Id.* §§ 6.251, 6.252. The company agreement may change these default rules.

Note that allowing for proxies, voting trusts, and voting agreements might undermine the fact that assignees have no voting rights. See Section VIII(A), below, for a discussion regarding assignees. The member who has assigned his or her membership interest could give the assignee a proxy to vote for the assignor, thus going around an important aspect of LLCs. One solution to this problem is to allow proxies, but only allow them to be given to other members.

5. Super-Majority Voting

Many company agreements attempt to require super-majority votes for certain decisions deemed important enough. For purposes of this paper, a "super-majority" is some percentage greater than a majority, but less than unanimity. Typically, the exact super-majority percentage chosen in a company agreement is tailored to achieve a particular purpose in the context of the members of that LLC. But common super-majorities include two-thirds or three-quarters of the outstanding membership interests. An example of the use of such a structure would be to require a super-majority to approve indebtedness in amounts greater than $100,000, but less than $500,000, and unanimity for indebtedness in amounts over $500,000. The practical result would be that a mere majority could approve indebtedness for amounts less than $100,000. Ultimately, requiring a super-majority merely gives a minority of the membership a veto right over what might be an important decision for the company.

6. Alteration of Default Rules by Company Agreement

All of the default rules regarding voting may be changed by the company's governing documents. Probable modification for which a reviewing attorney should look include:

- The default notice rules. BOC §§ 6.051(a), 101.352(a);
- Quorum. *Id.* §§ 101.355, 101.356(a);
- The meaning of "majority" when a quorum is present. *Id.*;
- The requirements for written consents. *Id.* § 101.358;
- The manner in which consent or approval may be established. *Id.* § 101.359; and
- The required vote to approve a company act.

VIII. MANAGERS

A. Generally

In the context of LLCs, managers are similar to the directors and officers, combined, of a corporation. They constitute the governing authority of the LLC and are responsible to manage the LLC's business and affairs, subject to the terms of the company agreement. BOC §§ 101. 251(1), 101.252.

The initial managers of a manager-managed LLC are named in the company's certificate. BOC § 3.010. The company's certificate also, by default, sets the number of managers simply by naming them. *Id.* § 101.302(b). There is no statutory limit to the number of managers (though there probably is a practical limit). *Id.* § 101.302(a). The typical company agreement will address the number of managers. *See id.* § 101.302(c).

Though probably not common, managers need not be individuals. Rather, the BOC simply states that a manager may be a "person". BOC § 101.302(a). Consequently, any legal entity or trust may serve as the manager of an LLC. *Id.* § 1.002(69-b) (defining "person"). Managers also need not be a resident of Texas or a member of the company. *Id.* § 101.302(d). The company agreement may alter the flexibility found in the statute.

The BOC does not require that a manager serve and be elected to a pre-defined term. BOC § 101.303. Therefore, unless the company agreement otherwise provides, the LLC's managers will serve until they resign, are removed, or die. *Id*. The interrelationship of the BOC and the company agreement becomes somewhat important in the context of manager vacancies. By default, manager vacancies are filled by the affirmative vote of the remaining managers, without regard to quorum. *Id.* § 101.305(a)(1). The only time the members control replacement of managers is if the number of managers has been increased. *Id.* § 101.305(a)(2). Similar rules apply in the context of managers elected by a certain class of members. *Id.* § 101.306(b). Instead, the members' control over managers is limited to their removal, based on the majority of the quorum rule. *Id.* § 101.304. Therefore and if member control of the appointment of managers is important, the reviewing

attorney should review the company agreement for relevant provisions.

In the context of series LLCs, different managers may be appointed for different series. BOC § 101.601(a). The company agreement also may provide for various groups or classes of managers. *Id.* § 101.607(a). If the governing documents fail to address managers of a series, the managers of the company also are the managers of the series. *Id.* § 101.608(b)(1).

B. Voting

Managers also are subject to the majority of the quorum rule discussed above in Section VII(J)(1) in connection with members. The rules apply slightly differently for managers because members will retain some control over managers for certain decisions. For all decisions apparently for carrying out the ordinary business of the company, an act by a majority of the managers present at a meeting at which a quorum is present constitutes an act of the governing authority (the "majority of the quorum rule"). BOC §§ 101.355, 101.356(a). A quorum, by default, is a majority of the managers. *Id.* § 101.353. Other decisions that fall under the majority of the quorum rule include:

- Interim distributions. BOC § 101.204; and
- Indemnification of a person. *Id.* § 101.402.

The consequence of the majority of the quorum structure for managers is the same as discussed above for members, except that it probably is not as likely to occur. The problem does not exist if there are three or fewer managers. Similarly, the rules regarding notices and written consents apply to managers to the same extent they apply to members. *See* Section VII(J)(1), above.

To the extent a decision involves an action "not apparently for carrying out the ordinary course of business of the company", an affirmative vote of a majority of all the managers is required. BOC § 101.356(c).

C. Powers

Many company agreements will specify the authority and the powers of the managers. Unless the intent is to restrict the scope of such authority and power, such efforts are not required. By default, the managers have the power to conduct business on behalf of the LLC which is both (1) apparently for, and (2) not apparently for, the carrying out the ordinary course of the company's business. BOC § 101.356. Managers do not have any control over fundamental business decisions and decisions that would make it impossible for the LLC to carry out its ordinary business because such decisions are reserved to the members. *Id.* § 101.356(c). Managers also have no control over changes to the certificate or the company agreement. *Id.* § 101.356(d).

D. Common Restrictions on Managers

Many company agreements will give managers responsibility over the company's day to day business and affairs, but reserve some material decisions to the members that do not rise to the level of fundamental business transactions. For example, the members might reserve decisions regarding settling litigation against the company to themselves. *See* BOC § 101.356(b) (unless the company agreement provides otherwise, the managers may decide issues not apparently for carrying out the ordinary course of business). Other examples include whether to make interim distributions, incur indebtedness and enter contracts over pre-determined values, and the compensation of managers. Because such issues are company specific, the reviewing attorney must simply work out the details of how the managers might be restricted in decision making.

IX. MEETINGS (AND ALTERNATIVES) OF MEMBERS AND MANAGERS

The BOC does not clearly state who has the authority to call a meeting of the members or managers. Presumably, any member or manager would be able to call a meeting. Whether the meeting is ultimately successful will depend on whether the person calling the meeting follows the formal prerequisites and a quorum actually attends the meeting. Company agreements regularly specify the persons with authority to call meetings, especially in the context of an LLC with many minority members.

Company agreements also usually contain provisions regarding the location of meetings and provide for alternative forms of meetings such as teleconferences and videoconferences. Under the BOC, the default location for meetings of members of a manager-managed LLC is the LLC's registered office or principal office. BOC § 6.001(b). For member-managed LLCs and for managers, the person calling the meeting may fix the meetings location anywhere if the company agreement does not otherwise fix a location. *Id.* § 6.001(c)(1)(B).

Following a corporate format, many LLC company agreements require annual meetings of the members and managers. But while the BOC contemplates annual meetings for an LLC, it does not require annual meetings. *Compare* BOC §§ 21.351(a) (requiring annual meeting for corporations), 101.305 (contemplating annual meetings for the election of managers of an LLC), 101.352(a) (contemplating notice of "regular" meetings), 101.358 (contemplating

written consents in lieu of annual meetings for LLCs). In fact, the BOC also does not require any meetings. Rather, the BOC makes clear that the members and managers may accomplish their business informally. *See id*. § 101.359(2)(C); TEX. PRAC. SERIES § 20:5. Members and managers may approve an act in any of the following manners:

- An affirmative vote at a meeting;
- Consent, which may be evidenced by:
  - The failure to object to an action in a timely manner constitutes consent, if the governing person has "full knowledge" of the action;
  - Written consent; or
  - "[A]ny other means reasonably evidencing consent.

Id. § 101.359. While the general rule under the BOC is to require unanimous consents unless the certificate provides otherwise, less than unanimous consents are specifically permitted for LLCs. *Id.* §§ 6.202(b) (general rule), 101.358(b) (providing for less than unanimous consents for LLCs despite the general rule and without the requirement for a statement in the certificate).

As discussed above in Sections VII(J)(1) and VIII(B), meetings are governed by the majority of the quorum rule with respect to decisions apparently for carrying out the ordinary business of the company. A majority of the members or managers who attend a meeting at which a quorum is present may act on behalf of the company. BOC § 101.355. A quorum, by default, is a majority of the members or the managers. *Id.* § 101.353. The majority of the quorum rule does not apply, however, to consents. *Id.* § 101.358(b).

The BOC requires some formalities in connection with less than unanimous consents that may be altered by the company agreement. BOC § 6.202(c). Less than unanimous consents must be dated and signed by the person giving consent. *Id.* Further, all of the consents must be signed and delivered to the entity within 60 days of the date the first such consent was signed. *Id.* The BOC provides great flexibility, however, with respect to how consent may be documented. *Id.* § 6.205. Any reliable reproduction, such as a copy or facsimile, of the consent suffices. *Id.* § 6.205(a). Emails also are sufficient. *Id.* §§ 1.002(20-a) (defining "electronic transmission"), 6.205(b). Note that the LLC must provide prompt notice of the less than unanimous consent to all persons who did not so consent. *Id.* § 6.202(d).

Again, the company agreement may alter the default methods for establishing approval or consent. BOC § 101.359. Well drafted company agreements are intentional in how they alter the default rules. Others might not be so careful. For example, some company agreements with managers in effect require annual meetings by tying a manger's term of office to annual elections by the members. Other agreements will specify the manner in which written consent may be evidenced in great detail, but fail to eliminate the "other means reasonably evidencing consent" method of approval by failing to negate the statute's application to the LLC. The company agreement may also fail to ensure written records of important decisions by not requiring that minutes of member and manager meetings be created and maintained. *See* BOC § 3.151(c) (the BOC does not require LLCs to maintain records of its minutes unless the company agreement so requires). Other examples abound and each company agreement's method of dealing with these issues must be read in context.

If the members or governing authority intend to hold a meeting (as opposed to acting informally),[13] written notice of the meeting is required to be delivered to each person entitled to attend the meeting. BOC §§ 6.051(a), 101.352(a). The notice is required to state the date and time of the meeting and its location. *Id.* § 6.051(a). Meetings may be held in person, or by teleconference or videoconference. *Id.* §§ 6.001(a), 6.002(a). If votes are to be taken at a teleconference or videoconference, the company must implement methods to verify the identity of the persons voting and keep records of the votes. *Id.* § 6.002(b). The company agreement may alter the default rules regarding remote conferences. *Id.* § 6.002(a).

Importantly, if the LLC is member-managed, there is no deadline for the notice to be provided to the members before the meeting. BOC § 101.352(a). The same rule applies for meetings of managers of manager-managed entities. *Id.* On the other hand, if the LLC is manager-managed, notice to members is required to be delivered to the members no later than the 10th day before the member meeting and no earlier than the 60th day before the member meeting. *Id.* § 101.352(b). Generally speaking, the notice to both members and managers is not required to state the business to be conducted at the meeting or the meeting's purpose. *Id.* §§ 6.051(a), 101.352(a). On the other hand, if the LLC is manager-managed, the notice to members shall state the business to be transacted or the meeting's purpose if the meeting is either a special meeting or the purpose of the meeting is to consider a matter described in section 101.356 of the BOC.[14] *Id.* § 101.352(b).

[13] Advance notice is not required to take action by written consent. BOC § 6.204.

[14] Section 101.356 relates to actions which are "not apparently for carrying out the ordinary course of business

Reviewing attorneys should be aware that implicit in the concept of consents and "other means reasonably evidencing consent" is that notice is not always required for the members to act. *See* TEX. PRAC. SERIES § 20:5. Depending on the circumstances of a particular LLC, the reviewing attorney may wish to carefully review how notice is treated in the company agreement as compared to the BOC and the interrelation of notice and informal methods of approving member actions as found in the company agreement.

X. ACTUAL AND APPARENT AUTHORITY

The LLC's governing authority[15] may, by resolution, delegate to a committee of one or more of the members (or managers as the case may be) the authority to act on behalf of the governing authority. BOC § 101.253(b). The company also may designate individuals who may or may not be members or managers to those officer positions traditionally found in the corporate context.[16] *Id.* § 3.103(a). The company agreement will define the roles and responsibilities of the officers, if any. *Id.* § 3.103(b).

Of course, most entities act (in the practical sense) through individuals. Each member (in a member-managed LLC) or each manager (in a manager-managed LLC) is deemed to be a "governing person" of the LLC. BOC §§ 1.002(35)(A)(iii), (iv) (defining governing authority), (37) (defining governing person). Each governing person and each officer, if any, is deemed to be an agent of the LLC and will be clothed with at least apparent authority to act on behalf of and bind the LLC. *Id.* § 101.254. In particular, the BOC designates each governing person and officer with actual or apparent authority as an agent for purposes of carrying out the company's business. *Id.* § 101.254(a). Regardless of whether the company agreement clothes a governing person or officer with actual authority, each will have at least apparent authority to bind the company for carrying out the company's ordinary course of business. *Id.* § 101.254(b). The apparent authority extends to executing instruments, documents, mortgages, or conveyances in the name of the company. *Id.* That apparent authority may be overcome only if the agent did not have actual authority and the third party has knowledge of the lack of actual authority. *Id.*

XI. CONTRIBUTIONS, CAPITAL ACCOUNTS, TAXATION, AND ALLOCATIONS

A. Contributions

As explained above in Section VII(F), a member's contributions to an LLC determine the member's membership interest. *See* BOC §§ 1.002(54) (defining "membership interest"), 101.201 (allocating profits and losses based on contributions), 101.203 (allocating distributions on contributions). A contribution may be anything of value. *Id.* § 1.002(9). Specifically, the BOC defines "contribution" to mean:

> [A] tangible or intangible benefit that a person transfers to an entity in consideration for an ownership interest in the entity or otherwise in the person's capacity as … a member.

Id. Examples include cash, services rendered, services to be rendered, promissory notes, securities, and real property. *See id*. (citing all examples except real property). To the extent the member's contribution is something other than cash or an exchange traded security, the members should agree to the contribution's value. *Id.* §§ 101.201 (basing allocations of profits and losses on agreed value), 101.203 (same for distributions). The well drafted company agreement will identify the contributions of the members or at least explain how the contributions will be determined.

One of the hallmarks of LLCs is that members have limited liability. BOC § 101.114. They also have no obligation to make contributions to the company unless they have so agreed in writing. *Id.* § 101.151. Many company agreement echo these default rules in some manner and go so far as to state that members have no obligation to make further contributions to the company. Some also may prohibit further contributions without the consent of some specified percentage of the members.

Sometimes, however, an LLC will find itself in a position where it needs an infusion of cash to carry on its business and protect the investments of its members. A majority member might think a provision allowing the governing authority to seek mandatory future contributions (sometimes referred to as a "cash call" or a "capital call") is therefore a good idea. Minority members who have little or no control over the management of the LLC might disagree. The reviewing attorney will want to determine what requirements (e.g., a majority vote as compared to a unanimous vote) must be met before a member is obligated to make a future contribution. Further, the reviewing attorney should verify what the

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of the company", fundamental business transactions, and actions "that would make it impossible to carry out the ordinary business of the company". BOC § 101.356(b), (c).

[15] The BOC speaks of the "governing authority" of the LLC as being responsible for management of the LLC. BOC §§ 3.101 (the BOC in general), 101.251 (typical LLC), 101.608 (series LLC). The members constitute the governing authority of a member-managed LLC, while the managers serve in that capacity in a manager-managed LLC. *Id.* § 101.251.

[16] The LLC may appoint officers unless the company agreement prohibits designating officers. BOC § 3.103(a).

consequences to a member might be for failing to make the cash call. Many times, the company agreement will specify the consequences, which may include that the member's membership interest be:

- Reduced;
- Subordinated to other membership interests of nondefaulting members;
- Redeemed or sold at a value determined by appraisal or other formula;
- Made the subject of a forced sale, forfeiture, or a loan from the other members in an amount necessary to satisfy the enforceable promise; or
- "Another penalty or consequence".

BOC § 101.153(b). Regardless, the LLC will have a claim against the member who fails to make the cash call. *Id.* § 101.153(a). Given that the obligation to make a cash call in this context is a written contract, the LLC should also be able to recover attorneys' fees from the defaulting member. TEX. CIV. PRAC. & REM. CODE § 38.001(8).

Note that any contribution to an LLC taxed as a partnership in a non-pro rata manner may have income tax consequences, a discussion of which is beyond the scope of this paper.

The reviewing attorney also should keep in mind that creditors have certain rights in connection with a member's obligations to the company. If the creditor reasonably relies upon a member's obligation to make a contribution to the company, the creditor may enforce that agreement. BOC § 101.155. On the other hand, the typical cash call provision will not be enforceable against the members as a whole because the cash call is usually contingent upon at least a vote of the majority of the members. *See id*. § 101.156(a) (requiring that the contingency be satisfied before enforcement is available).

B. Capital Accounts

The concept of capital accounts is a creature of federal income tax rules for partnerships under IRC § 704(b) and its associated regulation, Regs. § 1.704(b) (hereafter, the "partnership rules").[17] Provisions regarding capital accounts typically refer to the partnership rules and describe the manner in which the capital account is to be calculated. The calculation combines the member's contributions to the company and his or her share of the company's profits and losses, less distributions. Consistent with the partnership rules, the provision also should require that the capital account be adjusted to reflect unrealized gains and losses upon certain events, such as the exchange of additional membership interests in exchange for an additional contribution, and the distribution of company property. The typical capital account provision also states that the account will not bear interest. A detailed discussion of the application of the partnership rules to an LLC taxed as a partnership is well beyond the scope of this paper. A fine resource discussing these issues is Mckee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners* (Warren Gorham & Lamont (WG&L)).

C. Taxation

Single member LLCs are treated, for federal income tax purposes, as disregarded entities. Regs. § 301.7701-3(b)(1)(ii). An LLC owned as community property by two members who are married to each other also may elect to be taxed as a disregarded entity. REV. PROC. 2002-69. The election is not available if the married couple owns the entity as separate property. *Id.* The practical effect of an LLC treated as a disregarded entity is that its activities are treated in the same manner as a sole proprietorship, or as a branch, or division of the owner. Regs. § 301.7701-2(a). As such, the LLC will not file any income tax returns and its income will appear on the owner's personal returns. Note that an LLC with one member may, however, elect to be treated as either a C corporation or an S corporation. *Id.* § 301.7701-3(a).

If the LLC has two or more members, however, the LLC will be treated as a partnership, unless it elects to be taxed as a corporation. Regs. § 301.7701-3(a), (b)(1)(i).

D. Allocations

Most company agreements will address how the company's income, gains, losses, deductions, and credits are allocated among its members. Again, the provision is driven by taxes. A simple method is simply to allocate such items pro rata according to the member's percentage membership interests. Such an allocation should not run afoul of the "substantial economic effect test" required for special allocations under the Regulations. *See* Regs. § 1.704(b). As a savings provision, many company agreements nevertheless include instructions to adjust the allocations so that they meet the regulatory requirements.

The substantial economic effect test comes into play any time the members attempt to allocate such income tax items differently. Perhaps a member who has allocated real property with unrealized gains will want to allocate all gains associated with the sale of the property to himself before any regular income.

[17] Accordingly, capital accounts really are not relevant for single member LLCs and LLCs that have elected to be taxed as C corporations.

Such a special allocation must meet the test to be respected by the IRS. Any time a company agreement deviates from pure pro rata allocations, the reviewing attorney should consult a tax attorney with expertise in partnership taxation.

XII. DISTRIBUTIONS

A member's right to be allocated profits and losses, and to receive a share of distributions is dependent upon the relative value of the member's contributions to the company, as reflected in the company's records. *See* BOC §§ 101.201, 101.203. Members have no right to demand distributions in any form other than cash, regardless of the property contributed, either during the life of the entity or upon withdrawal (if permitted by the company agreement). *Id.* §§ 101.202 (general periodic distributions), 101.205 (upon withdrawal).

Whether to make a distribution is up to the LLC's governing authority. Minority members should therefore be aware that they generally have no control over whether the entity makes a distribution. Many agreements also include provisions relating to operating and capital accounts for the company designed to keep reserves to address fluctuations in cash flow and future capital expenses or investments. Accordingly, such agreements typically limit distributions to an amount net of such reserves, sometimes referred to as "available cash" or the like. Regardless, the company is prohibited from making distributions that would render the company insolvent. BOC § 101.206(a).

Typically, a member's right to receive distributions is based upon the value of the member's contributions to the company relative to the value of all contributions. BOC § 101.203. As discussed in Sections VII(H) and (I), above, the company agreement may alter this standard and provide a complex array of methods for distributions, all of which are beyond the scope of this paper.

That a member has no right to require a distribution and no right of withdrawal makes an investment in an LLC quite illiquid. The problem may be exacerbated in the context of an LLC that is taxed as either a partnership or an S corporation. Members, especially minority members, of such LLCs may be faced with phantom income. That is, the member is allocated taxable income according to the company agreement, but receives no distribution. The result is that the member is forced to pay taxes on something he or she did not receive. Consequently, such members should seek a provision in the company agreement for mandatory distributions of the LLC's net taxable income sufficient to satisfy at least the members' liability for income taxes. While this type of provision may be stated in a variety of ways, a distribution of 40% of the net taxable income generally is the amount necessary to satisfy the tax liability of those members in the higher tax brackets. To be effective, the provision requiring such a distribution also should have a reasonable deadline for distribution sometime before April 15 of each year.

Upon the declaration of a distribution, a member has an enforceable right against the LLC to receive the distribution. BOC § 101.204. Failure of the LLC to make the distribution will transform the member into a creditor of the LLC with respect to that distribution. *Id.* § 101.207. It may be that a company agreement alters these rights to facilitate transforming a member's capital account into a forced loan to the company. For example, the company could provide that upon the declaration of a distribution and the failure of the company to pay the distribution within a certain period, the member to whom the distribution is owed is deemed to have made a loan to the company based on a default promissory note written in to the agreement.[18]

XIII. TRANSFER RESTRICTIONS

A. Statutory Transfer Restrictions and Assignees

By default, members may freely transfer their membership interests to third parties.[19] BOC § 101.109(a). The consequences of any transfer are rather complex. The complexity begins with the meaning of "membership interest," which separates the member's economic rights from the member's management rights. *Id.* § 1.002(54). Specifically, a "membership right" includes:

> [A] member's share of profits and losses or similar items and the right to receive distributions, but does not include a member's right to participate in management.

Id. The BOC therefore includes a built-in transfer restriction that prohibits members from transferring their management rights. *Id.* § 101.109(b)(2)(A) (the assignee is not entitled to "participate in the management and affairs of the company"). Instead, the person to whom the membership interest is assigned is a mere assignee with limited rights. *Id.* § 101.108(b).

An assignee's rights include the right to receive allocations of profits and losses and distributions associated with the transferred membership interest. BOC § 101.109(a)(1), (2). The assignee also is entitled to "reasonable information or a reasonable

[18] The author has not reviewed the advisability of such a structure.

[19] Whether a member holding anything less than a 100% membership interest is able to find a buyer for a fair value is another matter.

account of the transactions of the company", but only for proper purposes. *Id.* § 101.109(a)(3). Finally, the assignee may inspect the company's books and records for a proper purpose. *Id.* § 101.109(a)(4). In contrast, the assignee specifically has no right to participate in the management and affairs of the company, to become a member, or to exercise any of the assigning member's rights in the company. *Id.* § 101.108(b)(2). On the other hand, the assignee is not liable to the company as a member so long as the assignee remains a mere assignee. *Id.* § 101.109(c).

In the meantime, the member who transferred his or her membership interest continues as a member of the company with all of the responsibilities and obligations to the company as held before the transfer. BOC § 101.111. A member's mere transfer of his or her membership interest also does not absolve the member of any liabilities or obligations to make contributions previously incurred regardless of whether the assignee becomes a member. *Id.* § 101.111(b).

Ultimately, the other members may, by unanimous approval, accept the assignee as a member. BOC § 101.109(b). At that point, the former member/assignor ceases to be a member. *Id.* § 101.111(a). But the former member/assignor is not relieved of any liability to the company. *Id.* § 101.111(b).

In contrast, the former assignee/new member accedes to all the rights and powers afforded to members. BOC § 101.110(a)1). The member also becomes liable to the company as a member. *Id.* § 101.109(c), 101.110(a)(3). But the new member does not become liable for the former member's obligations to the company of which the new member did not know as of the date the assignee became a member or which could not be ascertained from the company agreement. *Id.* § 101.110(b). The new member also automatically is subject to the company agreement as any other member. *Id.* § 101.110(a)(2).

The BOC also contains specific provisions covering assignments in the cases of divorce and death of a member. In both cases, the successor to any portion of the member's membership interest becomes an assignee and therefore has no management rights unless and until the assignee is accepted as a member. BOC § 101.1115(a).[20] With respect to a deceased member's estate, this provision seems to alter the default rule under the BOC that the executor of the estate would have the right to vote the ownership interest in the company. *See id*. § 6.154(a) (providing such a right). On the other hand, nothing in the provisions relating to LLCs in particular would cause the guardian of the member's estate or a conservator to be an assignee. *Id.* § 101.1115(a). Consequently, the guardian or conservator of an incapacitated member's estate would be able to exercise his or her voting rights unless the company agreement provided otherwise. *Id.* § 6.154(a). Similarly, the receiver of a member that is an entity would be able to exercise the insolvent member's voting rights. *Id.* § 6.155.

The BOC imposes broad transfer restrictions, on the other hand, with respect to professional LLCs. BOC § 301.009. Membership interests in a professional LLC may be transferred only to another member, the entity itself, or another professional of like kind. *Id*. The company agreement may further restrict such limitations, but not liberalize them. *Id*. The BOC fails to address what happens if a member dies, becomes incapacitated, or becomes subject to a receiver or bankruptcy trustee. The company agreement should therefore address these issues to avoid complications for everyone involved.

B. Transfer Restrictions in Bankruptcy

The BOC does not attempt to address what happens if a member becomes bankrupt, either voluntarily or involuntarily. *See* BOC § 11.051 (listing events requiring winding up of the LLC). On the other hand, many company agreements attempt to address member bankruptcies. When reviewing an LLC company agreement in the context of the actual or possible bankruptcy of a member, the attorney should keep in mind that federal bankruptcy law preempts state law and governs what constitutes the member/debtor's bankruptcy estate. Under the Bankruptcy Code, the debtor's bankruptcy estate is composed of "all legal or equitable interest of the debtor in property" as of the bankruptcy filing. 11 U.S.C. § 541(a)(1). The entire interest, both voting and economic, becomes part of the estate "notwithstanding any provision in an agreement transfer instrument, or applicable nonbankruptcy law" that imposes any restriction on the transfer of such interests. *Id*. § 541(c)(1). Depending on the circumstances, the company agreement may be considered an executory contract of the debtor. *See id*. § 365. Regardless, the trustee still may assume the contract and accede to the voting and management rights of the debtor/member. *Id*. § 365(a). Several bankruptcy courts have held that the bankruptcy trustee accedes to both the economic and voting rights associated with his or her interest in the company notwithstanding the division of such rights in state law and standard operating agreements. *See, e.g., LaHood v. Covey (In re LaHood)*, 437 B.R. 330, 336 (C.D. Ill. 2010) (the "bankruptcy estate received debtor's economic and noneconomic rights"); *In re Klingerman*, 388 B.R. 677, 679 (Bankr. E.D. N.C.

[20] Note the departure from the conventional numbering system for this particular section.

2008) (both economic and noneconomic interests became property of the estate); *In re B & M Land & Livestock, LLC*, 498 B.R. 262, 266 (Bankr. D. Nev. 2013) ("In obtaining the debtor's rights, the trustee is not a mere assignee, but steps into a debtor's shoes as to all rights, including the rights to control a single-member LLC.") The law is still evolving and a detailed analysis here is well beyond the scope of this paper. The lesson to be learned is that the bankruptcy of a member likely will cause many problems for the remaining members.

C. Company Specific Transfer Restrictions

The members of a company may wish to impose transfer restrictions for a variety of reasons. For example, the members may wish to be business partners only with specific individuals, and not with a member's family members or assignees. Other members may wish to keep ownership of a legacy property in a particular family. Members also may wish to create further obstacles to frustrate future creditors of members. The possible reasons and structures abound.

In reviewing a transfer restriction, one also must consider the economic effect upon both the member who may not freely transfer his or her membership interest and upon the company and the other members. Some transfer restrictions, such as options giving current members a first right of refusal, operate as a hurdle that the member seeking to sell must clear. But the persons with the option may not be able to afford the purchase without built in payment terms. Other restrictions in effect reduce the value of an interest to zero except to the extent income is distributed to the member. Various models will be discussed below, in passing.

In reviewing any transfer restriction, the following questions should be considered:

- *To which members does the restriction apply?* Company agreements may establish separate classes of membership interests to allow for different restrictions for different members.
- *Who are permitted transferees?* The company? Other members? Family members? Friends? Enemies? Under what circumstances are such persons permitted transferees? A clear understanding of terms will be necessary. For example, if permissible transferees include family members, the question arises as to just who family members might be.
- *Are gifts treated differently than sales?*
- *Is there a way out?* Transfer restriction are incomplete if they provide no way out for the member who wishes to depart. The provided method for departure might be unpalatable, but it should be spelled out. Methods range from giving members an option to sell to the company or other members to forcing members simply to walk away.
- *What happens in the case of retirement, disability, termination, and death?* These are important questions when the members also are employees of the business. There may be other contingencies that should be addressed. Not all of the listed contingencies may be appropriate in all circumstances. For example, in the context of a passive real estate holding company, whether a member retires or becomes disabled probably is not a real issue. In an estate planning context, the contingency may simply not be relevant.
- *What happens in the case of divorce and a former spouse acquires the membership interest?* The BOC addresses this question to a certain extent. But the company agreement could go farther and require the former spouse to sell the membership interest.
- *What happens in the case of insolvency, receivership, bankruptcy, creditor claims, and pledging of assets?* Keep in mind the preemption of federal bankruptcy law discussed above.
- *If the member is an entity what happens if there is a change of control or the member dissolves?* Failure to address this issue could open a back door to outsiders gaining voting rights.
- *If the member is a trustee, what happens when the trustee changes?* Especially in the context of revocable trusts, the intent may be that the trustee/member is the only permitted member of the company. Confusion and disputes likely will arise if trustee/membership succession is not addressed. On the other hand and in the context of an irrevocable trust, the identity of the trustee might not be an issue of concern.
- *What happens if there is a bona fide offer from a third party?* Typically, the company and the members will have a first right of refusal to purchase the interests at the same price and upon the same terms. If the option is not exercised, then the member will be free to sell.
- *What are the economics for the departing member?* The provision may provide for a buyout or simply require redemption for no value.
- *If there is an option to purchase the departing member's interest, what are the terms?* The

idea of giving an option to the company or the other members seems simple enough of a solution to a potential problem. But the option itself raises all sorts of questions that should be answered. For example, who exactly may exercise the option? What vote is required? For what period of time does the option last? How is it exercised? What happens if the option is not exercised?

- *How is price determined?* Various methods include predetermined prices that may or may not be set by agreement each year, book value, and fair market value as determined by appraisals. In the context of a potential sale to a third party, the price generally is determined by the third party's offer. Careful attention might have to be paid to what is included in the determination of value. For example, if life insurance is used to provide funding for a buy-out, then its value probably should be excluded from the calculation despite it being an asset of the company.
- *What are the payment terms?* To avoid straining the ability of the company to survive, especially for a large buyout, payment terms usually are provided. Security interests in the sold membership interests may be retained by the departing member. Again, in the context of a potential sale to a third party, the payment terms generally are the same as offered by the third party.
- *What are the remedies for the company and the non-transferring members?* Damages? Liquidated damages? Adjustments to the buyout price? Declaratory judgments?
- *In the estate planning context, how will the transfer restrictions affect valuation discounts?* Transfer restrictions are an important part of the analysis of value of a membership interest. But outright restrictions on transfer probably go too far. They also might affect whether the gift of a partial interest qualifies for the annual gift tax exclusion. Transfer restrictions and valuation discounts are topics in and of themselves.
- *If the transfer is ultimately consummated, what are the assignee's rights and obligations?* The company agreement may rely on the default provisions in the BOC, or it may impose further obligations on the assignee. Especially in family situations, it may be practical to accept the assignee as a member automatically. Another situation that calls for automatic membership is the transfer to a person who already is a member.
- *What procedural hurdles are required?* Many company agreements require review of any proposed transaction by both a tax lawyer and a securities lawyer before it may take place.
- *What rights does the assignor/member have?* The company agreement should spell out those rights, especially if the default BOC provisions are not adequate.
- *Do members have a right to grant security interests in their membership interests?* Many agreements attempt to void such grants without the company's permission. The author does not know whether such an attempt, if challenged, would be successful.

XIV. DISPUTE RESOLUTION

All company agreements for LLCs with more than one member should include provisions designed to help the members resolve disputes short of litigation. Various issues will be discussed below.

A. Stalemates

Generally, majority control will resolve most disputes because someone is able to make the final decision. On the other hand, if there are an even number of votes, stalemate may result. Stalemate also may be possible if voting is based on the members' respective percentage membership interests if any one or any group of members has 50% of the vote. Stalemate also may result in the context of supermajority votes if any one or any group control the required percentage. For example, if a vote greater than 60% is required to approve a certain action, stalemate may result if a single member or any group of members has votes totaling 60%. The reviewing attorney should look out for the possibility of stalemate and determine how the company agreement might address the possibility.

B. Mediation Provisions

Company agreements may include voluntary or mandatory mediation provisions. The idea behind such provisions is to give the members a chance to resolve those disputes which simply will not go away with the help of an impartial third-party and short of litigation.

A voluntary mediation provision may be seen as a waste of time and effort, especially if the dispute is heated. A significant concern related to voluntary mediations is that it might set up a race to the courthouse. The person contemplating litigation will want to be the plaintiff. But if the person chooses to pursue voluntary mediation before filing suit, that pursuit may simply cause the other party to realize the dispute is real and to file suit first. Accordingly,

mandatory mediation provisions may be preferred.

To avoid creating more disputes, a mediation provision may address the following issues:

- Whether mediation is a mandatory prerequisite to filing suit or seeking arbitration;
- The parties who have the right to seek mediation;
- The circumstances under which a party may seek mediation;
- The matters that may be the subject of a mediation;
- Whether and the manner in which the parties are required to identify the issues to be resolved;
- Whether and the extent to which the parties are required to exchange information regarding the dispute;
- The manner in which a mediator is to be selected;
- The identity of the persons who may be selected as a mediator;
- The time and place of the mediation, or at least how the time and place are to be chosen;
- The person responsible for paying the mediator;
- Whether the parties may be represented by counsel;
- The manner in which the mediation is to be conducted, if desired;
- The manner in which the mediation is to be terminate or continued, if appropriate;
- Whether the mediator may be a witness or consultant if the dispute is resolved;
- Whether the communications at or in connection with the mediation are confidential or may be used as evidence if the dispute is not resolved; and
- The extent to which the mediator must respect a party's direction regarding the disclosure of information provided and communications with the mediator. *See* TEX. CIV. PRAC. & REM. CODE § 154.053(b) (the provisions regarding alternative dispute resolution found in the statute apply to court ordered mediations).

C. Arbitration Provisions

Agreements to arbitrate disputes are valid under both Texas and federal law. TEX. CIV. PRAC. & REM. CODE § 171.001(a); 9 U.S.C. § 2. Arbitration has been touted as a cheaper and more efficient alternative to litigation. But it seems that arbitration has evolved such that it typically is conducted in the same basic manner as litigation in the courts, including motions, discovery, and trials. The main differences seem to be (1) there is no jury; and (2) there are no appeals for all practical purposes. Further and in the author's opinion, arbitration provisions tend to discourage taking disputes to the next level because of the expense associated with initiating an arbitration.[21] Depending on the circumstances, however, arbitration may be desirable for all parties.

In the context of a company agreement, the following issues should be addressed:

- Whether arbitration is mandatory;
- The parties who have the right to seek arbitration;
- The circumstances under which a party may seek mediation;
- The matters that may be the subject of a mediation;
- The rules for the arbitration. A typical choice are the rules promulgated by AAA. Those rules are available at www.adr.org. Note that the AAA applies different rules to different types of disputes. A simple reference to the AAA's rules, for example, will address most procedural issues surrounding an arbitration. On the other hand, the AAA's rules may provide a framework for analyzing the rules provided in the company agreement;
- The identity and number of arbitrators;
- The time and place of the arbitration; and
- Responsibility for paying for the arbitration, both initially and at completion.

D. Jury Waivers

Some company agreements contain provisions by which the members agree to waive their right to a jury trial notwithstanding that the agreement does not include an arbitration clause. The idea probably is to avoid the uncertainty that arises any time a jury is inserted into the equation. Whether that idea is valid (the alternative is a bench trial), conspicuous waivers of the right to trial by jury are valid. *In re Bank of America, N.A.*, 278 S.W.3d 342, 345 (Tex. 2009) (per curium) (finding a jury waiver in a "bolded, underlined, and captioned" provision to be valid). Therefore, if the company agreement includes a jury waiver, it should be conspicuous.

E. Push-Pull Provisions

Push-pull provisions are a form of dispute

[21] One should compare the filing fees required for initiating a lawsuit as compared to the filing fees required for initiating an arbitration with the American Arbitration Association (the "AAA").

resolution for entities with a few members. The idea behind a push pull provision is to give the members a way to part ways in an economically fair manner if irreconcilable differences arise. As an example, consider an LLC of which there are two members. The relative percentage of each member is not relevant. The push-pull provision gives either member the option of offering his or her membership interest to the other member for a stated price. At that point, the other member has the option of either accepting the offer or to sell his or her membership to the offering member for the same price. Regardless, the choice is mandatory for both members. One of them will sell and one will buy at the stated price. Presumably, the member triggering the push-pull provision will neither overstate nor understate the initial offering price because the initiating member does not know whether he or she will end up selling or buying. At the end, both parties walk their separate ways. One will own the entire company and the other will have received consideration for walking away.

Push-pull provisions are great in theory. Whether they actually will work in any given context probably is debatable. One issue at play is the relative bargaining positions of the parties. The party with greater resources probably has an advantage over the other. In such a situation, payment terms probably should be negotiated as part of the push-pull provision. Also, the relative percentage membership interests of the parties probably will affect the practicality of the push-pull provision. Finally, the structure of a push-pull provision for an LLC with more than two members will be somewhat complicated.

XV. DUTIES, EXCULPATION, INDEMNIFICATION, AND ADVANCEMENT

A. Member and Manager Duties

1. Fiduciary Duties

The BOC does not directly impose fiduciary duties upon the governing authority of an LLC. On the other hand, each of the governing persons most likely owes fiduciary duties, at least, towards the company. Under the BOC, each governing person is an agent of the company. BOC § 101.254(a). Agents generally owe their principals the duty of care and loyalty. RESTATEMENT (THIRD) OF AGENCY §§ 8.08 (duty of care), 8.01-8.06 (duty of loyalty); *see also* RESTATEMENT (SECOND) OF AGENCY §§ 379 (duty of care), 387-398 (duty of loyalty). Accordingly, the governing persons owe these duties to their principal, the company. *See In re Hardee*, 2013 WL 1084494 (Bankr. E.D. Tex. 2013) (recognizing that the manager of an LLC owes fiduciary duties towards the LLC). Note that the duty of loyalty would prohibit a governing person from competing against the LLC unless the company agreement provides otherwise.

Whether the governing persons or the members in general owe fiduciary duties to the members is another matter. The law does not yet seem clear and depends in large part on what the company agreement might have to say. For example, in *Allen v. Devon Energy Holdings, LLC*, 367 S.W.3d 355, 391 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgm't vacated w.r.m.), the court refused to recognize a fiduciary duty to members in general, but did find a fiduciary duty in the context of that case. In considering these issues, the recent supreme court decision addressing minority shareholder rights in the context of corporations should be kept in mind. *See Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014).

The BOC permits the company agreement to alter, by expansion or limitation, the duties a governing person might owe to the LLC or the members. BOC §§ 7.001(d)(3), 101.401. Accordingly, the company agreement should be reviewed to determine whether it addresses fiduciary duties. A common waiver would allow the governing persons to pursue other business opportunities outside the LLC notwithstanding the duty of loyalty. In certain situations, an appropriate alternative also might be to eliminate fiduciary duties in their entirety and replace them with a contractual duty of good faith.

In at least one case, the court found that an exculpation provision that tracked the limitations of exculpation found Section 7.001(c) of the BOC actually formed the basis for finding a formal fiduciary duty owed to members in general. *Allen*, 367 S.W.3d at 396. An important provision to address in any company agreement, therefore, is whether the managers owe fiduciary duties to the members and whether members owe fiduciary duties to other members.

A careful review of any company agreement will therefore determine (1) whether it waives any fiduciary duties of the managers to the company and the members, (2) whether it waives any fiduciary duties of the members to the company and the other members, and (3) the extent to which such duties are waived.

2. Self-Dealing

Self-dealing relates to the duty of loyalty owed by the governing persons to the company. By default, the BOC governs the approval of contracts and transactions between the LLC and an interested governing person. BOC § 101.255. Contracts with an interested governing person are valid and not void or voidable if any one of the following conditions is satisfied:

- The material facts of the conflict of interest "are disclosed to or known by either (1) the company's governing authority and it approves the contract "in good faith" by a majority of the disinterested governing persons, regardless of whether the disinterested persons constitute a quorum, or (2) the members approve the contract in good faith; or
- The contract was "fair to the company" when it was approved by the governing authority.

Id. § 101.255(b). Interested parties may be included in determining whether there is a quorum at the relevant meeting. *Id.* § 101.255(c). Further, such persons may participate in the meeting and sign relevant documents. *Id.* § 101.255(d). Unless the desire is to alter these provisions, there is no need to included them in the company agreement.

B. Exculpation, Indemnification, and Advancement

The concepts of exculpation, indemnification, and advancement are closely related. Careful attention should be applied to ensure that these provisions are consistent with one another to avoid confusion.

1. Exculpation

Exculpation relates to releasing a person from liability for violating a duty as distinct from releasing the same person from the duty. As indicated above, if a person has no duty (which could be the case as described in the preceding subparagraph under a company agreement that so provides), the person will have no liability. On the other hand, the LLC also may, or in the alternative may, exculpate its members, managers, officers and other persons from any liabilities for breaches of any one or more of their respective duties.[22] BOC § 101.401. Note that the breadth of exculpation for LLCs is broader than is available to corporations. *See id*. §§ 7.001(c) (prohibiting other entities from exculpating governing persons from liability for breaches of the duty of loyalty and acts or omissions not in good faith), 7.001(d)(3) (noting that the limitation on exculpation does not apply to LLCs).

By default, no one is exculpated from any liabilities. Any exculpation must appear in the governing documents. BOC § 101.401. On the other hand, governing persons are entitled to rely upon the information, opinions, reports, and statements (including financial statements) concerning the LLC prepared by officers and employees of the LLC, legal counsel, certified public accountants, investment bankers, and committees of the governing authority of which the person is not a member, if the governing person acts in good faith and with ordinary care. *Id.* § 3.102.

Careful attention should be applied to the level of exculpation provided to the managers and members.

2. Indemnification

Indemnification is the reimbursement of a person for expenses and liabilities incurred. The BOC's standard provisions for indemnity, which requires certain provisions to be included in an entity's governing documents, do not apply to limited liability companies. BOC § 8.002. Instead, an LLC is specifically permitted to indemnify anyone regardless of whether the provision is found in its company agreement. *Id.* § 101.402. The LLC also is permitted to include in its company agreement the BOC's provisions regarding indemnity or any other provisions including those that go beyond the indemnification required or permitted in Chapter 8. *Id.* §§ 8.002(b), 101.402(a)(1). To the extent the company agreement does not provide direction, whether and the extent to which the LLC might indemnify anyone will be left to the LLC's governing authority. The freedom afforded LLCs with respect to indemnity provisions also means that the company agreement may provide for indemnification that goes beyond the limitations otherwise found in the BOC. The breadth of the indemnification chosen should be carefully considered.

If the LLC adopts the default provisions found in the BOC, the LLC may indemnify current and former governing persons in a civil context if it determines that the person acted in good faith and reasonably believed his or her conduct was (1) in the LLC's best interests (if conducted in the person's official capacity), or (2) not opposed to the LLC's best interests (if conducted outside of the person's official capacity). BOC § 8.101(a). In a criminal proceeding, indemnity is permitted if the above factors are met and the person also did not have reasonable cause to believe the conduct was unlawful. *Id.* Judgments, settlements, convictions, and the like imposed against the person do not necessarily preclude indemnification. *Id.* § 8.101(d). The LLC also may provide indemnification for other persons under similar circumstances. *Id.* § 8.105 (for persons other than governing persons). The BOC also contains extensive rules regarding the scope of indemnification

[22] The distinction between duties and liabilities generally has no practical effect. If a person has no liability, then generally, there is no remedy for a breach. On the other hand, equitable remedies, such as injunctions, may be available to prevent future breaches of duty even if there is no liability for such breaches.

that may be paid and the manner in which the LLC is to determine whether to pay indemnification. *Id.* §§ 8.102, 8.103.

Sloppy drafting could lead to some interesting results. Consider a provision that states:

> The LLC shall indemnify its governing persons and members to the full extent allowed by the Business Organizations Code.

At first glance, such a provision would seem to refer to the provisions of Chapter 8 of the BOC. But because the BOC has no limitations on LLCs, the provision could be interpreted as meaning that the LLC is required to indemnify its governing persons and members for all liabilities associated with the company, including liabilities to the company itself and other members, all without limitation. Accordingly, any indemnification provision that does not simply adopt Chapter 8 should be reviewed carefully to determine the extent to which indemnification applies and how it is to be implemented.

3. Advancement

Advancement is the payment of expenses associated with defending against a claim while the claim is pending and on a current basis (as opposed to payment of those expenses after the fact). Again, the BOC's default provisions regarding advancement do not apply to LLCs. BOC § 8.002. Instead, the company may simply choose to provide advancements through its governing authority. *Id.* § 101.402(a)(2). Nevertheless, the advancement provisions should be consistent with the company's indemnification provisions.

XVI. WINDING UP & TERMINATION

A. Generally

"Winding up" an entity under the BOC is the process by which the entity prepares to cease doing its business, paying off its creditors, and distributing what is left to the members. "Termination" is simply the formal process of notifying the state and the world (through a filing) that the company has completed the winding up process.

B. Events Requiring Winding Up

For the most part and under the BOC, as long as the members follow the "form" of the LLC, the members have practical control over whether the LLC is ever required to wind up its affairs. An LLC is required to wind up upon the following events:

- Expiration of the LLC's duration as reflected in its governing documents. BOC § 11.051(1);
- The LLC voluntarily decides to wind up. *Id.* § 11.051(2);
- The events specified in the LLC's governing documents as requiring winding up, dissolution, or termination. *Id.* § 11.051(3);
- A court orders that the LLC wind up.[23] *Id.* § 11.051(5);
- The termination of the membership of the last remaining member of the LLC. *Id.* § 11056(a);[24] and
- The LLC fails to file required tax and information reports or has failed to maintain a registered agent. *Id.* § 11.251.

By default, only a majority vote of all members is required to approve a voluntary winding up.[25] *Id.* § 101.552(a).

The members of an LLC may vote to "cancel" many of the events requiring it to wind up under various circumstances. BOC § 11.152. Such a vote requires unanimous consent. *Id.* § 101.552(b).

The company agreement may specify additional events that require winding up of the company. BOC § 11.051(3). Whether a particular event is proper will depend on the circumstances. Some company agreements mention a member's bankruptcy. In such a situation, it is likely that the members will be unable to cancel that event if a member does declare bankruptcy. *See* Section XIII(B), above for a discussion regarding bankruptcy.

C. Distribution of Assets upon Winding Up

Not surprisingly, the BOC provides that the LLC must apply its remaining assets at winding up first to its liabilities and obligations. BOC § 11.053(a). It also provides guidance if the assets are insufficient to satisfy all debts. *Id.* § 11.053(b). Finally and if the

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[23] The grounds for a court ordered winding up and termination are found in Sections 11.301(a) and 11.314(2) of the BOC. Among other technical reasons, the court may order winding up if (1) the LLC "has continued to transact business beyond the scope of [its] purpose" as stated in its certificate, and (2) if the court determines that "it is not reasonably practical to carry on the [LLC's] business in conformity with its governing documents." BOC §§ 11.301(a)(4), 11.314(2). A court also may appoint a receiver to liquidate the entity under certain circumstances. Id. § 11.405.

[24] The legal representative or successor of the last remaining member has 90 days to elect to continue the company and become a member and thereby avoid the requirement to wind up the LLC. BOC § 101.056(a).

[25] If there are no members, a majority vote of the managers is sufficient. BOC § 101.552(a).

remaining assets are sufficient, the LLC may distribute its net assets to the members in accordance with their membership interests. *Id.* § 11.053(c).

Note that if the LLC's company agreement provides for capital accounts and to avoid adverse income tax issues, the agreement also should provide that the remaining net assets are to be distributed to its members who have positive capital account balances and in proportion to those capital account balances. In most situations and absent fancy allocations of income and losses, the relative proportions of the capital accounts will match the relative proportions of the members' membership interests.

An important provision to consider in this context is one that confirms that no member is required to replenish a negative capital account balance. *See Model Company Agreements* at 45-46. The Texas Supreme Court has required a general partner of a limited partnership to replenish a negative capital account balance for the benefit of a creditor. *Park Cities Corp. v. Byrd*, 534 S.W.2d 668 (Tex. 1976). Arguably, the basis for the opinion does not apply to an LLC, but it does not hurt to include a provision confirming the limited liabilities of the members.

XVII. SOME ADMINISTRATIVE MATTERS

A. Tax Matters Partner

Many company agreements designate a "Tax Matters Partner". That is because partnerships are required to have a tax matters partner to communicate with the IRS regarding tax audits and the like. IRC § 6231(a)(7); Regs. § 301.6231(a)(7)-2. On the other hand, small partnerships are not required to have a tax matters partner, though they can elect to have one. IRC § 6231(a)(1)(B). For purposes of the exception, a small partnership is one that has ten or fewer partners each of whom is an individual (other than a non-resident alien), a C corporation, or an estate of a deceased partner. *Id.*

Beginning with tax years after 2017, the audit regime for partnerships will change and the law has replaced the concept of "tax matters partner" with "partnership representatives." Bipartisan Budget Act of 2015, Pub. L. No. 114-74 (Nov. 2, 2015) § 1101. Under the new law, partnerships that do not elect to be treated as a small partnership will be required to designate a "partnership representative."

B. Books & Records

Generally speaking, LLCs are required to make its books and records and financial information available to its members and assignees upon written request. BOC §§ 101.501, 101.502. But the LLC's company agreement may impose restrictions upon the right to inspect which do not "unreasonably restrict a person's right of access". *Id.* § 101.054(e).

Some restrictions that might be appropriate include:[26]

- Requiring the written request to state the "proper purpose" for the request;
- Allowing for denial of a request if the person making the request previously used company information for an improper purpose;
- Providing that confidential information, such as trade secrets, be kept from non-governing persons and assignees;
- Explicit requirements that a person requesting information sign a confidentiality agreement; and
- Limitations on the frequency of access to financial information.

C. Fiscal Year

The fiscal year of most entities coincides with the calendar year. From a practical perspective, the company's fiscal year should match its tax year. For most entities, the tax year also will be the calendar year. On the other hand, LLCs that are taxed as partnerships must have the same tax year as the majority of its partners have. *See* IRC § 706(b). It will be, however, a rare situation where a majority of partners has a tax year that differs from the calendar year. A partnership also may be able to choose a tax year to correspond with a natural tax year. *Id*. But the partnership will need to convince the IRS of its business purpose for doing so.

D. Irrevocable Powers of Attorney

Some company agreements contain an irrevocable power of attorney from each member appointing the company or its managers as agent to accomplish certain company related tasks. For example, the power of attorney may grant the company authority to sign documents required to be filed with the Secretary of State on behalf of the members. Such powers of attorney are generally respected. *See* BOC § 101.055. The reviewing attorney should, of course, review the breadth of the grant of authority to ensure it is reasonable. By default, such powers of attorney are durable. *Id*. § 101.055(c).

E. Attorneys' Fees

Under Texas law, attorneys' fees generally are recoverable in the context of a written contract, such as a company agreement. TEX. CIV. PRAC. & REM. CODE § 38.001(8). But a handful of cases have

[26] The ideas come from *Model Company Agreements* at 28-29.

recently found that the statutory provision does not apply to limited liability companies. *See, e.g., Hoffman v. L & M Arts*, 2015 WL 1000838 (N.D. Tex. 2015); *Choice! Power, L.P. v. Feely*, 501 S.W.3d 199, 214 (Houston [1st Dist.] 2016, no pet.) (applying the concept to limited partnerships); *Fleming & Assoc., L.L.P. v. Barton*, 425 S.W.3d 560, 575 (Tex. App.—Houston [14th Dist.] 2014, pet. denied) (applying the concept to partnerships). Accordingly, if there is no provision in the company agreement allowing for the recovery of attorneys' fees, the LLC should have a claim for recovery as against the members, but the members might not have a claim against the LLC.

F. Merger Clause

Merger clauses are important to avoid alleged side agreements and understandings that might otherwise modify the company agreement.

G. Amendments

It is important to specify that all amendments to the company agreement be in writing. *Cf.* BOC § 101.001(a) (the company agreement and, by implication, amendments thereto may be oral).

H. Governing Law

For purposes of clarification, it is important to state the governing law to ensure the application of Texas law to disputes regarding the company agreement. Otherwise, the company and its members may find themselves in a conflicts of laws problem.

I. Choice of Venue.

Generally, choice of venue provisions are respected as a matter of contract law. Otherwise, far flung members might bring suit in some far away foreign land, like California or New York.

J. Notices

Like any contract, it may be helpful to include notice provisions that designate where the parties are to receive any notice permitted or required under the company agreement.

K. Securities Language and Warranties

Some agreements contain warranties from the members that they have acquired their membership interests for their own benefit and for investment purposes only, and have the necessary expertise, knowledge, and sophistication necessary to evaluate the economic merits and risks of their investment in the company. The agreements also may contain restrictive language that the membership interests have not been registered with the Securities and Exchange Commission. The provisions relate to the fact that sometimes it is not clear whether a membership interest is a security under federal and state securities laws and reflect an attempt to force the membership interests to fall within one or more of the exemptions to the registration requirements. The details of how securities laws apply to the typical limited liability company is well beyond the scope of this paper.

XVIII. CONCLUSION

Limited liability companies on their face seem to be a fairly simple concept. But in practice and when disputes arise, they are in fact rather complex if for no other reason that the agreement must be read in light of the underlying law. Adequate review of any company therefore requires intimate familiarity with the Business Organization Code.