HOW TO SELECT THE RIGHT ENTITY FOR YOUR CLIENT

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State Bar of Texas
ESSENTIALS OF BUSINESS LAW 2013
March 14-15, 2013
Dallas

CHAPTER 4

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I. INTRODUCTION

Attorneys are often asked by family, friends and clients what type of entity they should choose to structure their business enterprise. As is typical with most legal advice, the ultimate selection often boils down to factors relating to the facts and circumstances of the situation. There are, however, a few issues that must always be taken into account when determining which structure to use. This article breaks down the various options available for "for-profit" entity selection in Texas and outlines some of the issues that need to be considered when addressing the best possible entity selection for your client.

II. OVERVIEW OF TEXAS ENTITIES

A. Corporations

Some of the advantages to operating a business as a corporation include: i) status as a separate legal entity; ii) limited liability to shareholders; iii) centralization of management; and iv) flexibility in capital structure. The disadvantages include: i) expense and cost of formation; ii) the requirement to maintain corporate formalities; iii) tax treatment (double taxation for C-corporations and restrictions on S-corporations); and iv) state franchise tax.

1. Basic Players in a Corporation

At its most basic level, the corporation is made up of three players: the shareholders, the board of directors, and the officers.

a. Shareholders

The shareholders are the owners of the corporation in that they hold shares representing ownership interests. Typically, shareholders are entitled to a dividend, which is a sum of money often correlated to the amount of shares owned by the shareholder paid at certain intervals out of the corporation's profits. This payment or distribution is issued upon the authorization by the board of directors of the corporation.[1] Shareholders also have the right to vote on certain items, such as the election of members of the board of directors, as well as, fundamental business decisions affecting the corporation such as bylaw amendments, the sale of all or substantially all of the corporate assets, or the merging with another business. Some shareholder's powers are extremely limited when it comes to routine business decisions as these powers are vested in the corporation's board of directors. Some shareholders will enter into agreements with one another about how they will vote on a particular item.

b. Board of Directors

The board of directors governs the corporation by acting as the decision-maker of major issues concerning the corporation. The board of directors has the power to delegate substantial authority to the corporate officers and often times, the day-to-day operations of the corporation are left to the officers.

Only one member of the board of directors is required and this director must be a natural person.[2] The board of directors owes fiduciary duties to its shareholders, including the duty of care, the duty of loyalty, and the duty of obedience.[3] The duty of care requires the director to handle his duties with such care as an ordinarily prudent person would under similar circumstances. The duty of loyalty requires that a director act in good faith and not allow his personal interests to prevail over that of the corporations. The duty of obedience requires the director to conduct his or her activities in a manner that complies with the law and any provisions included on the certificate of formation for the corporation.

c. Officers

The officers are responsible for the day-to-day operations of the corporation. At a minimum, the corporation must have a president and secretary; however, one person may serve as both officers.[4] Officers are employees of the corporation, and they report to the board of directors. It is not uncommon for an officer to also be a member of the board of directors and a shareholder. Because officers are employees of the corporation, their relationship, and as a result their duty, to the corporation stems from agency law—that is, officers are agents for the principal corporation.

[1] Tex. Bus. Orgs. Code Ann. § 21.310 (West 2012).

[2] *Id.* § 21.403(a).

[3] *Id.* §§ 21.359, 21.363, 21.364.

[4] *Id.* § 21.417.

2. Tax Considerations

a. C Corporation

The hallmark of the C Corporation's tax structure is that it is subject to "double taxation." This means that the C Corporation's income is taxed first at the corporate level, as income to the corporation, then again at the shareholder level when the shareholder receives a dividend, which the shareholder must report as individual income. Additionally, C Corporations are subject to the Texas Franchise Tax.

b. S Corporation

An entity may avoid double taxation by electing to be taxed as an S Corporation; however, this option may not be permissible or suit all business ventures. To make a valid S corporation election, the corporation must not:

i. have more than 100 shareholders,
ii. have as a shareholder a person, other than an estate and certain trusts, who is not an individual,
iii. have a nonresident alien as a shareholder, and
iv. have more than one class of stock.[5]

In addition to the above requirements, all shareholders must consent to the S Corporation election. Additionally, S Corporations, like C Corporations, are subject to the Texas Franchise Tax.

3. Liability

The shareholder's liability is limited only to such shareholder's investment in the corporation. The corporate structure shields the board of directors and officers from being personally liable for the corporation's debts and obligations. In order to enjoy this limited liability, a corporation must comply with certain formalities.[6] Personal liability can arise, however, under the doctrine known as "piercing the corporate veil." As the name implies, this doctrine disregards the corporate entity and treats the corporation and individual as one and the same. This most often occurs when an individual and the corporation are so closely associated that the corporation is said to be an alter ego of the individual, when the corporate entity is used simply as a sham to perpetrate a fraud, or to a lesser extent, when the individual behind the corporation fails to follow corporate formalities.

4. Other Considerations

a. Governing Instruments

Other important characteristics of a corporation are the rules that govern the corporation. In Texas, the corporation is established by filing with the Texas Secretary of State a Certificate of Formation along with a $300 filing fee.[7] The Certificate of Formation includes items such as the name of the corporation, the name and address of its registered agent, and the name of at least one of the initial members of the board of directors.[8] Another important governing document is the bylaws, which set out the day-to-day rules and procedures of the corporation. Once the corporation is officially formed with the Texas Secretary of State, the corporation's initial board of directors should call an organizational meeting to adopt the bylaws of the corporation, elect officers of the corporation, and conduct other business as may be necessary.[9] In addition to the bylaws, the shareholders of a corporation may enter into a shareholders' agreement that governs the relationship of the shareholders of the corporation. Shareholders' agreements may address a variety of issues, such as, the voting of shares for the election and removal of directors and officers, governing the exercise or division of voting power between shareholders, directors and other persons, establishing the terms for transfer or use of property between the corporation and other persons and determining the manner in which profits and losses will be apportioned.[10]

b. Closely Held Corporation

In Texas, a closely held corporation is one that has fewer than thirty-five (35) shareholders and none of its shares are listed on a national securities exchange like the New York Stock Exchange or NASDAQ.[11] A corporation is designated as a close corporation through its certification of formation by stating that "this corporation is a close corporation." Closely held corporations are also sometimes referred to as "privately held" or "private" corporations. The primary use of a close corporation rather than an ordinary corporation is to alter the ordinary scheme for the management of corporate affairs. A close corporation may provide for the management with or without a board of directors and may provide for

[5] I.R.C. § 1361.
[6] Tex. Bus. Orgs. Code Ann. § 21.223.
[7] *Id.* §§ 3.001, 4.001.
[8] *Id.* § 3.005.
[9] *Id.* § 21.059(b).
[10] *Id.* § 21.101.
[11] *Id.* § 21.563.

management by its shareholders.[12] Frequently, shareholders in close corporations will limit the conditions under which shares may be transferred or sold, allocate the profits and losses of the corporation in a specific manner or set terms for ownership of management.

B. GENERAL PARTNERSHIIP

1. Basic Structure and Duties

A general partnership is an association of two or more individuals who carry on as co-owners of a for profit business. There is no limit on the number of partners that can make up a general partnership; however, at a minimum, there must two (2) partners. A general partnership can be formed regardless of whether the co-owners intend their association to be a general partnership.[13] It is not necessary that any written partnership agreement exist or that the parties even file a formal document with the Texas Secretary of State in order to form a partnership. The Texas Business Organizations Code delineates factors that indicate that persons have created a partnership which include the following:

1. a person's receipt or right to receive a share of profits;
2. expression of an intent to be partners in the business;
3. participation or right to participate in control of the business;
4. agreement to share in the losses of the business or to share in the liability for claims by third parties against the business; or
5. an agreement to contribute money or property to the business.

In determining whether a partnership has been formed, the Texas Supreme Court in *Ingram v. Deere*, used a totality of the circumstances test to determine whether a partnership had been formed instead of requiring that all five factors be present.[14] Thus the existence of a partnership may be implicated even in the absence of a partnership agreement or a filing with the Texas Secretary of State.

A partner in a partnership owes the partnership, the other partners and a transferee of a deceased partner's partnership interest the duty of loyalty and the duty of care.[15] The duty of loyalty includes placing the interest of the partnership ahead of one's own, it requires a partner to account to the partnership for the profits or benefits derived by the partner, requires the partner to refrain from competing or dealing with the partnership in an adverse manner.[16] The duty of care requires a partner to act as an ordinary prudent person would act in similar circumstances.[17]

2. Tax Considerations

A general partnership is similar to an S-Corporation in that it individually is subject to "pass through" taxation, which means that its business income is not taxed at the entity level. Rather, each partner reports and pays individual taxes on his portion of the income or loss resulting from the operation of the general partnership. A general partnership does have the option, however, to elect to be treated as a corporation for tax purposes. A general partnership, depending upon its owners, may be subject to the Texas Franchise Tax.

3. Liability

The general partnership does not limit or protect a partner from personal liability. Thus, each partner in a general partnership is jointly and severally liable for all of the debts and obligations of the general partnership, irrespective of the partner's investment in the partnership.

C. LIMITED PARTNERSHIP

1. Basic Structure and Duties

Limited Partnerships are an attractive structure in that it limits the liability of the limited partners. A limited partnership consists of one or more general partners and one or more limited partners. A limited partnership is formed by filing a Certificate of Formation with the Texas Secretary of State and by paying a $750 filing fee.

The general partner of a limited partnership assumes responsibility for management of the business and has the same unlimited liability as does a partner in a general partnership.[18] The limited partner is restricted in the extent to which he may participate in the management and control of the business if he wishes to maintain his limited liability. The Texas Business Organizations Code sets forth specific safe harbors that allow the limited partner to participate in the control of the business in limited ways, but yet will not constitute participating in the business for liability purposes.

[12] *Id.* § 21.714(b)(1), (2).
[13] *Id.* § 152.051.
[14] *Ingram v. Deere*, 288 S.W.3d 886, 895-96 (Tex. 2009).
[15] Tex. Bus. Orgs. Code Ann. § 152.204.
[16] *Id.* § 152.205.
[17] *Id.* § 152.206(a).
[18] *Id.* § 153.152.

Some of the safe harbors include allowing a limited partner to consult with and advise the general partner on any matter, including the business of the limited partnership; serving on a committee of the limited partnership or the limited partners; proposing, approving, or disapproving certain specified matters relating to partnership business, including the winding up or termination of the limited partnership; acting as a contractor, an agent, or an employee of the limited partnership; and guaranteeing specific obligations of the partnership.[19]

2. Tax Considerations

Like a general partnership, a limited partnership is subject to pass through taxation, which means the limited partnership's business income is passed through the partnership and taxed on each partner's individual level. A limited partnership is also subject to the Texas franchise tax unless it qualifies as a "passive" entity, in which case the partnership may be exempt from the Franchise tax.

3. Liability

The liability of a partner in a limited partnership depends on the status of the partner. The general partner in a limited partnership is subject to unlimited liability, similar to the liability of a partner in a general partnership. The limited partner, however, is liable only for his investment in the limited partnership, and is protected from personal liability for the debts and obligations of the limited partnership. A limited partner is not liable for the obligations of the limited partnership unless the limited partner is also a general partner or participates in the control of the business of the limited partnership.[20] As mentioned above, there are certain safe harbors that allow a limited partner to participate in the control of the business that will not be considered participating in the business for liability purposes. Even if the limited partner's activities exceed the safe harbors, the limited partner will only have unlimited liability to those third parties dealing with the limited partnership who have actual knowledge of the limited partner's participation and control and who reasonably believed that the limited partner was a general partner based on the limited partner's conduct.[21]

4. Other Considerations

a. General Partner

The general partner in a limited partnership can include not only individuals, but corporations and limited liability companies (discussed below) as well. It is advisable that when forming a limited partnership the general partner's interest be maintained in a limited liability company or entity designed to insulate potential liability of the general partner, particularly if the general partner is also a limited partner. While this structure provides added protection for the general partner, it increases the expenses in forming and maintaining the limited partnership.

D. LIMITED LIABILITY PARTNERSHIP

1. Basic Structure and Duties

A limited liability partnership consists of two or more partners and is established upon the filing of a Certificate of Registration with the Texas Secretary of State and paying a $200 filing fee for each partner in the limited liability partnership. Each year thereafter, the limited liability partnership must file an annual renewal with the Texas Secretary of State and pay a $200 fee for each partner in the limited liability partnership. Either a general or limited partnership may register as a limited liability partnership.[22] A general partnership that registers as a limited liability partnership is considered a limited liability partnership and a limited partnership registered as a limited liability partnership is referred to as a limited liability limited partnership.

2. Tax Considerations

Like a general partnership, a limited liability partnership is subject to pass-through taxation, which means the limited liability partnership business income is passed through the partnership and taxed as personal income to its owners. Further, a limited liability partnership is subject to the Texas Franchise Tax, although there is an exception for a partnership that meets the definition of a "passive" entity under the statute.

3. Liability

Each partner in a limited liability partnership is shielded from personal liability for the debts and obligations of the limited liability partnership so long as the limited liability partnership renews its registration yearly and the obligation arises under a contract or commitment entered into while the

[19] *Id*. § 153.103.
[20] *Id*. § 153.102(a).
[21] *Id*. § 153.102(b).
[22] *Id*. §§ 1.002(34), (47) (48).

partnership is a limited liability partnership.[23] A partner is not personally liable to any person, including a partner, directly or indirectly, by contribution, indemnity, or otherwise, for any obligation of the partnership incurred while the partnership is a limited liability partnership, unless otherwise provided by the partnership agreement.[24] It is important to note, however, that an individual partner may still be personally liable for her actions taken outside her status as a partner, such as a engaging in a tort or signing a contract to be personally liable.

E. LIMITED LIABILITY COMPANY

1. Basic Structure

A limited liability company consists of an unlimited number of owners called "members." The members own membership interests in the limited liability company. While the members can manage the limited liability company themselves, the management of the company can also be vested in one or more managers. The structure of the limited liability company is very fluid, providing the members or managers the ability to run the company in a way they see fit.

2. Tax Considerations

For federal tax purposes, the tax treatment of a limited liability company employs a "check the box" approach. This is because a limited liability company can elect to be treated as a corporation for federal income tax purposes. Failure to elect corporate status, a limited liability company can be taxed as either a disregarded entity or a partnership based on the number of members it has. A single-member limited liability company is treated as if the member and the company are one in the same. A multi-member limited liability company is treated as a partnership for federal income tax purposes.

For state tax purposes, a Texas limited liability company is subject to the Texas Franchise tax.

3. Liability

As the name suggests, the limited liability company provides limited liability for its owners. Except as provided in the company agreement of the limited liability company, the members or manager of a limited liability company will not be liable to third parties for the debts, obligation or liabilities of the limited liability company. However, the members of the limited liability company will be liable for the amount of any contributions they make to the company.[25] Unlike limited partners in a limited partnership, members of a limited liability company may participate in the management of the limited liability company without forfeiting any of the liability protection afforded to limited liability companies. That said, a member may be liable for their own torts.

4. Other Considerations

a. Governing Documents

A limited liability company is formed by filing a Certificate of Formation with the Texas Secretary of State. The company agreement is the primary governing document of a limited liability company. Like the bylaws in a corporation, the company agreement sets out the rules of the limited liability company such as organization, management structure, and capital contributions.

5. Series LLC

A series limited liability company is a limited liability company that provides for the separation of assets and liabilities into designated series so that each series can have different ownership, management, and activities separate and apart from all other series in the limited liability company.[26] The effect of dividing assets and liabilities into series is that each liability only applies to that particular series, thus reducing the risk to the entire limited liability company when one series is exposed.

F. PROFESSIONAL ENTITIES

A professional entity under Texas law includes a professional association, a professional corporation or a professional limited liability company and is available only to licensed professionals.

1. Professional Corporation

A professional corporation is formed by filing a Certificate of Formation with the Texas Secretary of State. A professional corporation is formed by a professional individual or professional organization for the purpose of providing a professional service, other than the practice of medicine by physicians, surgeons or other doctors of medicine. The practice of medicine is excluded because Texas prohibits the corporate practice of medicine. The corporate practice of medicine is a legal doctrine which generally prohibits corporations, entities or individuals (i.e. non-

[23] *Id*. § 152.801(c).
[24] *Id*. § 152.801(a).
[25] *Id*. §§ 101.114, 101.151.
[26] *Id*. § 101.601, 101.602.

physicians) from practicing medicine or interfering with a physician's professional judgment. The owners of a professional corporation are shielded from personal liability, although an individual owner or employee (such as an attorney) can be personally liable for his or her acts such as malpractice. A professional corporation is subject to the same federal income tax treatment as a corporation and is subject to the Texas franchise tax.

2. Professional Association

A professional association is formed by filing a Certificate of Formation with the Texas Secretary of State. Only certain professionals may establish a professional association including 1) doctors of medicine, 2) doctors of osteopathy, 3) podiatrists, 4) licensed mental health professionals, 5) dentists, 6) chiropractors, 7) optometrists and therapeutic optometrists, and 8) veterinarians.[27] In addition to limiting the availability of the professional association to these particular professions, a professional organization may not be an owner of a professional association. The personal liability of the owners and employees of the professional association is the same as that of a professional corporation. Under the Treasury regulations, "associations" are classified as corporations for federal tax purposes.

3. Professional Limited Liability Company

A professional limited liability company is formed by filing a Certificate of Formation with the Texas Secretary of State and indicating the type of professional service to be provided by the professional limited liability company. Unlike the traditional limited liability company, only professional individuals or certain professional entities are permitted to be members or managers of a professional limited liability company. A professional limited liability company can elect to be treated as a corporation for federal income tax purposes. If no election is made, a single-member professional limited liability company is treated as if the member and company are one, while a multi-member professional limited liability company is treated as a partnership for federal income tax purposes. In Texas, a professional limited liability company is subject to the Texas franchise tax. Like the other professional entities, the professional limited liability company provides a shield to personal liability for its members; however, it is always important to note that an individual professional can still be subject to personal liability for his or her actions such as malpractice or signing a personal guaranty on a contract.

III. QUESTIONS TO ASK BEFORE STARTING

A. Who is the Client?

One threshold consideration in any representation is "Who is the Client?" Although this seems a rather simplistic question, when forming entities, this issue is imperative to determining from whom you, as the lawyer, will take direction and whether you may continue to represent the client if and when a conflict or issue arises in the coming years. There are often a few approaches to representation, which range from representing a single investor in the entity, multiple investors in the entity, or the entity itself.

For example, in the typical scenario an individual investor ("Investor A") may come to you and say "A couple of my buddies have this business idea and we want to form an entity to run it. Can you help us?" Depending upon the approach of the investors, Investor A may determine that he prefers that you represent him in his investment in the newly formed entity rather than have you represent the newly formed entity. On the other hand, Investor A and his buddies may wish for you to form the entity and represent the entity. In that case, you will take direction from the governing body of the entity, such as the board of directors, the general partner or the managers, subject to any restrictions set forth in the Business Organizations Code or the entity's operating documents. Even though you are taking direction from the governing body of the entity, the essential consideration is that you must operate in the best interests of the entity and not to the benefit of a particular owner or governing member.

B. Who is going to own the entity?

When an investor or a group of investors comes to you to form an entity, it is not uncommon for them to know all of the owners and have a general idea as to the breakdown of ownership between the investors. Although the investors may have considered the breakdown of ownership, the owners likely have not addressed or considered what they plan to do should they add additional owners, who determines whether or not they will add additional owners or how they plan to handle an owner leaving the entity.

1. Single Investor Entity Choices and Considerations.

If a business venture will have only one investor, then the selection of available entities is more limited and includes choosing between either a limited liability

[27] *Id*. § 301.003(2).

company or a corporation. Remember that there must be at least two investors to form a partnership.

Determining whether the best option is a limited liability company or a corporation often boils down to tax considerations and the ease of operations. A single member limited liability company, for federal income tax purposes, is disregarded as an entity separate from its owner unless it elects to be taxed as a corporation.[28] A limited liability company that is disregarded is not required to file its own tax return. An additional benefit with using a limited liability company instead of a corporation is the ease of operations and lack of corporate formalities.

Using a corporation as the selected entity requires turning to either a S Corporation or a C Corporation. A C Corporation will be taxed at the corporate level and then again at the shareholder level when distributed as dividends. An S Corporation is not taxed at the corporate level; rather the corporation's income is treated as income being received by the individual shareholders, whether or not the income is distributed, and is taxed at the shareholder level. From a liability perspective, both a limited liability company and a corporation provide liability protection to its owners.

Although the owners or investors of a newly formed entity are often easily determined on the front end of the deal, it is important for the lawyer to consider various scenarios that may come into play down the road for example, whether an additional investor may be brought into the business venture after the initial formation. Such consideration are important even if on the first meeting with the client, the client indicates that he or she will be the only investor.

2. Multiple Investor Entity Choices and Considerations.

When there are multiple investors in an entity, the choices of available entities increases from forming either a limited liability company or a corporation, to potentially include a partnership. It is essential to consider how the operating agreement of the entity will be drafted to ensure that owner's rights are properly delineated and there are adequate provisions to address the management of investors as they leave or join the entity. An additional consideration is whether the investors will be required to contribute additional capital to the entity and the timing of these contributions. Depending upon the ultimate goal, such provisions may be drafted in a manner that results in the dilution of the owners, and/or or permits repurchase of the ownership interest, among a few options.

[28] Treas. Reg. § 301.7701 – 3(a)

C. Who is going to govern the Entity?

Once the owners are established, the next question typically turns to who is going to be running the entity and how involved the investors plan to be in the day-to-day operations of the entity. Some investors want to be significantly involved; others plan to be passively involved and consulted only on issues relating to fundamental business decisions; still others want to be more moderately involved where they are not operating the day-to-day management, but yet are more involved than just being consulted with on fundamental business issues. Each type of entity provides varying levels of flexibility, as discussed below:

1. Limited Liability Company – Manager Run, Member Run

A limited liability company may be managed by either its members or its managers. As the names imply, a "manager-run" limited liability company is a limited liability company managed and directed by its managers, and a "member-run" limited liability company is a limited liability company managed and directed by its members. The determination of whether a limited liability company will be either manager-run or member-run is set forth in the certificate of formation of the company by asserting that the entity will either have one or more managers or will not have managers and will be managed by its members.[29] Under the Business Organizations Code, the members or managers of a limited liability company may be individuals, corporations, partnerships, limited liability companies or other persons.[30] Additionally, various classes of members and managers having varying degree of rights and responsibilities may be established through the company agreement. This provides significant flexibility to the members and managers of the entity to specifically delineate rights and responsibilities of varying classes of ownership and management.

Many limited liability companies are organized as manager-managed limited liability companies where the managers manage the day-to-day operations of the company and the members retain specific reserved powers set forth in the company agreement. Unlike the limited partners in a limited partnership, the members may participate in the management of the limited liability company without forfeiting the protections of limited liability. The member may be liable for their own torts, but participating in the management of the limited liability company will not, in and of itself,

[29] Tex. Bus. Org. Code Ann. §101.251.
[30] *Id.* §§ 101.102(a),1.02(4).

cause the member to forfeit the liability shield afforded to them.[31] Although the law is not settled in Texas, the concept of "piercing the corporate veil" appears not to apply to Texas limited liability companies.[32]

2. Limited Partnership

The management of limited partnerships is generally reserved to one or more general partners. Limited partners generally are not involved in the day-to-day operations of the partnership. Their function is primarily as a passive investor. This concept may be difficult for some owners to use or consider because in many instances the limited partners retain the majority of the equity interest in a partnership yet have little to no control over its operations.

In the management and functions of the partnership, if a limited partner participates in the management of the partnership business, then the limited partner may lose the limited liability afforded to the limited partner under the Business Organizations Code.[33] Additionally, if the limited partner participates in the control of the business or is also a general partner, then that limited partner may be liable for the obligations of the limited partnership.[34] It is not uncommon for the general partner of a limited partnership to be a limited liability company or a corporation, instead of an individual. Whether the general partner is a limited liability company or a corporation, the use of an entity as general partner is often employed to shield upstream parties from liability. Often times, these entities are formed for the sole purpose of acting as a general partner of the limited partnership and have no other responsibilities or funding. Whether these general partner entities formed solely to act as the general partner are actually successful in protecting or insulating upstream liability is not well settled and may rest on the maintenance of corporate formalities and on whether an entity is adequately capitalized for veil piercing purposes.[35]

3. Corporation

Corporations offer a centralized management structure through their board of directors. The board of directors manages the affairs of the corporation with the officers managing the day-to-day operations. The shareholders of the corporation will retain certain authority over fundamental business matters.[36] Should the shareholders desire to retain more control over the corporation, the shareholders may enter into a shareholder agreement that restricts the authority of or even eliminates the board of directors.[37]

D. Drafting Considerations

When drafting the organizational documents for an entity, many investors request to include provisions that limit the investors in the business venture and/or permit flexibility in removing certain "wayward" investors. These objections may be addressed by incorporating certain provisions related to restrictions on transfer and voting rights, as discussed below.

1. Transfer Restrictions

The ownership interests in most entities are generally freely transferrable and often such transfers are limited only by the operating documents of an entity. Even though an interest is assignable in whole or in part, as is permissible in both limited partnerships and limited liability companies, the assignment of the interest will not automatically entitle the assignee to full partnership or membership rights.[38] Instead, the assignment will entitle the assignee to an allocation of income, gain, loss, deductions, credits or similar items and to receive distributions to which the assignor was entitled.[39] In many business ventures, the owners of the entity want to restrict who may be an investor and become a member or a partner. These restrictions may vary depending upon the investors and the type of business venture and may include defining who may qualify as a partner or a member. These provisions are common in the governing documents of professional entities where the investors must meet a certain set of criteria in order to be and remain an owner. Other common provisions include granting a right of first refusal to the other investors in the entity in the event a current investor wants to transfer his or her ownership interest to an unrelated third party.

[31] *Id*. §§ 101.114 and 101.151.
[32] Byron F. Egan, *Choice of Entity Decision Tree*, 140, *available at* http://images.jw.com/com/publications/1744.pdf (TexasBarCLE, Choice and Acquisition of Entities in Texas) (May 25, 2012).
[33] Tex. Bus. Orgs. Code Ann. § 153.102
[34] *Id.* § 153.102.
[35] *See* Elizabeth S. Miller, *Owner Liability Protection and Piercing the Veil of Texas Business Entities,* 19 (TexasBarCLE)(May 27, 2011).
[36] Tex. Bus. Orgs. Code Ann. §§ 21.358, 21.359, 21.363, 21.364.
[37] *Id.* § 21.101(a).
[38] *Id.* §§ 153.251, 101.108.
[39] *Id.* §§153.251(b)(3),101.111.

Another consideration in drafting the operating agreement is whether the investors want to grant the entity affirmative repurchase options in the operating agreement. These repurchase options may be "triggered" upon the particular owner no longer meeting certain criteria or upon the happening of certain events, such as the investor's death, violation of a law, loss of professional license or divorce of the investor.

In entities where there are only two owners, it is often advantageous for the operating agreement to address what the two investors plan to do should the investors no longer get along or when one of the investors wants out of the business venture. Drafting these provisions while everyone is getting along and on the front end of the business deal is may help ensure that the parting of the investors is amicable.

2. Voting Rights

The operating agreement commonly defines various voting percentages or requirements, such as "Majority," "Majority Interest," or "Super-Majority"; however, it is important that you confirm that your client understands the implications of these defined terms and that you ensure that you have used the terms properly throughout the operating agreement. These provisions often come into play for the individual investors after the entity has added more investors into the venture or removed some of the investors. From a drafting perspective it is important to consider whether the term is defined based upon the number of investors or based upon their respective ownership interests and to ensure that the terms are consistent throughout the agreement.