DRAFTING GOVERNING DOCUMENTS

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State Bar of Texas
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CHAPTER 1

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Concentration

Securities offerings, mergers and acquisitions, corporate restructurings and general corporate law

Summary

Mollie Duckworth represents public and private businesses in a wide variety of corporate and securities matters. She represents both public and private companies in connection with M&A transactions, and represents issuers and investment banking firms in public offerings and private placements of equity and debt securities. In addition, she advises public and private companies with respect to general corporate and transactional matters, including compliance with federal securities law issues, state corporate law issues and general corporate matters.

Representative Engagements

Mergers, Acquisitions and Private Equity Transactions

- $2.1 billion divestiture by a NYSE-listed company of selected onshore E&P operations to a NASDAQ-listed independent oil and natural gas development company
- Recombination of two NASDAQ-listed independent energy companies and a privately held midstream energy company
- Represented private equity firm in connection with the formation and $100 million commitment to purchase units of a private limited partnership to fund the acquisition of retail propane businesses
- Joint venture between independent oil and gas company and private equity firm to develop renewable energy projects in Chile
- Merger of two private-equity-backed financial services companies
- $56 million stock acquisition of privately held international logging company
- $28 million preferred stock financing and restructuring of a privately held pharmaceutical company

Securities Offerings

- $282 million initial public offering of a NYSE-listed midstream MLP

- $219 million initial public offering of a NASDAQ-listed financial services company
- $50 million initial public offering of a NYSE-listed international offshore drilling company
- Represented NYSE-listed independent oil and natural gas development company in multiple equity offerings totaling in excess of $1 billion
- Represented NYSE-listed independent oil and natural gas development company in multiple private placements of high-yield notes totaling in excess of $5 billion
- $23.5 million equity offering for a NASDAQ-listed clean energy solutions provider
- Represented initial purchasers in private placements of high-yield notes for a NYSE-listed independent propane company totaling in excess of $1 billion
- Represented various underwriters in multiple equity offerings for a NYSE-listed independent propane company totaling in excess of $800 million
- Represented NYSE-listed independent propane company in connection with $500 million continuous equity offering
- Represented underwriters in connection with a $69 million equity offering for a NYSE-listed midstream MLP
- Represented the underwriter in connection with a $91 million overnight "bought" deal for a NYSE-listed independent propane company

Education and Honors

J.D., The University of Texas School of Law, 2005
Order of the Coif
Articles and Notes Editor, *Texas International Law Journal*

B.S. (*summa cum laude*), communication sciences and disorders, The University of Texas, 1999

Recognized as a "Texas Rising Star," 2013

Admissions and Affiliations

State Bar of Texas

Austin Bar Association

Travis County Women Lawyers Association

United Way Women's Leadership Council

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Mollie Duckworth[1]

I. INTRODUCTION

One of the very first steps in the lifecycle of a business is to form the business entity. The first decision will be to determine which type of legal entity will be the best fit for the business. Once the type of entity has been selected, the governing documents for that entity will provide the framework for the ownership, management and corporate governance structures of the business. This article provides an introduction to the types of entities available in Texas, the steps required to form a legal entity, and certain drafting considerations in connection with preparing an operating agreement for the entity.

II. CHOICE OF ENTITY

The form of business entity that is most appropriate for a given situation will depend on the objectives of the business for which the entity is being organized. There are a number of factors that should be considered, including (i) how the entity and its owners will be taxed, (ii) the extent to which the entity will shield the owners of the business from liabilities arising from its activities and (iii) the level of flexibility that the owners will have in terms of structure and management of the entity. It is often helpful to think about business entities in two buckets: corporations and unincorporated entities.

A. Corporations

Texas corporations are organized under and governed by the Texas Business Organizations Code ("TBOC"). Corporations can be attractive business forms for companies because they offer limited liability for the business owners—an advantage that some other business forms (like sole proprietorships or general partnerships) are unable to provide. Despite the growing popularity of unincorporated entities in recent years, the corporate form has been available as a separate legal entity for a much longer period of time and as a result is considered to have a more established and fully developed body of case law, which in some cases may provide a greater degree of certainty in terms of how the corporation and its owners, officers and directors will be treated under the law. On the other hand, the corporate form also comes with a greater degree of statutorily required formalities that may increase the costs of doing business and does not provide the level of flexibility that is available in unincorporated entities.

Corporations can be classified as a C-corporation or S-corporation for federal tax purposes. C-corporations are separately taxable entities, and therefore are subject to "double taxation" — in other words, the corporation's earnings are taxed at the corporate level and then again at the shareholder level upon distribution. If a corporation meets the requirements of, and elects to be treated as, an S-corporation, the corporation can avoid the double taxation and be treated as a flow through entity. However, there are a number of restrictions associated with S-corporations to keep in mind. For example, an S-corporation can only have one class of stock, can have no more than 100 shareholders and certain types of entities (such as partnerships, corporations, non-resident aliens and certain types of trusts) are not permitted to be shareholders in an S-corporation.

B. Unincorporated Entities

An unincorporated entity is essentially any entity that is in a form other than a corporation. One advantage of unincorporated entities is that they are considered "flow through" entities for federal taxation purposes (unless the entity makes an election to be treated as a corporation for federal income tax purposes). Thus, they are able to avoid the double taxation of C-corporations, without being subject to the limitations on capital structure or allowable shareholders that apply to S-corporations.

Another benefit of unincorporated entities is the lack of corporate formalities required by statute, giving owners broader freedom to create a contract that best fits the needs of the business. However, with the increased flexibility comes the potential for greater complexity and the need for a detailed operating agreement to set out the agreement among the parties.

The most common types of unincorporated entity forms include the general partnership, limited partnership, and limited liability company:

1. General Partnership. A general partnership is defined in the TBOC as an association of two or more persons to carry on a business for profit as owners.[2] A general partnership can be created regardless of whether the persons intended to create a partnership, and regardless of whether the partners call themselves a "partnership," "joint venture" or any other name. All partners of a general partnership are generally liable jointly and severally for all debts and obligations of the partnership. Because a general partnership does not provide limited liability for its owners, it is not the

[1] Mollie Duckworth is a partner of Baker Botts L.L.P., Austin, Texas.

[2] TEX. BUS. ORGS. CODE ANN. § 152.051.

most advantageous form of unincorporated entity, particularly in the context of raising capital.

2. Limited Partnership. A limited partnership is defined in the TBOC as a partnership that has filed a certificate of formation in accordance with the TBOC and that has one or more general partners and one or more limited partners.[3] In other words, unlike a general partnership, you cannot unintentionally create a limited partnership because a filing is required with the Texas Secretary of State. A general partner of a limited partnership has the same unlimited liability as a partner of a general partnership. In contrast, a limited partner's liability for debts and obligations of the partnership is limited to the partner's capital contribution to the partnership. However, in order to maintain this liability protection, a limited partner must not participate in the control of the business.[4]

3. Limited Liability Company. A limited liability company is a statutory entity formed by filing a certificate of formation with the Texas Secretary of State. A fundamental premise of a limited liability company, or LLC, is the freedom to contract. As a result, the structure and organization of an LLC is largely determined by the company agreement entered into by the members. A member is not liable for the debts, obligations or liabilities of the LLC unless otherwise provided specifically in the company agreement.[5] Unlike limited partnerships, members of an LLC are not prohibited from participating in the management or control of the business in order to maintain this liability protection. LLCs are often considered to bring together the best of both worlds — the liability protection of a corporation and the pass through tax benefits of a partnership.

III. FORMATION DOCUMENTS

A. Overview

With the exception of general partnerships,[6] all of the other entity forms discussed above require a filing with the Secretary of State in order to form the entity. The TBOC provides the statutory minimum requirements for a certificate of formation for each type of business entity. Once filed, the certificate of formation becomes a publicly available document. Another important formation document is the entity's operating agreement. Although not required by statute, and not required to be filed publicly, the operating agreement is an important document that sets forth the agreement of the owners or managers of the business regarding voting, management and corporate governance structures. This is especially important in the case of unincorporated entities that are based on the freedom to contract, because the operating agreement serves as the contract in which the duties, rights and obligations of the partners or members are set forth.

B. The Certificate of Formation

In order to form a corporation in Texas, a certificate of formation must be filed with the Texas Secretary of State. The certificate of formation for a corporation must include the following information:[7]

- name of the entity;
- type of entity being formed;
- purpose (can be "any lawful purpose");
- period of duration (default is perpetual unless stated otherwise);
- name and address of the initial registered agent;
- name and address of the organizer;
- aggregate number of authorized shares;
- par value (or a statement that each share is without par value);
- number of directors constituting the initial board of directors and the name and address of each initial director[8]; and
- if the corporation is authorized to issue more than one class or series of shares:
    - the designation of the class/series;
    - the aggregate number of shares in the class/series;
    - the par value of each share in the class/series (or a statement that each share is without par value); and
    - the preferences, limitations, and relative rights of the shares.

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[3] TEX. BUS. ORGS. CODE ANN. § 1.002(50).

[4] TEX. BUS. ORGS. CODE ANN. § 153.102. For a non-exclusive list of actions not constituting participation in the control of the business, see also TEX. BUS. ORGS. CODE ANN. § 153.103.

[5] TEX. BUS. ORGS. CODE ANN. § 101.114.

[6] Although general partnerships do not require any formal documentation for formation, the partners should file an assumed name certificate in all counties where business is being conducted.

[7] TEX. BUS. ORGS. CODE ANN. § 3.005 and § 3.007. Note that the requirements listed assume that the entity is not being formed under a plan of conversion or merger, in which case additional filing requirements would apply.

[8] Or if the corporation is to be managed pursuant to a shareholders' agreement in a manner other than by a board of directors, the name and address of each person who will perform the functions required under the TBOC to be performed by the initial board of directors. See TEX. BUS. ORGS. CODE ANN. § 3.007(a)(4).

The certificate of formation establishes the initial board of directors and capital structure of the corporation. The board of directors would then adopt bylaws, which control the governance of the corporation by its directors and officers. Whereas the certificate of formation for a corporation must include the details of the corporation's capital structure, and as a result can be a lengthy and complex document, particularly if there are multiple classes of stock with various rights and preferences to be described, a corporation's bylaws can be a relatively simple document. This is due in part to the level of statutory corporate formalities and default rules that are mandated for a corporation and may not be altered by a corporation's directors or stockholders.

In contrast, the certificate of formation for an LLC can be much simpler, and the operating agreement for the LLC would typically contain the details related to the entity's capital structure, including any rights and preferences given to certain members or the holders of certain membership interests. The certificate of formation for an LLC must include the following information:[9]

- name of the entity
- type of entity being formed;
- purpose (can be "any lawful purpose");
- period of duration (default is perpetual unless you state otherwise);
- name and address of the initial registered agent;
- name and address of organizer (can be any authorized person);
- whether the entity will or will not have managers; and
- the names and addresses of the initial governing persons (either the initial managers or, if there will not be managers, the initial members).

C. The Operating Agreement

Once the entity is formed, the next step is to prepare the operating agreement. Although a certificate of formation is often drafted to meet the minimum statutory requirements for filing and as a result tends to be a "bare bones" document, an operating agreement typically sets forth in detail the management structure and internal governance matters of the entity. The operating agreement is particularly important for unincorporated entities. The TBOC provides a set of default rules for each type of unincorporated entity, but also provides a great deal of flexibility for unincorporated entities to contract around those default rules. For example, with few limited exceptions, any provision of the TBOC that is applicable to an LLC may be waived or modified by the parties in the operating agreement. This allows the parties to clearly articulate their expectations or interests and alter the default rules to the extent that they conflict with these expectations or interests. If the entity does not have an operating agreement, or if the operating agreement does not address a particular issue, then the default rules under the TBOC will apply. Often the default rules do not reflect the intent of the parties, which can lead to undesirable or unexpected outcomes if not properly addressed in the operating agreement.

For instance, if not otherwise provided in the operating agreement, each of the following actions requires unanimous approval of the members of an LLC:

(1) amending the operating agreement;[10]
(2) amending the certificate of formation;[11] and
(3) admission of new members.[12]

In the context of member voting, the default rules under the TBOC provide that a majority of members is required for a quorum,[13] each member is entitled to one vote[14] and majority approval is required for any act of the governing authority, members, or committee of the company.[15]

The default rules also provide for all profits and losses of the LLC to be allocated to its members according to the agreed value of their contributions.[16] These agreed values must be included in the company's books and records and available upon request.[17]

These default rules often do not reflect the expectations of the parties and may produce unexpected results if not properly addressed in the operating agreement. Therefore it is important to have a solid knowledge of the default rules so that the agreement will alter the rules to the extent necessary to reflect the intent of the parties. With a few limited exceptions,[18] virtually all of the provisions in the

[9] TEX. BUS. ORGS. CODE ANN. § 3.005 and § 3.010.

[10] TEX. BUS. ORGS. CODE ANN. § 101.053.

[11] TEX. BUS. ORGS. CODE ANN. § 101.356.

[12] TEX. BUS. ORGS. CODE ANN. § 101.103(c).

[13] TEX. BUS. ORGS. CODE ANN. § 101.353.

[14] TEX. BUS. ORGS. CODE ANN. § 101.354.

[15] TEX. BUS. ORGS. CODE ANN. § 101.355.

[16] TEX. BUS. ORGS. CODE ANN. § 101.203.

[17] TEX. BUS. ORGS. CODE ANN. § 101.501.

[18] See TEX. BUS. ORGS. CODE ANN. § 101.054 for a list of provisions that may not be waived or modified, which include the requirement that an LLC have at least one

TBOC related to LLCs can be waived or altered in the company's governing documents.

IV. DRAFTING AN OPERATING AGREEMENT

Although many of the elements of an operating agreement discussed below apply to various forms of unincorporated entities, this article will focus on the operating agreement (referred to as a "company agreement" in the TBOC) of an LLC, which has been the most common type of entity formed by the Texas Secretary of State over the last several years. In fact, in 2012 nearly 75% of the new business entities formed in Texas were LLCs.[19] Each of the standard elements of an operating agreement for an LLC are discussed briefly below.

A. Owners and Ownership Interests

The ownership interest of each member of an LLC is referred to as a "membership interest" and is typically expressed as a percentage or a number of "units." Unlike the requirement for a corporation that shares of capital stock of the same class or series have the same rights and preferences, membership interests in an LLC may carry different interests in the management, capital, profits and losses of the LLC. The membership interests can be classified as voting or non-voting, and the operating agreement should set forth in detail the rights and obligations of each type of membership interest.

B. Management Structure

As mentioned above, the LLC's certificate of formation must specify whether the LLC will be managed by members or managed by managers.

Within the member-managed LLC form, there are a number of different ways that the management can be structured, including a "general partnership" model and a "corporate" model. In the general partnership model, all of the members participate in management decisions. This sort of active involvement in management by all of the members is more common when the LLC has only a few members. In contrast, the members could choose to structure the management of the entity more like a corporation, where the members act as a board of directors for major decision-making, but appoint officers to run the day to day business of the entity.

Member-managed LLCs are most commonly used in situations where either the LLC only has a few members (and all of the members will be actively involved in the business) or it is a single-member LLC. A single-member LLC is often used by an individual owner of a business (in lieu of a sole proprietorship) or as part of a larger corporate structure where the sole member of the LLC is another entity in the ownership chain.

An LLC can also be managed by managers, which managers may or may not also be members of the LLC. In this structure, some or all of the members will be passive investors in the entity, but will not be actively involved in managing the entity. A manager-managed structure might be advantageous when the LLC has a large number of members, some or all of whom do not desire to be actively involved in the business, and in instances where some or all of the members are passive investors only.

A manager-managed structure is often similar to the board of directors in a corporation, and the managing group may even be referred to as a "board of managers" or "board of directors." The operating agreement will set forth the number of managers, which member or members have rights to appoint or elect managers, as well as the rights, powers and duties of the managers.

C. Capital Contributions

The operating agreement will typically address capital contributions of the members, including whether any member will be required to make additional capital contributions in the future. Contributions by members may consist of tangible or intangible property or other benefits to the LLC, including promissory notes, services performed or to be performed, or any other property or interest. The operating agreement usually also contains provisions related to capital accounts of the members and the allocation of profits and losses to the members. These provisions can have important tax consequences and can create unintended tax consequences for a member if they are not drafted carefully. For this reason, it is typical to involve a tax lawyer in drafting and reviewing these provisions to ensure that they properly reflect the business deal among the parties.

D. Distributions

As discussed above, if the operating agreement does not provide otherwise, distributions will be made to members on the basis of the agreed value of the

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member (§ 101.101), the requirement to maintain books and records (§ 101.501), and the prohibition against making a distribution to a member if it would leave the LLC with liabilities that exceed the fair value of the company's assets (§ 101.206). However, even those provisions listed in § 101.054 may be waived or modified if the provision itself contains language permitting waiver or modification in the company's governing documents.

[19] According to data obtained from the Business & Public Filings Division of the Texas Secretary of State, 100,452 of the 134,799 new business filings received by the Texas Secretary of State during 2012 were limited liability companies.

contributions made by each member.[20] This is often not the business deal, and the operating agreement will need to set forth the way that distributions will be calculated, and provide the order in which distributions will be paid to members (often referred to as the "distribution waterfall"). As long as a distribution does not leave the LLC with liabilities that exceed the fair value of the company's assets, the members have considerable freedom to customize the distribution mechanics as they see fit. It is important to consider how the LLC's distribution provisions work together with the provisions regarding allocations of profits and losses, and again, always a good idea to involve a tax lawyer to avoid unintended tax consequences for the members.

E. Transfer of Interests

This section outlines the process by which an existing member may properly sell, assign, dispose of, or transfer its membership interests. The operating agreement typically contains restrictions on the assignment of interests, and may also grant other members in the LLC rights of first refusal before the transferring member may assign its membership interest to a third party.

F. Dissolution and Winding-Up

It is common for an LLC's duration to be "perpetual," however, it is critical that the agreement also provides for the process by which the LLC may be dissolved if and when the members wish to terminate company operations. If the certificate of formation provided for a fixed period of duration for the LLC (which is not common), then the LLC would dissolve upon the expiration of that period. The default rule is that a majority vote of all of the members is required to approve a voluntary winding up of the company.[21] However, this can be modified in the operating agreement to provide for a set percentage of membership interests that are required to voluntarily dissolve (or a unanimous vote), or to provide for certain events that will trigger a mandatory dissolution.

Unlike a general partnership, which does not require any sort of formal filing with the Texas Secretary of State for formation or termination, an LLC does not simply vanish when its members decide to terminate the business. Making sure that an LLC is properly terminated requires additional formal filings with the Secretary of State to ensure no future tax liabilities accrue after the wind-up.

G. Protective Provisions

Certain members may also negotiate special approval rights, often referred to as "protective provisions," in the operating agreement. These provisions typically require the consent of certain members before the company can take a specified list of actions. For example, the management of the company may need the consent of a particular member (often one of the LLC's founders or largest investors) in connection with: amending any governing documents of the LLC; issuance of any senior securities; a potential sale of the company or other major transaction; the hiring of certain executives and/or increase of salaries; increasing the available option pool; the incurrence of indebtedness exceeding a certain set amount; the authorization of capital expenditures exceeding a certain amount; transacting with affiliates; or changing a line of business.

H. Amendments

Although the provision for amending the operating agreement is often grouped together with various "miscellaneous" provisions that are often considered boilerplate, particular care should be given to drafting the amendment provisions of the operating agreement to ensure that they work together with special rights and privileges that have been negotiated in other parts of the agreement. For example, if a particular member with a minority interest (Member A) is given rights to appoint a manager in Section X of the agreement, but the amendment provision states that any amendment may be approved by members holding a majority of the outstanding membership interests, then this may create a situation where the rights negotiated by Member A at the time the agreement is drafted can be immediately taken away by the other members. This potential loophole can be closed, for example, if the amendment provision instead stated that any amendment may be approved by members holding a majority of the outstanding membership interests, except for Section X, which may only be amended with the consent of Member A.

V. CONCLUSION

When it comes to drafting governing documents for a business, the first step is to evaluate the advantages and disadvantages of different entity types and determine which business entity will be the best fit for the business. The governing documents for that entity will provide the framework for the ownership, management and corporate governance structures of the business going forward. It is important to understand how the certificate of formation and operating agreement of an entity will work together, and to carefully draft the operating agreement to reflect the desires and expectations of the parties. Properly drafted governing documents are an essential part of

[20] TEX. BUS. ORGS. CODE ANN. § 101.203.

[21] TEX. BUS. ORGS. CODE ANN. § 101.552.

any new business venture and will set the stage for the relationships, rights and responsibilities of the owners, officers and directors throughout the lifecycle of the business.