DIVISIVE MERGERS: HOW TO DIVIDE AN ENTITY INTO TWO OR MORE ENTITIES UNDER A MERGER AUTHORIZED BY THE TEXAS BUSINESS ORGANIZATIONS CODE

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State Bar of Texas
14th ANNUAL
ADVANCED BUSINESS LAW COURSE
November 17-18, 2016
Dallas

CHAPTER 12

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SELECTED HONORS, PUBLICATIONS AND PRESENTATIONS

Selected by *The Best Lawyers in America*® published by Woodward/White, Inc., as 2017 Austin Securities/Capital Markets Law Lawyer of the Year.

Listed in *The Best Lawyers in America*® published by Woodward/White, Inc., Banking and Finance Law; Corporate Law; Mergers & Acquisitions Law; Securities / Capital Markets Law, 2010-2017.

"Choice of Entities – Who Owns the Deal; Model Company Agreements for Simple LLCs," (co-authored with Prof. Elizabeth S. Miller), State Bar of Texas, 9th Annual Advanced Real Estate Strategies Course, December, 2015.

"Model Company Agreements for Simple LLCs," (co-authored with Prof. Elizabeth S. Miller), University of Texas CLE seminar, July, 2015.

"Top Ten 'Gotchas' in Drafting LLC and Partnership Agreements," University of Texas CLE seminar, July, 2015.

"Exploring the Flexibility Offered by the TBOC Merger Provisions," University of Texas CLE seminar, July, 2014.

"Acquisitions of Professional Firms," State Bar of Texas, 12th Annual Choice and Acquisition of Entities Course, May, 2014.

"Primer: Nuts and Bolts of LLCs, LPs and Partnerships," University of Texas CLE seminar, July, 2013.

"Duties of Managers and Members of LLCs and Partners of Partnerships," State Bar of Texas, Advanced Real Estate Law Course, July, 2013.

"2012 Choice of Jurisdiction Considerations: Texas vs. Delaware," University of Texas CLE seminar, July, 2012.

"Distributions, Profit and Loss Allocations and Tax Reimbursement Provisions," University of Texas CLE seminar, July, 2012.

"Considerations Relating to Negotiating and Drafting Purchase and Sale Agreements," State Bar of Texas, Choice and Acquisition of Entities in Texas Course, May, 2012.

"Capital Contributions, Capital Calls, Financing, Funding and New Equity: Key Planning and Drafting Issues for LLCs, LPs and Partnerships," University of Texas CLE seminar, July, 2011.

"Planning, Drafting and Implementing Capital Call Provisions," University of Texas CLE seminar, July, 2009.

"Sale of Partnership and LLC Interests: A Walk Through Purchase and Sale Agreements," University of Texas CLE seminar, July, 2007.

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DIVISIVE MERGERS: HOW TO DIVIDE AN ENTITY INTO TWO OR MORE ENTITIES UNDER A MERGER AUTHORIZED BY THE TEXAS BUSINESS ORGANIZATIONS CODE

I. INTRODUCTION

The common conception of a merger is the combination of two entities into one surviving entity.[1] However, the Texas Business Organizations Code (the "**TBOC**")[2] provides that through the use of the merger provisions of the code, a Texas domestic entity (an organization formed under or the internal affairs of which are governed by the TBOC[3]) may be divided into two or more new domestic entities or other organizations or into a surviving domestic entity and one or more new domestic or foreign entities or non-code organizations.[4] This division through use of the merger statutes is sometimes called a divisive merger or a divisional merger.[5] These provisions remain unique to Texas, although Pennsylvania provides for a statutory division but does not deal with division in its merger statutes.[6]

Through an illustrative, fictitious case study, this paper will consider the possibilities presented by the Texas divisional merger provisions as a tool to accomplish client goals and will provide a checklist of steps required to accomplish a divisional merger of a Texas limited liability company or limited partnership (including presenting a form plan of merger). This paper will not examine the federal income tax implications of a divisional merger.[7]

[1] Steven A. Bank, *Taxing Divisive and Disregarded Mergers*, 34 Ga. L. Rev. 1523 (2000).

[2] TEX. BUS. ORG. CODE § 101.001 et seq.

[3] TBOC Sec. 1.002(18).

[4] TBOC Sec. 1.002(55)(A).

[5] The Texas divisional merger provisions came into existence when Texas adopted the revised Texas Business Corporation Act in 1989 and have since been expanded to cover not only corporations, but other forms of entities, as described above. Texas Business Corporation Act, 71st Leg., R.S., ch. 801, § 26, 1989 Tex. Gen. Laws 3610, 3629.

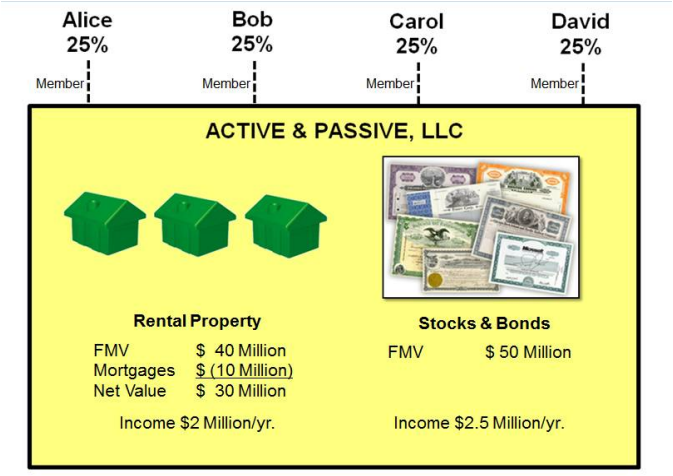
[6] 15 Pa. C.S.A. § 1951, et seq.

[7] See *Tax Consequences of Partnership Divisions* by Craig M. Bergez, presented at The University of Texas School of Law Continuing Legal Education Program on LLC's, LP's and Partnerships.

II. A CASE STUDY

A. Factual Assumptions

To illustrate how the flexible Texas merger statute could be used to solve problems for owners of an entity, let us consider a case study involving a fictitious entity that we will call "Active & Passive, LLC." Let's assume that Active & Passive, LLC is a Texas limited liability company with four individual owners, Alice, Bob, Carol and David, each whom own a 25% membership interest in the company. Let's further assume that Active & Passive, LLC has the following assets: rental real estate properties with an aggregate fair market value of $40 million and a portfolio of stocks and bonds with an aggregate fair market value of $50 million. Let's assume that rental properties are encumbered by mortgages to secure debt aggregating $10 million (so that the equity in the rental properties is $30 million) and that the stocks and bonds are owned free and clear. Let's assume that the rental properties produce rental income each year of $2 million and let's assume that the stock and bonds pay annual dividends and interest equaling $2.5 million. The diagram below illustrates these assumptions.



B. Issues

This case study presents a few issues for the owners of our fictitious company. These issues might be solved by a reorganization of the entity into two entities.

1. Liability Issues

The rental properties are the kind of investment that creates potential liability to its owners. A tenant, guest of a tenant or a worker injured on the premises might sue the owner of the real property in connection with the injury on the theory that the owner was negligent in allowing a dangerous condition to exist on the property. Besides having the company purchase comprehensive liability insurance, the members of

Active & Passive, LLC attempted to address this concern by placing the rental property in a liability shielding entity, a limited liability company. The members of the limited liability company are not liable for obligations or liabilities of the limited liability company,[8] including judgment creditors who obtain a judgment against the company based upon claims related to its rental properties. So far so good. But remember that for purposes of our case study, we assumed that Active & Passive, LLC also owns a portfolio of stocks and bonds. Ownership of passive investments such as stocks and bonds do not create the same kind of risk for claims arising out of the ownership of operating assets, such as rental property. However, because the stocks and bonds are held inside of the company, as assets of the company, these assets will be vulnerable to claims by creditors of the company.

The mixture of assets, rental properties that might generate third party claims and valuable stock and bonds, inside the company, creates a need to separate the assets into two separate entities: one to hold the rental properties and one to hold the stock and bonds. Let's assume for purposes of our case study that there are lock-up agreements or other transfer restrictions which would prohibit easily distributing the stocks and bonds to the owners of the company and that the owners, Alice, Bob, Carol and David, would prefer to keep the portfolio of stocks and bonds together in an entity for ease of management. And, let's assume that the mortgages covering the rental properties have "due on sale" clauses that would be triggered by a transfer of the real estate.

2. State Franchise Tax Issues

There is another reason why Alice, Bob, Carol and David might be motivated to consider a division of Active & Passive, LLC into two entities. And the name of the company is a clue to this issue.

Most entities formed under the laws of the state of Texas or qualified to do business in Texas, including limited liability companies such as Active & Passive, LLC, are subject to franchise tax for the privilege of doing business in Texas.[9] If an entity is operating in multiple states, the amount of tax due to Texas will be based upon gross receipts within Texas as a percentage of gross receipts everywhere.[10] For purposes of our study, let's assume that the rental properties are located in Texas and that the stocks and bonds are issued by Texas companies. Therefore, absent an exception or exemption, all of the annual revenue of Active & Passive, LLC will be taxable by the state of Texas.

There is an exception to the general rule that all entities pay franchise tax. Entities that are defined as "passive entities" under the Texas Tax Code are not included in the entities that must pay Texas franchise tax.[11] The Texas Tax Code defines a "passive entity" as follows:

> 171.0003. Definition of Passive Entity
>
> (a) An entity is a passive entity only if:
>
> (1) the entity is a general or limited partnership or a trust, other than a business trust;
>
> (2) during the period on which margin is based, the entity's federal gross income consists of at least 90 percent of the following income:
>
> (A) dividends, interest, foreign currency exchange gain, periodic and nonperiodic payments with respect to notional principal contracts, option premiums, cash settlement or termination payments with respect to a financial instrument, and income from a limited liability company;
>
> (B) distributive shares of partnership income to the extent that those distributive shares of income are greater than zero;
>
> (C) capital gains from the sale of real property, gains from the sale of commodities traded on a commodities exchange, and gains from the sale of securities; and
>
> (D) royalties, bonuses, or delay rental income from mineral properties and income from other non-operating mineral interests; and
>
> (3) the entity does not receive more than 10 percent of its federal gross income from conducting an active trade or business.
>
> (a-1) In making the computation under Subsection (a)(3), income described by Subsection (a)(2) may not be treated as income from conducting an active trade or business.
>
> (b) The income described by Subsection (a)(2) does not include:
>
> (1) rent; or

[8] TBOC § 101.114.

[9] Texas Tax Code § 171.001 et. seq.

[10] Texas Tax Code § 171.106.

[11] Texas Tax Code § 171.0002(b)(3).

(2) income received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is a member of an affiliated group and another member of that group is the operator under the same joint operating agreement.

Under our case study the $2.5 million of dividends and interest received annually from the portfolio of stocks and bonds held by Active & Passive, LLC would qualify as the type of income that would entitle the recipient to treatment as a passive entity for purposes of the Texas Tax Code.[12] But in our example these receipts are 56% of the annual receipts of the company and the statutory requirement is that at least 90% of annual receipts be "passive" revenue.[13] Note that Texas Tax Code § 171.0003(b) specifically provides that rent does not qualify as the kind of receipt that will be counted as passive. In addition, because Active & Passive, LLC is a limited liability company, it does not qualify as a passive entity.

If there were a way to restructure the ownership of assets so that the portfolio of stocks and bonds was held by a limited partnership and the rental properties were held in a separate entity, then the limited partnership would potentially qualify as a passive entity and avoid the Texas franchise tax. Remember that for purposes of our case study, we assumed that Active & Passive, LLC has agreed not to transfer the stocks and bonds without the consent of third parties who refuse to consent to a distribution of the assets and that the mortgages prevent a transfer of the rental properties.

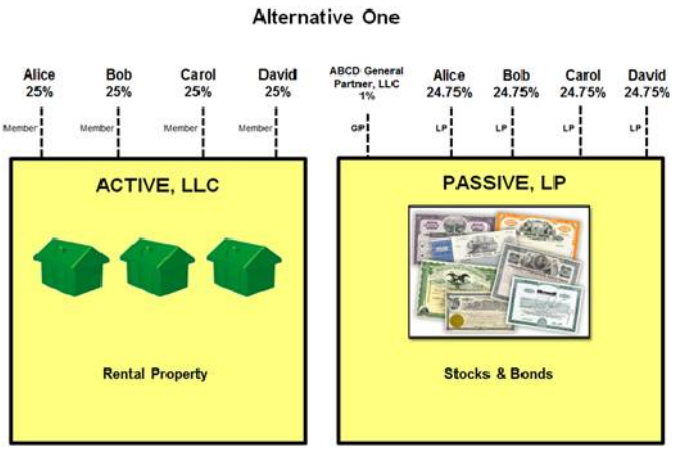
These facts thus set the stage for using the Texas merger statute to divide Active & Passive, LLC into two new entities, an entity that we will call Active, LLC that will own the rental properties and an entity that we will call Passive, LP, that will own the stocks and bonds.[14]

C. Alternative Plans

Having set the stage for a division of Active & Passive, LLC into two new entities, Active, LLC and Passive, LP, let's examine some alternatives for structuring the transaction.

1. Alternative One

One alternative for planning the division would involve dividing the company using a divisional merger into the two resulting entities and giving each of the current owners of Active & Passive, LLC an equivalent ownership interest in the two resulting entities. Because limited partnerships must have at least one general partner, there must be an interim step, the creation of a general partner entity. The general partner of a limited partnership is generally liable for the liabilities of the entity.[15] Even though the assets that will end up in Passive, LP will be the kind of assets that do not typically produce liabilities, let us assume that none of the individual owners wish to serve as general partner. Therefore an interim step will be required: the formation of an entity to serve as the general partner and the contribution by the owners of a small portion of their respective interests to the new general partner entity in exchange for ownership of the entity. We will assume that the general partner entity will be a limited liability company owned equally by the four owners and we will call it ABCD General Partner, LLC. The diagram below illustrates Alternative One.



2. Alternative Two

The Texas merger statute does not require that all of the owners of the original entity must be owners of each of the resulting entities.[16] Let us assume for purposes of our case study that Alice and Bob are bullish in the real estate market and believe that the potential appreciation in real estate values will outpace the stock and bond markets. They want to continue to

[12] Texas Tax Code § 171.0003(a)(2)(A).

[13] Texas Tax Code § 171.0003(a)(2).

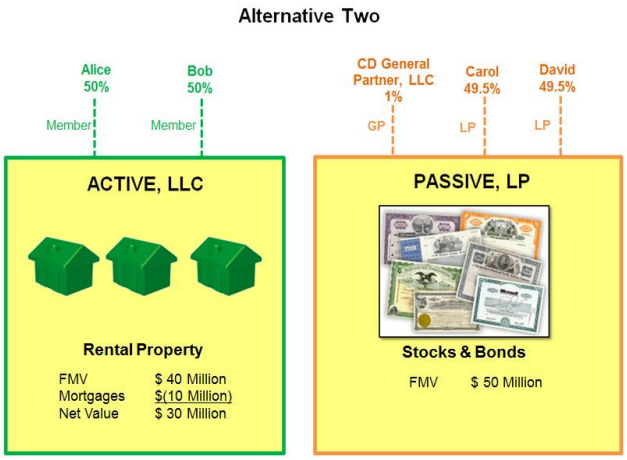
[14] In the "real world" the name "Passive, LP" might not be available because it might be deceptively similar to an existing entity, including the merging entity. To avoid a rejected filing, the practitioner would need to check the name availability of the new entity prior to filing the required Certificate of Merger.

[15] TBOC § 152.304.

[16] TBOC § 10.002(5)(A).

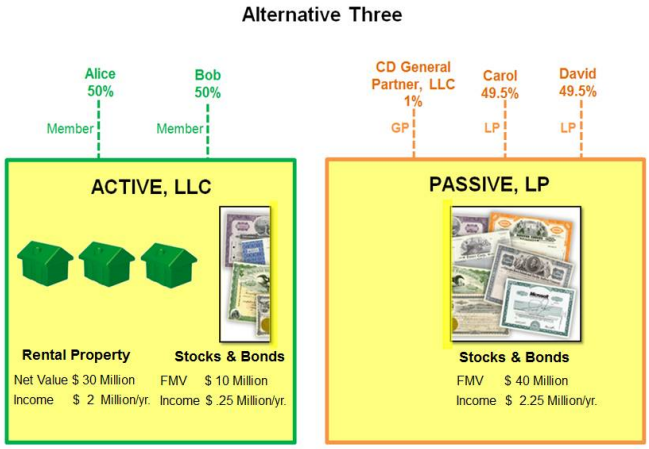
own and operate the rental properties but do not want to continue to own the stocks and bonds. Let's also assume that Carol and David are more risk adverse than their co-owners Alice and Bob and that they also believe the stock and bonds represent a greater future growth opportunity than the real estate and they want to continue to own the stocks and bonds and not the real estate.

To address these desires, the solution might be to form a general partner entity only owned by Carol and David, let's call it CD General Partner, LLC, with Carol and David (and not Alice and Bob) contributing part of their interest to the new general partner entity, then splitting Active & Passive, LLC into two resulting entities: Active, LLC owned by Alice and Bob, and Passive, LP owned by CD General Partner, LLC, as general partner, and Carol and David, as limited partners. The diagram below illustrates Alternative Two.



3. Alternative Three

To add one additional twist in our long, and now rather involved, tale, let's assume that even the foregoing structure does not totally satisfy the owners. This is because this structure would result in assets with a fair market value of $50 million (the entity portfolio of stocks and bonds) being owned by Carol and David's entity, while the assets owned by Alice and Bob's entity would only have a value (net of liabilities) of $30 million. Alice, Bob, Carol and David each indirectly owned a fourth of the total assets before the reorganization and Alice and Bob would own indirectly less than a fourth the value of the combined assets under the reorganization described in Alternative Two. To resolve this situation, lets add one final twist to our case study situation. Let's assume that a portion of the stocks and bonds with a fair market value of $10 million will remain in Active, LLC (giving it a total value of assets, net of liabilities of $40 million) and the balance of the stock and bonds, also with a market value of $40 million, will end up in Passive, Ltd. The diagram below illustrates Alternative Three.



III. STEPS TO ACCOMPLISH A DIVISIONAL MERGER

Having now set the stage for our divisional merger of Active & Passive, LLC into two resulting entities, Active, LLC and Passive, LP, let's examine the steps involved in completing the transaction. The first steps involve due diligence that needs to be conducted and the results considered in planning the transactions. The remainder of the steps relate to the transaction itself.

A. Due Diligence; Third Party Consents

The TBOC provides that when a merger takes place, the assets of the parties become vested in the parties to the merger according to the plan of merger and no sale or transfer of the assets occurs. The relevant provisions are quoted below:

BOC § 10.008. EFFECT OF MERGER

(a) When a merger takes effect:
(1) the separate existence of each domestic entity that is a party to the merger, other than a surviving or new domestic entity, ceases;
(2) all rights, title and interests to all real estate and other property owned by each organization that is a party to the merger is allocated to and vested, subject to any existing liens or other encumbrances on the property, in one or more of the surviving or new organizations as provided in the plan of merger without:
(A) reversion or impairment;
(B) any further act or deed; or

(C) any transfer or assignment having occurred; . . .

Notwithstanding these provisions, as part of the due diligence for the transaction, it will be important to examine all relevant documents, including the mortgages encumbering any real property, and any contractual provisions, such as the lock-up agreements mentioned for the stocks and bonds owned by Active & Passive, LLC to determine if they contain contractual obligations of the entity that provide, either explicitly or by interpretation, that the transaction requires third party consents.

The "due on sale" clauses in the Form 22-1 Deed of Trust published in the *2014 Texas Real Estate Forms Manual, 2nd ed.* provide as follows:

> *E.10.* If Grantor transfers any part of the Property without Lender's prior written consent, Lender may declare the Obligation immediately payable and invoke any remedies provided in this deed of trust for default. If the Property is residential real property containing fewer than five dwelling units or a residential manufactured home, this provision does not apply to (a) a subordinate lien or encumbrance that does not transfer rights of occupancy of the Property; (b) creation of a purchase-money security interest for household appliances; (c) transfer by devise, descent, or operation of law on the death of a co-Grantor; (d) grant of a leasehold interest of three years or less without an option to purchase; (e) transfer to a spouse or children of Grantor or between co-Grantors; (f) transfer to a relative of Grantor on Grantor's death; (g) a transfer resulting from a decree of dissolution of marriage, a legal separation agreement, or an incidental property settlement agreement by which the spouse of Grantor becomes an owner of the Property; or (h) transfer to an inter vivos trust in which Grantor is and remains a beneficiary and occupant of the Property.
>
> *E.10.* Grantor may not sell, transfer, or otherwise dispose of any Property, whether voluntarily or by operation of law, without the prior written consent of Lender. If granted, consent may be conditioned upon (a) the grantee's integrity, reputation, character, creditworthiness, and management ability being satisfactory to Lender; and (b) the grantee's executing, before such sale, transfer, or other disposition, a written assumption agreement containing any terms Lender may require, such as principal pay down on the Obligation, an increase in the rate of interest payable with respect to the Obligation, a transfer fee, or any other modification of the Note, this deed of trust, or any other instruments evidencing or securing the Obligation.

Notice that Paragraph E.10 of the Deed of Trust set out above states that "Grantor may not … transfer or otherwise dispose of any Property voluntarily or by operation of law …". Assuming that the Deeds of Trust for the rental properties owned by Active & Passive, LLC have this language or similar language, would a divisional merger that resulted in a different entity owning the property be a transfer or disposition "by operation of law," notwithstanding TBOC § 10.008, which states that divisional merger is not a transfer? If the parties or their counsel have any concern about this outcome, then the solution, which will work in our case study, might be to have the limited liability company survive the merger so the same entity, a Texas limited liability company, will own the assets before and after the transaction. In fact, consideration might be given to keeping the same name to avoid any confusion.

Also consider that the merger may trigger other provisions of company contracts besides the transfer or assignment provisions. For instance, if the entity that is being divided is the party to a loan agreement, does the loan agreement include financial covenants that will be impacted by the transaction? Can the entity that retains the loan liabilities as part of the division transaction continue to satisfy the loan covenant provisions after the merger? Or perhaps the divisional merger would improve the entity's ability to meet its financial covenants by moving unproductive assets or unrelated liabilities into the entity that does not retain the loan liability.

B. Due Diligence; Fraudulent Conveyance Laws

Consideration should be given to whether the proposed reorganization will be subject to attack as a fraudulent transfer. The Texas Uniform Fraudulent Transfer Act[17] allows a creditor to bring an action to void a transfer that is found to be fraudulent.[18] TBOC § 10.008(a)(2) provides that "all rights, title and interests to all real estate and other property … is

[17] TEX. BUS. & COM. CODE ANN. §§ 24.001 et seq.

[18] TEX. BUS. & COM. CODE ANN.§ 24.008 (West 2009).

vested … in … the surviving or new organizations as provided in the plan of merger without ... any further act or deed … or … any transfer or assignment having occurred." TBOC § 10.008(a)(4) provides that all liabilities are allocated according to the plan of merger "except as otherwise provided … by law." It remains unsettled whether a divisional merger could be attacked as a fraudulent transfer. However, one could certainly imagine an egregious situation where all assets were allocated to one party to the merger and all liabilities were allocated to another party without assets and creditors might attempt to void the transaction as a fraudulent conveyance. This possibility should be considered in planning a divisional merger and if there is a concern, then the parties might consider obtaining a fairness opinion or taking other measures to gain comfort that the transaction would withstand such an attack.

Texas courts have held that a merger does not violate a non-assignability clause in a contract.[19] However, a federal court where a Texas divisional merger seemed to be involved recently held that, state law notwithstanding, a merger that resulted in two intellectual property licenses being owned by an entity as a result of a merger that was different than the entity that was initially granted the licenses was an invalid transfer under federal common law regarding intellectual property rights.[20]

C. Due Diligence; Dissenter's Rights

Shareholders of Texas corporations and owners of certain other entities are entitled, under detailed provisions of the TBOC, to assert dissenters rights objecting to the terms of the merger and obtaining an appraisal.[21] Partnerships and limited liability companies are not subject to the statutory rights of dissent and appraisal unless the entity's operating agreement specifically grants these rights.[22] Therefore, one last due diligence item might be to check the company agreement or the partnership agreement to confirm that no contractual rights of dissent and appraisal have been granted.

D. Plan of Merger

The TBOC requires a written plan of merger and contains specific and detailed provisions that must be included in the plan or merger.[23] The plan of merger is, in effect, the road map for the merger that provides how the assets and liabilities of the entities will be divided in a divisional merger and what the ownership will be of the resulting entities.

A form of Plan of Merger for the transaction described as Alternative Three above is attached hereto as **Appendix A**.

Note that it is important to include all assets and liabilities (including contingent liabilities) in the plan of merger. The TBOC states[24] that if the Plan of Merger does not provide for allocation of any asset, then the asset is owned jointly by the surviving entities pro rata based upon the number of surviving entities. Thus in our case study, any asset that the parties failed to cover in the plan of merger would be owned 50% by Active, LLC and 50% by Passive, LP, as joint owners. If the Plan of Merger does not provide for allocation of any liability, then the liability will be a joint and several liability of the surviving entities pro rata based upon the number of surviving entities. Thus in our case study, any liability that the parties failed to cover would be a joint and several liability of both new entities. Because it is a joint liability, a creditor could seek to recover against either entity and an entity suffering a loss as a result would have a right of contribution for 50% of the loss from the other entity.

E. Approval of the Plan of Merger

The TBOC requires that a plan of merger must be approved by the entity.[25] The TBOC contains detailed provisions for approval of a merger by a corporation.[26] The TBOC provides that the partnership agreement of each domestic partnership that is a party to a merger must contain provisions authorizing the merger. [27] If the entity being divided is a partnership, then an interim step may be amending the partnership agreement to insert such a provision. In our case study, the merging entity is a limited liability company. The governing provisions regarding approval of a merger by a Texas limited liability company are found in TBOC § 101.356(c):

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[19] *TXO Production Co. v. M.D. Mark, Inc.*, 999 S.W.2d 137 (Tex. App. – Houston [14th Dist.] 1999, pet. denied).

[20] *Cincom Sys. V. Novelis Corp.* 581 F.3d 431 (6th Cir. 2009).

[21] TBOC § 10.354.

[22] TBOC § 10.351.

[23] TBOC § 10.002.

[24] TBOC § 10.008(b).

[25] TBOC § 10.001(a).

[26] TBOC § 21.452.

[27] TBOC § 10.009(f).

> "(c) [A] fundamental business transaction of a limited liability company . . . must be approved by the affirmative vote of the majority of all of the company's members."

A merger is defined as a "fundamental business transaction" by the TBOC.[28] It is interesting to note that these provisions call for approval by a majority in number of the members of the limited liability company rather than voting according to ownership percentages. This presents a bit of a trap for the unwary because it gives owners who represent a majority of the number of members the right to veto a merger (or other fundamental business transaction) even if they do not own a majority of the percentage interests of the company. For this reason, this provision of the TBOC is often altered by a provision in the company agreement, as permitted by the TBOC.[29]

A form of Consent of Members Approving the Plan of Merger for the transaction described as Alternative Three is attached hereto as **Appendix B**.

F. Agreement of the Owners

The TBOC requires that the entity approve the Plan of Merger, but it does not require that the owners of the entity enter into an agreement regarding the merger. However, if the result of the merger is multiple entities with different ownership of the resulting entities, then it may be prudent for the owners to enter into an agreement of merger that covers items not covered by the plan of merger, such as representations and warranties about the assets and liabilities of the entity (which may serve as a basis for valuation of the assets in the division), and reciprocal indemnities.

G. Certificate of Merger

The TBOC[30] requires the filing of a Certificate of Merger for a merger in which any party to the merger or any survivor of the merger is a "filing entity" (that is a corporation, limited partnership, limited liability company, professional association, cooperative, or real estate investment trust)[31]. Our case study, the division of Active & Passive, LLC into Active, LLC and Passive, LP, would require the filing of a Certificate of Merger with the Texas Secretary of State. The merger becomes effective upon the filing of the Certificate of Merger. [32]

A form of Certificate of Merger for the transaction described as Alternative Three is attached hereto as **Appendix C**.

H. Certificates of Formation

TBOC § 10.151(b)(E) requires that a Certificate of Merger must state that a Certificate of Formation is being filed for each new filing entity to be created under the Plan of Merger. This serves as reminder to draft and file the new certificates which are typically attached to the Certificate of Merger.

I. Operating Agreements

Likewise, new operating agreements will need to be prepared and signed for each new entity that is created under the plan of merger. In addition, the operating agreement of the surviving entity may need to be amended to, for example, reflect a name change or change in members. Note that the Certificate of Formation of the surviving entity may be amended in the Certificate of Merger and the governing documents of the surviving entity may be amended in the Plan of Merger.[33]

IV. Summary and Conclusion

In summary, the unique Texas merger provisions allow not only for multiple entities to be combined into one resulting entity, but allow that one Texas entity may be split into two or more entities. One Texas limited liability company could be split into one surviving Texas limited liability company, two new Texas corporations, three new Texas limited partnerships, four new Texas general partnerships, and one new Texas nonprofit corporation. The possibilities are limitless. The TBOC merger provisions also provide that the ownership of the resulting entities does not have to match the ownership of the original entity and in fact an owner of the original entity may receive no ownership of any resulting entity. In a Texas divisional merger, the Plan of Merger adopted by the owners of the entity, as provided in the TBOC or the operating agreement of the entity, will spell out which assets will be owned by which resulting entity and who the owners of each entity will be. These provisions give owners of Texas entities and their counsel, the opportunity to be creative and highly flexible in using this statute to restructure Texas entities.

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[28] TBOC § 1.002(32).

[29] See TBOC § 101.052(d) and § 101.054(b).

[30] TBOC § 10.151.

[31] TBOC § 1.002 (22).

[32] TBOC § 10.007.

[33] TBOC § 10.004(a).

The TBOC specifically provides that division of an entity by merger is not a transfer of assets and this may also allow the entity to avoid the limitations of, or time consuming and costly requirements for, prior consents. But caution should be exercised during the planning stages of the transaction to be sure not to run afoul of any broadly drafted transfer restriction provisions in contracts to which the merging entity is party or of any situations where federal law or specific state law might trump the TBOC merger provisions.

Finally, federal income tax provisions are beyond the scope of this paper, but it should be noted that divisional mergers of entities, particularly of entities federally taxed as partnerships (including most limited liability companies) raise a myriad of complex federal income tax issues.

The case study presented in the paper and the attached forms may be helpful tools for an entity and its counsel considering a divisional merger. Happy dividing!

Appendix A

FORM[1] OF PLAN OF MERGER

DIVISIONAL MERGER OF ACTIVE & PASSIVE, LLC INTO TWO TEXAS ENTITIES

This Plan of Merger is entered into as of the ___ day of _____, 20__ by Active & Passive, LLC, a Texas limited liability company (the "Merging Entity").

W I T N E S S E T H:

WHEREAS, The Merging Entity is a limited liability company duly organized and existing under the laws of the State of Texas; and

WHEREAS, the Manager and Members of the Merging Entity deem it advisable and in the best interests of such entity that the Merging Entity be divisionally merged to become two separate entities (the "Merger"), as authorized by the statutes of the State of Texas, under and pursuant to the terms and conditions hereinafter set forth; and

WHEREAS, as a result of the Merger, the surviving entities will be the Merging Entity and Passive, LP, a newly formed Texas limited partnership (collectively, the "Post Merger Entity"); and

WHEREAS, as a result of the merger, the name of the surviving entity will be changed to Active, LLC;

NOW, THEREFORE, in consideration of the premises and the mutual covenants and agreements herein contained, and for the purpose of setting forth the terms and conditions of the Merger, the mode of carrying the same into effect, the manner and basis of converting the membership interests of the Merging Entity into ownership interests of the Post Merger Entities and such other details and provisions as are deemed necessary or desirable, the parties hereto have agreed and do hereby agree, subject to the conditions hereinafter set forth, as follows:

1. The name, organizational form, and jurisdiction of formation of each entity that is a party to the Merger is:

   (a) Active & Passive, LLC, a Texas limited liability company.

2. The name of the entity that will survive the merger is:

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(a) Active & Passive, LLC, a Texas limited liability company.

3. The name, organizational form, and jurisdiction of formation of the new organization that is to be created by this Plan of Merger are:

(a) Passive, LP, a Texas limited partnership.

4. The terms and conditions of the Merger are (in addition to those set forth elsewhere in this Plan of Merger) as follows:

At the Effective Time of the Merger (as hereinafter defined):

(a) The Merging Entity shall be divided into two separate entities, which shall be the Merging Entity and Passive, LP.

(b) The separate existence of the Merging Entity shall continue after the Merger.

(c) The property of the Merging Entity shall be allocated and vested among the Post Merger Entities as outlined in Exhibit A attached hereto.

(d) All property, rights, privileges, powers and franchises, and all and every other interest shall be thereafter as effectually the property of the Post Merger Entity to which it is assigned under Exhibit A, and the title to any real estate vested by deed or otherwise in the Merging Entity shall not revert or be in any way impaired by reason of the Merger; but all rights of creditors and all liens upon any property of the Merging Entity shall be preserved unimpaired, and all debts, liabilities and duties of the Merging Entity shall thenceforth attach to the Post Merger Entity to which it is assigned under Exhibit A, and may be enforced against it to the same extent as if said debts, liabilities and duties had been incurred or contracted by it.

(e) All acts, plans, policies, contracts, approvals and authorizations of the Merging Entity and its members, managers, officers, or committees elected or appointed by the members, managers, officers and agents, which were valid and effective immediately prior to the Effective Time of the Merger shall be taken for all purposes as the acts, plans, policies, contracts, approvals and authorizations of the Post Merger Entities and shall be as effective and binding thereon as the same were with respect to the Merging Entity.

(f) The manner and basis of allocating each liability and obligation of the Merging Entity to the Post Merger Entities is set forth on Exhibit B attached hereto.

(g) The assets, liabilities, reserves and accounts of the Merging Entity shall be recorded on the books of the Post Merger Entities as described in Exhibit B subject to such adjustments or eliminations of intercompany items as may be appropriate in giving effect to the Merger.

(h) The Post Merger Entities shall be responsible for all fees and franchise taxes of the Merging Entity as described in Exhibit B, and the Post Merger Entities shall be obligated to pay such fees and franchise taxes if the same are not timely paid.

5. The Certificate of Formation of the Merging Entity, as amended and existing and constituted immediately prior to the Effective Time of the Merger shall, upon the Merger's becoming effective, be and constitute the Certificate of Formation of the Merging Entity until amended in the manner provided by law, subject to the filing of a Certificate of Merger reflecting the following change:

(a) Article I shall read in its entirety as follows: The name of the limited liability company is Active, LLC.

6. The Certificate of Formation for Passive, LP to be filed with the Secretary of State at the time of filing of the Certificate of Merger is attached hereto as Exhibit C.

7. The Company Agreement of the Merging Entity, as amended and existing and constituted immediately prior to the Effective Time of the Merger shall, upon the Merger's becoming effective, be and constitute the Company Agreement of the Merging Entity until amended in the manner provided by law, subject to the following changes:

(a) All references in the Company Agreement to "Active & Passive, LLC" shall be changed to "Active, LLC"; and

(b) Exhibit A to the Company Agreement showing the names and Percentage Interests of the Members shall be amended to reflect the change in Members and Percentage Interests set forth in Exhibit E hereto.

8. The Agreement of Limited Partnership for Passive, LP, which will take effect upon the filing of the Certificate of Merger, is attached hereto as Exhibit D.

9. The manner and basis of converting the membership interests of the Merging Entity into ownership interests of the Post Merger Entities and the mode of carrying the Merger into effect are outlined in Exhibit E.

10. This Plan of Merger shall be submitted to the members of the Merging Entity as provided by Chapter 10 and § 101.356 of the Texas Business Organizations Code ("TBOC") and as required by the Company Agreement of the Merging Entity. After the approval or adoption thereof by the members of the Merging Entity in accordance with the requirements of the laws of the State of Texas and the Company Agreement of the Merging Entity, all required documents shall be executed, filed and recorded and all required acts shall be done in order to accomplish the Merger under the provisions of the applicable statutes of the State of Texas.

11. The Merging Entity shall bear and pay all costs and expenses incurred by it or on its behalf (including without limitation fees and expenses of financial consultants, accountants and counsel) in connection with the consummation of the Merger.

12. At any time, whether before or after submission to or adoption by the members of the Merging Entity, this Plan of Merger may be amended in matters of form, or supplemented by additional agreements, articles or certificates, as may be determined in the judgment of the members of the Merging Entity to be necessary, desirable or expedient to clarify the intentions of the parties hereto or to effect or

facilitate the filing, recording or official approval of this Plan of Merger and the consummation hereof and the Merger provided for herein, in accordance with the purpose and intent of this Plan of Merger.

13. The Merger shall become effective (such time of effectiveness being herein referred to as the "Effective Time of the Merger") when all the following actions shall have been taken:

(a) this Plan of Merger shall have been adopted and approved on behalf of the Merging Entity in accordance with the TBOC and the Company Agreement of the Merging Entity; and

(b) a Certificate of Merger, setting forth the information required by, and executed and verified in accordance with, the TBOC, shall have been filed in the office of the Secretary of State of the State of Texas.

14. This Plan of Merger cannot be altered or amended except pursuant to an instrument in writing signed on behalf of the parties hereto.

IN WITNESS WHEREOF, the Merging Entity has caused this Plan of Merger to be executed by its Manager pursuant to authorization contained in the Consent of Members approving this Plan of Merger, all as of the date first above written.

ACTIVE & PASSIVE, LLC a Texas limited liability company

By:_____
Name: Alice
Its: Manager

EXHIBIT A

TO PLAN OF MERGER

The rights, privileges, powers and franchises of a public as well as a private nature, and all property, real, personal and mixed, and all debts due to the Merging Entity on whatever account, as well for stock subscriptions as all other things in action or belonging to the Merging Entity, shall be divided among the Post Merger Entities as follows:

Passive, LP

Passive, LP will receive all interests in the following entities owned by Active & Passive, LLC:

[List of Stocks and Bonds to be owned by Passive, LP.]

Active, LLC (formerly known as Active & Passive, LLC)

Active, LLC (formerly known as Active & Passive, LLC) will retain all other assets held by it prior to the merger, including without limitation, the following:

[Property descriptions of Rental Properties.]

[Lists of Stocks and Bonds to be owned by Active, LLC.]

EXHIBIT B

TO PLAN OF MERGER

The liabilities and obligations, including the responsibility for all fees and franchise taxes of the Merging Entity will be distributed among the Post Merger Entities as follows:

Passive, LP

0% of the promissory notes and property taxes described below as retained by Active, LLC (formerly known as Active & Passive, LLC).

100% of all Texas franchise taxes with respect to any period ending on or before the Effective Time of the Merger.

50% of all other liabilities and obligations, including all fees and franchise taxes.

Active, LLC (formerly known as, Active & Passive, LLC)

100% of the following obligations:

[List of notes secured by mortgages.]

All real property taxes associated with the real property described in **Exhibit A**.

50% of all other liabilities and obligations, including all fees and franchise taxes, other than Texas franchise taxes allocated to Passive, LP as set forth above.

EXHIBIT C

TO PLAN OF MERGER

CERTIFICATE OF FORMATION OF
PASSIVE, LP

EXHIBIT D

TO PLAN OF MERGER

AGREEMENT OF LIMITED PARTNERSHIP OF
PASSIVE, LP

EXHIBIT E

TO PLAN OF MERGER

The manner and basis of converting the membership interests of the Merging Entity into ownership interests of the Post Merger Entities are as follows:

The membership interests of Alice and Bob will be converted into the following Percentage Interests in Active, LLC (formerly known as Active & Passive, LLC):

Name	Percentage Interest
Alice	50%
Bob	50%

The membership interests of CD General Partner, LLC, Carol and David in the Merging Entity will be converted into the following interests of Passive, LP:

Name	Interest
CD General Partner, LLC	1% General Partner Interest
Carol	49.5% General Partner Interest
David	49.5% General Partner Interest

APPENDIX B

FORM[1] OF
ACTIVE & PASSIVE, LLC
CONSENT OF MEMBERS

The undersigned, being all of the Members of Active & Passive, LLC, a Texas limited liability company (the "Company"), do hereby consent to the adoption of the following resolutions:

WHEREAS, the undersigned deem it advisable and in the best interests of the Company that the Company engage in a divisional merger (the "Merger") by dividing into two separate surviving entities, the Company and Passive, LP ("Passive");

NOW, THEREFORE, IT IS

RESOLVED, that the undersigned hereby adopt, approve, ratify and confirm the provisions of the Plan of Merger of even date herewith (the "Plan of Merger"), a true and correct copy of which is attached to these resolutions as Exhibit A and incorporated by reference; and further

RESOLVED, that subject to the terms and conditions of the Plan of Merger of even date herewith, the Company shall divide into two separate surviving entities, the Company and Passive; and further

RESOLVED, that the Manager of the Company is authorized to execute, for and in the name and on behalf of the Company, the Plan of Merger, in substantially the form attached hereto as Exhibit A, with such changes therein as it may approve, such approval to be conclusively evidenced by her execution thereof; and further

RESOLVED, that the Manager of the Company is authorized to file a Certificate of Merger with the office of the Secretary of State of the State of Texas, to pay the filing fee therefor and to take such other action and to pay such other expenses as may be necessary for the completion of the Merger; and further

RESOLVED, that the Manager of the Company is authorized to take all actions and to execute and file all documents that are necessary or convenient to carry out and perform the provisions of the Merger.

This Consent of Members may be executed in any number of counterparts or with counterpart signature pages, each of which shall be deemed an original, but all of which shall constitute one and the same instrument.

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Executed to be effective _____, 20____.

MEMBERS:

_____
Ann

_____
Bob

_____
Carol

_____
David

CD GENERAL PARTNER, LLC

By:_____
Name: Carol
Title: Manager

EXHIBIT A

TO CONSENT OF MEMBERS

PLAN OF MERGER

APPENDIX C

FORM[1] OF CERTIFICATE OF MERGER[2]

DIVISIONAL MERGER

Merging Entity Information: Pursuant to Chapter 10 of the Texas Business Organizations Code, and the title applicable to the filing entity, the undersigned submits this Certificate of Merger to divide itself into two or more new domestic entities or otherwise organize or divide itself into a surviving domestic entity and one or more domestic or foreign entities or non-code organizations.

1. The name of the domestic filing entity that is dividing itself is Active & Passive, LLC.

2. Its principal place of business is _____.

3. The file number issued to the filing entity by the Secretary of State is _____.

4. The entity is organized as a Texas limited liability company.

5. The filing entity will survive the merger.

6. Article I of the Certificate of Formation of the filing entity is amended to read in its entirety as follows: The name of the limited liability company is Active, LLC.

7. In lieu of providing the Plan of Merger, the domestic filing entity certifies that:

   a. A signed Plan of Merger is on file at the principal place of business of each surviving, acquiring, or new domestic entity or non-code organization provided in this form.

   b. On written request, a copy of the Plan of Merger will be furnished without cost by each surviving, acquiring, or new domestic entity or non-code organization to any owner or member of any domestic entity that is a party to or created by the Plan of Merger.

8. Organizations Created by the Merger:

   The name, jurisdiction of organization, principal place of business address, and entity description of each entity or other organization to be created pursuant to the Plan of Merger are set forth below. The Certificate of Formation of the domestic entity to be created are attached to this Certificate of Merger as Exhibit A.

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[2] A form of Certificate of Merger and accompanying instructions is also available on the Texas Secretary of State's website at http://www.sos.state.tx.us/corp/forms_boc.shtml (Form 621).

Name of New Organization: Passive, LP.

Jurisdiction: Texas
Entity Type: limited partnership

Principal Place of Business: _____.

9. The Plan of Merger has been approved as required by the laws of the jurisdiction of formation and by the governing documents of the merging filing entity.

10. In lieu of providing the tax certificate, the newly created organization will be liable for the payment of the required franchise taxes.

Dated _____, 20___.

ACTIVE & PASSIVE, LLC

By: _____
Name: Alice
Title: Manager

EXHIBIT A

TO
CERTIFICATE OF MERGER
DIVISIONAL MERGER

Certificate of Formation