

TEXAS JOURNAL OF BUSINESS LAW

Volume 45

Fall 2012

Number 1

CONTENTS:

SUPPLEMENT NO. 5 TO THE REPORT OF THE LEGAL OPINIONS COMMITTEE REGARDING LEGAL OPINIONS IN BUSINESS TRANSACTIONS <i>Legal Opinions Committee of the Business Law Section of the State Bar of Texas</i>	1
SERIES LLCs: NUTS AND BOLTS, BENEFITS AND RISKS, AND THE UNCERTAINTIES THAT REMAIN <i>Jennifer Avery, David Lawrence, Todd Lowther, Karen Rose, Joshua Russ, Brandon Schubert, Andrew Wootton & Travis Youngblood</i>	9
PRACTICAL PITFALLS IN DRAFTING TEXAS LIMITED LIABILITY COMPANY AGREEMENTS <i>Elizabeth S. Miller</i>	27
THE SERIES LLC: A NEW PLANNING TOOL <i>Adrienne Randle Bond & Allen Sparkman</i>	57
RECENT BUSINESS DEVELOPMENTS	
<i>Bankruptcy Law</i>	89
<i>Guaranty and Suretyship Law</i>	93
<i>Partnership Law</i>	97

CORRECTION AND APOLOGY

The Texas Journal of Business Law published the following article in volume 44, issue 3: Roger B. Greenberg, *Fifth Circuit Class Certification Update: Is the Fraud-on-the-Market Presumption Alive and Well in the Fifth Circuit?* Without consulting with the author, the Journal inadvertently published this article, which was written before the United States Supreme Court granted certiorari in *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011) and thus, does not reflect the United States Supreme Court's decision in that case. In its decision, the Supreme Court rejected the requirement of the United States Court of Appeals for the Fifth Circuit, discussed in the article, that securities plaintiffs must demonstrate loss causation at the class certification stage as a prerequisite to obtaining class certification. The Journal apologizes for this error. A summary of the Supreme Court's decision will appear in a forthcoming issue.

COPYRIGHT

Copyright © 2012, Business Law Section of the State Bar of Texas
(U.S. ISSN 1547-3619)

Cite as: TEX. J. BUS. L.

Articles in this publication may be reproduced and distributed, in whole or in part, by nonprofit institutions for educational purposes including distribution to students, provided that the copies are distributed at or below cost and identify the Author, the Journal, the volume, the number of the first page, and the year of the article's publication.

The statements and opinions in the **TEXAS JOURNAL OF BUSINESS LAW** are those of the editors and contributors and not necessarily those of the State Bar of Texas, the Business Law Section, South Texas College of Law, or any government body. This publication is designed to provide accurate and authoritative information in regard to the subject matter covered and is made available with the understanding that the publisher is not engaged in rendering legal or other professional service. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

ABOUT THE JOURNAL

The **TEXAS JOURNAL OF BUSINESS LAW** is dedicated to providing Texas attorneys and academics with comprehensive, up-to-date coverage of the ever-changing and rapidly expanding field of business law. The Journal presently has over 4,000 subscribers, making it one of the most widely circulated student-run publications in Texas, as well as one of the largest business law journals in the nation. The Journal is also the official publication of the Business Law Section of the State Bar of Texas. Please visit the Business Law Section's website at www.texasbusinesslaw.org.

MISSION STATEMENT

The mission of the **TEXAS JOURNAL OF BUSINESS LAW** is to serve as a leading source in the practice of business law in Texas. The Journal is dedicated to providing comprehensive, practical, and current information for practicing attorneys, judges, students, and academics. To this end, the Journal will strive to provide accurate, reliable, and contemporary information regarding the practice of business law in Texas.

In order to assure the ability to provide quality information, the Journal will select only the highest quality student members and will provide an invaluable learning and support network for students.

SUBMISSIONS

The **TEXAS JOURNAL OF BUSINESS LAW** welcomes article submissions from judges, practitioners, and academics. Articles should address an area of business law relevant to Texas legal practitioners and be written in a style suitable for a law journal. Article submissions must be in Microsoft Word format, include a Table of Contents, include an Abstract, contain footnotes rather than endnotes, and conform to both *The Bluebook: A Uniform System of Citation* (19th ed.) and the *Texas Rules of Form* (12th ed.). Submissions should be addressed to:

Texas Journal of Business Law
Attn: Submissions
C/O South Texas College of Law
1303 San Jacinto Street, Suite 307
Houston, Texas 77002

Please include a hard copy of the article, an article abstract, and CD with both the article and the abstract. Alternatively, submissions may be made electronically via email to tjblawme@stcl.edu. All submissions are reviewed by a committee composed of student Journal members, faculty advisers, and practitioners in the Business Law Section of the State Bar of Texas.

SUBSCRIPTIONS

A subscription to the **TEXAS JOURNAL OF BUSINESS LAW** is included as a benefit of membership in the Business Law Section of the State Bar of Texas. For an additional subscription to the Journal, or to subscribe without joining the Section, please contact the Sections Department of the State Bar of Texas at 1-800-204-2222 or at:

State Bar of Texas
Attn: Sections Department
P.O. Box 12487
Austin, Texas 78711

REPRINTS

For back issues, please contact:

Texas Journal of Business Law
Attn: Reprints
C/O South Texas College of Law
1303 San Jacinto Street, Suite 307
Houston, Texas 77002
tjblawme@stcl.edu

TEXAS JOURNAL OF BUSINESS LAW

Volume 45

Fall 2012

Number 1

South Texas College of Law
2012–2013 EDITORIAL ADVISORY BOARD

Editor

W. DAVID EAST
Professor of Law

Faculty Advisors

W. DAVID EAST
Professor of Law

DAVID KEYES
Professor of Law

BRUCE A. MCGOVERN
Associate Dean and Professor of Law

TEXAS JOURNAL OF BUSINESS LAW

Volume 45

Fall 2012

Number 1

South Texas College of Law
2012–2013 STUDENT EDITORIAL BOARD

Managing Editor

LAUREN SCHAFFER

Articles Editors

ALEXANDRA CANIZALEZ
BRANDON FRENZA
SHANNAN PITCHFORD JONES

Associate Editors

ROBERT ARTHUR
ALANNA BECK
PHILLIP BLACK
YVETTE CANO
ERREN CHEN
ELEANOR CURRY
KERRI DOBBINS
THOMAS HORTON
JOHN KOVACH
ZAHRA LAKHANI
MARY NORRIS
RACHEL PEREZ
DEREK PERSHING
BRADLEY RATLIFF
TIMOTHY SCHLOSSER
ERIN SWANSON
LAUREN VALENTI

The State Bar of Texas Business Law Section
Journal Committee

RUSSELL BROADWAY (Chairman), *Austin*

Paul Dickerson, *Houston*

Scott G. Night, *Dallas*

TEXAS JOURNAL OF BUSINESS LAW

Volume 45

Fall 2012

Number 1

BUSINESS LAW SECTION

Gregory R. Samuel
Haynes and Boone, LLP
2323 Victory Avenue, Suite 700
Dallas, TX 75219
Chair

David R. Keyes
Kelly Hart & Hallman LLP
301 Congress Avenue, Suite 2000
Austin, TX 78701
Chair-Elect

David E. Harrell, Jr.
Locke Lord Bissell & Liddell, LLP
JP Morgan Chase Tower
600 Travis Street, Suite 2800
Houston, TX 77002
Immediate Past Chair

Ronald L. Chichester
Law Office of Ronald Chichester, P.C.
31526 Helen
Tomball, TX 77375
Vice Chair

Ryan R. Cox
Haynes and Boone, LLP
2323 Victory Avenue, Suite 700
Dallas, TX 75219
Secretary/Treasurer

COUNCIL

E. Steve Bolden II (Dallas), David R. Keyes (Austin/Houston), Irene Kosturakis (Houston), John Podvin (Dallas), Gregory R. Samuel (Dallas), Ronald L. Chichester (Houston), Shanna Nugent Cobbs (Dallas), Carol Bavousett Mattick (San Antonio), Cheryl Crandall Tangen (Houston), and Stephen C. Tarry (Houston).

JOURNAL COMMITTEE CHAIRMAN

Russell Broadway
Haynes and Boone, LLP
600 Congress Avenue, Suite 1300
Austin, TX 78701

**SUPPLEMENT NO. 5 TO THE REPORT OF THE LEGAL
OPINIONS COMMITTEE REGARDING LEGAL OPINIONS
IN BUSINESS TRANSACTIONS:**

**STATEMENT ON ENTITY STATUS, POWER AND
AUTHORITY OPINIONS REGARDING PRE-CODE TEXAS
ENTITIES AND PRE-CODE REGISTERED FOREIGN
ENTITIES UNDER THE TEXAS BUSINESS
ORGANIZATIONS CODE**

**LEGAL OPINIONS COMMITTEE OF THE BUSINESS LAW SECTION
OF THE STATE BAR OF TEXAS**

When the Texas Business Organizations Code (the “Code”) initially became effective on January 1, 2006, it did not apply to the following entities:

- an entity formed under a Predecessor Statute (as defined below) before the Code’s initial effective date that did not voluntarily elect to be governed by the Code before January 1, 2010 (a “Pre-Code Texas Entity”); and
- a foreign (non-Texas) entity that applied for and received a certificate of authority, or took equivalent action, to transact business in Texas before the Code’s initial effective date that did not voluntarily elect to be governed by the Code before January 1, 2010 (a “Pre-Code Registered Foreign Entity”).

Effective January 1, 2010, the Code mandatorily became applicable to Pre-Code Texas Entities and Pre-Code Registered Foreign Entities (collectively, the “Pre-Code Entities”).

This Statement by the Legal Opinions Committee of the Business Law Section of the State Bar of Texas (the “Committee”)¹ addresses whether the Code’s application has affected

¹ This Statement has been prepared by a Subcommittee of the Legal Opinions Committee of the Business Law Section of the State Bar of Texas consisting of the following members: John C. Ale, Byron F. Egan, Frank T. Garcia, Roderick A. Goyne, David R. Keyes, Gail Merel, Scott G. Night, Daryl B. Robertson, Stephen C. Tarry and Richard A. Tulli. This Statement was approved by the Committee on September 5, 2012.

The Committee has published a report and a statement regarding third-party legal opinions under Texas law. See Legal Opinions Committee of the Business Law Section of the State Bar of Texas, *Report of the Legal Opinions Committee Regarding Legal Opinions in Business Transactions*, BULLETIN OF THE BUSINESS LAW SECTION OF THE STATE BAR OF TEXAS, (Special Issue) June–September 1992, at 1 (the “*Texas Legal Opinions Report*”). The Texas Legal Opinions Report has been supplemented on four occasions (collectively, the “*Supplements*”): Legal Opinions Committee of the Business Law Section of the State Bar of Texas, *Supplement No. 1 to the Report of the Legal Opinions Committee Regarding Legal Opinions in Business Transactions*, BULLETIN OF THE BUSINESS LAW SECTION OF THE STATE BAR OF TEXAS, December 1994, at 1 (addressing certain Texas usury law issues); Legal Opinions Committee of the Business Law Section of the State Bar of Texas, *Supplement No. 2 to the Report of the Legal Opinions Committee Regarding Legal Opinions in Business Transactions*, BULLETIN OF THE BUSINESS LAW SECTION OF THE STATE BAR OF TEXAS, Spring 2001, at 1 (addressing Texas opinions regarding security interests in investment property collateral); Legal Opinions Committee of the Business Law Section of the State Bar of Texas, *Supplement No. 3 to the Report of the Legal Opinions Committee Regarding Legal Opinions in Business Transactions: Statement on Legal Opinions Regarding Indemnification and Exculpation Provisions under Texas Law*, 41 TEX. J. BUS. L. 271 (Winter 2006) (addressing Texas legal opinions regarding indemnification and exculpation provisions); and Legal Opinions Committee of the Business Law Section of the State Bar of Texas, *Supplement No. 4 to the Report of the*

certain opinions commonly given in commercial transactions insofar as such opinions relate to Pre-Code Entities, including after amendments to the Code that became effective September 1, 2011 (the “2011 Amendments”).² In summary, the Committee believes that the application of the Code, by itself, would not affect the rendering of customary legal opinions addressing a Pre-Code Entity’s existence (or authority to transact business, in the case of a Pre-Code Registered Foreign Entity), good standing and entity power and authority to execute, deliver and perform obligations under a contract (collectively, the “Status, Power and Authority Opinions”).³

Definitions. Some key terms used in this Statement are defined as follows:

- “Application” means the application filed with the Texas Secretary of State for a Pre-Code Registered Foreign Entity to obtain a certificate of authority, or an equivalent application filed for a Pre-Code Registered Foreign Entity, to transact business in Texas under a Predecessor Statute.
- “Pre-Code Formation Document” means the formation document filed with the Texas Secretary of State to form a Pre-Code Texas Entity under a Predecessor Statute, such as articles of incorporation, certificate of limited partnership or articles of organization.
- “Predecessor Statutes” means the Texas entity statutes that the Code replaced, including the Texas Business Corporation Act (the “TBCA”), the Texas Non-Profit Corporation Act, the Texas Revised Partnership Act, the Texas Revised Limited Partnership Act (the “TRLPA”) and the Texas Limited Liability Company Act.

Background. The Code combined and codified a host of Predecessor Statutes into a single, comprehensive statute. When the Code became effective on January 1, 2006 and until January 1, 2010, a Pre-Code Entity became subject to the Code only if it affirmatively opted

Legal Opinions Committee Regarding Legal Opinions in Business Transactions: Statement on ABA Principles and Guidelines, 43 TEX. J. BUS. L. 1 (Spring 2009) (addressing the *Legal Opinion Principles* and the *Guidelines for the Preparation of Closing Opinions* published by the Committee on Legal Opinions of the Business Law Section of the American Bar Association). The Committee also published a statement regarding the Texas Supreme Court’s decision in 1999 concerning the liability of Texas lawyers for negligent misrepresentation, *Limiting Negligent-Misrepresentation Liability for Third-Party Legal Opinions*, 38 TEX. J. BUS. L. 20 (Winter 2003). The Texas Legal Opinion Report and the Supplements are available electronically at the website of the Business Law Section of the State Bar of Texas at <http://www.texasbusinesslaw.org/committees/legal-opinions>.

² S.B. 748, 82nd Texas Legislature (Regular Session), §§ 59–62. This bill was authored by Senator John Carona, with a parallel bill in the House introduced by Representative Helen Giddings, and signed by Governor Rick Perry on May 27, 2011.

³ The Status, Power and Authority Opinions regarding a Texas corporation are commonly stated as follows:
The Corporation is a corporation validly existing and in good standing under the laws of the State of Texas.
The Corporation has the requisite corporate power and authority to execute and deliver, and perform its obligations under, each of the Transaction Documents to which it is a party.

A customary opinion regarding a foreign corporation that has registered to transact business in Texas is commonly stated as follows:

The Corporation is authorized [or registered] to transact business as a foreign entity in, and is in good standing under the laws of, the State of Texas.

To the extent that Status, Power and Authority Opinions are predicates on which other opinions (such as due authorization, execution and delivery opinions) are explicitly or implicitly based, the principles discussed in this Statement would also apply unless matters regarding status, power and authority are either the subject of assumptions or are otherwise excluded from the scope of such other opinions.

for the Code to govern it.⁴ Effective January 1, 2010, the Code mandatorily began to govern all Pre-Code Entities, and the Predecessor Statutes expired.⁵

The Code's transition provisions do not require a Pre-Code Entity to amend its Pre-Closing Formation Document or Application to comply with, or conform to, the Code. To the contrary, section 402.005(a)(3) of the Code requires a Pre-Code Texas Entity that is a type of "filing entity" under the Code⁶ to amend its Pre-Code Formation Document to conform to the requirements of the Code only when such Pre-Code Texas Entity next files an amendment to its Pre-Code Formation Document. Similarly, section 402.005(a)(4) of the Code requires a Pre-Code Registered Foreign Entity that is a type of "foreign filing entity" under the Code⁷ to amend its Application to conform to the requirements of the Code only when such Pre-Code Registered Foreign Entity next files an amendment to its Application.

Rendering Opinions. Lawyers often are asked to render the Status, Power and Authority Opinions to a third party (such as a lender or a contract counterparty) at the closing of a commercial transaction. The following is the Committee's analysis of the impact, if any, on rendering the Status, Power and Authority Opinions of the Code's becoming applicable to Pre-Code Entities mandatorily, rather than through the opt-in process:⁸

- **Existence.** The provisions of the Code plainly contemplate that a Pre-Code Texas entity continues its entity existence once the Code becomes applicable to it.⁹ Moreover, an entity's continued existence is not impaired by the fact that the entity's Pre-Code Formation Documents differ from what the Code contemplates those documents should provide. In this connection, Pre-Code Formation Documents typically employ terminology used in the Predecessor Statutes that differs from that used in the Code. For example, a corporation incorporated under the TBCA before January 1, 2006, would have filed a document titled "articles of incorporation," and that document might have referred to the corporation as a "business corporation" "incorporated" under the TBCA, rather than referring to the document as a "certificate of formation," which is the document filed under the Code to form any filing entity, and to that kind of entity as a "for-profit corporation" "formed" under the Code, as contemplated by the Code's terminology. Pre-Code Formation Documents may also omit information that the Code now requires for the filing of a certificate of formation or application for registration. For example, articles of incorporation might not have stated that the entity is a

⁴ TEX. BUS. ORGS. CODE ANN. (Vernon Pamphlet 2011) (hereinafter the "Code") §§ 402.003–.004.

⁵ Code § 402.005; H.B. 1156, 78th Texas Legislature (Regular Session), §§ 2-12, 16(b) (amending Predecessor Statutes to set expiration dates and repealing miscellaneous statutes).

⁶ The Code defines a "filing entity" as a Texas entity that is a corporation, limited partnership, limited liability company, professional association, cooperative or real estate investment trust. See Code § 1.002(22). The term "corporation" is, in turn, defined to include a for-profit corporation, nonprofit corporation, and professional corporation. Code § 1.002(14).

⁷ The Code defines a "foreign filing entity" as an organization formed under, or whose internal affairs are governed by, a jurisdiction other than Texas, and that registers or is required to register to transact business in Texas under Chapter 9 of the Code and is not a foreign limited liability partnership. See Code §§ 1.002(29).

⁸ The Committee's analysis is limited to a Pre-Code Entity that is either a "filing entity" or "foreign filing entity," as defined in the Code.

⁹ For example, as noted above, section 402.005(a)(3) of the Code requires a Pre-Code Entity to amend its Pre-Code Formation Document to conform to the requirements of the Code only when such Pre-Code Entity next files an amendment to its Pre-Code Formation Document. The requirement in this section for such an amendment must mean that a Pre-Code Entity's existence would not terminate merely because the Code became applicable to it.

corporation or a business corporation; such a statement was not required by the TBCA because filing articles of incorporation under the TBCA meant by definition that a business (*i.e.*, for-profit) corporation was being incorporated.¹⁰

The Committee does not believe that a failure to use Code terminology or to mention the type of entity in a Pre-Code Formation Document or Application affects the existence of a Pre-Code Texas Entity. The existence¹¹ of a Pre-Code Texas Entity commenced under its applicable Predecessor Statute, and nothing in the Code provides that an entity, whether formed under a Predecessor Statute or the Code, ceases to exist because its governing documents do not comply with the Code, including a failure to comply with section 402.005(a)(3) of the Code, which requires a Pre-Code Texas Entity to conform its Pre-Code Formation Document to applicable Code requirements when it next files an amendment to such document. So long as the Pre-Code Formation Document is not amended, there is no requirement under the Code to conform.¹² If it is amended, the Secretary of State accepts a filing of the amendment only when it finds that the filing conforms to the applicable provisions of the Code.¹³ The 2011 Amendments further provide explicitly that specified inconsistencies with the terminology or requirements of the Code do not constitute failures to conform with the requirements of the Code.¹⁴ As a result, the Committee concludes that a

¹⁰ The Code calls the document filed to form an entity a “certificate of formation.” Because that document is used for any type of filing entity, it must state what type of entity is being formed. Code § 3.005(a)(2). There was no need under the Predecessor Statutes to require that formation documents state the type of entity being formed. If the filing was made under the Predecessor Statute for a particular type of entity, such as the TBCA, then that was the type of entity formed.

¹¹ The Committee notes that in rendering an opinion as to the valid existence of a Texas entity, many opinion givers simply state that their opinion as to existence is based solely on the certificate of existence issued by the Secretary of State and that opinion recipients typically will accept this qualification.

¹² While no requirement exists, some Pre-Code Texas Entities have found it advisable to amend their Pre-Code Formation Documents to conform to the Code in order to avoid uncertainties arising from such non-conformance.

¹³ Code § 4.002(a). Except in a proceeding by the State of Texas to terminate existence, an acknowledgment by the Secretary of State of the filing of a certificate of formation (which includes a Pre-Code Formation Document) is conclusive evidence of the entity’s existence and authority to transact business in Texas. Code § 3.001(d)(1). Article 3.04 of the TBCA contained an analogous provision stating that the Secretary of State’s issuance of a certificate of incorporation that has become effective “shall be conclusive evidence that all conditions precedent required to be performed for valid incorporation have been complied with and that the corporation has been duly incorporated under [the TBCA], except as against the State in a proceeding for involuntary dissolution.” This Committee previously concluded that Article 3.04 relieved “the Opinion Giver of the need to determine whether the requirements for incorporation were met at the time the entity was incorporated so long as the Opinion Giver verifies the issuance of the certificate of incorporation.” Texas Legal Opinions Report, *supra* note 1, at 81.

On a related point, the Committee notes that the Secretary of State may terminate a filing entity’s existence after a finding that certain failures have occurred, such as not filing required reports or failing to maintain a registered agent or registered office, but only after notice and a 90-day opportunity to cure the failure. Code § 11.251(b). The entity’s existence ceases when the Secretary of State issues a certificate of termination for an involuntary winding up by the Secretary of State or, in the case of a voluntary winding-up, upon the filing of a certificate of termination with the Secretary of State. Code §§ 11.252(c), 11.102. Of course, the Secretary of State would not issue a certificate of existence for a filing entity if a certificate of termination had previously been issued by or filed with the Secretary of State with respect to that filing entity.

¹⁴ The 2011 Amendments added subsection (c) to section 402.005. It states that a domestic or foreign filing entity is not considered to have failed to comply with section 402.005(a)(3) or (4) of the Code (*i.e.*, conform its certificate of formation or application for registration to the Code requirements) because: (i) the certificate of formation does not state the type of entity formed, (ii) the application for registration or any amendment thereto does not state the type of entity or appoint the Texas Secretary of State as agent for service of process, notice or demand under the circumstances provided by section 5.251 of the Code, or (iii) a circumstance described by new

failure to conform Pre-Code Formation Documents at the time of an amendment thereto as contemplated by Section 402.005(a)(3) does not affect the rendering of an opinion as to the existence of a Pre-Code Texas Entity.

- *Qualification of Pre-Code Registered Foreign Entities to Transact Business in Texas.* A similar analysis applies with respect to Pre-Code Registered Foreign Entities continuing to have authority to transact business in Texas. The Code nowhere provides that existing authority terminated because of the mandatory application of the Code on January 1, 2010. To the contrary, the qualification or registration of a foreign entity remains in effect until it is terminated, withdrawn or revoked.¹⁵ Although the Code contemplates the use of different terminology and may mandate additional information in filings, section 402.005(a)(4) of the Code requires a Pre-Code Registered Foreign Entity to conform its Application to the Code only when it first files an amendment to the Application. Either the Pre-Code Registered Foreign Entity has not amended its Application, or it filed an amendment that the Secretary of State accepted as conforming to the Code.¹⁶ The 2011 Amendments clarify that certain inconsistencies with the terminology or requirements of the Code do not constitute failures to conform with the requirements of the Code.¹⁷ Thus, the Committee does not believe that a

section 402.0051 of the Code (which is discussed in the next paragraph of this footnote) applies. As a result, the Pre-Code Formation Document of a Pre-Code Texas Entity or the Application of a Pre-Code Registered Foreign Entity is not required to be updated for any of the foregoing matters, even in the next amendment made to its Pre-Code Formation Document or Application.

The 2011 Amendments also added new section 402.0051, which clarifies that none of the following is considered to be a failure to conform to the Code if contained in a governing document or filing instrument, including a certificate of formation or an application for registration: (i) a reference to prior law (which is defined to include the Predecessor Statutes) that was applicable or a provision that was authorized by prior law at the time of its filing or adoption, (ii) a term or phrase described in section 1.006 of the Code (which provides that, when used in governing documents, certain terms and phrases found in the Predecessor Statutes are synonymous with certain terms and phrases used in the Code), or (iii) a term or phrase from prior law that is different from the corresponding term or phrase used in the Code. *See* Code § 402.0051(a). In addition, section 402.0051(c) of the Code provides that an entity is not considered to have failed to comply with the Code if a governing document or filing instrument makes a reference to any of the Predecessor Statutes rather than to the corresponding provisions of the Code.

¹⁵ Code § 9.008(a)-(b). The Secretary of State's issuance of an acknowledgement that a foreign filing entity has filed an Application is conclusive evidence of the authority of the entity to transact business in Texas except in a proceeding to revoke the registration brought by the Secretary of State. Indeed, many opinion givers simply state that their opinion on authority or registration to transact business is based solely on a certificate from the Secretary of State regarding the status of the authority or registration of the foreign filing entity to transact business in Texas, and opinion recipients typically will accept this qualification.

On a related point, the Committee notes that the process for the Secretary of State to revoke a registration of a foreign filing entity under sections 9.101 and 9.102 of the Code is essentially the same as the process for terminating the existence of a Texas domestic filing entity. *See supra*, note 13. The Secretary of State may revoke a foreign filing entity's registration after a finding that certain failures have occurred, such as not filing required reports or failing to maintain a registered agent or registered office, but only after notice and a 90-day opportunity to cure the failure. Code § 9.101. A foreign filing entity's registration terminates (a) when the Secretary of State files a certificate of revocation for an involuntary revocation of the entity's registration by the Secretary of State or (b) upon the filing of (i) a certificate of withdrawal for a voluntary termination of the entity's registration, or (ii) a certificate evidencing termination when the foreign filing entity's existence or separate existence terminates because of dissolution, termination, merger, conversion or other circumstances. Code §§ 9.011(e), 9.102(c). A foreign filing entity's registration may also terminate by judicial action under Subchapter D of Chapter 9 of the Code or by tax forfeiture under the Texas Tax Code. However, in both of those instances as well, a filing evidencing such termination would be filed with the Secretary of State. Of course, the Secretary of State would not issue an acknowledgement that a foreign filing entity has filed an Application if a certificate of revocation, certificate of withdrawal or certificate evidencing termination had previously been filed as to that entity with the Secretary of State.

¹⁶ Code § 4.002(a).

¹⁷ *See supra*, note 14.

failure to use Code terminology or to mention the type of entity in an Application affects the qualification or registration of a Pre-Code Registered Foreign Entity.

Regarding the authority of a Pre-Code Registered Foreign Entity to transact business in Texas, the Predecessor Statutes used differing terminology to address that concept: “procuring a certificate of authority”¹⁸ or “filing an application for registration.”¹⁹ The Code, however, uses the single terminology of “registration” to address a foreign entity’s qualification to transact business in Texas.²⁰ Nevertheless, the Committee believes that the following opinion formulations have the same meaning: “the Corporation is *authorized* to transact business as a foreign entity. . .” and “the Corporation is *registered* to transact business as a foreign entity”

- *Good Standing.* The Committee previously has stated that an opinion with respect to “good standing” of an entity means that the entity is in existence and is not delinquent in its filing of franchise tax returns to the extent that the State of Texas is entitled to revoke its existing charter.²¹ In addition, the Texas Comptroller of Public Accounts states at its website that an entity is in good standing with it if that entity has filed its franchise tax report so that a balance due was correctly computed and if any amount computed to be due has been paid.²² The Committee notes that application of, or compliance with, the Code is entirely separate from whether an entity has filed a franchise tax return, correctly computed the balance due or paid the tax computed to be due, and thus is in good standing. Hence, the mandatory application of the Code to Pre-Code Entities would not affect the rendering of a good standing opinion.
- *Power and Authority.* Subchapter B of chapter 2 of the Code gives all Texas entities broad powers. Neither the meaning of a power and authority opinion nor the nature of the due diligence required to render such an opinion has changed by virtue of the application of the Code. A Texas lawyer should generally review the provisions of the Code and the entity’s governing documents, both filed and unfiled (*e.g.*, by-laws, partnership agreements or limited liability company agreements), in light of the particular transaction before rendering an opinion on whether the entity has the entity (*e.g.*, corporate or partnership) power and authority to execute, deliver and perform its obligations under specified documents.²³ With respect to Texas unregulated²⁴ for-profit corporations, limited liability companies, limited

¹⁸ See *e.g.*, TBCA § 8.01A.

¹⁹ See *e.g.*, TRLPA § 9.02(a).

²⁰ See Code §§ 9.001 *et seq.*

²¹ Texas Legal Opinions Report, *supra* note 1, at 83. For purpose of supporting this opinion, opinion givers commonly rely solely upon, and opinion recipients commonly accept, a current Certificate of Account Status from the Texas Comptroller of Public Accounts (which provides, in part, that the entity “is . . . in good standing with this office having no franchise tax reports or payments due at this time”). See Texas Legal Opinions Report, *supra* note 1, at 84.

²² Texas Comptroller of Public Accounts, Certificates of Account Status, What the Account Status Terms Mean, <http://www.window.texas.gov/taxinfo/coasintr.html>. See also Texas Legal Opinions Report, *supra* note 1, at 83.

²³ See Texas Legal Opinions Report, *supra* note 1, at 86.

²⁴ Section 2.003 of the Code provides that a domestic entity may not operate as a bank, trust company, savings association, insurance company, cemetery organization (except as authorized by Chapter 711, 712 or 715 of the Texas Health and Safety Code) or abstract or title company governed by Title 11 of the Texas Insurance Code.

partnerships and general partnerships, the Committee has not identified any situation in which the application of the Code diminishes the permitted powers of such entities as compared to the powers granted under the Predecessor Statutes.

The Pre-Code Formation Document or other governing documents of a Pre-Code Texas Entity may recite that the Pre-Code Texas Entity is authorized to conduct any business that is authorized by a Predecessor Statute or that it has all of the powers granted by a Predecessor Statute or by a particular provision of a Predecessor Statute. For example, many corporations incorporated under the TBCA included a provision in their articles of incorporation to the effect that the corporation “is authorized to conduct any and all business authorized or permitted by the Texas Business Corporation Act and has the power to take any action and hold any property permitted by that Act.” What does that mean when the referenced statute has expired? Because the Predecessor Statutes expired as of January 1, 2010, would such a reference mean that the Pre-Code Texas Entity is no longer authorized to conduct business at all until it amends its Pre-Code Formation Document to refer to the Code?

The answer can be found in section 402.0051 of the Code, added by the 2011 Amendments. Section 402.0051 provides that a reference in a governing document or filing instrument to a Predecessor Statute or its specific provisions is considered to be a reference to the provision or provisions of the Code that correspond to the Predecessor Statute or provision thereof unless the governing document or filing instrument expressly provides otherwise. Thus, in reviewing provisions in a Pre-Code Formation Document or other governing document that refer to Predecessor Statutes, a Texas lawyer may treat them as referring to the corresponding provisions under the Code.²⁵

Conclusion. For the reasons stated above, the Committee has concluded that the application of the Code, by itself, would not affect the rendering of customary Status, Power and Authority Opinions with respect to Pre-Code Entities. The Committee believes that the same Status, Power and Authority Opinions that could have been rendered as to a Pre-Code Entity under the Predecessor Statutes can continue to be rendered as to a Pre-Code Entity under the Code even though the Pre-Code Entity that has not yet modified its Pre-Code Formation Documents or Application, as the case may be, to comply with the Code. Further, an opinion giver need not consider whether an amendment, if filed, has caused its Pre-Code Formation Documents or Application to conform to the requirements of the Code in order to render any of the typical formulations of the Status, Power and Authority Opinions. Because

²⁵ The Committee believes this was the proper conclusion even before the 2011 Amendments took effect. Section 1.006 of the Code includes a list of terms (*e.g.*, articles of incorporation, certificate of limited partnership) used under Predecessor Statutes and the parallel terms used under the Code (*e.g.*, certificate of formation) and provides that references, in the Code and other Texas statutes, to the old terminology includes use of the corresponding Code term. Section 1.052 of the Code states that references in laws to Predecessor Statutes are considered to be references to the corresponding part of the Code. Although Pre-Code Formation Documents are not a part of laws, these Code provisions manifest a policy of automatically translating the terminology of the Predecessor Statutes into the terminology of the Code. The Committee believes that it was reasonable and appropriate for Texas lawyers, before the adoption of the 2011 Amendments, to have implicitly based their opinions on the analysis set forth in this footnote and on other relevant factors. Further, as noted above, by enacting section 402.005, the Legislature took care to allow Pre-Code Texas Entities to continue without having to make a filing.

any Pre-Code Formation Document—as well as certificates of formation or amendments filed under the Code—may contain provisions beyond those required to form an entity, an opinion giver will want to continue to review, to the same extent as before the Code became applicable, the substance of a Pre-Code Entity’s governing documents (including those not filed, such as by-laws, partnership agreements and limited liability company agreements) in order to assess matters such as power and authority in light of the applicable statutory provisions and the specifics of the transaction.

SERIES LLCs: NUTS AND BOLTS, BENEFITS AND RISKS, AND THE UNCERTAINTIES THAT REMAIN

Jennifer Avery, David Lawrence, Todd Lowther, Karen Rose, Joshua Russ,
Brandon Schubert, Andrew Wootton & Travis Youngblood*

TABLE OF CONTENTS

I.	INTRODUCTION.....	10
	A. Definition of a Series LLC	10
	B. History of the Series LLC.....	10
	C. Laws Authorizing Series LLCs	11
	D. The Appeal of Series LLCs	11
	E. Article Overview.....	12
II.	FORMATION, GOVERNANCE, AND STRUCTURE.....	12
III.	RISKS AND POTENTIAL USES	14
	A. Hazards of a Series LLC	14
	B. Potential Uses of a Series LLC.....	16
IV.	TAXES	17
	A. Federal Tax Issues	17
	B. State Tax Issues	20
	C. Federal Employment Tax Issues.....	21
V.	BANKRUPTCY TREATMENT AND ISSUES.....	21
	A. Bankruptcy Eligibility of Series LLCs	21
	B. Substantive Consolidation of Series LLCs	23
VI.	CONCLUSION.....	25

* Jennifer Avery is a corporate attorney who focuses her practice on M&A in the energy sector. She formerly practiced with Thompson & Knight LLP in Dallas but has recently relocated to Chicago.

David Lawrence is an associate with Thompson & Knight LLP. David focuses his practice on real estate and real estate finance matters, including the representation of special servicers in the CMBS market, lenders in originations and workouts of existing loans, and real estate developers in connection with the acquisition, sale, and development of real property.

Todd Lowther is a tax associate in the Houston office of Thompson & Knight LLP where he focuses primarily on private equity, mergers and acquisitions, and tax structuring for oil and gas and real estate transactions.

Karen Rose is a bankruptcy attorney with Baker & Associates in Bryan, Texas. She formerly practiced tax law with Thompson & Knight LLP in Houston.

Joshua M. Russ is an attorney at Thompson & Knight LLP. He concentrates his practice on corporate health law, including regulatory compliance, health industry transactions, and litigation-related matters. He has experience assisting clients with fraud and abuse analysis, HIPAA compliance, contractual disputes, and evaluation and management of responses to investigations and *qui tam* actions.

Brandon Schubert is an associate in the London office of Davis Polk & Wardwell LLP.

Andrew Wootton is a tax associate with Thompson & Knight, LLP. Andrew focuses his practice primarily on matters including corporation, partnership, and LLC formation and operation; federal and state tax planning and advice; corporate tax issues including mergers, acquisitions, and divisions; and private equity transactions. He also represents international clients in planning for the establishment or expansion of U.S. and international business operations.

Travis Youngblood is an associate with Thompson & Knight LLP. Travis focuses his practice on real estate and real estate finance matters, including commercial lease negotiations, revolving credit facilities secured by multi-state pipeline networks, and defeasance transactions.

I. INTRODUCTION

A. Definition of a Series LLC

A series limited liability company (“**Series LLC**”) is a variation of the traditional limited liability company (“**Traditional LLC**”) that is available under several states’ limited liability company (“**LLC**”) statutes. A Series LLC is, effectively, a collection of subunits within one LLC that can be created according to statute without actually forming multiple LLCs. Under a typical Series LLC statute, found in Delaware, Texas, Illinois, and several other states, a Series LLC can have as many different, individual series as the members desire, and each series looks and acts almost exactly like a separate LLC. In effect, a Series LLC is a way around creating multiple LLCs – only a single entity need be created, but assets, ownership and, therefore, liability, can be allocated exactly as if multiple entities had been formed.

A Series LLC begins with the formation of an LLC, which, for the sake of clarity, will be referred to in this article as the “**Umbrella LLC**.” The Umbrella LLC may, provided it meets certain statutory requirements discussed below, form one or more series within itself (although most statutes use the term “series” for an individual cell under an Umbrella LLC, for clarity this article refers to a “**Subunit**”). In spite of the fact that they are contained within a single Umbrella LLC, each Subunit behaves like a separate LLC. A Subunit may have its own assets, its own liabilities and its own owners, which need not resemble the assets, liabilities or ownership of the Umbrella LLC. A Subunit can, just like a Traditional LLC, enter into contracts in its own name, sue or be sued, and hold title to assets in its own name. And, just like a Traditional LLC, each Subunit within a Series LLC is shielded from the liabilities of the other Subunits.

The liability limitation is the most important feature of a Series LLC. As long as one complies with the requirements of the statute, only the assets of a given Subunit are available to satisfy the liabilities of that Subunit. And not only is each Subunit shielded from the liabilities of each other Subunit, but the Umbrella LLC is likewise shielded from the liabilities of each of its Subunits. Furthermore, it makes no difference for liability purposes whether a Subunit shares common ownership with another Subunit or the Umbrella LLC or whether none of the Umbrella LLC members is an owner of such Subunit.

B. History of the Series LLC

The Series LLC first arose with the passage of the Delaware LLC statute in 1996. The concept of a series-type entity, though, was not novel at the time. The idea of a series entity existed in Delaware and other jurisdictions in the arena of investment companies, statutory trusts and asset securitization.¹ For investment companies, series can be created as “administrative subunits” that allow a single company to partition assets without creating multiple legal entities, thus simplifying SEC filings and other administrative requirements.² In the context of statutory trusts, a single trustee can allocate assets into different series without the burden of creating multiple trusts. Similarly, in the asset securitization field, multiple series securities backed by different assets can be issued by a single entity with less administrative difficulty than it would require to create multiple entities.

¹ DEL. CODE ANN. tit. 12, § 3804 (2006); Thomas E. Rutledge, *Again, For Want of a Theory: The Challenge of the “Series” to Business Organization Law*, 46 AM. BUS. L.J. 311, 313 (2009).

² *Id.*

The series concept has matured outside of the United States, as well, in the form of segregated portfolio companies. In tax havens like Guernsey, the Caymans, and the British Virgin Islands, companies can be formed with multiple portfolios or cells, each of which is protected from the liabilities of the others. Segregated portfolio companies, also known as captive cell companies, are used extensively in the fields of captive insurance³ and also as investment companies.⁴

The Delaware Series LLC statute took the general concept of series creation, as seen in investment companies, asset securitization, and segregated portfolio companies, and adapted it to the LLC form. Since Delaware adopted its statute in 1996, 10 additional jurisdictions have made provisions for Series LLCs in their LLC statutes.⁵

C. Laws Authorizing Series LLCs

While the various Series LLC authorization statutes have the same general aims, there are some key differences among them. The few states that have a Series LLC statute generally follow either the Illinois-style statute or the Delaware-style statute. The primary difference between the two is their characterization of the legal status of an individual Subunit. The Delaware statute gives each Subunit many of the powers and rights of separate legal entities, but does not explicitly recognize each Subunit as such.⁶ The Illinois system explicitly grants each Subunit separate legal entity status.⁷ The difference is further emphasized by the filing requirements of the two states. Delaware simply requires that the Umbrella LLC file a certificate of formation disclosing the limitation of liability of any Subunit that has been or might be created.⁸ There are no requirements that the Umbrella LLC file any document with the state upon the creation of a new Subunit. By contrast, Illinois requires that a separate certificate of designation be filed by the Umbrella LLC for each Subunit created.⁹ Further, the certificate of the Subunit in Illinois must identify the members and managers of a Subunit if different than the members and managers of the parent.¹⁰ Most states, including Texas, follow the Delaware model for their Series LLC statutes.

D. The Appeal of Series LLCs

Features like liability shielding and distinct asset ownership have long been possible through the creation of separate LLCs. And, practically speaking, the benefits of Series LLCs are not groundbreaking. But conceptually, the Series LLC is a useful simplification, a way to ease the burden and cost of creating layers of numerous entities. Rather than having to prepare multiple sets of formation documents and pay the fees to form multiple entities, a single Series LLC would suffice. Furthermore, Series LLCs provide flexibility to members of the Umbrella

³ HANDBOOK OF INT'L INS. 935 (J. David Cummins & Bertrand Venard eds., 2007).

⁴ Sandra Mertens, Series Limited Liability Companies: A Possible Solution to Multiple LLCs, 84 CHI.-KENT L. REV. 300 (2009).

⁵ The following jurisdictions have a series LLC statute: Delaware, Illinois, Iowa, Kansas, Nevada, Oklahoma, Puerto Rico, Tennessee, Texas, Utah, and Wisconsin.

⁶ DEL. CODE ANN. tit. 6, § 18-215(c) (2010).

⁷ 805 ILL. COMP. STAT. 180/37-40(b) (2010).

⁸ DEL. CODE ANN. tit. 6, § 18-215.

⁹ 805 ILL. COMP. STAT. 180/37-40.

¹⁰ *Id.*

LLC to decide how to allocate assets and liabilities without having to create new entities.¹¹ Ideally, the Series LLC looks like a cheaper, easier way to structure a business.

And were it not for the numerous issues and problems discussed below, the Series LLC could in practice be just that. In fields like real estate where a single-asset entity makes both legal and business sense, Series LLCs could be widely implemented. The administrative simplicity and cost savings could also appeal to specially regulated businesses that want to avoid having to pay additional fees and face various regulatory waiting periods.¹²

But several problems and questions surround Series LLCs that have, in the 16 years since the enactment of the Delaware statute, kept them out of mainstream use.¹³ There is little hard evidence to help practitioners know how a Series LLC formed in a state like Texas would be treated in state without a Series LLC statute. Also, significant questions in the areas of taxation, bankruptcy, and securities law, combined with a general dearth of case law, make the consequences of establishing a Series LLC too uncertain to be worth the small administrative and cost savings over forming multiple entities.

E. Article Overview

Because of the lack of certainty surrounding Series LLCs as noted above, there is little practical experience from which to glean concrete advice for practitioners. However, in September 2010 the Internal Revenue Service (“IRS”) issued Proposed Regulations which help resolve what was previously one of the biggest unknowns: tax treatment of Series LLCs. We believe that the potential benefits of utilizing Series LLCs, combined with such additional guidance, will lead to more use of Series LLCs. Here, we offer an overview of the requirements for forming and maintaining Texas Series LLCs, risks and potential uses for Series LLCs, and a discussion of federal and state tax treatment and bankruptcy issues.

II. FORMATION, GOVERNANCE, AND STRUCTURE

The Texas Business Organizations Code (“TBOC”) contains the formation and governance requirements for Series LLCs created in Texas. This statute provides that an LLC may establish “one or more designated series of members, managers, membership interests, or assets” in its company agreement.¹⁴ These Subunits may engage in separate business activities and may carry on any lawful business allowed under the TBOC.¹⁵ This is the informal process by which a Traditional LLC becomes a Series LLC. While there is no statutory requirement that each Subunit in a Series LLC must have its own operating agreement, such an arrangement might be preferable, particularly in an LLC with a complex governance structure. Because each Subunit of a Series LLC enjoys separate liability from other Subunits and from the Umbrella LLC, the Texas statute requires the Umbrella LLC to provide a notice of these liability limitations in its certificate of formation.¹⁶

The Texas statute mandates that LLCs utilizing separate Subunits follow certain business practices in order to maintain separate Subunit liability. First, the records for each Subunit must account for that Subunit’s assets separately from the assets of the Umbrella LLC

¹¹ Wendell Gingerich, *Series LLCs: the Problem of the Chicken and the Egg*, 4 ENTREPRENEURIAL BUS. L.J. 185, 187 (2009).

¹² Vicki R. Harding, *Series LLCs: A Wave of the Future – Or Not?*, 1 MICH. BUS. L.J. 19, 22 (2007).

¹³ Mertens, *supra* note 4, at 309–10.

¹⁴ TEX. BUS. ORGS. CODE ANN. § 101.601(a) (West 2011).

¹⁵ *Id.* § 101.601(a)(2), (b).

¹⁶ *Id.* § 101.602(b)(3).

or any other Subunit.¹⁷ However, the assets of a Subunit may be held either directly or indirectly, “including being held in the name of the series, in the name of the limited liability company, through a nominee, or otherwise.”¹⁸ Second, the company agreement of the Umbrella LLC must contain a statement providing for the separate liability of each Subunit; namely, that the debts, liabilities, obligations, and expenses of a Subunit are enforceable against the assets of that Subunit only.¹⁹ Third, as mentioned above, the Umbrella LLC must provide notice of these Subunit liability limitations in its certificate of formation.²⁰ However, an Umbrella LLC need not have any Subunit already established at the time this notice of limitations is included in the certificate of formation, and, once the notice is included, it is not required to make reference to any particular Subunit.²¹ Because of this, a general notice of separate Subunit liability may be included in the Umbrella LLC certificate of formation at the outset, giving the Umbrella LLC the flexibility to create Subunits in the future without amending its certificate.²²

In contrast to these mandated formation provisions for maintaining separate Subunit liability, the TBOC provides a flexible scheme for Series LLC governance. As with Traditional LLCs, the company agreement can create a wide array of governing powers, duties, and controls. The company agreement can establish groups of managers or members to be associated with a particular Subunit; it can create the process to be used for establishing additional groups of managers or members; and it can provide the voting rights of various members, managers, or groups thereof.²³ Additionally, the company agreement can establish a record date for distributions with respect to a particular Subunit.²⁴ Hence, the members or managers of a Series LLC have wide latitude for creating a customized governance structure in the company agreement.

Texas law applies flexible statutory provisions to Series LLCs that encourage both compartmentalized liability as well as entity perpetuation. For instance, an event under the company agreement that causes a member of a particular Subunit to no longer qualify as a member of that Subunit does not, in and of itself, revoke membership status in the Umbrella LLC or in any other Subunit.²⁵ The same holds true for managers.²⁶ Therefore, members or managers may be associated with various Subunits of an Umbrella LLC, but their roles are treated as mutually exclusive unless otherwise specified in the company agreement. These provisions prevent administrative and managerial hiccups in one Subunit from spilling into additional Subunits or the Umbrella LLC as a whole.

Similar protections are applied to winding up and termination. The Umbrella LLC must provide notice of the termination of any Subunit pursuant to the requirements, if any, in

¹⁷ *Id.* § 101.602(b)(1). These records should be maintained “in a manner so that the assets of the series can be reasonably identified by specific listing, category, type, quantity, or computational or allocational formula or procedure, including a percentage or share of any assets, or by any other method in which the identity of the assets can be objectively determined.” *Id.* § 101.603(b).

¹⁸ *Id.* § 101.603(a).

¹⁹ *Id.* § 101.602(a), (b)(2).

²⁰ *Id.* § 101.602(b)(3).

²¹ *Id.* § 101.604.

²² 19 Robert W. Hamilton, Elizabeth S. Miller & Robert A. Ragazzo, *TEX. PRACTICE BUS. ORGS.* § 19:35 (3d ed. 2012).

²³ *See* *TEX. BUS. ORGS. CODE ANN.* § 101.607 (West 2011).

²⁴ *Id.* § 101.612.

²⁵ *TEX. BUS. ORGS. CODE ANN.* § 101.610(b) (West 2011). In fact, even if the last remaining member of a series ceases to be a member, this alone does not require the winding up of the series. *Id.* § 101.610(b).

²⁶ *Id.* § 101.610(a).

the company agreement.²⁷ Yet, entity continuity is ensured by the fact that the winding up and termination of one Subunit does not cause the winding up of any other Subunit or the Umbrella LLC; nor does the winding up of a Subunit affect the separate liability enjoyed by that Subunit.²⁸ Naturally, however, the winding up of the Umbrella LLC requires the winding up of all Subunits contained within the Umbrella LLC.²⁹

III. RISKS AND POTENTIAL USES

A. Hazards of a Series LLC

At first glance, it seems clear that the Texas Legislature intended to keep separate the liabilities of each Subunit in a Texas Series LLC: “the debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to a particular series shall be enforceable against the assets of that series only, and shall not be enforceable against the assets of the limited liability company generally or any other series.”³⁰ While it appears the language is clear, it is important to note that in order to be treated in such a way, each Subunit must meet a number of formal requirements.³¹ Most importantly, the records that are maintained for a particular Subunit must only account for assets of that Subunit and keep separate all other assets of the company or any other Subunit.³²

While this may not seem that difficult in theory, it may be more unrealistic to implement in practice. The standard for complying with maintaining Subunit records separately does not appear to be altogether cumbersome;³³ however, it is important to remember that one reason Traditional LLCs are so widely used is because very few formalities are required of them.³⁴ Thus, any requirements to keep separate records for different Subunits in a Series LLC is an added step that is not required when operating under a Traditional LLC.

Although keeping separate records is not a huge obligation, it is essential because debts and liabilities will not be treated as belonging to a separate entity if these formalities are not precisely met. Therefore, the risks may outweigh the benefits in this regard, as a company may be operating under the impression that liabilities of a particular Subunit belong to that Subunit alone, when in reality it may only take a slight record-keeping oversight to allow the liabilities to attach to the entire Umbrella LLC and the other Subunits.

This would prove especially disastrous in the case of a particular Subunit engaging in risky behavior. For example, imagine a large Texas company, Conglomerate, LLC, which is involved in a number of different industries, with different parts of the Umbrella LLC being organized into various Subunits. One such Subunit is involved in transporting hazardous waste materials to the proper disposal sites. If each truck transporting the waste, or even the entire transporting division itself, was organized as a separate Subunit of Conglomerate, the

²⁷ *Id.* § 101.615(b).

²⁸ *Id.* § 101.614, .615(c).

²⁹ *Id.* § 101.616(1).

³⁰ *Id.* § 101.602(a)(1).

³¹ *Id.* § 101.602(b).

³² *Id.* § 101.602(b)(1).

³³ “If the records of a series are maintained in a manner so that the assets of the series can be reasonably identified by specific listing, category, type, quantity, or computational or allocational formula or procedure, including a percentage or share of any assets, or by any other method in which the identity of the assets can be objectively determined, the records are considered [separately maintained according to] the requirements of Section 101.602(b)(1).” *Id.* § 101.603(b).

³⁴ *See generally id.* §§ 101.051-101.054.

intent would be for that Subunit to have liabilities separate from the Umbrella LLC and other Subunits. Thus, in the event of a catastrophic accident or spill of the hazardous material, the general assets of Conglomerate and the assets of the other Subunits would be protected from liability; however, if all the records of Conglomerate were maintained together and could not be reasonably identified as belonging to a particular Subunit, then the Subunit would lose this protection and liability that Conglomerate thought it was protecting against would instead be a liability of the entire Series LLC.

In a similar vein, Series LLCs may be risky because of the uncertainty of how they will be treated in bankruptcy and tax contexts. While both of these issues have different implications, it appears that they both may hinge on whether the series is treated as a separate legal entity. A serious issue is what happens when a single series in a Series LLC declares bankruptcy. For example, if the Conglomerate series involved in the shipping of hazardous waste materials declares bankruptcy because the liabilities from the spill have become too great for the series to bear, what effect does this have? While this may be somewhat clearer in jurisdictions where the statute specifies the series is a separate legal entity, such as in Illinois,³⁵ there is no such provision in the Texas Series LLC statute. If Texas does not treat each series as a separate legal entity, then this poses the potential risk that if one series becomes involved in bankruptcy proceedings, it could endanger all of the Conglomerate's assets. A more in-depth discussion of the tax and bankruptcy issues follows this section.

Another hazard of Series LLCs is the fact that they are still relatively new and are only recognized in a minority of states. If Series LLCs become more popular and begin conducting business in a state with a similar Series LLC statute (such as a Delaware series doing business in Texas), it is easier to see how that particular state would treat the Subunits. However, what happens when a Series LLC begins operating in a foreign jurisdiction without a Series LLC statute? Choice of law provisions may apply so that the foreign jurisdiction has to recognize the laws where the company is organized, but it is unclear what happens if the foreign jurisdiction is not forced to recognize an entity as a separate Subunit.

This uncertainty would undoubtedly cause concern for a company thinking about organizing as a Series LLC because if it plans on conducting business outside of Texas (save for, perhaps, in states with Series LLC statutes similar to Texas's), the company has no indication of how any foreign jurisdiction would treat the Subunit – indeed, it may well vary from jurisdiction to jurisdiction. Borrowing from the example above, if Conglomerate conducts business in a state that has not adopted Series LLCs, it could expose the entire company's assets to liability for a hazardous waste spill, even if it observes all the corporate formalities and properly keeps the records of the different Subunits separate. With this doubt, it might make more sense for a company to form multiple LLCs in similar instances rather than exposing itself to uncertain liability by forming Series LLCs.

Series LLCs also may be more susceptible to courts piercing the corporate veil. Courts have been willing to ignore the limitation on corporate liability “when the corporate form has been used as part of a basically unfair device to achieve an inequitable result.”³⁶ Courts will sometimes pierce the corporate veil when owners of a company fail to treat it as a distinct legal entity or fail to observe the corporate formalities. A company is especially susceptible to piercing when the court finds the company is the mere alter ego of the owners.

³⁵ See 805 ILL. COMP. STAT. 180/37–40(b) (2010).

³⁶ SSP Partners v. Gladstrong Invs. (USA) Corp., 275 S.W.3d 444, 451 (Tex. 2008) (quoting Castleberry v. Branscum, 721 S.W.2d 270, 271 (Tex. 1986)).

This biggest problem of Series LLCs relating to piercing the corporate veil is the same recurring problem: the uncertainty associated with how Series LLCs will be treated. While Series LLCs may be afforded similar protection as Traditional LLCs, they may also be treated like a close corporation and be more susceptible to piercing. This could become even more likely and problematic if, as discussed above, the owners fail to keep separate records for each of the Subunits. In this context, a court could potentially decide the owners were failing to observe the corporate formalities and would pierce the corporate veil to go after the owners personally.

The above discussion relates to potential problems for the owners of a Series LLC; however, a Series LLC could have unfair effects on those dealing with the Series LLC, namely its creditors. Creditors that are dealing with an LLC will generally know that the company has some sort of limited liability protection. There is a great risk, though, that a creditor of a Series LLC will have no idea the company is a Subunit. All that is required to give notice of limitation on liabilities of a Subunit is notice contained in the certificate of formation.³⁷ Furthermore, a blanket notice of the Subunits can be given, as the notice does not have to refer to a specific Subunit,³⁸ and a Subunit does not even have to be established when the notice in the certificate of formation is given.³⁹

Thus, it is very likely that a potential creditor of a Series LLC would have no idea there was a Subunit. This could cause a creditor to lend more money to a Subunit than it probably should because of the mistaken notion that it has all of the assets of the entire LLC to back the loan. This is especially hazardous to potential creditors because there is no requirement that the name of the Subunit be distinguishable from the Umbrella LLC as a whole. Therefore, unless the creditor actually looks to the certificate of formation filed with the secretary of the state, it is very likely that the creditor will believe it is dealing with a Traditional LLC rather than a Subunit in a Series LLC.

Although some of the hazards discussed above are more likely than others, there is one recurring theme: due to Series LLCs being relatively new and to so few states utilizing them, there is a lot of uncertainty as to the risks involved. While Series LLCs do provide a number of benefits, it is important to be cognizant of the risks and potential risks associated with forming a Series LLC.

B. Potential Uses of a Series LLC

Although there are a number of potential risks one may encounter in forming a Series LLC, there are a number of beneficial ways in which they may be used. The most obvious benefit of the Series LLC is allowing owners of an LLC to limit the liabilities of certain assets or activities within the company. However, they can also be quite useful for companies with multiple assets, diversified activities, or multistate operations.

A Series LLC may be quite useful for companies with multiple assets. The example often given pertains to taxi cabs and cab drivers. When a cab company owns a number of taxi cabs, it is important to have some limited liability so that if one cab driver gets into an accident, it does not jeopardize the personal assets of the owner. However, in order to protect the assets of the entire corporation or LLC, an owner would have to set up multiple corporations or LLCs for each cab or at least for a small number of cabs. With a Series LLC,

³⁷ TEX. BUS. ORGS. CODE ANN. § 101.604 (West 2011).

³⁸ *Id.* § 101.604(2).

³⁹ *Id.* § 101.604(1).

however, a cab company can own hundreds of cabs and set up a distinct Subunit for each cab, thereby limiting any liability incurred by that cab to that Subunit alone.

Another area with multiple assets where this would be useful is when a company or owner owns a number of real estate projects. Typically, LLCs or corporations are set up for different real estate ventures for the same reason – to limit liability to that project alone. By utilizing a Series LLC, however, a company can maintain this same limited protection by establishing a different Subunit for each real estate project, and thereby limiting any risk to that project if the project never gets completed, becomes insolvent or needs to be foreclosed, or if there is some accident on the premises.

While companies are still able to enjoy many of these benefits currently under Traditional LLCs or corporations, the benefit of forming a number of different Subunits is that it appears to be a more simplistic approach. The benefit of a Series LLC is the simplicity of having a single business entity controlling all of these assets, rather than an interconnected web of numerous different LLCs each controlling a separate asset, in addition to any cost reduction in setting up a Subunit as opposed to an entirely new LLC.

Much in the same way, a company with diversified activities could do well to use a Series LLC to limit the liability of each different activity. In the example above pertaining to Conglomerate, LLC, Conglomerate would be wise to segregate its different activities into distinct Subunits. This would allow Conglomerate to operate as one company overseeing all of its different divisions, yet it would still provide the protection of limiting the liability of each division.

Furthermore, a business entity that provides professional services in a number of different jurisdictions would be wise to set up a Series LLC. While this would obviously be affected by which jurisdictions either allow for Series LLCs or would at least acknowledge them, an enterprise could effectively set up a different Subunit for each state it does business in, thereby limiting malpractice to the states where the activity took place. For example, a national hospital chain could create a different Subunit for each state it has a hospital in and thereby limit malpractice claims against a doctor in Texas to Texas alone and not encumber the entire organization.

These are just a few potential uses for a Series LLC. Anytime there is a business that either has a number of assets or operations and wants to limit liabilities to each particular asset or operation, it is important to consider whether a Series LLC would be appropriate to use and whether it could accomplish the same goals with more ease.

IV. TAXES

A. Federal Tax Issues

Until recently, the IRS has offered relatively little supervision as to the correct tax treatment for Series LLCs. In fact, that is likely one of the primary reasons that Series LLCs have not been used more frequently. In order to provide some clarification for taxpayers looking to utilize the Series LLC entity structure, on September 14, 2010, the IRS issued Proposed Regulation § 301.7701-1(a)(5) (the “**Proposed Regulation**”) to offer some guidance as to how Series LLCs should be treated for federal tax purposes. Specifically, the Proposed Regulation recognizes each individual Subunit in a series organization (for our purposes, the

Series LLC)⁴⁰ as an entity for federal tax purposes, lays out rules for how it will treat the ownership of each Subunit in a Series LLC, and establishes a transition rule for existing Series LLCs that have previously filed tax returns differently from how the regulation will require going forward, assuming it is adopted. Therefore, while it has not answered every question with respect to Series LLCs,⁴¹ the Proposed Regulation has largely clarified the IRS's position with respect to these entities, and likely enhances their attractiveness as a business entity by providing taxpayers with some security as to how they will be treated from a federal tax standpoint.

The most significant function of the Proposed Regulation is to recognize each Subunit in a Series LLC as an entity for federal tax purposes. Specifically, the Proposed Regulation holds that each Subunit established under a series statute will be treated as an entity for federal tax purposes, regardless of whether the Subunit meets the requirements necessary to qualify as a formal entity under state law.⁴² The Proposed Regulation defines a "series statute" as a state statute that provides for the organization of a series, and explicitly permits members of the Series LLC to have "rights, powers, or duties with respect to the series," for each Subunit in the organization to have "separate rights, powers, or duties with respect to specified property or obligations," and "the segregation of assets and liabilities such that none of the debts and liabilities of the series organization...or of any other series of the series organization are enforceable against the assets of a particular series in the organization."⁴³ The Proposed Regulation defines a series (here, a Subunit) as "a segregated group of assets and liabilities that is established pursuant to a series statute...by agreement of a series organization."⁴⁴ Finally, the Proposed Regulation also holds that being established as an entity under a state statute is insufficient; the entity must also meet standard requirements such as a business purpose and a business activity other than tax avoidance in order to qualify as an entity for federal purposes.⁴⁵

Also significant, the Proposed Regulation lays out guidelines for how taxpayers should treat the ownership of each Subunit in a Series LLC. The Proposed Regulation specifies that the ownership of the interests of an individual Subunit, and ownership of the assets associated with an individual Subunit, will be determined under "general tax principles," and that the Series LLC will not necessarily be treated for federal tax purposes as the owner of a Subunit, or of the assets associated with that Subunit, merely because it holds legal title to those assets.⁴⁶ While the Proposed Regulation does not specify how a "general tax principles" analysis should proceed, the Preamble to the Proposed Regulation suggests that in order to assess the ownership of a Subunit, an analysis under general tax principles will look to determine which parties receive the economic benefits and bear the economic burdens of ownership, and may also look to any common-law principles that may apply.⁴⁷

⁴⁰ Though this discussion is limited to Series LLCs, the Proposed Regulation also applies to series partnerships, series trusts, protected cell companies, segregated cell companies, segregated portfolio companies, and segregated account companies. Prop. Treas. Reg. § 301.7701-1(a)(5)(viii)(A), 75 Fed. Reg. 55699, 55708 (Sept. 14, 2010). The Proposed Regulation also discusses entities formed under foreign statutes and series organizations conducting insurance business, both of which are also outside the parameters of this discussion. *See id.* § 301.7701-1(a)(5).

⁴¹ Specifically, the Proposed Regulation does not address, and the IRS requests comments on, several issues including potential options for employment tax issues (both federal and state) and employee benefits issues with respect to individual series. *See* Preamble to Prop. Treas. Reg. § 301.7701-1(a)(5), 75 Fed. Reg. 55699, 55704 (Sept. 14, 2010).

⁴² Prop. Treas. Reg. § 301.7701-1(a)(5)(i).

⁴³ *Id.* § 301.7701-1(a)(5)(viii)(B).

⁴⁴ *Id.* § 301.7701-1(a)(5)(viii)(C).

⁴⁵ *Id.* § 301.7701-1(a)(5).

⁴⁶ *Id.* § 301.7701-1(a)(5)(vi).

⁴⁷ Preamble to Prop. Treas. Reg. 301.7701-1(a)(5).

In addition to providing a means by which to evaluate Subunit ownership, the Proposed Regulation also establishes the type of entity that each individual Subunit will be for federal tax purposes, and therefore establishes the process for determining the tax return filing responsibilities for each individual Subunit. It does so by providing that once a Subunit is determined to be an entity for federal tax purposes (as explained above), that the evaluation as to what type of entity it will be for federal purposes will fall under a standard analysis through Treasury Regulations 301.7701-2 through 301.7701-4.⁴⁸ Essentially, unless a Subunit specifically elects to check the box and treat itself as a corporation, a Subunit with one owner will be treated as a disregarded entity for tax purposes, and a Subunit with multiple owners will be treated as a partnership. To provide additional guidance, the Proposed Regulation offers an example to demonstrate how Subunit ownership should be treated. In the example, a Series LLC properly formed under a series statute has three members (1, 2, and 3), and establishes two Subunits (Series A and B). Under a general tax principles analysis, Members 1 and 2 own Series A, and Member 3 owns Series B. The Proposed Regulation holds that each Subunit is an entity for federal tax purposes, and an analysis under Treasury Regulation 301.7701-3 finds that Series A is a partnership and that Series B is a disregarded entity.⁴⁹

Finally, the Proposed Regulation sets up a transition rule for Series LLCs that have previously treated themselves in a manner that differs from the Proposed Regulation's guidelines. Under the transition rule, the IRS will respect the taxpayer's prior treatment of Series LLCs, even if that treatment is inconsistent with the terms of the final regulation.⁵⁰ In order to qualify for the transition rule, the Subunit must have been established and conducting business or investment activity prior to September 14, 2010; no owner in the Subunit can treat the Subunit as an entity separate from other Subunits in the Series LLC or from the Umbrella LLC; the Series LLC must have a reasonable basis for its claimed classification (within the guidelines of I.R.C. section 6662); and neither the Subunit nor any owner of the Subunit was notified prior to September 14, 2010 that the Subunit's classification is under examination.⁵¹ The transition rule will cease to apply at the point at which fifty percent or more of the ownership of the Series LLC (or Subunit) shifts to a party that did not own an interest in the Subunit as of September 14, 2010.⁵²

While the Proposed Regulation is useful in that it provides substantial guidance to those considering the Series LLC structure, it does so in a manner such that it will require careful tax planning in order to maximize the utility of the Series LLC as a vehicle for allocating business or investment assets. Because the Proposed Regulation requires that each Subunit having multiple owners be treated as a partnership and therefore have to file a separate tax return, an optimal arrangement would be one in which each Subunit would be treated as having a single owner, and therefore be disregarded as an entity for federal tax purposes. At the same time, the tax planner must be mindful of the "general tax principles" criteria for evaluating Subunit ownership. One potential alternative for using the Series LLC entity while minimizing tax filing responsibilities would be for a partnership to form a wholly-owned subsidiary LLC to serve as the Umbrella LLC, from which each individual Subunit would be created. In this framework, the partnership would be treated as the sole owner of each of the Subunits in the Series LLC, and the partners of the partnership could allocate items of income and loss from each Subunit at the partnership level. Under such a scenario, the partnership and its partners could fully take advantage of the Series LLC entity structure while minimizing tax

⁴⁸ Prop. Treas. Reg. § 301.7701-1(a)(5)(iv).

⁴⁹ *Id.* § 301.7701-1(a)(5)(x), Ex. 1.

⁵⁰ *Id.* § 301.7701-1(f)(3)(ii).

⁵¹ *Id.* § 301.7701-1(f)(3)(ii)(A).

⁵² *Id.* § 301.7701-1(f)(3)(ii)(B).

filing requirements, as the only tax return necessary would be that of the partnership, because the Series LLC and each of its related Subunits would be treated as disregarded entities.

B. State Tax Issues

It is important to consider how the state in which a Series LLC is formed, as well as any state in which the Series LLC or any of the Subunits does business, will each tax the Series LLC and the Subunits.

Before the IRS issued the Proposed Regulation, a couple of states had already treated Subunits of a Series LLC as separate entities for state income tax purposes. For purposes of the California LLC income tax and annual fee, the California Franchise Tax Board treats each Subunit doing business in California as a separate entity if it meets certain criteria.⁵³ Under these criteria, fewer Subunits would be treated as separate entities than would be treated as separate entities under general federal tax principles. For example, A and B may own each of the Subunits in a Series LLC. If the company agreement provides that A and B will share in all of the income of all of the Subunits and all of the assets of all of the Subunits upon liquidation, those Subunits would not meet the California criteria for treatment as separate entities.⁵⁴ However, those Subunits would probably be considered separate entities for federal tax purposes under the Proposed Regulation as long as each Subunit had some kind of business purpose other than tax avoidance.

The Massachusetts Department of Revenue also recognized Subunits as separate entities in 2008 when it issued a letter ruling to a mutual fund stating that if the fund reorganized into a Delaware Series LLC, each Subunit would be treated as a separate entity for Massachusetts income and corporate excise tax purposes.⁵⁵ However, the letter ruling was specific to the entities described in the ruling; it expressly declined to rule generally on whether or not each Subunit of a Series LLC would be treated as a separate entity. The Proposed Regulation had not been issued at that time, but the ruling followed the federal tax treatment of regulated investment companies.⁵⁶ The letter ruling stated further that classification of each Subunit would follow its classification for federal tax purposes.

In contrast, the Texas Comptroller has elected to treat a Series LLC as a single legal entity which must file one margin tax report under the Umbrella LLC's taxpayer identification number, effectively preventing each Subunit from being taxed separately even though they may not be engaged in a unitary business.⁵⁷ For states that have not made any determinations regarding Subunits, the general rule is that they will follow the treatment of Subunits for federal tax purposes. Some states have stated this explicitly.⁵⁸

In spite of the Proposed Regulation and states' general willingness to follow it for state tax purposes, a number of state and local tax issues remain to be addressed. For example, the Proposed Regulation does not have any bearing on the issue of whether the in-state activities of one Subunit can create a nexus to the state for participants in a different Subunit

⁵³ FTB Pub. 3556 (Rev. 9-2009).

⁵⁴ See Jacob Stein, *Tilting at Windmills: Examining FTB's Treatment of Series LLCs*, 10 BUS. ENTITIES 16 (2008).

⁵⁵ Mass. Letter Ruling 08-2 (Feb. 15, 2008).

⁵⁶ See I.R.C. § 851(g).

⁵⁷ Tex. Policy Ltr. Rul. No. 201005184L (May 5, 2010; released Sept. 2011).

⁵⁸ E.g., Florida and Illinois. Fla. Dep't of Revenue Tech. Assist. Adv. No. 02(M)-009 (Nov. 27, 2002); Q&A 1 of "Questions and Answers for 2006/2007 Illinois Department of Revenue Practitioners' Meetings," available at <http://www.revenue.state.il.us/LegalInformation/Practqna/2006-2007qna.pdf>.

within the same Series LLC. Also, just because the states may follow the Proposed Regulation and treat Subunits as separate entities for state income tax purposes does not necessarily mean that they will treat Subunits as separate entities for the purpose of other state and local taxes. On the collections side, states must determine the extent to which they will respect the liability shield between Subunits of a Series LLC organized in a foreign state and refrain from collecting the unpaid taxes of one Subunit out of the assets of another Subunit in the same Series LLC. These and other issues relating to the treatment of Series LLCs for state and local tax purposes remain to be resolved.

C. Federal Employment Tax Issues

Even more issues remain to be resolved with respect to the treatment of Series LLCs for federal employment tax purposes. The Proposed Regulation identifies some of these issues, such as whether the Subunit or the Series LLC will be considered the employer of any employees and whether a Subunit can maintain an employee benefit plan. Entities are not always treated the same for federal employment tax purposes as they are for federal income tax purposes. For example, entities that are disregarded for federal income tax purposes may not be disregarded for federal employment tax purposes.⁵⁹ Very little guidance exists on these and other employment tax issues. The Proposed Regulation requests comments on them. Hopefully, the comments will enable the IRS to publish guidance on these issues in the final regulations or in future regulations.

V. **BANKRUPTCY TREATMENT AND ISSUES**

Despite being an entity option for more than a decade, the validity of the asset segregation of a Series LLC has yet to be tested in bankruptcy court. How a Subunit will be treated in bankruptcy court will ultimately determine the attractiveness of a Series LLC as an entity option. The purported appeal of a Series LLC is the ability to segregate assets into different Subunits within a single LLC rather than establishing an entirely new entity for each set of assets. Thus, if the Subunit segregation is ineffective as to limiting the creditors in a bankruptcy case to the assets of the filing Subunit, the Series LLC has little appeal. Further, how the doctrine of substantive consolidation will be applied to a Series LLC is a significant concern for both potential debtors and creditors. Due to the fact that no bankruptcy court has ushered a Series LLC through the process to date, these questions must be answered by analogy to the treatment of other entities by the bankruptcy courts.

A. Bankruptcy Eligibility of Series LLCs

The threshold question is whether an individual Subunit within a Series LLC can declare bankruptcy at all. The bankruptcy code (the “**Code**”) only allows “persons” to file for bankruptcy.⁶⁰ Thus, the question is whether an individual Subunit of a Series LLC is a “person” under the Code. If a Subunit is not a “person,” then the Umbrella LLC will have to file on behalf of the Subunit, thereby exposing the other Subunits to liability to creditors.⁶¹

⁵⁹ Treas. Reg. § 301.7701-2(c)(2)(iv) (2012).

⁶⁰ 11 U.S.C. §§ 101(13), 109(a) (2010).

⁶¹ *In re ICLNDS Notes Acquisition, LLC*, 259 B.R. 289, 293 (Bankr. N.D. Ohio 2001) (finding that an LLC is a “person” and thus eligible to file for bankruptcy protection despite not being explicitly provided for in the Code).

While Series LLCs are not specifically included in the definition of “person,” neither are they excluded.⁶² Further, the list of entities defined as a “person” in the Code is prefaced by “includes” which the Code expressly defines as not limiting.⁶³ Acknowledging the non-exhaustive nature of the definition of “person,” bankruptcy courts have previously dealt with other non-listed entities and determined their eligibility by analogy to listed forms.⁶⁴ The same analysis can be applied to a Subunit of a Series LLC to determine its likely treatment. Due to the differences in the two types of statutes establishing Series LLCs, the outcome may differ based on the enabling state. For instance, the Illinois-type statutes specifically grant a Subunit separate legal status and require a new filing for each Subunit created whereas the Delaware-type statutes do neither.⁶⁵

How bankruptcy courts treated Traditional LLCs when first faced with the question is instructive as to how they are likely to treat a Subunit of a Series LLC. Like a Subunit of a Series LLC, Traditional LLCs are not specifically mentioned in the Code’s definition of a “person.”⁶⁶ However, the definition found in the Code is non-exhaustive,⁶⁷ and when the bankruptcy court first considered the eligibility of a Traditional LLC, it was found to fit the definition.⁶⁸ Further, when the Code was significantly revised in 2005, Traditional LLCs were not explicitly excluded from the definition of “person,” indicating Congress’ assent to the judicial decision to define them as a “person.”

In *In re ICLNDS*, the court determined that the list of bankruptcy eligible entities was not comprehensive.⁶⁹ Therefore, while LLCs are not specifically granted the ability to declare bankruptcy, they are not necessarily excluded. The court then analyzed the character of LLCs to determine if they are similar enough to corporations or partnerships (both of which are explicitly authorized to file) to warrant bankruptcy protection.⁷⁰ The court determined that an LLC

is a form of legal entity that has attributes of both a corporation and a partnership but is not formally characterized as either one. Generally, an LLC offers all of its members, including any member-manager, limited liability as if they were shareholders of a corporation but treats the entity and its members as a partnership for tax purposes.⁷¹

The court reasoned that these common characteristics, along with separate legal entity status, made LLCs a sort of hybrid of partnerships and corporations, sharing characteristics with each. Thus, because LLCs draw their character from two entities that are explicitly authorized to seek bankruptcy protection, the court held that LLCs, too, could file for bankruptcy.⁷²

This reasoning is likely to also be applied to a Subunit filing for bankruptcy, if that ever occurs. A Subunit under both the Delaware- and Illinois-style statutes are given many

⁶² 11 U.S.C. § 101(41).

⁶³ *Id.* § 102(3).

⁶⁴ *In re ICLNDS Notes Acquisition*, 259 B.R. at 292–93.

⁶⁵ DEL. CODE ANN. tit. 6, § 18–215 (2010); 805 ILL. COMP. STAT. 180/37–40 (2010).

⁶⁶ 11 U.S.C. § 101(41).

⁶⁷ *In re ICLNDS Notes Acquisition*, 259 B.R. at 292; 11 U.S.C. § 102(3) (the former stating that the definition of “person” includes several entities and the latter stating that “includes” is not a limiting term.).

⁶⁸ *In re ICLNDS Notes Acquisition*, 259 B.R. at 292–93.

⁶⁹ *Id.* at 292.

⁷⁰ *Id.* at 292–93.

⁷¹ *Id.* (quoting *In re DeLuca*, 194 B.R. 65, 71 (Bankr. E.D. Va. 1996)).

⁷² *Id.* at 293.

characteristics similar to those the court found relevant in *In re ICLNDS Notes Acquisition* such as the limited liability for the owners, and the ability to enter contracts and hold assets.⁷³ Thus, they qualify under part of the test set forth by the court. Because the Illinois statute explicitly grants a Subunit separate legal entity status, and individual Subunits have characteristics similar to other bankruptcy eligible entities, it seems very likely that a Subunit under the Illinois statute will be able to file for bankruptcy as a separate legal entity. The Delaware statute, in contrast, does not explicitly grant a Subunit separate legal status, making a Delaware Subunit's eligibility for bankruptcy less clear.

In absence of clarity of classification in the establishing statute, the court could look to other areas of law to determine how to classify a Subunit. The IRS, as the tax analysis in this article indicates, and the Delaware Department of Finance, Division of Revenue, will likely treat each Subunit in a Delaware Series LLC as a separate legal entity. Therefore, it seems likely that, even without explicit statutory language granting a Subunit separate legal status, the bankruptcy court will consider a Subunit a separate legal entity. If that is the case, then it is likely that a Delaware-type Subunit will also be allowed to file for bankruptcy protection.

Alternatively, a Subunit of a Series LLC under either type of statute could qualify as a "person" under the Code by being classified as an "unincorporated association or company."⁷⁴ While the Code does not define these terms, the bankruptcy court has previously found these words to include "persons joining together at least in part for some common business or commercial purpose, and conducting their affairs somewhat after the pattern of corporations."⁷⁵ While a single-member Subunit would probably fail to meet this definition, a Subunit with multiple members would likely fit this definition and thus, qualify for bankruptcy protection. This analysis is particularly helpful in determining how a Delaware Subunit will be treated. Under the broad definition of an unincorporated association or company, a Delaware Subunit is likely eligible to file for bankruptcy.

Subunits of a Series LLC under both types of statutes clearly have attributes similar to those of entities expressly allowed to file for bankruptcy protection. Thus, the threshold question seems to be whether a Subunit is a separate legal entity. The Illinois-type statutes expressly grant a Subunit separate legal entity status and would likely be eligible to file for bankruptcy protection as an independent legal entity. While the Delaware-type statutes do not expressly grant separate legal entity status to the Subunits within a Series LLC, other considerations could lead a bankruptcy judge to determine that they are eligible for bankruptcy. While it is impossible to tell how a Subunit will be treated until the bankruptcy court actually considers the question, the analysis indicates they will be treated as separate legal entities for bankruptcy purposes.

B. Substantive Consolidation of Series LLCs

Even if a Subunit of a Series LLC can meet the threshold question of being bankruptcy eligible, the threat of substantive consolidation must also be considered. There is a "modern' . . . trend toward allowing substantive consolidation, due to the increased use of interrelated corporate structures for tax and other business purposes."⁷⁶ The power to

⁷³ See DEL. CODE ANN. tit. 6, § 18–215 (2010); see also 805 ILL. COMP. STAT. 180/37–40 (2010).

⁷⁴ See 11 U.S.C. § 101(9)(A)(iv) (2012).

⁷⁵ *In re T.W. Koeger Trucking Co.*, 105 B.R. 512, 515 (Bankr. E.D. Mo. 1989) (quoting *Pope & Cottle Co. v. Fairbanks Realty Trust*, 124 F.2d 132, 134 (1st Cir. 1941)).

⁷⁶ *Simon v. Brentwood Tavern, LLC (In re Brentwood Golf Club, LLC)*, 329 B.R. 802, 811 (Bankr. E.D. Mich. 2005) (citing *Eastgroup Props. v. S. Motel Ass'n, Ltd.* 935 F.2d 245, 248–49 (11th Cir. 1991)).

substantively consolidate emanates from the bankruptcy court's equitable powers and "treats separate legal entities as if they were merged into a single survivor left with all the cumulative assets and liabilities (save for inter-entity liabilities, which are erased). The result is that claims of creditors against separate debtors morph to claims against the consolidated survivor."⁷⁷ Obviously, if the various Subunits in a Series LLC were to be consolidated in bankruptcy court, the entity would have little appeal as an entity option. The possibility of substantive consolidation should be a concern to creditors as well. Because all assets and liabilities are consolidated, even innocent creditors of non-filing Subunits would be swept into the bankruptcy case. This could harm creditors of non-filing Subunits by having their claims settled out of a common estate that is likely insolvent rather than the assets of the specific borrower the creditor looked to in extending credit.

"[T]he Supreme Court, little more than six decades ago, approved . . . what became known as substantive consolidation."⁷⁸ Despite roots in a Supreme Court decision, the concept took time to gain traction.⁷⁹ Eventually two dominant methods of applying the doctrine emerged: the Augie/Restivo Banking test and the Auto-Train test.⁸⁰ The Augie/Restivo Banking test considers two critical factors to determine whether or not to impose substantive consolidation: "(i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, . . . or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors"⁸¹ The Auto-Train test focuses more on the identity of the debtors and finds a rebuttable presumption that substantive consolidation is appropriate if there is substantial identity between the entities (less than alter ego standard), and consolidation is necessary to avoid some harm or to realize some benefit.⁸² The presumption can be rebutted if a creditor can show that it relied upon the separate credit of one of the entities and that it will be prejudiced by the consolidation.⁸³ However, even if the presumption is rebutted, a bankruptcy court applying this test will still impose substantive consolidation if the benefits of consolidation "heavily" outweigh the harm.⁸⁴

The Court of Appeals for the Third Circuit recently reconciled the two unwieldy tests into a single, more straightforward set of criteria.⁸⁵ The court in *In re Owens Corning* held that substantive consolidation will be imposed only where debtors "(i) disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) postpetition [the] assets and liabilities [of the various units] are so scrambled that separating them is prohibitive and would hurt all creditors."⁸⁶ This test is designed to minimize the risk to innocent creditors that relied on the separateness of the entities being considered for consolidation.

While it is not clear which of these three tests will emerge as the preeminent theory, it is clear that substantive consolidation is an available tool of equity for the bankruptcy court.

⁷⁷ *In re Owens Corning*, 419 F.3d 195, 205 (3d Cir. 2005) (quoting *Genesis Health Ventures, Inc. v. Stapleton*, 402 F.3d 416, 423 (3d Cir. 2005)).

⁷⁸ *Id.* at 206 (citing *Sampson v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941)).

⁷⁹ *See id.* at 206–07.

⁸⁰ *Id.* at 207.

⁸¹ *Id.* at 207–08 (citing *In re Augie/Restivo Baking Co.*, 860 F.2d 515, 518 (2d Cir. 1988) (internal quotation marks and citations omitted)).

⁸² *See Simon v. Brentwood Tavern, LLC (In re Brentwood Golf Club, LLC)*, 329 B.R. 802, 812 (Bankr. E.D. Mich. 2005) (citing *In re Standard Brands Paint Co.*, 154 B.R. 563, 569 (Bankr. C.D. Cal. 1993)).

⁸³ *See id.* at 812.

⁸⁴ *Id.*

⁸⁵ *In re Owens Corning*, 419 F.3d at 211.

⁸⁶ *Id.*

Because the Subunits of a Series LLC will likely be related to each other in various ways, due care should be taken to minimize the risk of being consolidated. Specifically, each Subunit should be operated as a separate entity despite common membership with other Subunits in the group, and all finances should be kept clearly separate. Further, creditors should be explicitly made aware of the nature of the asset allocation among the Subunits to avoid confusion. The last point is particularly relevant for Series LLCs under the Delaware-type statutes that do not require separate filings for each Subunit, which would give constructive notice to would-be-creditors of the segregation of assets.

VI. CONCLUSION

While new laws and recently released tax guidance may resolve some of the critical questions surrounding Series LLCs, they remain fraught with uncertainty. Series LLCs were developed with the goal of simplifying corporate organizations. Therefore, there is a good possibility that legislatures will eventually tackle the remaining obstacles to Series LLCs becoming more widespread. Until this happens, it is unclear whether, and to what extent, practitioners and their clients will decide that the benefits of Series LLCs are great enough to warrant the risks they entail.

PRACTICAL PITFALLS IN DRAFTING TEXAS LIMITED LIABILITY COMPANY AGREEMENTS

Elizabeth S. Miller^{*}

TABLE OF CONTENTS

I. VOTING AND MANNER OF DECISION MAKING	28
II. CONTRIBUTION PROVISIONS	31
III. ADMISSION OF INITIAL MEMBERS IN MANAGER-MANAGED LLC (THE “SHELF LLC”).....	34
IV. WITHDRAWAL OF A MEMBER	36
V. PROBLEMS ARISING IN CONNECTION WITH TRANSFER PROVISIONS AND ASSIGNMENT OF A MEMBERSHIP INTEREST.....	40
VI. FIDUCIARY DUTIES OF MEMBERS AND MANAGERS	44
VII. APPENDIX A.....	48

^{*} Elizabeth S. Miller is a Professor of Law at Baylor University School of Law where she teaches Business Organizations, Business Planning, and related courses. Professor Miller speaks and writes extensively on business organizations topics, particularly partnerships and limited liability companies.

I. Voting and Manner of Decision Making

The following default rules of the Business Organizations Code (BOC) merit careful consideration in drafting the company agreement.

Consent or approval of all members of a limited liability company (LLC) is required for:

- (1) amendment of the company agreement;¹
- (2) amendment of the certificate of formation;²
- (3) admission of a member after formation of the LLC;³
- (4) issuance of a membership interest after formation of the LLC;⁴
- (5) release or settlement of a member's obligation to contribute "or otherwise pay . . . or transfer property to the [LLC], or to return cash or property to the [LLC] paid or distributed to the member in violation of [the BOC] or the company agreement";⁵ and
- (6) cancellation of the expiration of a period of duration specified in the governing documents or cancellation of any other event specified in the governing documents as requiring winding up.⁶

"Majority" is determined on a per capita basis, i.e., one member, one vote.⁷ Consent or approval of a majority of all members is required for the following fundamental business transactions and other extraordinary matters:⁸

- (1) "merger, interest exchange, conversion, or sale of . . . substantially all of [the LLC]'s assets;⁹
- (2) an act that would make it impossible to carry on the LLC's ordinary business;¹⁰
- (3) "voluntary winding up of the [LLC];"¹¹

¹ TEX. BUS. ORGS. CODE ANN. § 101.053 (West 2012).

² *Id.* § 101.356(d)(1). It appears that a majority of the managers named in the certificate of formation would be permitted to amend the certificate of formation during the period between the formation of the LLC and the admission of the first member or during the period after the termination of the last remaining member. *See id.* §§ 101.101(b), (c); 101.355; 101.356(a), (e).

³ *Id.* § 101.103(c).

⁴ *Id.* § 101.105.

⁵ *Id.* § 101.154.

⁶ *Id.* § 101.552(b).

⁷ *Id.* § 101.354.

⁸ *Id.* §§ 101.356(c), 101.552(a).

⁹ *Id.* §§ 1.002(32), 101.356(c).

¹⁰ *Id.* § 101.356(c).

¹¹ TEX. BUS. ORGS. CODE ANN. § 101.552(a)(1) (West 2012). If the LLC has no members, a majority vote of all of the managers is required.

- (4) “revocation of a voluntary decision to wind up the [LLC];”¹² and
- (5) reinstatement of the LLC after termination.¹³

The consent or approval of a majority of all managers of a manager-managed LLC or a majority of all members of a member-managed LLC is required for acts (other than those listed above) not apparently for carrying out the ordinary business of the LLC.¹⁴

Other actions or decisions not listed above are generally authorized upon the act of a majority of the governing persons (i.e., the members of a member-managed LLC or managers of a manager-managed LLC) who are present at a meeting of such persons at which a quorum is present.¹⁵

Drafting Tip: Modification of some of these rules in the company agreement without addressing others may provide opportunities for members to invoke default rules that undercut provisions of the agreement. For example, a merger requires, as a default rule, the approval of a majority of the members by number. Failure to modify this rule in the company agreement may give a majority of the members the ability to effect a transaction that results in dramatic changes to the LLC that could not have been accomplished directly without the consent of all members to amend the company agreement. (Simply changing the per capita majority vote requirement to a majority-in-interest requirement may still create a situation where the majority-in-interest can indirectly accomplish through a merger what they could not otherwise accomplish directly, e.g., an amendment of the company agreement or expulsion of a member.) As another example, failure to address the vote required to revoke a voluntary winding up could result in a situation where a majority of the members by number have the ability under the statutory default rule to revoke a decision to wind up made by a majority-in-interest or other specified group of members in accordance with the company agreement.

A written consent in lieu of a meeting is permitted if signed by persons having not fewer than the minimum number of votes that would be necessary to take the action at a meeting at which all persons entitled to vote on the matter were present and voted.¹⁶

The company agreement may provide for the manner in which members or managers may take action, including means of taking action without a meeting.¹⁷

An action is effective if taken by the affirmative vote of those persons having not fewer than the minimum number of votes that would be necessary to take the action at a meeting at which all members or managers, as the case may be, entitled to vote on the action

¹² *Id.* § 101.552(a)(2). If the LLC has no members, a majority vote of all of the managers is required.

¹³ *Id.* § 101.552(a)(3). If the LLC has no members, a majority vote of all of the managers is required.

¹⁴ *Id.* § 101.356(b).

¹⁵ *Id.* § 101.355. Provisions regarding notice and permissible means of holding a meeting (e.g., by telephone or other electronic means of communication) are found at Sections 6.001-6.053 and 101.352 of the Texas Business Organizations Code.

¹⁶ *Id.* § 101.358(b).

¹⁷ *Id.* § 101.359.

were present and voted.¹⁸ This provision thus authorizes action to be taken by informal votes (i.e., a series of phone calls or a combination of emails and conversations).

An action is effective if taken with the consent of each member, which may be established by the member's failure to object to the action in a timely manner (if the member has full knowledge of the action), the member's signed written consent, or any other means reasonably evidencing consent.¹⁹ This tacit consent/failure to object provision may or may not be desirable depending upon the level of formality expected by the members and managers of the LLC.

Drafting Tip: Company agreements often contain provisions regarding meetings, notice of meetings, and written consents without addressing less formal means of taking action. If certain means of taking action, such as meetings and written consents, are specified in the company agreement while less formal means (i.e., those authorized in BOC Section 101.359) are neither expressly permitted nor expressly precluded, a question may arise as to whether the company agreement implicitly precludes other means of taking action set forth in the statute or whether the other means set forth in the statute are still available because the company agreement does not specifically provide otherwise.²⁰ In particular, if the members do not desire for an action to be effective based on the knowledge of all members and the members' failure to object in a timely manner, the company agreement should expressly so state or otherwise clearly specify that the methods of taking action set forth in the company agreement are the exclusive methods of taking action.

The BOC allows members to vote by written proxy as a default rule and allows managers to vote by written proxy if the company agreement so permits.²¹ Careful thought should be given to these default rules when drafting the company agreement. The *delectus personae* principle reflected in the statutory default rules (i.e., an assignee is not entitled to participate in management or exercise any rights of a member, and consent of all members is required to admit an assignee as a member)²² may be largely undercut by a member's ability to grant another person a proxy.

Drafting Tip: The members should consider whether they want to negate or limit the statutory default rule permitting members to vote by written proxy. Preferences in this regard will be dictated by the management structure, allocation of control, and degree to which the members are concerned with limiting participation in decisions to those with whom the members have chosen to go into business. Particularly in a member-managed LLC, the members may wish to prohibit proxy voting altogether, or they may wish to provide that a member may not grant a proxy to anyone other than another member or that a member may only grant a proxy to vote in a specific manner (i.e., that a member may not grant the proxy holder the authority to vote in the proxy holder's discretion on a matter). Even in the manager-

¹⁸ *Id.* § 101.359(1).

¹⁹ *Id.* § 101.359(2).

²⁰ See Paul v. Del. Coastal Anesthesia, LLC, 2012 WL 1934469 (Del. Ch. 2012) (operating agreement requiring vote of holders of 75% of LLC's shares to terminate member and containing provisions regarding notice of meetings and voting of shares at meetings did not preclude members from taking action by written consent, as permitted by Delaware LLC Act unless otherwise provided in a limited liability company agreement, where agreement at issue was silent as to method by which vote terminating membership must be taken and did not specifically disallow votes by written consent).

²¹ TEX. BUS. ORGS. CODE ANN. § 101.357 (West 2012).

²² See *id.* §§ 101.108(b)(2), 101.109(b).

managed LLC context, the members may wish to eliminate or limit the extent to which members may vote by proxy.

Proxy voting by managers is not authorized by the statute unless the company agreement authorizes it, and the members should carefully consider the implications if proxy voting by managers is to be authorized by the company agreement. Such provisions might be drafted to provide that a manager may only grant a proxy to another manager, that a proxy may be granted only with respect to certain decisions or categories of decisions, or that a proxy must specify how the proxy holder is to vote. If managers or managing members are allowed to grant a proxy that vests the proxy holder with discretion in voting, thought should be given to including provisions in the company agreement addressing the duties and liabilities of those who have given and exercised the proxy.²³

II. Contribution Provisions

It is not uncommon to find in a company agreement a provision to the effect that a member's liability is limited to the amount of the member's contribution or contribution obligations. Such a statement may be intended as a mere affirmation of the member's limited liability with respect to third parties, or it may be intended to embrace liability to the LLC or the other members for breach of duty or breach of the company agreement. The intended scope and the wording of a provision specifying that a member's liability is limited to the amount of the member's contribution or contribution obligations should be carefully considered.²⁴

In *Park Cities Corp. v. Byrd*,²⁵ the Texas Supreme Court held that the deficit capital account of the general partner of a limited partnership was an asset of the partnership and that the general partner was liable to pay to the partnership the amount of the deficit although the deficit was created by the allocation of non-cash depreciation. (The court reached this result based upon the provisions of the Texas Uniform Limited Partnership Act, the Texas Uniform Partnership Act, and the partnership agreement.) The partnership agreement provided that the limited partner would have no liability beyond its capital contribution and that the general partner would bear all of the losses. If the company agreement of an LLC addresses only the sharing of losses without making it clear that the members have no obligation to make up any negative capital account balance, a creditor or another member with a positive capital account balance might argue that a member whose capital account has a negative balance due to the allocation of losses must contribute an amount sufficient to eliminate the deficit. It may be persuasively argued that the reasoning in the *Park Cities* case has no application to limited partners or LLC members absent an express provision requiring restoration of negative capital accounts, but provisions expressly negating any obligation to make up a negative capital

²³ See *supra* Part VI discussing fiduciary duties in the LLC context.

²⁴ See *Cooke v. Dykstra*, 800 S.W.2d 556 (Tex. App.—Houston [14th Dist.] 1990, no writ). In that case, a limited partnership agreement stated that the limited partners' liability with regard to the partnership was limited "in all respects" to the amount of the capital contributions they made or agreed to make. The court held that the general partner could not recover damages from the limited partners in excess of the amount of their capital contributions when the limited partners breached the partnership agreement by attempting to terminate the partnership without the ninety-day notice required under the partnership agreement, and the general partner's access to the partnership's line of credit, which was guaranteed by the limited partners, was blocked.

²⁵ *Park Cities Corp. v. Byrd*, 534 S.W.2d 668 (Tex. 1976).

account balance obviously avoid the need to test the argument.

Provisions that require future capital contributions or permit capital calls should be carefully considered. The BOC provides for non-liability of the members to LLC creditors for the LLC's obligations, but there are nevertheless certain situations in which a member may be held liable to the LLC in an action by an LLC creditor. A creditor of an LLC may enforce a member's obligation to make a contribution to the LLC even though it has been released by the LLC if the creditor extended credit or otherwise reasonably relied on the obligation after the member signed a writing reflecting the obligation and before the writing was amended or cancelled to reflect the release.²⁶ Additionally, a member is obligated to return to the LLC a distribution that the member knows was improperly made.²⁷ Though the statute does not explicitly give LLC creditors the right to enforce this obligation, it would not be surprising if a court permitted a creditor to do so.²⁸

Sometimes it may be desirable for the company agreement to grant manager(s) or managing member(s) the right to call for contributions when they conclude the LLC needs additional cash.²⁹ These "cash call" or "capital call" provisions ordinarily do not give creditors any rights unless the call has already been made because a creditor may not enforce a conditional obligation to make a contribution unless the conditions or obligations have been satisfied or waived.³⁰ Conditional obligations include contributions payable upon a discretionary call of the LLC before the call occurs.³¹ Nevertheless, these provisions should be carefully drafted to avoid any implication that the members have agreed to waive their limited liability.³² Additionally, even if creditors cannot invoke a discretionary capital call provision,

²⁶ TEX. BUS. ORGS. CODE ANN. § 101.155 (West 2012).

²⁷ *Id.* § 101.206(d).

²⁸ If a creditor has standing to enforce the obligation at all, it would appear that the creditor should be required to proceed derivatively on behalf of the LLC.

²⁹ In *Potter v. GMP, L.L.C.*, 141 S.W.3d 698 (Tex. App.—San Antonio 2004, pet. dismissed), an LLC sued one of its members to enforce a capital call. The member argued that the regulations ("regulations" under the Texas Limited Liability Company Act were the equivalent of a company agreement under the BOC) did not obligate him to make additional capital contributions without his consent. The court of appeals concluded the regulations were susceptible to two interpretations regarding additional capital contributions. On the one hand, they could be read to require members to contribute if requested by the manager and agreed to by a majority-in-interest of the members. On the other hand, as the member argued, they could be read as providing that additional contributions were not mandatory for members who objected. Since the regulations were ambiguous, the trial court properly submitted the issue of their interpretation to the jury. The court of appeals found there was sufficient evidence (which included testimony by the lawyer who drafted the regulations) to support the jury's finding that the regulations obligated the member to make the contribution that the other two members had approved.

³⁰ TEX. BUS. ORGS. CODE ANN. § 101.156.

³¹ *Id.* § 101.156(b). *Cf.* *Racing Inv. Fund 2000, LLC v. Clay Ward Agency, Inc.*, 320 S.W.3d 654 (Ky. 2010) (noting that the provision of the Kentucky LLC statute permitting a creditor to enforce a written contribution obligation on which the creditor has relied has no application in the case of a future contribution obligation which is not for an amount certain and is at the discretion of the manager on an as-needed basis).

³² *See Racing Inv. Fund 2000*, 320 S.W.3d at 660. The trial court and court of appeals in this case concluded that a provision of an LLC operating agreement requiring the members to contribute to pay expenses as determined necessary by the manager fell within the provision of the Kentucky LLC statute that allows members of an LLC to alter their limited liability in a written operating agreement. Because other provisions of the agreement addressing the limited liability of the members contained provisos referring to the capital call provision, the court of appeals rejected the argument that these other provisions overrode the capital call provision. The court of appeals also stated that the case was not about the personal liability of the LLC's members, but rather involved an order against the LLC, a separate legal entity, to make a capital call for the purpose of complying with its obligations to pay an agreed judgment. *Racing Inv. Fund 2000 v. Clay Ward Agency, Inc.*, 2008 WL 5102151 (Ky. App. 2008), rev'd, 320 S.W.3d 654 (Ky. 2010). The Kentucky Supreme Court reversed the court of appeals, concluding that the provision was designed to assure members would contribute additional capital as deemed necessary by the manager, and that the manager could have made a capital call, but the provision was not an agreement by the members to be personally obligated to pay any of the debts, obligations, or liabilities of the LLC, nor was it a debt collection mechanism by

the members should consider carefully the extent to which they want to expose themselves to this type of obligation, at whose discretion, and with what consequences in the event of a failure to contribute.³³

Drafting Tip: If a provision of the company agreement limiting the liability of a member is intended merely to confirm that the member has no liability to any third party for the debts and obligations of the LLC, it is probably preferable to state the provision in those terms rather than broadly stating that a member's liability is limited in all respects to the member's contribution or obligations to contribute. If the intent is actually to eliminate the member's liability for the amount of the contribution and/or consequential damages for the failure to fulfill a future capital contribution, the provision should clearly provide. Other obligations that may be imposed by the company agreement (e.g., a requirement to render services, a post-withdrawal non-competition provision, etc.), should obviously be taken into consideration in connection with any provision that may be read as limiting the liability of a member for breach of the agreement or otherwise. If the agreement provides for reduction of the member's interest or some other specified consequence in the event of a failure to make a required contribution, the agreement should be clear as to whether the specified consequence is the sole remedy or is in addition to liability for damages (and if damages are recoverable, whether they are limited to the amount of the contribution or include consequential damages).

Though it would not seem that the provisions of the company agreement on loss sharing should be interpreted as an agreement to contribute in the event of a negative capital account (i.e., as satisfying the statutory rule that a promise to make a contribution must be in writing and signed by the member to be enforceable) without a more specific indication that such an obligation was intended, any doubt on this issue can be eliminated if the company agreement explicitly states whether or not there are any circumstances under which a member must contribute. The agreement might state that there is no obligation on the part of any member to make any future

which a court could order a capital call.

³³ In *Canyon Creek Dev., LLC v. Fox*, 263 P.3d 799 (Kan. Ct. App. 2011), the appellate court interpreted capital call provisions of an LLC operating agreement and concluded that the operating agreement authorized a member to make a capital call to satisfy a current obligation under an outstanding loan notwithstanding the general requirement of majority member approval of a decision to make a capital call. The court then turned to the more difficult question of whether a member who failed to satisfy a capital call could be held personally liable for the amount of the additional contribution or whether the remedy was limited to reduction of the member's ownership interest in the LLC. The agreement provided for reduction of a defaulting member's interest but did not say whether that was the sole remedy. The court examined the contribution provisions of the operating agreement and the Kansas LLC statute and concluded that in circumstances such as those in this case, where the operating agreement prohibited withdrawal from the venture, subjecting an investor to personal liability for potentially endless capital calls to prop up a failing venture was neither contemplated by the parties nor envisioned by the LLC statutes. The court acknowledged that the Kansas LLC statute provides that a member is obligated to perform any promise to contribute cash or property in addition to any other rights the LLC may have against a noncontributing member under the operating agreement or other law. The capital call provisions of the operating agreement in this case did not state that reduction of a noncontributing member's interest was the sole remedy, but the provisions also did not state that additional remedies were available. The court found it significant that the remedy of damages, the most fundamental remedy for breach of contract, was conspicuously absent from the provisions of the operating agreement dealing with additional capital contributions whereas the provisions of the agreement regarding withdrawal addressed damages. Thus, the court concluded that the failure to include damages as a remedy for failure to make an additional contribution expressed a clear intent to preclude recovery of damages from a member who failed to do so.

contributions whatsoever or, if there are specified future obligations, that these specified obligations are the only contribution obligations, and that there is no obligation to restore a negative capital account balance. On the other hand, the members may wish to effectuate their loss sharing arrangement by imposing a limited obligation on the part of a member with a negative capital account balance to contribute if, after satisfaction of creditors on liquidation, the LLC assets are exhausted and another member has a positive capital account balance. Obviously, the members would not want to include in the company agreement a provision generally imposing an unconditional deficit restoration obligation (or a general statement regarding compliance with the Section 704(b) regulations that could be read to include a deficit restoration obligation), as such would essentially eviscerate the liability protection provided by the LLC.³⁴

Provisions obligating members to make future capital contributions and addressing the circumstances under which the obligations may be waived or released should be carefully considered in light of the ability of creditors to enforce such contribution obligations in certain circumstances. Because creditors cannot enforce a conditional obligation unless the condition has been satisfied or waived, it may be preferable to specify future contribution obligations in a manner that is conditional, at least to some extent, on conditions over which the member has some control (such as a vote or consent of the member or some percentage of members). Discretionary capital call provisions should be carefully drafted so as not to effectively subject a member to unlimited contribution obligations at the discretion of a manager or other members.

III. Admission of Initial Members in Manager-Managed LLC (the “Shelf LLC”)

Generally, even in a manager-managed LLC whose certificate of formation does not identify the initial members, the identities of one or more initial members will be understood at the time an LLC is formed, and it is prudent for the initial members to execute a written company agreement prior to or contemporaneously with the filing of the certificate of formation so that it is clear who the members are and what their economic and governance rights are.³⁵ The BOC expressly recognizes, however, the formation of an LLC that does not initially have any members, sometimes referred to as a “shelf” LLC. Under this provision, an organizer may file a certificate of formation that identifies one or more initial managers, but

³⁴ There is some tension between the preservation of limited liability of members in an LLC classified as a partnership for federal income tax purposes and the “substantial economic effect” test that must be met for special allocations to be respected under the Treasury regulations. *See* Treas. Reg. § 1.704(b). A special allocation of income, gain, deduction, loss, or credit is one that is disproportionate to the partners’ interest in the partnership (which is determined by taking into account numerous factors and is not necessarily the percentage interest specified in the partnership agreement). This subject is quite complicated, and a detailed explanation is beyond the scope of this paper. In general, the “substantial economic effect” test stands for the proposition that an allocation must be consistent with the underlying economic arrangement of the partners and must substantially affect the dollar amounts received by the partners independent of the tax consequences. For an allocation to have substantial economic effect, the partnership agreement must provide that liquidating distributions will be made in accordance with the partners’ positive capital account balances, and any partner with a capital account deficit at liquidation must be obligated to restore the deficit. Of course, such an obligation is inconsistent with the limited liability desired by an LLC member. Fortunately, there is an alternative to the deficit restoration obligation under the Treasury regulations, i.e., a qualified income offset provision, which is generally the preferred approach in an LLC. Again, these tax issues are quite complicated and are beyond the scope of this paper, but the practitioner should be sensitive to the impact of language included for tax purposes on liability issues and vice versa.

³⁵ Of course, a company agreement need not be in writing, but an oral company agreement obviously presents potential proof problems.

the LLC need not have any members for a “reasonable period” after the LLC is formed.³⁶

While it is possible to utilize a “shelf” LLC, there are some questions associated with such a practice. First, what is a “reasonable period” after the filing of the certificate of formation? Is it merely a temporal concept or does it also relate to the activities undertaken by the LLC? Presumably, the managers may undertake certain actions to facilitate the organization of the LLC and securing of investors, but it would be unwise to transact significant business prior to the admission of members. What is the tax classification of an LLC without members? If the LLC undertakes any significant business and there is a failure to obtain members or a dispute as to whether there are members and who they are, this could be a thorny situation.

At the point that there are persons who desire to be members in an LLC that has previously been formed but has no members, may they simply execute a company agreement identifying themselves as the members and thereby become members “in connection with the formation” of the LLC? It would appear so, but what if there is a dispute as to who the members will be, i.e., a fight over the LLC? If two factions each execute a company agreement claiming to be the members, who determines which is the company agreement of the LLC? Inasmuch as becoming a member “in connection with the formation of the LLC” when one is not named as an initial member in the certificate of formation depends upon a reflection of the person’s membership in an LLC “record,”³⁷ it appears that the manager or managers may have a role in determining which company agreement is the company “record” of membership.

If, after the filing of the certificate of formation of an LLC, a substantial period of time elapses without the admission of members, the question might arise whether a person who desires to become a member must do so in accordance with the statutory procedures applicable “after the formation” of the LLC. This result would be problematic because the statute requires that a person becoming a member after formation of the LLC must do so with the consent of all members unless a company agreement provides otherwise.³⁸ It would be impossible to admit a member under such circumstances because the LLC has no members and thus no company agreement.³⁹ It is more logical to interpret the statute as permitting persons to become members “in connection with the formation” of the LLC if the LLC has previously existed as a memberless shell entity, even if a substantial period of time has passed since the filing of the certificate of formation.

Drafting Tip: Some of the questions raised in the previous two paragraphs can be alleviated if the certificate of formation provides for a procedure for the admission of initial members that involves the consent of the initial managers named in the certificate. The provisions regarding admission to membership are not among the provisions of the statute that cannot be waived or modified in the company

³⁶ TEX. BUS. ORGS. CODE ANN. § 101.101(b) (West 2012) (stating that an LLC that has managers is not required to have members during a “reasonable period between the date the company is formed and the date the first member is admitted to the company”). See also *id.* § 101.356(e) (providing that member approval is not required for an action during the reasonable period that a manager-managed LLC is permitted not to have any members after formation).

³⁷ *Id.* § 101.103(b).

³⁸ *Id.* §§ 101.052, 101.103(c).

³⁹ The company agreement is defined as “any agreement, written or oral, of the members concerning the affairs or the conduct of the business of a limited liability company.” *Id.* § 101.001(1).

agreement, and while there are no members to enter into a company agreement in this situation, the certificate of formation may contain any provision that may be included in the company agreement.⁴⁰

IV. Withdrawal of a Member

The BOC states that “[a] member may not withdraw or be expelled from the company.”⁴¹ This is a default rule that may be modified by the company agreement,⁴² but a member has no right to withdraw unless it is provided by the company agreement. It is not clear whether a member has the power to withdraw in violation of the statute. Arguably, there is also no power to voluntarily withdraw unless the company agreement confers it since the statute does not so provide.⁴³ In other words, a member of an LLC is unlike a general partner, who may be denied the right to withdraw by the partnership agreement but expressly has the power to withdraw and suffer the consequences for wrongful withdrawal.⁴⁴ A member of an LLC is apparently “locked in” unless and until the company agreement permits withdrawal or winding up.⁴⁵

The apparent inability of a member to withdraw absent a provision in the company agreement is advantageous from an estate planning perspective⁴⁶ and may well reflect the

⁴⁰ See *id.* §§ 101.051-.052, 101.054.

⁴¹ *Id.* § 101.107.

⁴² *Id.* § 101.052.

⁴³ The BOC does not define the term “withdrawal.” It appears that the term refers only to a member's ceasing to be associated as a member by the voluntary or volitional act of the member. Whether the death of a member is a “withdrawal” under the BOC is further discussed below. The statute obviously cannot preclude a member's ceasing to be a member by reason of death. The provision of the BOC addressing the buyout of a withdrawn member's interest might be read to suggest that there is a power to withdraw absent the right to withdraw under the company agreement. Section 101.205 states that “[a] member of a limited liability company who validly exercises the member's right to withdraw from the company granted under the company agreement is entitled to receive, within a reasonable time after the date of withdrawal, the fair value of the member's interest in the company as determined as of the date of withdrawal.” TEX. BUS. ORGS. CODE ANN. § 101.205. Perhaps this provision could be interpreted to imply that it is possible for a member to withdraw when not permitted by, or in violation of, the company agreement, but the provision makes clear that a member is only entitled to receive payment for the member's interest if the withdrawal occurs as permitted by the company agreement. Of course, the company agreement may provide other terms for liquidating the interest. *Id.* § 101.052.

⁴⁴ See *id.* §§ 152.002(b)(5), -.501(b)(1), -.503(b) (general partnership context); 153.155(b), -.157 (limited partnership context).

⁴⁵ In the absence of any provision to the contrary in the company agreement, one member of a multi-member LLC will not have the power to require winding up of the LLC. See TEX. BUS. ORGS. CODE ANN. § 11.051. A voluntary decision to wind up the LLC requires the vote or consent of a majority of all the members unless otherwise provided by the company agreement or certificate of formation. *Id.* §§ 101.051-.052, 101.552(a)(1). Perhaps a court would borrow from the corporate law to provide the remedy of an equitable buyout of a minority member's interest if the member established that the majority had engaged in “oppressive” conduct toward the minority member. See *Davis v. Sheerin*, 754 S.W.2d 375, 380 (Tex. App.—Houston [1st Dist.] 1988, writ denied). In *Pinnacle Data Servs., Inc. v. Gillen*, 104 S.W.3d 188, 196 (Tex. App.—Texarkana 2003, no pet.), the court appeared to accept the proposition that a member of an LLC may assert a claim for oppression as defined in shareholder oppression cases, but upheld the trial court's summary judgment for the defendants on the claim because the plaintiff had failed to set forth any evidence to support its allegations of oppressive conduct.

⁴⁶ One of the issues in valuation and discounting of interests in family businesses for transfer tax purposes is whether certain restrictions imposed on liquidation rights (“applicable restrictions”) will be ignored for valuation purposes. Under Section 2704(b)(3)(B) of the Internal Revenue Code, an applicable restriction does not include any restriction imposed by state law. I.R.C. § 2704(b). As a default rule, a member is entitled to be paid the fair value of the member's interest within a reasonable time after withdrawal. TEX. BUS. ORGS. CODE ANN. § 101.205 (West 2012). However, the statute does not provide for withdrawal of a member absent a provision in the company agreement. *Id.* § 101.205. See also TEX. BUS. ORGS. CODE ANN. § 101.107. Thus, the statutory default rules do not provide liquidity and should support a discount for lack of liquidity. Valuation and discounting for tax purposes is a somewhat complex and developing area, and analysis of these issues is not undertaken here.

usual expectations of the parties. While a partner is exposed to personal liability for the liabilities of the partnership and owes the other partners fiduciary duties, a member is not exposed to liability for the debts and obligations of the LLC. Thus, it may be argued that the statute logically treats a member of an LLC like a limited partner in a limited partnership⁴⁷ or a shareholder of a corporation⁴⁸ in this regard. The analogy to a shareholder or limited partner is apt in the case of a member of a manager-managed LLC. The problem arises in connection with a member-managed LLC in which the member may be deemed to have fiduciary duties.⁴⁹ The statute seems to create the potential for a situation in which a member will be forced to remain in a fiduciary relationship against the member's will.⁵⁰

Consider a member-managed LLC in which members A, B, and C agree in the company agreement to devote their full time and efforts to operate a dry cleaning business. If A becomes disillusioned with the other members and “quits,” but there is no provision for withdrawal by a member in the company agreement, what is the effect? Though A might be liable for damages for breaching his agreement to devote his full time and efforts to the business, one would not expect a court to specifically enforce A's obligation.⁵¹ In other words, a member always has the power to become an inactive member. However, if A wants to form his own dry cleaning business after he “quits,” is he still a member with a duty of loyalty not to compete because he did not have the power to withdraw? This would be quite an untenable posture for A—one which goes well beyond liability for damages for breach of the agreement to remain an active member of the LLC. There are doubtless many LLCs with company agreements that simply deny the right to withdraw or that do not address a member's ability to withdraw. In such cases, it remains to be seen how the courts will deal with the ongoing rights and liabilities of a member who attempts to dissociate.

Drafting Tip: If the goal is to require the indefinite commitment of capital by the members and to avoid having to liquidate a member's interest at the will of the member, the goal may be quite easily accomplished by permitting a member to withdraw as a member while altering the statutory default rule that entitles a

⁴⁷ “A limited partner may withdraw from a limited partnership only at the time or on the occurrence of an event specified in a written partnership agreement. The withdrawal must be in accordance with that agreement.” *Id.* § 153.110.

⁴⁸ In Texas, a shareholder has no statutory right to withdraw or to “put” the shareholder's shares to the corporation or the other shareholders. Absent contractual buy-sell provisions, the shares of a shareholder in a closely held corporation are basically unmarketable and illiquid. *See Davis v. Sheerin*, 754 S.W.2d 375 (Tex. App.—Houston [1st Dist.] 1988, writ denied). A minority shareholder may have an equitable right to a buyout if the shareholder has suffered “oppression” at the hands of the majority. *Id.* at 381.

⁴⁹ *See supra* Part VI.

⁵⁰ The language of Article 5.05 of the Texas Limited Liability Company Act, which has been recodified in Section 101.107 of the BOC, was borrowed from the Texas Revised Limited Partnership Act. *See* TEX. REV. CIV. STAT. ANN. art. 1528n, art. 5.05 (expired Jan. 1, 2010); TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 6.03 (expired Jan. 1, 2010). The rationale for this approach to limited partners is only partially applicable to LLC members. Limited partners have limited liability (that is, they are not personally liable for the debts and obligations of the partnership) and, as passive investors, ordinarily do not owe the partnership or other partners fiduciary duties. *See Strelbel v. Wimberly*, 371 S.W.3d 267, 281 (Tex. App.—Houston [1st Dist.] 2012, pet. filed). Thus, while there may be other concerns emanating from the illiquid nature of their investment, no particular hardship or risk is imposed from the perspective of liability if limited partners are “locked into” their investment. To the extent that LLC members, at least in a member-managed LLC, may be deemed to have fiduciary duties, being “locked into” the LLC has ramifications not present for limited partners.

⁵¹ Contracts involving the performance of personal services are generally not specifically enforceable. *See E.M. Goodwin, Inc. v. Stuart*, 82 S.W.2d 632, 634 (Tex. 1935).

withdrawn member to receive the fair value of the member's interest within a reasonable time. The company agreement might provide that a member who withdraws without consent of all other members (or some other desired threshold of approval) shall thereafter be deemed an assignee. If the members intend that some or all of them should commit their efforts and services for the duration of the LLC, the company agreement might provide that a withdrawal prior to winding up and termination is wrongful and gives rise to liability on the part of the withdrawn member for damages.

As noted above, the BOC provides that a member who validly exercises a right to withdraw conferred by the company agreement is entitled to receive, within a reasonable time after withdrawal, the fair value of the member's interest as of the date of the member's withdrawal.⁵² Because this rule is itself a default rule that can be modified by the company agreement, and because the statute denies a member the right to withdraw absent a provision in the company agreement,⁵³ this statutory buyout provision only applies in cases where the company agreement permits withdrawal but does not address or modify the statutory requirement that the member be paid the fair value of the member's interest within a reasonable time after withdrawal.

The BOC does not define or describe how to determine the “fair value” of a withdrawn member's interest. Cases from other contexts in which the term “fair value” is used may be instructive but are not necessarily determinative of the meaning of “fair value” in the LLC context.⁵⁴ The provision requiring that a withdrawn member receive the fair value of the member's interest as of the date of withdrawal was patterned after a similar provision of the Texas Revised Limited Partnership Act applicable to withdrawal of a limited partner,⁵⁵ but there do not appear to be any cases in Texas construing that provision.⁵⁶

⁵² TEX. BUS. ORGS. CODE ANN. § 101.205 (West 2012). The BOC does not define “fair value.” The term is also used in similar contexts in the general partnership and limited partnership contexts. *Id.* §§ 152.602(a), 153.111. Section 101.205 does not expressly state that a withdrawing member will get distributions to which the member is entitled under the company agreement. However, similar language was used in the Texas Revised Limited Partnership Act, and the drafters felt such a statement was implicit and thus unnecessary. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 6.04 (expired Jan. 1, 2010), Source and Comment—Bar Committee. Similarly, Section 101.205 does not expressly state that a withdrawing member's distribution is to be based upon the right to share in distributions. Presumably, as was the case with the Texas Revised Limited Partnership Act, the drafters thought the expression unnecessary.

⁵³ See TEX. BUS. ORGS. CODE ANN. §§ 101.052, 101.107.

⁵⁴ The term “fair value” is also used in the dissent and appraisal provisions of Chapter 10 of the BOC. *See id.* § 10.362.

⁵⁵ TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 6.04 (expired Jan. 1, 2010). However, prior to the 2003 amendments to the Texas Limited Liability Company Act, the effect of the withdrawal of a limited partner and an LLC member were quite different, and the comparison of these provisions was less apt. A limited partnership is not dissolved by the withdrawal of a limited partner; therefore, the distribution to a withdrawn limited partner of the fair value of the limited partner's interest occurs in the context of a continuation of the partnership business. Prior to September 1, 2003, however, the withdrawal of an LLC member caused dissolution of the LLC unless otherwise provided in the regulations. Unless the remaining members agreed to continue the business, the LLC was required to be wound up. If the dissolution was to be followed by winding up, the remaining members might have argued that the withdrawn member should be paid pursuant to the dissolution process along with the other members. Arguably, payment of the “fair value” of a withdrawn member's interest within “a reasonable time” in the context of a dissolution triggered by the member's withdrawal was the liquidating distribution of the member's share of the LLC's assets after payment of, or provision for payment of, creditors. *See* TEX. REV. CIV. STAT. ANN. art. 1528n, art. 6.05A(3) (expired Jan. 1, 2010). The withdrawn member might have argued, however, that the “fair value” of the member's interest “as of the date of withdrawal” was an amount greater than liquidation value, e.g., going concern value, and that payment within a reasonable time required payment before completion of the liquidation process. To the extent that the regulations dealt with dissolution, withdrawal, and payment of withdrawing members, these questions were avoided. With the amendment of the Texas Limited Liability Company Act to eliminate withdrawal of a member as a cause of dissolution, the situation is no longer presented by the statute.

⁵⁶ The drafters' comments to Section 6.04 of the Texas Revised Limited Partnership Act note that the

Unlike the partnership statutes, which define what constitutes “withdrawal” of a general partner,⁵⁷ the Texas LLC statutes have never defined or specified what constitutes “withdrawal” of a member for purposes of the LLC statutes. Although the scope of the term “withdrawal” was somewhat unclear under the Texas Limited Liability Company Act, the current BOC provision requiring a fair value buyout of a withdrawn member’s interest is apparently only triggered by a member’s voluntary act of withdrawal pursuant to a right expressly conferred by the company agreement. The current provision requires payment of the fair value of a member’s interest if the member “validly exercises the member’s right to withdraw from the company granted under the company agreement,”⁵⁸ whereas the prior provision in the Texas Limited Liability Company Act simply stated that “any withdrawing member” was entitled to receive the fair value of the member’s interest.⁵⁹ The prior provision raised questions as to whether involuntary acts that caused a member to cease to be a member, e.g., death or expulsion of a member, were events triggering the statutory buyout.⁶⁰ Other provisions of the Texas Limited Liability Company Act containing the term “withdrawal” tended to support the conclusion that “withdrawal” encompassed only a voluntary decision by the member to terminate the member’s status as a member, but the matter was not free from doubt.⁶¹ The language used in the BOC appears to resolve this issue in accordance with the view that “withdrawal” refers to a voluntary act of withdrawal by the member. Because the statute does not provide for a buyout of a member’s interest in circumstances other than a withdrawal pursuant to a right conferred in the company agreement, a deceased member’s estate is relegated to the status of an assignee of a membership interest indefinitely.⁶²

Drafting Tip: For various reasons, the inclusion of buyout provisions in the company agreement is generally advisable. First, well-drafted buyout provisions help

withdrawing limited partner’s distribution under that provision is based upon the limited partner’s right to share in distributions and that Section 6.04 does not explicitly say that a withdrawing limited partner will receive distributions (e.g., interim distributions) to which the withdrawing partner is entitled under the partnership agreement, explaining that these distributions are included in the definition of a partnership interest and it is thus unnecessary to refer specifically to them. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 6.04 (expired Jan. 1, 2010), Source and Comment—Bar Committee.

⁵⁷ The partnership statutes define an event of withdrawal of a general partner to include death or expulsion of the partner as well as other involuntary types of withdrawal. *See* TEX. BUS. ORGS. CODE ANN. §§ 152.501(b), 153.155(a); *see also* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 4.02(a) (expired Jan. 1, 2010); TEX. REV. CIV. STAT. ANN. art. 6132b-6.01(b) (expired Jan. 1, 2010).

⁵⁸ TEX. BUS. ORGS. CODE ANN. § 101.205 (West 2012).

⁵⁹ TEX. REV. CIV. STAT. ANN. art. 1528n, art. 5.06A (expired Jan. 1, 2010).

⁶⁰ Faced with somewhat similar language in the limited partnership context, the Delaware Court of Chancery interpreted a provision of the Delaware limited partnership statute calling for the payment of fair value of a partner’s partnership interest to any withdrawing partner upon withdrawal and determined that the provision addressed only a withdrawal pursuant to a partner’s voluntary decision to withdraw. *Hillman v. Hillman*, 910 A.2d 262, 272 (Del. Ch. 2006).

⁶¹ *See* TEX. REV. CIV. STAT. ANN. art. 1528n, art. 5.05A (expired Jan. 1, 2010) (stating that a member may “withdraw or be expelled only at the time or on the occurrence of events specified in the regulations” and thus seemingly using “withdraw” to refer to the voluntary action of a member to withdraw). Prior to Sept. 1, 2003, Article 6.01A stated that an LLC was dissolved upon the “death, expulsion, withdrawal pursuant to or as provided in the articles of organization or regulations, bankruptcy, or dissolution of a member or the occurrence of any other event which terminates the continued membership of a member in the limited liability company.” *See* Act of May 22, 2003, 78th Leg., R.S., ch. 572, § 5, 2003 Tex. Gen. Laws 1934, 1936. This wording also supports the conclusion that the statutory term “withdrawal” referred only to a voluntary decision to terminate one’s status as a member inasmuch as other causes of termination of membership were separately listed and withdrawal was couched as an act that would not occur other than as permitted in the regulations.

⁶² TEX. BUS. ORGS. CODE ANN. § 101.1115(a)(2) (West 2012).

provide definition and certainty to the process. Statutory terms such as “fair value” and “reasonable time” may be defined or altered. Additionally, if the company agreement allows a member to withdraw but has no provisions regarding payment of the withdrawn member, the statutory default provision may frustrate the remaining members' right to continue the business. An LLC may not have sufficient liquidity to pay the withdrawn member the fair value of the member's interest within a reasonable time. For this reason, company agreements often provide for deferred payment or payment on an installment basis with interest. Even if withdrawal is not permitted by the company agreement, the company agreement should make clear the consequences of a member's death or other termination of membership. As discussed above, the company agreement should also make clear what events terminate the membership of a member inasmuch as the statute does not specify any events of withdrawal or termination of membership.

V. Problems Arising in Connection with Transfer Provisions and Assignment of a Membership Interest

Under the BOC, a membership interest is assignable “wholly or partly,”⁶³ but assignment of a membership interest involves the transfer of economic rights, not a transfer of membership status. Assignment of a membership interest does not trigger winding up of the LLC, and it does not confer upon the assignee any management rights or entitle the assignee to become or exercise the rights of a member.⁶⁴ An assignee of a membership interest is entitled to be allocated, to the extent assigned, the income, gain, loss, deduction, credit, and similar items associated with the interest.⁶⁵ An assignee is also entitled to receive, to the extent assigned, distributions to which the assignor was entitled.⁶⁶ Finally, an assignee is entitled to require reasonable information and to make reasonable inspection of the books and records of the LLC.⁶⁷ An assignee does not have liability as a member by virtue of the assignment of the interest.⁶⁸

Just as the assignee does not become a member merely by virtue of the assignment of a membership interest, the assignor member does not cease to be a member merely by assigning the member's interest.⁶⁹ Unless otherwise provided by the company agreement, until the assignee becomes a member, the assignor member continues to be a member and have all the associated rights and powers not assigned.⁷⁰ Of course, a member might cease to be a

⁶³ *Id.* § 101.108(a) (“A membership interest of a limited liability company may be wholly or partly assigned.”). This section states a default rule that will apply if the company agreement does not otherwise provide. *See id.* § 101.052.

⁶⁴ *Id.* § 101.108(b)(2)(B). Admission as a member is a separate and distinct issue and requires, unless otherwise provided by the company agreement, the consent of all members. *Id.* §§ 101.103(c), 101.109(b). These sections state default rules that will apply if the company agreement does not otherwise provide. *See id.* § 101.052.

⁶⁵ *Id.* § 101.109(a)(1).

⁶⁶ *Id.* § 101.109(a)(2).

⁶⁷ *Id.* § 101.109(a)(3), (4).

⁶⁸ *Id.* § 101.109(c).

⁶⁹ TEX. BUS. ORGS. CODE ANN. § 101.111(a) (West 2012).

⁷⁰ *Id.* § 101.111(a). The effect of Section 101.111 is somewhat unclear in the case of a partial assignment. By stating that a member continues to be a member “until the assignee becomes a member,” the provision implies that an assignor member will cease to be a member when and if the assignee is admitted as a member. *Id.* If a member assigns only a portion of the member's interest (e.g., a member assigns one-half of the member's one-half interest, or a one-fourth interest in the LLC), and the assignee is admitted as a member, the assigning member presumably remains a member insofar as the member has retained an interest in the LLC, though the provision is not clear in this regard.

member in connection with an assignment (e.g., the member's death or voluntary withdrawal if the company agreement allows withdrawal), but assignment of a member's interest does not itself terminate the member's membership under the BOC.

The effect of a transfer of an interest from one member to another member is an area in which many company agreements are somewhat unclear. If a membership interest is voluntarily or involuntarily assigned (e.g., by contract, gift, devise, or descent), and the person who acquires the member's membership interest is another member, the question sometimes arises whether the person who has acquired the membership interest is merely an assignee as to such interest or may exercise voting rights based on the ownership of the interest. If the default per capita voting rules of the BOC apply, the issue does not arise because each member has one vote, and the member who has acquired the interest continues to have one vote.⁷¹ Many agreements, however, provide for voting based on a member's ownership percentage, profit sharing ratio, or ownership units, in which case the agreement needs to be worded in a manner that makes it clear whether an assignment of a member's interest to a person who is already a member results in the acquiring member's being able to exercise voting rights based on the acquired interest.⁷²

Note that if the assignor member is still a member, the assignor member's vote may be required to admit the assignee because the consent of all members is necessary to admit an assignee as a member as a default rule. *Id.* §§ 101.103(c), 101.109(d). In *Faulkner v. Kornman*, 2012 WL 1066736 (Bankr. S.D.Tex. 2012), a judgment debtor who was a 95% LLC member assigned to a receiver all of his right, title, and interest in the LLC as well as all of the stock in a corporation that was the 5% member. The court stated that the 95% member assigned not only his 95% interest in the LLC, but all of his rights as a member, including his ability to approve the admission of new members. Thus, the court stated that the corporate member, which was now owned and controlled by the receiver, was the only member whose consent was necessary to approve the admission of the receiver, as assignee of the 95% interest, as a member.

⁷¹ See TEX. BUS. ORGS. CODE ANN. § 101.354.

⁷² An issue of this type was present in the case of *In re Delta Star Broadcasting, L.L.C.*, 2006 WL 285974 (E.D. La. 2006), but the court ultimately found it unnecessary to resolve whether a member who acquired an interest from an assignee of another member obtained the voting rights associated with the interest. Three individuals each owned a 1/3 membership interest in a Louisiana LLC, and one of the members (Bruno) filed a voluntary Chapter 11 bankruptcy petition on behalf of the LLC. Bruno argued he was authorized to file the petition because his action was approved by two of the three members (Bruno and Treen) based on a consent signed by Treen the day before the bankruptcy filing. The third member (Starr) argued that Treen had transferred his membership interest to an entity controlled by Starr eleven days prior to the filing of the bankruptcy and that Treen's consent to the bankruptcy filing was thus ineffective. Starr further argued that the bankruptcy filing was ineffective even if Treen remained a member after the transfer of his interest because the bankruptcy filing was not approved at a properly-noticed meeting of the LLC's members. The court first discussed the effect of the transfer of Treen's membership interest and pointed out that the Louisiana LLC statute provides that the assignee of a membership interest is not entitled to exercise the rights of a member until admitted by unanimous consent of the other members. Under the statute, the assignor member remains a member unless and until the assignee becomes a member. Starr argued that, because of his control of the assignee, it was not really a "new" member and was entitled to exercise the membership rights associated with the membership interest transferred. Starr also argued that if the entity that was the assignee was not entitled to exercise the membership rights, Starr was entitled to do so when the entity later transferred the interest to him. The court rejected these arguments and concluded Treen retained his membership, including his right to vote, because the entity to which Treen assigned his interest was not admitted as a member. The court did not need to reach the issue of whether Starr later acquired Treen's membership rights when the entity transferred the interest to Starr because that transfer did not occur until after the bankruptcy filing. Ultimately, the court determined that the action taken by Bruno and Treen was sufficient to authorize the bankruptcy filing.

In *Ault v. Brady*, 37 Fed. Appx. 222 (8th Cir. 2002), the court interpreted provisions of an LLC operating agreement providing for "units" and concluded that a transfer of a member's units to another member did not entitle the transferee member to vote the units because the transferee member did not become a "substituted member" with respect to the units transferred.

In *Achaian, Inc. v. Leemon Family LLC*, 25 A.3d 800 (Del. Ch. 2011), the LLC agreement defined a member's interest as "the entire ownership interest" of a member and permitted a member to transfer "all or any portion of" its

Drafting Tip: If member voting is based on a member's ownership percentage, profit sharing ratio, ownership units, or is otherwise measured by some aspect of the membership interest, the provisions of the company agreement should be carefully worded to make clear whether an assignment of a member's interest to a person who is already a member results in the acquiring member's being able to exercise the voting rights based on the acquired interest or is to be treated as an assignee with respect to such interest unless admitted with respect to the assigned interest by the requisite vote.

The use or establishment of a trust to hold a membership interest sometimes gives rise to questions. If a member initially holds a membership interest in the member's individual capacity and then establishes a trust of which the member is trustee, has the membership interest been assigned such that the member as trustee is merely an assignee with no management or voting rights?⁷³ Similarly, if a trust or trustee is designated as a member of the LLC and the trustee dies, has there been an assignment of the membership interest where the interest continues to be held in the same trust by a successor trustee?⁷⁴ The company

interest to any person at any time. The agreement also provided that no person shall be admitted as a member without the written consent of the members. After dissension among the three members of the LLC arose, one of the members purported to transfer its entire 30% membership interest to a 20% member. The remaining 50% member argued that the agreement did not change the default rules under the Delaware statute and that the agreement unambiguously distinguished between a member's economic interest and voting rights. Reading the LLC agreement as a whole, the court concluded that it allowed an existing member to transfer all of the rights accompanying an interest, including voting rights, without the written consent of the other members. The court found nothing in the Delaware LLC statute or secondary sources suggesting that a serial admission scheme, under which a person who is already a member must be readmitted to acquire additional voting rights, is standard practice.

⁷³ Company agreements often contain provisions restricting transfers and defining permitted transfers, but these agreements still are not always clear about the scope of permitted transfers and the effect of a transfer.

In *Clark v. Kelly*, 1999 WL 458625 (Del. Ch. 1999), the issue was whether the transfer of all of the shares of a corporate member of the LLC to a trust was a "transfer" of an LLC interest within the meaning of the operating agreement. Plaintiff Clark was the sole shareholder of one of the members of the LLC. The other member of the LLC was La Empresa De La Mar D'Oro, Inc. (La Empresa), a California corporation. The stock of La Empresa was titled in Danis at the time La Empresa became a member of the LLC. After formation of the LLC, Danis transferred the stock of La Empresa to a living trust of which Danis and his wife were the trustors and co-trustees. The issue was whether the transfer of the shares to the trust triggered a provision of the operating agreement requiring consent. If the transfer requiring consent occurred without such consent, the transferee's status was that of a mere assignee. The definition of "transfer" under the operating agreement included a transaction whereby the equity owners of a member as of the date of the member's admission to the LLC own less than 90% of the equity securities of the member after the transaction. The court determined that the transfer of the shares of La Empresa to the trust did not fall within the definition of a transfer under the operating agreement because the shares were community property under California law and Danis's wife therefore had a 50% equitable interest in the shares before the transfer to the trust.

In *Lusk v. Elliott*, 1999 WL 644739 (Del. Ch. 1999), an LLC member (Elliott) assigned his 99% interest in the LLC to a family trust, and the 1% member (Lusk) claimed that he was the sole remaining member and manager on the basis that the assignment was not effective to transfer membership rights. The court determined that the assignment transferred Elliott's membership along with his 99% financial interest. The operating agreement prohibited assignment of a member's interest other than to another member; however, both members signed a consent to the transfer of Elliott's 99% membership interest and agreed that the assignment would not constitute a prohibited assignment under the operating agreement. The parties agreed that the consent amended the prohibition on transfer in the operating agreement but disagreed as to whether the consent authorized the conveyance of Elliott's membership along with the financial interest. Lusk relied upon provisions of the Delaware Limited Liability Company Act that characterize an assignment as carrying only the financial interest of the member. Since the operating agreement did not define "assignment," Lusk argued the court should look to the Delaware statute for the effect of an assignment. The court disagreed. The court said that the consent and assignment indicated what was meant by the term "assignment" since the instruments referred to assignment of Elliott's "entire undivided membership interest." The court concluded that this language encompassed Elliott's membership as well as his 99% ownership interest.

⁷⁴ Compare *Presta v. Tepper*, 102 Cal. Rptr. 3d 12 (Cal. Ct. App. 2009) (holding death of trustee partner triggered buyout provisions of the partnership agreement applicable on the death of a partner, relying heavily on the principle that an ordinary express trust is not an entity separate from its trustee) with *Dunbar v. Willis*, 2010 WL 336406 (Cal. Ct. App. 2010) (interpreting provisions of an LLC operating agreement and holding that the death of the

agreement needs to be clear regarding these situations.

Drafting Tip: With respect to membership interests that are held in trust, the company agreement should make clear whether a change in trustees is considered an assignment and the effect of such an assignment. Even if trusts are not involved in the initial membership of the LLC, it will often be desirable to have provisions that address how a transfer by a member of the member's membership interest into a trust and a subsequent change in trustee will be treated under the company agreement. "Permitted transfer" provisions should make clear whether a "permitted transfer" means simply that the membership interest itself (i.e., the economic interest) may be transferred without regard to other transfer restrictions in the agreement or whether the transferee will also have the management and voting rights that the member had prior to the transfer.

After a transfer of a membership interest to an assignee who is not admitted as a member, questions sometimes arise as to the rights of the members to amend the company agreement so as to affect adversely the rights of the assignee. If, for example, a member dies, and the remaining members amend the company agreement to increase one or more of the remaining members' share in the profits and decrease the share of the deceased member's estate, does the assignee estate have any recourse?⁷⁵ Even if members may owe one another fiduciary-type duties in some situations, members do not necessarily owe such duties to an assignee.⁷⁶ The question may boil down to one of contract law.⁷⁷ If the company agreement could have been amended over the deceased member's objections, then the estate surely has no greater rights than the member to complain.⁷⁸ Even if the company agreement requires

trustee of a revocable living trust to which the trustee had previously transferred his entire membership interest (as permitted by the operating agreement) did not trigger the provision of the operating agreement permitting the remaining members to purchase the interest of a member on the member's death).

⁷⁵ Obviously, if the company agreement provides the estate of the deceased member a right to be bought out at a value fixed at the date of death, such a scenario does not become an issue. If, however, the deceased member's estate is not entitled to a buyout and the LLC continues with the deceased member's estate as a mere assignee, a scenario like that described could easily be imagined.

⁷⁶ See *Griffin v. Box*, 910 F.2d 255, 261 (5th Cir. 1990), in which the Fifth Circuit, applying Texas law, stated that general partners did not owe a fiduciary duty to transferees of partnership interests who had not been admitted as substituted partners. See also *Bauer v. Blomfield Co./Holden Joint Venture*, 849 P.2d 1365 (Alaska 1993) (holding that partners owed no duty to an assignee to act in good faith and that assignee could not challenge the payment of a large commission to a partner that eliminated income payments to the assignee); but see *Bader v. Cox*, 701 S.W.2d 677, 685 (Tex. App.—Dallas 1985, writ ref'd n.r.e.) (stating that surviving partners owed fiduciary duties to the representative of a deceased partner under the Texas Uniform Partnership Act). The Texas Revised Partnership Act was amended in 2003 to provide that partners owe duties to transferees of deceased partners. TEX. REV. CIV. STAT. ANN. art. 6132b-4.04(a) (expired Jan. 1, 2010), recodified in TEX. BUS. ORGS. CODE ANN. § 152.204(a) (West 2012).

⁷⁷ See *Bailey v. Fish & Neave*, 868 N.E.2d 956 (N.Y. 2007) (holding that provision of partnership agreement permitting all questions relating to the partnership business to be decided by majority-in-interest vote applied to amendment of the partnership agreement and permitted agreement to be amended to change compensation of withdrawing partners without the consent of partners who had given notice of their intent to withdraw); but see *Abbott v. Schnader, Harrison, Segal & Lewis, LLP*, 805 A.2d 547 (Pa. Super. Ct. 2002) (holding that partnership agreement could not be amended by partners to reduce retirement benefits of retired partners without their consent because the benefits were vested contract rights that could not be retroactively abrogated pursuant to the general amendment provision).

⁷⁸ See *Aztec Petroleum Corp. v. MHM Co.*, 703 S.W.2d 290, 294 (Tex. App.—Dallas 1985, no writ) (upholding amendment of partnership agreement to authorize removal of general partner without general partner's consent because "any unanimity which may be required by contract law was met when all parties to the partnership agreement consented to be bound by amendments passed by 'the holders of seventy percent (70%) or more of the Units'"). See

unanimous consent of the members for such an amendment, the estate, being only an assignee, literally does not have any right to block the amendment.⁷⁹ It may be advisable, however, to expressly address the rights of assignees regarding changes of this nature in the company agreement.⁸⁰

Drafting Tip: To minimize uncertainty as to whether the members may amend the company agreement in a manner that adversely affects an assignee, it may be desirable to expressly address the matter in the company agreement. The company agreement might provide that an assignee has the same voting rights, solely with regard to amendments that would reduce the assignee's economic interest, that the assignor member would have had, or the company agreement might make clear that an assignee's interest may be affected by amendment approved by the members after the assignment. For example, in a business where all the members participate and their personal services and efforts are significant in producing income, it would seem appropriate to decrease the share of the profits to which a deceased member's estate is entitled after the member's death. In such a case, the company agreement might make clear that such adjustments may be made without the assignee estate's consent.

VI. Fiduciary Duties of Members and Managers

The management authority of directors in a corporation and general partners in a partnership carries with it certain responsibilities and duties that are generally described as fiduciary duties and are typically broken down into two categories: the duty of care and the duty of loyalty.⁸¹ The management authority of managers in a manager-managed LLC and members in a member-managed LLC would seem to carry with it similar responsibilities and

also Bailey, 868 N.E.2d 956 (holding that provision of partnership agreement permitting all questions relating to the partnership business to be decided by majority-in-interest vote applied to amendment of the partnership agreement and permitted agreement to be amended to change compensation of withdrawing partners without the consent of partners who had given notice of their intent to withdraw).

⁷⁹ See TEX. BUS. ORGS. CODE ANN. § 101.052(a) (specifying that, except as provided by Section 101.054 of the BOC, the company agreement governs “the relations among members, managers, and officers of the company, assignees of membership interests in the company, and the company itself”). Cf. *Griffin*, 910 F.2d 255 (holding that general partners did not owe a fiduciary duty to transferees of partnership interests so as to mandate admission of transferees as substituted limited partners); *Griffin v. Box*, 956 F.2d 89 (5th Cir. 1992) (concluding that transferees who had not been admitted as substituted limited partners in accordance with the partnership agreement had no voting rights under the agreement). Cf. *7547 Corp. v. Parker & Parsley Dev. Partners, L.P.*, 38 F.3d 211, 219 (5th Cir. 1994) (“*Griffin* confirms that one seeking to assert the rights of a limited partner must establish compliance with the partnership agreement's admission procedures and that the agreement controls the qualifications and rights of limited partners.”). The agreements in those cases expressly stated that admission of an assignee required the consent of the general partner which could be granted or withheld in the general partner's sole discretion. See *also Adams v. United States*, 2001 WL 1029522 (N.D. Tex. 2001) (stating that remaining partners did not owe a fiduciary duty to assignees of the deceased partner); *but see Bader*, 701 S.W.2d at 685 (stating that surviving partners owed fiduciary duties to the representative of a deceased partner under the Texas Uniform Partnership Act). The Texas Revised Partnership Act was amended in 2003 to provide that partners owe duties to transferees of deceased partners. TEX. REV. CIV. STAT. ANN. art. 6132b-4.04(a) (expired Jan. 1, 2010), recodified in TEX. BUS. ORGS. CODE ANN. § 152.204(a) (West 2012).

⁸⁰ In a voluntary assignment where the assigning member remains a member and retains voting rights, the assignee may contract with the assignor in such a manner as to ensure the assignee's rights are protected through the exercise of the assignor's voting rights. On the other hand, a different situation faces an assignee who has succeeded to the interest of a deceased member (or, for that matter, a former member who is in the nature of an assignee by having withdrawn as a member). To the extent that the company agreement makes clear that it may be amended to affect the rights of assignees, assignees are on notice that they take subject to such risk.

⁸¹ A third aspect of the fiduciary duty of such persons is the duty of obedience, but it arises less frequently and generally receives less treatment in the case law and literature. The duty has been described in the corporate context as forbidding *ultra vires* acts. See *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984).

duties,⁸² but the Texas LLC statute is silent as to the precise duties and liabilities, and Texas courts have said little in this area as of yet.

Like the predecessor Texas Limited Liability Company Act, the BOC does not directly address the duties owed by managers and members. The BOC implies that managers and members may owe certain duties by virtue of other provisions that allude to the possibility of duties or are premised on the assumption that duties may exist.⁸³ For example, the BOC states that “the company agreement of a limited liability company may expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person has to the company or to a member or manager of the company.”⁸⁴ Additionally, the drafters apparently contemplated that managers and managing members would be subject to a duty of loyalty to the LLC that would be implicated in self-dealing transactions inasmuch as the statute includes provisions addressing transactions involving interested governing persons that were patterned after the interested director provisions in the corporate context.⁸⁵ A duty of care is implied by provisions of the BOC that protect governing persons and officers of an LLC if they, in good faith and with ordinary care, rely on information provided by specified persons.⁸⁶ Broad authorization to indemnify, advance expenses to, and insure managers, members, and other persons can be read to reflect some concern with liabilities to the LLC as well as liabilities to third parties.⁸⁷ Finally, provisions specifying procedures applicable to derivative proceedings reflect an underlying assumption that members need a mechanism to hold management accountable and a concern for balancing the rights and powers of owners and management in these circumstances.⁸⁸

⁸² See generally, 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES §§ 9.1-9.12 (West 2012); 2 CARTER BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW §§ 10.01-10.09 (West 2011).

Indeed, when acting as an agent of the LLC, a manager or managing member owes a duty of care pursuant to basic agency principles. RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006 & Supp. 2012); see also RESTATEMENT (SECOND) OF AGENCY § 379 (1958). Further, the agent status of a manager in a manager-managed LLC and a member in a member-managed LLC provides a basis under agency law to impose a duty of loyalty. See RESTATEMENT (THIRD) OF AGENCY §§ 8.01-8.06 (2006 & Supp. 2012); see also RESTATEMENT (SECOND) OF AGENCY §§ 387-398. (1958). In *Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193 (Tex. 2002), the Texas Supreme Court discussed the fiduciary nature of the agency relationship under Texas common law. Bankruptcy courts in some cases have analyzed breach of fiduciary duty claims against LLC members who were also officers of the LLC in terms of the duties of corporate officers without indicating any recognition that an LLC is not actually a corporation. See *In re Supplement Spot, L.L.C.*, 409 B.R. 187 (Bankr. S.D. Tex. 2009) (relying on corporate case law for the proposition that corporate officers have fiduciary duties to creditors in analyzing fraudulent transfer of LLC funds to pay mortgage debts of LLC officer); *In re Brentwood Lexford Partners, L.L.C.*, 292 B.R. 255 (Bankr. N.D. Tex. 2003) (discussing and relying on duties owed by corporate officers to corporation and creditors in analyzing claims against LLC officers arising from distributions while LLC was insolvent and officers' resignation from LLC and formation of new LLC to which some business was transferred); *In re Mega Sys., L.L.C.*, 2007 WL 1643182 (Bankr. E.D. Tex. 2007) (citing corporate case law rejecting proposition that duties are owed to corporate creditors when debtor approaches zone of insolvency in addressing breach of fiduciary duty claim against LLC's president/majority owner).

⁸³ Provisions addressing reliance on information and reports of others with knowledge or expertise, indemnification of managers and members, interested manager and member transactions, restriction or expansion of duties and liabilities, and derivative suits imply that certain duties may be owed without defining the duties themselves. See TEX. BUS. ORGS. CODE ANN. §§ 3.102-.103, 3.105, 8.002(b), 101.255, 101.401-.402, 101.451-.463 (West 2012).

⁸⁴ *Id.* § 101.401.

⁸⁵ See *id.* §§ 21.418, 101.255.

⁸⁶ *Id.* §§ 3.102, -.105.

⁸⁷ *Id.* § 101.402.

⁸⁸ *Id.* §§ 101.451-.463.

Thus, while the BOC does not define or specify any duties, it acknowledges that such duties may be imposed by the courts and provides broad flexibility to specify contractually in the company agreement what the duties and attendant liabilities are. To date, there is scant case law in Texas dealing with fiduciary duties in the LLC context.⁸⁹ Absent provisions in the company agreement otherwise, managers and managing members would seemingly owe the common law fiduciary duties of an agent to the LLC as principal, even without resort to analogies to corporate or partnership law.⁹⁰ Much less clear is the extent to which members owe each other fiduciary duties.⁹¹ The doctrine of oppression of a minority shareholder has

⁸⁹ In *Pinnacle Data Servs., Inc. v. Gillen*, 104 S.W.3d 188, 192 (Tex. App.—Texarkana 2003, no pet.), the court of appeals addressed an LLC member's breach of fiduciary duty claim against the other two members in connection with the amendment of the LLC's articles of organization to change the management structure of the LLC. The court's discussion suggests that the duties of the LLC members (who were members of a member-managed LLC until the action to change the structure to a manager-managed LLC) might be comparable to those of corporate directors and officers, but the court was not clear as to whether the presence of factors supporting an informal fiduciary relationship might be required. *Id.* at 198. The court of appeals concluded that the trial court erred in granting summary judgment to the defendants on the breach of fiduciary duty claim. *Id.* at 199. The court rejected the defendants' argument that, because the defendants complied with the articles of organization when they amended the articles of organization to change the management of the LLC from member management to manager management, the plaintiff's claim was without merit. *Id.*

In an unpublished opinion, the Dallas Court of Appeals concluded that members of an LLC do not necessarily owe *one another* fiduciary duties. *Suntech Processing Sys., L.L.C. v. Sun Commc'ns, Inc.*, 2000 WL 1780236, at *6 (Tex. App.—Dallas 2000, pet. denied). The court relied on Texas case law rejecting the notion that co-shareholders in a closely-held corporation are necessarily in a fiduciary relationship. *Id.* That the governing documents imposed upon members a duty of loyalty *to the company* did not mandate any such duty between the members according to the court. *Id.* In *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355, 391-96 (Tex. App.—Houston [1st Dist.] 2012, pet. filed), the court declined to recognize a broad formal fiduciary duty on the part of a majority member to a minority member because Texas does not recognize such a relationship between majority and minority shareholders in closely held corporations, but the court concluded that the majority member's position as the controlling member and sole manager was sufficient to create a formal fiduciary duty to the minority member in a transaction in which the minority member's interest was being redeemed (thus increasing the ownership of the majority member). The court did not address the scope of the duty. *Id.* at 396 n.53. The court also concluded that an exculpation provision in the articles of organization referring to the manager's "duty of loyalty to [the LLC] or its members" could be read to create a fiduciary duty to the members individually. *Id.* at 397. In *Federal Ins. Co. v. Rodman*, 2011 WL 5921529 (N.D. Tex. 2011), the court stated that there is no formal fiduciary relationship created as a matter of law between LLC members but concluded that the plaintiff had sufficiently pled the existence of an informal fiduciary relationship. *Id.* at *3. In *Cardwell v. Gurley*, 2011 WL 6338813 (E.D. Tex. 2011), the court held that the bankruptcy court did not err in giving preclusive effect to a state court's findings that the managing member of an LLC owed the other member direct fiduciary duties of loyalty, care, and disclosure, comparing the fiduciary duty owed by a managing member to his fellow member to the trust-type obligation owed by partners and corporate officers. *Id.* at *3, *8, *10.

Several other courts in Texas have encountered breach of fiduciary duty claims asserted by an LLC member against a fellow member under Texas law. *See Entm't Merch. Tech., L.L.C. v. Houchin*, 720 F. Supp. 2d 792, 797 (N.D. Tex. 2010) (stating, in response to the claim that an individual owed a fiduciary duty by virtue of his status as an officer of the LLC, that no Texas court has held that fiduciary duties exist between LLC members as a matter of law and concluding that the statute of limitations barred the breach of fiduciary duty claim in any event); *Gadin v. Societe Captrade*, 2009 WL 1704049, *2-3 (S.D. Tex. 2009) (discussing formal and informal fiduciary relationships under Texas law, pointing out that the duties owed by managers and members are not directly addressed under the Texas LLC statute and that Texas courts have not yet held that a fiduciary duty exists as a matter of law among members in an LLC, and denying member's motion to dismiss fellow member's breach of fiduciary duty claim "[b]ecause the existence of a fiduciary duty is a fact-specific inquiry that takes into account the contract governing the relationship as well as the particularities of the relationships between the parties"); *Doonan v. Wood*, 224 S.W.3d 271, 276-77 (Tex. App.—El Paso 2005, no pet.) (stating that minority member's spouse did not establish that she was owed a fiduciary duty by party that lent money to the LLC and acquired a membership interest, and, assuming a fiduciary duty was owed to the minority member, the various acts alleged, including foreclosure on LLC assets and enforcement of the minority member's personal guaranty, did not raise any genuine issue of material fact as to breach of fiduciary duty because the actions were taken for legitimate business reasons rather than for the fiduciary to profit by taking advantage of its position).

⁹⁰ *See* RESTATEMENT (THIRD) OF AGENCY §§ 8.01-8.06, 8.08 (2006 & Supp. 2012); *see also* RESTATEMENT (SECOND) OF AGENCY §§ 379, 387-398 (1958) and cases cited in *supra* note 82.

⁹¹ *See supra* note 89.

been recognized by Texas courts of appeals and may apply in the LLC context as well.⁹² A member who seeks to convince a court that the member is owed a duty by another member will likely rely on the shareholder oppression doctrine or argue that the partnership rather than corporate context furnishes the appropriate analogy.⁹³

Although the BOC does not specify or define fiduciary duties and related liabilities in the LLC context, the statute provides broad freedom to contract with respect to such duties and liabilities.

Drafting Tip: Provisions defining or limiting the extent to which duties and liabilities are owed by members and managers to the LLC and to the members are advisable given the undeveloped state of the law in this area. [Appendix A](#) includes examples of some typical provisions addressing duties, indemnification, and exculpation in the LLC context along with comments regarding issues and problems raised by such provisions.

⁹² See *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355 (Tex. App.—Houston [1st Dist.] 2012, pet. filed) (affirming summary judgment in favor of majority member on minority member’s oppression claim because the alleged oppressive conduct was not similar to conduct in previous oppression cases and commenting that the court was not deciding whether the oppression doctrine applies in the LLC context); *Pinnacle Data Servs., Inc. v. Gillen*, 104 S.W.3d 188 (Tex. App.—Texarkana 2003, no pet.) (defining “member oppression” based on shareholder oppression cases and upholding summary judgment in favor of the defendants because the plaintiff member failed to adduce any evidence to support its allegations of oppressive conduct); *Gadin v. Societe Captrade*, 2009 WL 1704049 (S.D. Tex. 2009) (noting that the plaintiff had brought a claim for minority member oppression but finding it unnecessary to discuss the claim because the defendant’s motion to dismiss did not address the claim).

⁹³ Duties of partners are phrased in terms of being owed to the partnership and the other partners. TEX. BUS. ORGS. CODE ANN. § 152.204(a) (West 2012). Actually, however, most aspects of the duties owed by partners impose obligations that involve the interests of the partnership as an entity rather than the interests of individual partners (e.g., obligations precluding competition with the partnership, diversion of business opportunities of the partnership, acting in a manner adverse to the partnership’s interests, etc.). Traditionally, the primary obligation running directly between partners has been an obligation of full disclosure in a matter involving the partnership such as a buyout by one partner of the other’s interest.

In *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355 (Tex. App.—Houston [1st Dist.] 2012, pet. filed), the court declined to recognize a broad formal fiduciary duty on the part of a majority member to a minority member because Texas does not recognize such a relationship between majority and minority shareholders in closely held corporations, but the court concluded that the majority member’s position as the controlling member and sole manager was sufficient to create a formal fiduciary duty to the minority member in a transaction in which the minority member’s interest was being redeemed (thus increasing the ownership of the majority member). The court did not address the scope of the duty but indicated it would encompass disclosure of material facts affecting the value of the interest. The court also noted that the relationship between the majority owner/sole manager and minority owner resembled that between a general partner and limited partner in a limited partnership, thus supporting recognition of a fiduciary duty between them with respect to the majority owner’s operation and management of the LLC.

In *Cox v. S. Garrett, L.L.C.*, 245 S.W.3d 574 (Tex. App.—Houston [1st Dist.] 2007, no pet.), the court rejected a member’s claims that the other owners of the LLC breached a fiduciary duty to him in connection with the repurchase of his interest. The member couched his argument in terms of duties owed in the context of a closely held corporation and argued that the defendants had the burden to establish the fairness of the transaction. The court stated that the member’s breach of fiduciary duty claim regarding the voiding of his interest depended upon his argument that certain transfer restrictions applied to the purchase of his interest. The court concluded that the transfer restrictions did not apply, and the breach of duty claim thus failed as a matter of law. The court stated that another breach of fiduciary duty claim (which was based on alleged fraudulent transfers of ownership in the LLC) related to transactions that occurred after the member’s withdrawal and that the LLC owed him none of the duties owed members after that date.

Appendix A

Problematic Indemnification and Exculpation Provisions in the LLC Context

Example #1:

The Company shall have the power to indemnify a Manager, Member, officer, or other person to the fullest extent permissible under Article 2.20 of the Texas Limited Liability Company Act (TLLCA) and Article 2.02-1 of the Texas Business Corporation Act (TBCA).

Issues: References to the TLLCA and TBCA are somewhat commonly found in articles of organization or regulations of LLCs formed before January 1, 2006, i.e., the date the BOC became effective. Unfortunately, these sorts of references may also find their way into the governing documents of an LLC formed after the effective date of the BOC if the form used in drafting the document has not been carefully reviewed and updated. Entities formed before 2006 continued to be governed by the pre-BOC statutes until January 1, 2010, unless an election to be governed by the BOC was made before 2010. On January 1, 2010, the pre-BOC statutes were repealed; therefore, it is advisable for pre-BOC entities to review and amend their governing documents to avoid the question of how to interpret operative provisions that depend upon repealed statutes. Some assistance in interpreting references in governing documents to repealed statutes is provided by provisions of the BOC that were added in 2011. *See* BOC § 402.0051. Obviously, newly formed LLCs should avoid references to pre-BOC statutes that have been repealed. Simply replacing the references to the pre-BOC statutes with the analogous provisions of the BOC as set forth below, however, still leaves a more subtle problem unaddressed.

The Company shall have the power to indemnify a Manager, Member, officer, or other person to the fullest extent permissible under Section 101.402 and Chapter 8 of the Texas Business Organizations Code.

The combined references to the LLC and corporate statutes in the above provisions create an ambiguity. Is the intent of the provision to limit the LLC's ability to indemnify to the standards and procedures set forth in the corporate statutes? Or, by stating that the LLC has the power to indemnify to the extent permissible under both the LLC indemnification statute and the corporate indemnification statute, does the provision encompass any further latitude provided under the broadly worded LLC statute? Unlike the provisions of TBCA Art. 2.02-1 and Chapter 8 of the BOC applicable in the corporate context, TLLCA Art. 2.20 and BOC §101.402 do not set forth any prohibitions or limitations on indemnification, nor do the LLC provisions specify procedures to be followed to authorize indemnification when a request or claim for indemnification is made. The provision should make clear whether the intent is to permit indemnification to the fullest extent, but only to the extent, provided for a corporation under Chapter 8, or to permit indemnification to the fullest extent permitted for a corporation by Chapter 8 and to such further extent permitted by the LLC statute (in which case the reference to Chapter 8 may be superfluous or a more narrow reference to BOC § 8.002 may be more appropriate). Note that Chapter 8 of the BOC does not automatically apply to LLCs, but an LLC is permitted to adopt the indemnification provisions of Chapter 8 if so desired or to adopt "other provisions, which will be enforceable," relating to indemnification, advancement of expenses, or insurance. *See* BOC § 8.002. Whereas the terminology in the TBCA would have to be "translated" to LLC terms, the terminology in Chapter 8 is more conducive to

application in the LLC context.

One additional observation that may be made about the above provision is that it does not mandate any indemnification. Under Chapter 8, indemnification of a director or officer is required if the individual is “wholly successful, on the merits or otherwise” in the defense of a proceeding. Thus, it is not necessary to provide for mandatory indemnification to this extent in a corporation’s governing documents. (Often-times, of course, the desire is to expand the scope of mandated indemnification, and the corporate documents can make indemnification mandatory where it would otherwise be permitted by the statute but not required.) In the LLC context, the statute does not purport to mandate indemnification at all as a default rule, and the provision in the example above does not make it clear that the mandatory indemnification in the corporate context is being adopted for the LLC. Perhaps a manager or officer could rely on common law agency principles in some circumstances absent a provision in the company agreement, but questions in this regard can be avoided by addressing the issue in the company agreement.

Example #2:

Notwithstanding the foregoing provisions of this Company Agreement, the Company shall approve indemnification of any Indemnitee to the fullest extent then permitted by law. [The “foregoing provisions” consist of detailed provisions modeled after corporate indemnification provisions.]

Issues: As previously noted, the LLC statutes do not place any express limitations on indemnification. The statutes simply permit an LLC to indemnify a person and indicate that provisions other than those in Chapter 8 of the BOC are enforceable. If the company agreement sets forth detailed provisions (for example, based on the provisions in Chapter 8), but then includes a broad catch-all provision such as that above, it is unclear what, if any, limitations exist with respect to indemnification. Would indemnification be mandated even where the manager is found liable to the LLC for an egregious violation of the duty of loyalty? The answer is left to the courts.

Example #3:

A Manager shall not be personally liable to the Company or its Members for monetary damages for any act or omission in his or her capacity as a Manager except to the extent a statute of the State of Texas expressly precludes elimination or limitation of such personal liability. Any repeal or modification of this Article shall be prospective only, and shall not adversely affect limitation of the personal liability of a Manager existing at the time of the repeal or modification.

Issues: BOC § 101.401 provides that the company agreement (or, by virtue of BOC § 101.051(a), the certificate of formation) “may expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person has to the company or to a member or manager of the company.” Unlike BOC § 7.001, which forms the backdrop for the above type of provision exculpating directors in the corporate context and expressly precludes elimination of certain types of liability, BOC §§ 7.001 and 101.401 contain no explicit limitations on the exculpation of liability of an LLC manager. If you

represent an investor in an LLC, what do you tell the investor about the scope of such a provision? Has a manager been released from liability no matter how egregious the manager's breach of duty? It might be argued that the elimination of a manager's liability for "an act or omission in his or her capacity as a Manager" does not literally address certain duty of loyalty situations such as competition or usurpation of opportunity that might be characterized as involving activity that is undertaken by the manager on his or her own behalf rather than in the manager's capacity as a manager; however, the fact that liability stems from a duty of loyalty premised on a person's status as a manager might be viewed as sufficient to include such conduct within this type of provision. In contrast to the Delaware LLC Act, which expressly permits elimination of duties and liabilities (but does not permit elimination of the implied contractual covenant of good faith and fair dealing or liability for a bad faith breach of such covenant), BOC § 101.401 does not explicitly say that the duties and liabilities of a manager can be "eliminated." Thus, there may be some public policy limitations on the scope of a provision eliminating all duties or liabilities, but the Texas courts have not yet directly addressed the outer limits of the latitude provided under BOC § 101.401. In the course of discussing an exculpatory provision in an LLC's articles of organization that largely tracked BOC § 7.001(b) and (c), a Texas court of appeals pointed out that the members were not confined by the provisions of BOC § 7.001(c) and stated that the members were "free to expand or eliminate, as between themselves, any and all potential liability" of the LLC's manager, citing BOC §§ 7.001(d)(3) and 101.401. *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355, 396 (Tex. App.—Houston [1st Dist.] 2012, pet. filed). Characterizing the BOC as conferring on LLC members the power to "eliminate, as between themselves, any and all potential liability" appears to reflect the view that the statute confers complete contractual freedom in this regard, but the court was not actually called upon to enforce or apply a provision purporting to eliminate all duties or liabilities. As the court explained, the members "chose not to completely eliminate [the manager's] potential liability to [the LLC] or its members, but instead, limited it to the same extent that corporations may limit the duties of their officers and directors." A couple months before the *Allen* decision, another panel of the same court of appeals gave effect to a provision in a limited partnership agreement providing that the general partner would owe no fiduciary duties to the limited partners. *Strebel v. Wimberly*, 371 S.W.3d 267 (Tex. App.—Houston [1st Dist.] 2012, pet. filed). The court in *Strebel* did not discuss the provisions of the BOC addressing the extent to which partners may contract regarding duties and liabilities. The court relied upon the Texas Supreme Court's emphasis on the importance of honoring parties' contractual terms defining their obligations, including limiting fiduciary duties that might otherwise exist, especially in arm's-length transactions in which the parties are sophisticated businessmen represented by counsel. *Id.* at 284, citing *Nat'l Plan Adm'rs, Inc. v. Nat'l Health Ins. Co.*, 235 S.W.3d 695, 703 (Tex. 2007).

Example #4:

No Manager shall be liable to the Company or its Members for monetary damages for an act or omission by the Manager in the Manager's capacity as a Manager except as otherwise expressly provided by Section 7.001 of the Texas Business Organizations Code.

Issues: Subsections (b) and (c) of BOC § 7.001 (like the predecessor provisions in Texas Miscellaneous Corporation Laws Act Art. 1302-7.06B) permit the certificate of formation of a corporate entity to eliminate or limit director liability except for certain enumerated types of liabilities, such as a breach of the director's duty of loyalty. The intent of the provision in the example is presumably to provide the same scope of exculpation for a manager as may be provided for a corporate director, but a literal reading of the provision goes further. In order to provide partnerships and LLCs more flexibility and freedom to contract in this respect, subsections (b) and (c) of BOC § 7.001 do not apply to LLCs and partnerships.

BOC § 7.001(d) states that the liability of a governing person in a partnership or LLC may be limited or restricted as provided in the statutes applicable to those entities. BOC § 101.401 states that an LLC may expand and restrict the duties and liabilities of a manager, and the statute does not impose any express limits or prohibitions on the extent to which such duties and liabilities can be restricted. Thus, because BOC § 7.001(b) and (c) do not by their terms apply to LLCs, and BOC § 7.001(d) authorizes limitation of liability as provided in the LLC statute, the reference to Section 7.001 in the above provision does not literally provide any exceptions to the exculpation of liability. Merely adding “(b)” to the reference to Section 7.001 in the provision above may make it sufficiently clear that the intent is to adopt the limitations on exculpation set forth in subsection (b), but there is still a literal gap because the express limitations set forth in subsection (b) do not by their terms apply to LLC managers. If this type of short-hand provision referring to BOC § 7.001 is desired, the provision should make clear that the provision provides for a manager’s exculpation to the fullest extent, but only to the extent, that exculpation is permitted for a director of a corporation under Section 7.001(b) and (c). It is certainly possible to provide the same scope of exculpation in the case of an LLC manager by explicitly setting forth the exculpation and the limits on exculpation—i.e., spelling out in the same terms as the statute the elimination of liability and exceptions to elimination of liability—without reference to Section 7.001. A provision of that type was at issue in *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355, 396-97 (Tex. App.—Houston [1st Dist.] 2012, pet. filed). The court of appeals concluded that the provision could be understood to create a duty of loyalty to the members individually (as opposed to collectively) based on the provision’s elimination of liability except for “a breach of the Manager’s duty of loyalty to the Company or its members.”

Example #5:

A Member, whether or not serving as a Manager, may engage in or possess an interest in other businesses or ventures of any nature and description. Such other businesses or ventures may be the same as or similar to the Company’s and in direct competition with the Company, and may be engaged in independently or with others. Neither the Company nor the other Members shall have any right, by virtue of this Company Agreement or the relationship created thereby, in or to such other ventures or businesses, or to the income or proceeds therefrom, and the pursuit of such businesses or ventures, even if competitive with the Company, shall not be deemed wrongful or improper.

Issues: A similar provision appeared in the limited partnership agreement of a District of Columbia limited partnership addressed in *Alloy v. Wills Family Trust*, 944 A.2d 1234 (Md. App. 2008). The court in *Alloy v. Wills Family Trust* recognized the contractual freedom of the partners of a limited partnership to modify the fiduciary duties of the general partners but concluded that the breach of fiduciary duty claim of a limited partner against the general partners was viable notwithstanding the above provision permitting the partners to engage in and possess other business ventures of any nature. The provision did not protect the general partners from liability for secretly competing with the partnership because the clause did not relieve the general partners from the obligation to *disclose* such opportunities to the partnership.

The limited partnership at issue was governed by District of Columbia partnership

law, and the court applied the provisions of the D.C. Revised Uniform Partnership Act defining and authorizing modification of fiduciary duties. The court noted that these provisions were applicable to general partners in a limited partnership by virtue of the D.C. Revised Uniform Limited Partnership Act provision that a general partner of a limited partnership has the rights and powers and is subject to the liabilities and restrictions of a general partner in a general partnership.

The limited partnership agreement identified the limited partnership as a business venture relating to certain real property upon which were located warehouse buildings and stated that the business and purpose of the partnership was to own, develop, improve, operate, and maintain the property. The partnership agreement contained the following provision:

The Partnership shall be a limited partnership only for the purposes specified in Article II hereof, and this Agreement shall not be deemed to create a partnership among the Partners with respect to any activities whatsoever other than the activities within the business purposes of the Partnership specified in Article II hereof. Any of the Partners may engage in and possess any interest in other business or real estate ventures of any nature and description, independently or with others, including but not limited to, the ownership, financing, leasing, operating, managing and developing of real property; and neither the Partnership nor the other Partners shall have any rights in and to such independent ventures or the income or profits derived therefrom.

For purposes of the appeal, the court of appeals assumed without deciding that (1) language explicitly authorizing partners to compete with the partnership business was not required to waive the duty not to compete, (2) the waiver was specific enough to unambiguously identify the purchase and offer of competing warehouses in the same neighborhood as “specific types or categories of activities that do not violate the duty of loyalty,” and (3) such a waiver of the duty of loyalty was not “manifestly unreasonable.” Even with these assumptions, the court upheld the trial court’s decision to send the breach of fiduciary duty claim to the jury because the waiver did not dispense with the duty to disclose opportunities and conflicts, and there was testimony regarding a prior course of dealing of disclosure by the partners such that a reasonable juror could conclude that the partners agreed that prompt disclosure of opportunities and conflicts would be the measure of each partner’s good faith and loyalty in transactions that competed with the partnership. The court also concluded that the breach of fiduciary duty claim was a viable claim upon which the plaintiff could recover nominal damages notwithstanding an absence of proof of monetary loss stemming from the breach.

As an alternative ground for its breach of fiduciary duty claim, the plaintiff limited partner alleged that the general partners attempted to “squeeze out” the plaintiff. The trial court did not permit the plaintiff to submit this claim to the jury. The court of appeals concluded that the limited partner plaintiff was entitled to pursue a squeeze out/oppression claim based on evidence of the general partners’ secret competition, discontinuance of what had been regular cash distributions, and sudden allocation to the limited partner of over one-half million dollars in taxable income.

Example #6:

The Manager shall conduct the affairs of the Company in good faith in a manner the Manager believes to be in the best interests of the Company.
THE MANAGER IS LIABLE FOR ERRORS AND OMISSIONS IN

PERFORMING ITS DUTIES WITH RESPECT TO THE COMPANY ONLY IN THE CASE OF BAD FAITH, GROSS NEGLIGENCE, OR BREACH OF THE PROVISIONS OF THIS AGREEMENT, BUT NOT OTHERWISE. The Manager shall devote such time and effort to the Company business and operations as is necessary to promote fully the interests of the Company; however, the Manager is not required to devote full time to Company business.

To the fullest extent permitted by law, the Company shall indemnify each Manager, Member, and Affiliate, and their respective officers, directors, partners, managers, employees, and agents, and hold them harmless from and against all losses, costs, liabilities, damages, and expenses (including, without limitation, costs of suit and attorney's fees) any of them may incur as a Member or Manager in the Company or in performing the obligations of that Member or Manager with respect to the Company, **SPECIFICALLY INCLUDING THE SOLE, PARTIAL, OR CONCURRENT NEGLIGENCE OF THE INDEMNIFIED PERSON**; provided, however, that this indemnity does not apply to actions constituting bad faith, gross negligence, or breach of the provisions of this Agreement.

Issues: The first paragraph above addresses liability and exculpation, and the second paragraph addresses indemnification. The use of all caps, bold-face type, and certain language above reflects a concern regarding the "fair notice" requirements applicable to exculpatory and indemnification agreements that operate to release or indemnify a party in advance from the party's own negligence. *See, e.g., Dresser Indus., Inc. v. Page Petroleum, Inc.*, 853 S.W.2d 505 (Tex. 1993) (holding fair notice requirements, which include the express negligence doctrine and the conspicuousness requirement, apply to both indemnity agreements and releases that protect a party from the party's own negligence in advance). It is not clear whether or to what extent the fair notice requirements addressed in the *Dresser* line of cases apply to provisions addressing liability and indemnification of governing persons with respect to fiduciary-type duties in partnerships and LLCs. Certainly, it would be unusual to see charter and bylaw provisions in the corporate context drafted in such a way as to evidence concern with the conspicuousness and express negligence requirements applied in the *Dresser* line of cases, and it may be persuasively argued that the duties and standards applicable to governing persons in business organizations, along with the statutory authorization for contractual variation and indemnification, do not call for application of the "fair notice" requirements in the same manner that they have been applied in other contexts. Nevertheless, practitioners may want to avoid the issue by drafting exculpatory and indemnification provisions in a manner that satisfies the conspicuousness and fair notice requirements. If this is the goal, the practitioner should carefully study the decisions addressing the conspicuousness requirement and express negligence doctrine.

Another observation that may be made regarding the above provisions relates to the list of persons referenced in the indemnification provision versus the liability/exculpation provision. The liability/exculpation provision is phrased only in terms of the manager. If the manager is an entity and its owners, governing persons, officers, or other agents make decisions for the manager or engage in transactions on behalf of the manager in its capacity as manager of the LLC, do such persons have any duties to the LLC, and are they subject to the same standard of liability as the manager? *Cf. Strebel v. Wimberly*, 371 S.W.3d 267 (Tex.

App.—Houston [1st Dist.] 2012, pet. filed) (holding that waiver of general partner's fiduciary duties in limited partnership agreement precluded claims of breach of fiduciary duty against individual where recovery sought was based on actions that were all taken by individual in his capacity as manager of the general partner LLC); *Guerriero v. Kilroy (In re Kilroy)*, 2008 WL 780692 (Bankr. S.D. Tex. 2008) (applying Delaware law and concluding that, where a provision in the limited partnership agreement limited the general partner's duty, a higher standard could not be imposed on the controlling member of the LLC general partner). Alternatively, if the manager delegates responsibilities to officers of the LLC or others who act directly on the LLC's behalf, are these persons protected by the provision addressing liability of the manager? A Texas bankruptcy decision applying Delaware LLC law posed some of these questions. The court indicated that individuals who were acting as agents of the manager would be protected by the terms of the clause exculpating the manager. As for the standard applicable to officers of the LLC itself, the court reasoned that, under the management and delegation structure specified in the LLC agreement, the president of the LLC had no duties because a broad exculpation provision eliminated all duties of the manager, and the LLC agreement stated that the president's authority "was subject to the same duties and powers" granted to the manager under the agreement. Any duties of the other officers of the LLC were derived under the LLC agreement by a delegation or prescription by the manager or president, and absent any evidence of such a delegation or prescription, the court concluded the officers owed no duties. See *Faulkner v. Kornman (In re Heritage Org., L.L.C.)*, 2008 WL 5215688 (Bankr. N.D. Tex. 2008). These issues obviously merit careful thought and explicit drafting to reflect the intent in the context of any particular LLC.

Example #7:

The Company must, before final disposition of a Proceeding, advance funds to pay for or reimburse the reasonable Expenses incurred by a Person who is a Party to a Proceeding because he or she is a Member, Manager or Officer if such Person delivers to the Company a written affirmation of his or her good faith belief that his or her conduct does not constitute behavior that would result in Liability for (i) intentional misconduct or a knowing violation of law, or (ii) any transaction for which such Member, Manager or Officer received a personal benefit in violation or breach of any provision of this Agreement; and such Member, Manager or Officer furnishes the Company a written undertaking, executed personally or on his or her behalf, to repay any advances if it is ultimately determined that he or she is not entitled to indemnification under this Section.

Issues: The above provision was discussed in a New York decision addressing advancement and indemnification of litigation expenses in the LLC context. See *Ficus Invs., Inc. v. Private Capital Mgmt., LLC*, 872 N.Y.S.2d 93 (N.Y. App. 1st Dept. 2009). The court relied upon Delaware case law in interpreting this provision, entitled "Advance for Expenses," in a Florida LLC's operating agreement. Another provision in the operating agreement, entitled "Obligation to Indemnify; Limits," relieved the LLC of the obligation to indemnify a member, manager, or officer who "is adjudged liable to the Company or is subjected to injunctive relief in favor of the Company" for intentional misconduct or a knowing violation of law or for any transaction for which the individual received an unauthorized personal benefit. The action arose out of allegations that the LLC's CEO and other named defendants misappropriated millions of dollars in funds and assets of the LLC. During the course of the proceeding, the CEO sought reimbursement and advancement of his litigation fees and expenses. The trial court had already issued multiple temporary restraining orders and preliminary injunctions against the CEO, and the plaintiffs argued that the issue of advancement was academic if he would not be entitled to indemnification. The appellate court

concluded, however, that the provision referring to injunctive relief pertained solely to indemnification and was separate and distinct from the advancement provision. Advancement was contingent only upon the person's submission of a written affirmation that he or she had not engaged in the prohibited conduct and an undertaking to repay any funds disbursed. Two other individuals whose status as "officers" the plaintiffs contested, but who had been held out as officers of the LLC, were also entitled to advancement according to the court. *See also In re Aguilar*, 344 S.W.3d 41 (Tex. App.—El Paso 2011, no pet.) (holding that corporation was required to advance expenses to a director/officer sued by the corporation—notwithstanding the corporation's argument that the person breached his fiduciary duties and that the board did not consider advancement to be in the best interest of the corporation—because the corporation's bylaws provided that the corporation "shall" advance reasonable expenses to a person named in a proceeding after the corporation receives the person's written affirmation of his good faith belief that he has met the standard for indemnification in a written undertaking to repay the amount advanced if it is ultimately determined that indemnification is prohibited).

THE SERIES LLC: A NEW PLANNING TOOL

Adrienne Randle Bond & Allen Sparkman*

TABLE OF CONTENTS

I.	THE SERIES LLC IN TEXAS.....	58
II.	WHAT IS A SERIES LLC?	58
III.	HOW DO YOU CREATE A SERIES LLC?.....	59
IV.	IF YOU CREATE A SERIES LLC, WHAT ARE ITS POWERS?	62
V.	WHAT POWERS ARE DENIED TO AN INDIVIDUAL SERIES WITHIN A SERIES LLC?	62
VI.	WHO MANAGES AN INDIVIDUAL SERIES WITHIN A SERIES LLC?.....	62
VII.	THE MAGIC PROVISION – SECTION 101.609	65
VIII.	WHAT ARE THE RULES ON DISTRIBUTIONS FROM THE SERIES LLC DURING OPERATIONS?	66
IX.	DISSOLUTION OF A SERIES.....	67
X.	WHAT IS NOT EXPRESSLY STATED IN THE STATUTE ABOUT SERIES LLCS?	68
	A. Questions about Management Structures.....	68
	B. Amendment of the Series LLC Agreement.....	70
	C. Assignment of the Interests in the Series LLC.....	70
	D. Withdrawal and Rights to Cash Distributions.....	71
	E. Books and Records.....	71
	F. Duties, including Fiduciary Duties.....	72
XI.	STATUTORY ISSUES OTHER THAN THE LLC STATUTE – UCC, BANKRUPTCY AND TAX.....	73
	A. UCC	73
	B. Bankruptcy.....	74
	C. Federal and State Taxation.....	75
	D. Current Cases.....	82
XII.	OTHER LIMITATIONS ON SERIES LLCS.....	83
XIII.	WHAT ARE CIRCUMSTANCES WHERE SERIES LLCS MAY BE HELPFUL?....	84
XIV.	EXAMPLE – AN OIL AND GAS DEVELOPMENT AGREEMENT.....	85
XV.	CONCLUSION.....	86

* Adrienne Randle Bond is the general counsel for Fortitude Management Group, LLC, and specializes in energy and energy finance law. Skills include the formation of limited liability companies, corporations and partnerships, private placements, corporate compliance, and acquisitions or sales of assets, routine contract issues for E&P and oilfield service companies. She is a graduate of the Columbia University School of Law and Rice University. She is licensed to practice law in Texas and Colorado.

Allen Sparkman is a partner of Sparkman + Foote LLP. He has a transactional and business and tax planning practice in Houston and Denver. Allen is listed in THE BEST LAWYERS IN AMERICA® and speaks regularly in Colorado, Texas, and nationally on entity selection, fiduciary duties and governance, mergers and conversion, veil piercing, ethics, and tax planning at continuing legal education seminars. Allen is an active member of the LLCs and Partnerships Committee of the Business Law Section of the American Bar Association and is a co-chair of its task force on Series LLCs. He participated on two panels at the Committee's 2012 LLC Institute and was recently named as a member of a new drafting committee of the National Conference of Commissioners on Uniform State Laws. The committee is charged with preparing proposed uniform provisions for series in unincorporated business entities.

I. The Series LLC in Texas

Texas adopted new provisions permitting the creation and operation of series limited liability companies (the “Series LLC”) under Texas law in 2009.¹ This paper discusses the state of law on Series LLCs under the Texas Business Organizations Code (“TBOC”) with some consideration of other jurisdictions’ laws and practice pointers for resolving the issues presented by the statutory formulation for the Series LLC. After discussing what Series LLCs are and can do, the paper will analyze points of ambiguity and development where the results of the use of the Series structure may not be perfectly clear. This vehicle for formation is still under development, but, in the right circumstances, presents an elegant solution to ownership and management of closely related, but not identical, groups of assets.

II. What is a Series LLC?

The Series LLC was first created in Delaware in 1996,² but has only recently gained traction in legislation in other states. Like all new formation vehicles, it is an idea that is in process, and the several statutory formulations are not uniform. In fact, the American Bar Association and the National Conference of Commissioners on Uniform State Laws, the organizations that usually draft and distribute model and uniform laws, have only recently weighed in with draft legislation, in the Uniform Statutory Trust Entity Act. Texas is one of the most recent thoughts on drafting, and tends to follow the Delaware formulations (and reject those state formulations that have strayed from Delaware). The kernel legal concept of the Series LLC is the internal segregation of assets. The TBOC states the following: “A company agreement may establish...one or more designated series...that: (1) has separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligations, or (2) has a separate business purpose or investment objective.”³

If you consider the concept of internal asset segregation, that means that two other issues have to necessarily complement that idea: first, if assets are segregated, the primary reason for such segregation is to allocate the economic rights to those assets differently among the owners. That may mean (i) an economic segregation of income, or allocations among different owners with the same management, or (ii) an economic segregation of liabilities with the same owners and management, but the liabilities of the operating assets of each project can be separated from the other projects. Second, if the segregation is internal, and the purpose for the segregation is economic, then there must be some commonality within the entity. The commonality might be with the management of the enterprise, where groups of assets segregated within separate series (which might have different equity owners) have common management. Alternatively, the assets that are segregated in different series might also be separated in other ways that would suggest the desirability of separate management for the different series. For example, the Buffalo Series of a Texas Series LLC might own a high-rise office building in Houston, the Big Tex Series, an apartment complex in Dallas, and the Sooner Series, a large block of raw land outside Oklahoma City. Although this Series LLC would no doubt have common overall management at the Mothership level,⁴ each separate

¹ TEX. BUS. ORGS. CODE ANN. § 101.601 (West 2011).

² DEL. CODE ANN. tit. 6, § 18-215 (2005).

³ TEX. BUS. ORGS. CODE ANN. § 101.601.

⁴ The authors use the term “Mothership” to refer to the totality of the LLC of which a Series within the LLC is a segregated part. Other commentators state that the term that should be used is “juridical entity.” The authors find this term, although technically accurate, to be clunky and see no harm in using Mothership. At least in part, the

series, because of the geographic separation as well as the different types of assets, likely would need at least a general manager type on location. While the Texas statute affords significant flexibility around the issues of ownership and operation of the assets in the series, this flexibility should not confuse the basic nature and use of the vehicle: segregation of assets with common management structures. Business lawyers have always split up and recombined management structures and economic allocations of the enterprise, and the Series LLC is a permutation of that concept.

Since the Texas statute is based on “commonality” among the Series LLC, that definitional concept has been embedded in the statutory formulation. The entity for state law purposes is the LLC itself and not the Series within the LLC. Stated positively, the Series within the LLC is not a separate entity under the TBOC. Although an individual series of a Texas Series LLC has the power and capacity to, in its own name, contract, hold title to assets (including real, personal, and intangible property), grant liens and security interests, and sue and be sued, a Series may not enter into a merger or conversion.⁵ The TBOC permits a “domestic entity” to enter into a merger or conversion.⁶ Further, the TBOC defines a “domestic entity” as “an organization formed under or the internal affairs of which are governed by this code.”⁷ In the case of a Series LLC, only the Mothership is formed under the TBOC, and the individual Series are formed pursuant to the LLC Agreement of the Mothership, which also governs their internal affairs. This basic concept has effects throughout the formation of a Series LLC, the drafting of the LLC Agreement, the operation of the LLC and the Series within the LLC, and the exit strategies for the Series within the LLC. Some states, namely Kansas, Illinois, Iowa, and the District of Columbia, have considered this issue and have permitted (but not required) a Series within a Series LLC to be a separate entity. However, six of the ten statutory formulations, including Texas and Delaware, follow the model in which a Series within a Series LLC is not a separate entity. This is *the* core issue that creates the ambiguity and mystery of forming and using this vehicle and will be a theme throughout this paper. While many discuss (and complain about) this issue, this paper will suggest treatments available to provide certainty for the use of the Series LLC.

III. How Do You Create a Series LLC?

The TBOC states express requirements for the filing of a Series LLC, including requirements for the contents of the certificate of formation, requirements for the terms and conditions of the LLC Agreement, and requirements for specific record keeping. Section 101.602(b) of the TBOC sets forth these three express statutory requirements. Upon formation, or by amendment, the Certificate of Formation must contain a notice of the limitations (internal) caused by the segregation of the assets in the Series LLC, as specified in Section 101.602(a). Those Series LLC limitations are as follows:

commentators who prefer “juridical entity” do so because, as discussed later in this paper, the preamble to the proposed income tax regulations applicable to series organizations discusses the possibility that the Mothership may be completely ignored for federal tax purposes if all of the assets and business operations are in one or more individual series and none are at the Mothership level. However, even if totally ignored for federal tax purposes, the Mothership will be an entity for state law purposes.

⁵ TEX. BUS. ORGS. CODE ANN. § 101.605.

⁶ *Id.* § 10.001.

⁷ *Id.* § 1.002(18).

- (1) The debts, liabilities, obligations and expenses incurred, contracted for, or otherwise existing with respect to a particular series shall be enforceable against the assets of that series only and shall not be enforceable against the assets of the limited liability company generally or any other series; and
- (2) None of the debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to the limited liability company generally or any other series shall be enforceable against the assets of a particular series.⁸

The notice of limitations is effective whether or not a series has been established at the time it is placed in the certificate of formation and whether or not it refers to a specific series.⁹

The Texas Secretary of State has not promulgated a separate form for filing a Texas Series LLC although there is a form to qualify a foreign Series LLC.¹⁰ We recommend that you expressly state that the LLC is a Series LLC within the meaning of Subchapter M, Sections 101.601, et seq., and then quote the language of Section 101.602(a), set out above, out of caution. Stated directly, follow the statutory directions and diction slavishly.

The remaining provisions of Subchapter M impose indirect or implied requirements for the Certificate of Formation in addition to the express requirements of Section 101.602(a). Looking at the Secretary of State's Form 305, the first question about how Series LLCs function is presented by the issue of the name of the entity. If the LLC is the entity, the Series within the LLC is not an entity, and there is not an express location to name a Series within the LLC, then the name in the Certificate of Formation will be the name of the limited liability company, or the Mothership. This feature impacts the requirements for the segregation of the assets within the Series within the LLC, namely, if a Series within the LLC does not have a name that separately identifies it, how can the LLC, internally or externally, identify or label the asset that is segregated in that Series within the LLC? How can a Series within the LLC enter into a contract if it does not have a name? How can it be sued or sue if it does not have a name? Obviously, a Series within the LLC must have a name that must be set out, at a minimum, in the LLC Agreement. As the paper discusses in more detail below in the section concerning UCC issues, the authors suggest that in the Supplemental Provisions of the Form 305, initially or by amendment, you state that the Series within the LLC has a name and create a public record of that name. This does not solve all of the legal issues, but it certainly goes a long way towards solving the contract and related identification problems that could complicate the legal issues. A separate name on record in the Certificate of Formation will establish a focal point for the separation of the assets. We also suggest that you do not have to use the mundane "Series A" or "Series I." If the point of the name is to help segregate assets, name the Series LLC after the assets to help the identification and notice process.

Next, you need to expressly deal with who the governing persons are or will be of the LLC and any Series within the LLC. Because the LLC (Mothership) is the entity, the usual places in the Form 305 must set out governing persons for the entity, not for any Series within the LLC. Again, this is where you need to be thoughtful about the issue of the entity being the

⁸ *Id.* § 101.602(a).

⁹ *Id.* § 101.604. This is also the rule in Delaware for a Series LLC. DEL. CODE ANN. tit. 6, § 18-215(b) (2005).

¹⁰ Texas Secretary of State Form 313.

LLC and not the Series. Therefore, on the Form 305, you must list the governing persons of the LLC (Mothership). That means an initial determination of whether the LLC is manager-managed or member-managed. The important point here is that the persons that you name in the Certificate of Formation will be the governing persons of the LLC, and not necessarily the governing persons of any particular Series within the LLC. Please hold this thought until the discussion below concerning the provisions on governing persons in Subchapter M of the TBOC with respect to Series LLCs. If, however, you know at formation that the LLC will have managers or managing members that are unique to a particular Series LLC, the authors believe that best practice requires adding that information to the Supplemental Provisions of the Form 305 Certificate of Formation.

Even though a Series within the LLC is not a separate entity, if you determine to have governing persons associated with a Series within the LLC, make sure that the Certificate of Formation designates the managers or members associated with each specific series. In fact, the authors recommend that you amend your Certificate of Formation upon the creation of each series to publicly record this information. We believe that this could support maintaining the integrity of the Series within the LLC in a debtor/creditor controversy, as this paper discusses below. Because the Secretary of State's form does not have a space to designate members or managers associated with a Series within the LLC, you will have to use the "catch all box" of the Supplemental Provisions in the form to include that information.

The authors do not believe that the issues of addresses, registered offices, or registered agent present any significant difficulties as long as you recognize that the only entity is the LLC. Therefore, a Series within the LLC cannot have a separate address or separate registered agents or offices from the LLC (Mothership) itself.

Next, in the formation process, the LLC Agreement must contain provisions creating the series structure. Hold this thought, because we will discuss it more fully after we have had the opportunity to look at and think about the remaining provisions of TBOC Subchapter M on Series LLCs, and how those must interact with the entire TBOC Chapter 101 on LLCs and the remainder of the TBOC and its hubs and spokes.

To be entitled to the internal liability shields offered by the series structure, a Series LLC must also create internal records that "account for the assets associated with that series separately from the other assets of the company or any other series...."¹¹ Contemporaneous records are best, and the authors believe this needs to include an identifying list of the assets, a related balance sheet, income statement, and statement of cash flows that flow from the segregated assets, whatever the precise nature of the internal asset allocation may be. As discussed below in this paper, the IRS has issued proposed regulations that, if adopted in final form, will require each Series within a Series LLC to report separately for federal tax purposes, so there will be a direct pressure to maintain these segregated records. The nature of the segregation of the assets in the Series does not change the requirement to keep records, so if you are creative in your series structure and accomplish matters other than asset segregation, you must still keep these internal records. With these issues, we have covered how to file a Certificate of Formation for a Series LLC and summarized the other formation requirements. Once you have a Series LLC, what can you do with it?

¹¹ TEX. BUS. ORGS. CODE ANN. §101.602(b)(1) (West 2011).

IV. If you create a Series LLC, what are its powers?

Texas drafters had the benefit of reviewing the history of drafts of Series LLC legislation in other jurisdictions, and the general powers provisions contained in Section 101.605 of the TBOC are well thought out. There are four specific powers set out for an individual Series within a Series LLC, as follows:

- (1) To sue and be sued;
- (2) To contract;
- (3) To hold title to assets of the series, including real property, personal property and intangible property; and
- (4) To grant liens and security interests in assets of the series.¹²

This enumeration of powers is illustrative of the basic premise that a Series LLC is a vehicle to segregate assets within an entity. These powers comprise the basic functions required to acquire, own, operate, convey or dispose of assets. This express grant of powers to an individual Series of a Series LLC is a helpful start in sorting out its status for statutory regimes, such as the UCC, that will affect the operations of a Series LLC. For example, if a Series within the LLC has the specific power to contract and to grant liens, then that Series should be able to execute and deliver a security agreement, and a creditor should be permitted under the UCC to file an effective financing statement.

This express grant of specific powers to an individual Series of a Series LLC is further evidence that the Texas legislature did not intend that an individual Series be treated as a separate entity for purposes of the TBOC generally. Otherwise, why would it have been necessary to set forth these specific powers for an individual Series? That is, if an individual Series were a separate entity under the TBOC, it would have all these powers, as well as others, without a specific enumeration in Subchapter M.

V. What Powers are denied to an Individual Series within a Series LLC?

Because of the structure of Subchapter M, there are a number of transactions that are not permitted to a Series within the LLC. Briefly, a Series within the LLC, alone, may not merge, convert, conduct an interest exchange, or sell substantially all of its assets under the terms and conditions of Chapter 10 of the TBOC. Thus, while a Series within the LLC may sell its assets, it may not use the provisions for approval of a sale of substantially all of its assets in the TBOC outside of Chapter 101 on LLCs. The TBOC reserves these transactions to the LLC, or the Mothership, itself through the structure of Chapter 101 and Subchapter M by the fact that an individual Series within a Series LLC is not within the definition of a “Domestic Entity.”

VI. Who Manages an Individual Series Within a Series LLC?

The express rules on management provisions of a Series LLC are contained in four provisions: Section 101.606, which contains provisions limiting the liability of members and managers associated with a series and permits the duties of the members and managers to be expanded or restricted, Section 101.607, which contains the affirmative rules on how one may establish members and managers of a series, Section 101.608, which contains the default provisions so that there will be governing persons if the drafter makes a mistake, and Section

¹² *Id.* § 101.605.

101.610, which concerns the termination of the relationship between a governing person and the Series LLC.

Section 101.606, concerning liability limitation is not remarkable. It simply makes express that any members and managers associated with a Series LLC are not liable for “a debt, obligation or liability of a series, including a debt, obligation or liability under a judgment, decree or court order.”¹³ One may safely assume that an individual Series within a Series LLC will be subject to the same theories of veil piercing that are applicable to LLCs in general. Section 101.606 also contains the statutory authorization to expand or restrict duties of members or managers, but the paper discusses that issue and related practice pointers in more detail below.

Section 101.607 affords great flexibility for designating members and managers, and allocating their respective voting rights. Section 101.607 states:

- (a) The company agreement may:
 - (1) establish classes or groups of one or more members or managers associated with a series each of which has certain express relative rights, powers, and duties, including voting rights; and
 - (2) provide for the manner of establishing additional classes or groups of one or more members or managers associated with the series each of which has certain express rights, powers, and duties, including providing for voting rights and rights, powers, and duties senior to existing classes and groups of members or managers associated with the series.

- (b) The company agreement may provide for the taking of an action, including the amendment of the company agreement, without the vote or approval of any member or manager or class or group of members or managers, to create under the provisions of the company agreement a class or group of the series of membership interests that was not previously outstanding.

- (c) The company agreement may provide that:
 - (1) all or certain identified members or managers or a specified class or group of the members or managers associated with a series have the right to vote on any matter separately or with all or any class or group of the members or managers associated with the series;
 - (2) any member or class or group of members associated with a series has no voting rights; and
 - (3) voting by members or managers associated with a series is on a per capita, number, financial interest, class, group, or any other basis.¹⁴

Key words in the statutory formulation include “group” and “associated.” The authors believe the significance of the use of the term “group” can be analyzed by noting that the TBOC provisions applicable to LLCs that are not Series LLCs uses the same statutory language, but only with respect to members. Thus, TBOC section 101.104 states that the company agreement may “establish within the company classes or groups of one or more

¹³ *Id.* § 101.606.

¹⁴ Added by Acts 2009, 81st Leg., R.S., Ch. 84, Sec. 45, eff. Sept. 1, 2009.

members or membership interests each of which has certain expressed rights, powers, and duties, including voting rights,” may provide for the manner of establishing additional such classes or groups, and may provide that the rights, powers, or duties of any class or group may be senior to the rights, powers, or duties of any other class or group. In the authors’ experience, in traditional, non-Series LLCs, it is common to have different classes of membership, but very uncommon to have managerial authority that is limited to particular aspects of the LLC’s operations. Series LLCs, however, contemplate there may be different management for different individual Series. Accordingly, the statute needed to extend the concept that a team or set of people may be involved with respect to an individual Series but not otherwise. The word “associated” is significant because it denotes a subset of rights under the TBOC. Because a Series within a Series LLC is not a separate entity, the drafters of the Series LLC statutes have used the word “associated.” This is appropriate because a person under the TBOC may have a membership interest only in the Series LLC (Mothership) itself, not in an individual Series and, likewise, a person named in the Certificate of Formation as a manager is a manager of the Series LLC (Mothership) itself. The persons who have the economic benefits and burdens of a particular Series, or who have the right to make management decisions with respect to that Series had to be identified in some other way. Being “associated” with a Series within the LLC gives the members or managers the rights to deal with the Series within the LLC under the specific powers set forth in Subchapter M, but not necessarily the full rights of members and managers generally for the LLC (Mothership).

Section 101.608 contains the express back up provisions concerning the governing authority. The first rule is that the provisions of the company agreement concerning the governing authority for a Series will trump the materials on file publicly with the Certificate of Formation. The ability to determine the persons authorized and able to enter into contracts for an LLC continue to be difficult for a Series within the LLC also, requiring that the company agreement always be produced. Next, if the company agreement does not name governing persons for a Series, they will be the managers or members associated with the Series in the Certificate of Formation for the Series. Hence, as set forth earlier, if possible, it is best to include in the Certificate of Formation an express statement of the members or managers associated with each Series within the LLC. Of course, there is no back up rule for the event that the Certificate of Formation is silent on the Series within the LLC. It is likely to take a lawsuit to figure out if the managers or members designated in the Certificate of Formation for the LLC (Mothership) will be those associated with a Series within the LLC in absence of a designation. This is one of the many situations where lawyers may find themselves bedeviled by clients who amend their Company Agreement orally or change it by course of conduct.

Finally, Section 101.610 provides rules that permit a manager or a member to “cease to be a manager with respect to a series” [NOTE and see below – why does this not say “cease to be a manager associated with a series”?] or “cease to be a member associated with a series,” and the termination of the relationship does not terminate the Series within the LLC or cause either the manager or member to terminate the relationship with the LLC (Mothership) or another Series in the LLC. With respect to the member, the fact that there is not any member of a Series will not require the Series to terminate. This means that the members of the LLC (Mothership) are the members of each Series within the LLC. The difference in the two statutory formulations (i.e. the use of the word “associated” with respect to members) may be important. Under this formulation, the statute uses the word “associated” with a Series with respect to members to indicate that the members are members of the LLC (Mothership) itself, not just the Series within the LLC, while managers may belong solely to a Series within the LLC, if that is intended.

What does all this mean for the governance of a Series within the LLC? First, the information in the Certificate of Formation will be critical to the analysis, because if there is not a public filing, and the LLC Agreement is not clear, one must look to the back up rule contained in Section 101.608 of the TBOC. This rule indicates that the governing persons for a Series within the LLC will be (1) the managers associated with the series, if its LLC (Mothership) is a manager-managed LLC or (2) those members associated with the Series, if the LLC (Mothership) is a member-managed LLC.¹⁵ Second, Section 101.608 of the TBOC provides that the Company Agreement may set out the governing persons of the Series. By this provision “notwithstanding any conflicting provisions of the Certificate of Formation of a limited liability company,” the statute permits a Series to have governing persons different from the LLC (Mothership), thus a manager-managed LLC may have a member-managed Series.¹⁶ A member-managed LLC may have a manager-managed Series also. Remember that the statute only requires that this be set forth in the Company Agreement. The authors suggest that it would be wise to consider using the Certificate of Formation to give public notice of the governing persons of each Series to establish a public record of the actual authority. However, inclusion of this information in the Certificate of Formation will not eliminate the need to examine the Company Agreement because the Company Agreement can still override the Certificate of Formation.

A Series within the LLC may also designate officers of the Series LLC by availing itself of the authority to create and use officers in Section 101.254, though the mechanism of Section 101.609 (as discussed in detail below). Also, remember that under the TBOC, if the LLC (Mothership) or a Series within the LLC is a manager-managed LLC, each manager has express agency authority for the LLC (Mothership) and any of the Series within the LLC, so that if you wish the managers to act as a group, and not individually, you must specifically provide for that in your LLC Agreement, and this particular authorization may differ between the LLC (Mothership) and the Series within the LLC, since it is also based in contract, and not statute.

VII. The Magic Provision – Section 101.609

This is a key provision of the TBOC that grants the powers or activities permitted to Series LLCs, as opposed to LLCs in general, which are not contained in Subchapter M specifically. This is the provision that permits a Series LLC to avail itself of the rules applicable to LLCs in general. Section 101.609 does NOT permit a Series LLC to avail itself of other provisions of the TBOC (such as the merger sections). Section 101.609(a) states that the general rules on LLCs apply to Series LLCs “to the extent not inconsistent” [good question – what is or is not consistent?]. Section 101.609(b) contains the converse rule, so that if a provision specific to Series within the LLCs is affected by the rest of the Chapter on LLCs, the rest of the Chapter may be applied to the Series within the LLC. Through Section 101.609, all of the back up rules on voting requirements, election or appointment of managers and officers, assignment of interests and related rights of assignees and general record keeping requirements are neatly placed into the Series within the LLC. In general, the backup rules of LLCs are very sparse (in comparison to the statutory rules available for corporations) and those back up rules are generally unpleasant, requiring unanimous approvals per capita, so Section 101.609 perpetuates the contractual nature of LLCs and the requirement for specific drafting.

¹⁵ TEX. BUS. ORGS. CODE ANN. § 101.608(b).

¹⁶ *Id.*

Examples of provisions that are imported into Series within the LLCs include (1) amendment of the Company Agreement (requires a unanimous vote of the members), Section 101.053, (2) the prohibitions on waiver or amendment of specific statutory provisions, Section 101.054, (3) the nature of a membership interest as personal property (important in the UCC discussion below), Section 101.106, (4) prohibitions on withdrawal or expulsion of members, Section 101.107, assignment of interests, Section 101.108, (5) rights of assignees, Section 101.110, enforceability of contribution obligations, Section 101.151, (6) rules prohibiting distribution in kind, Section 101.202, (7) transactions with interested persons, Section 101.255, (7) rules concerning the appointment, term, removal, vacancy and so forth applicable to managers, Section 101.301, et seq., and (8) general rules on meetings and voting, Section 101.351, et seq.

As an incorporation by reference section, Section 101.609 is very valuable, but like all incorporation by reference sections, a carefully drafted LLC Agreement that will include Series within the LLC will need to check each of the default rules and consider how the default rule needs to apply to the Series within the LLC and how the default rule will affect the relationship among each Series within the LLC and the LLC (Mothership).

VIII. What Are the Rules on Distributions from the Series LLC during Operations?

If a Series within the LLC segregates rights to assets within an LLC, it makes sense that there are particular rules on the distributions to the economic owners of those segregated assets. Briefly, the statute uses the time honored statutory rules and formulations on distributions with revisions to make the concepts work for a Series LLC. This particular set of rules could not be incorporated by reference because of the many possible contractual permutations of a Series within the LLC, so the drafters tackled this issue as a *sui generis* issue. The statute makes its way through distribution provisions generally applicable to LLCs to ensure that with respect to a Series within the LLC, distribution provisions apply with respect to the assets allocated by the records maintained by the Mothership to the Series making the distribution.

The distribution rules for Series within an LLC seek to isolate the liabilities for distributions of the assets of the Series. The rules first protect a distribution to “a member associated with a series” by expressly granting that member the rights as a creditor of the Series within the LLC (not the LLC (Mothership)), Section 101.611, in parallel to the general provision for LLCs found in Section 101.207. The important detail, however, is that the member associated with the Series is a creditor of that Series only and not the entire entity or any other Series.

More importantly, the rules on distributions emphasize the separateness of the assets allocated to the Series. First, distributions from a Series are expressly authorized.¹⁷ Second, distributions do NOT have to only be made to members associated with that Series. Section 101.613(b) provides that the rules on distributions apply to all members, not just to members associated with the Series, by the deletion of the qualifier “associated with a series” in the express authorization of the persons to whom distributions may be made. Presumably, a member that is not associated with a Series will be protected by the general provision in Section 101.207 of the TBOC. In determining the appropriateness of a distribution, that is, when you will be liable for a distribution, the tests of the liabilities and fair value of the assets

¹⁷ *Id.* § 101.613(a).

are based on the liabilities and fair value of the assets of the Series making the distribution, with the same exceptions from the tests as set forth in Section 101.207, except limited to that Series. As a result, Section 101.206 is excluded and not incorporated by reference, so that the distribution rules in the case of a Series within a Series LLC are limited to the assets and liabilities of that Series. The distribution rules for an individual Series do not have the exception found in Section 101.206 for distributions made in liquidation of the LLC (Mothership), which makes perfect sense because the Series may be terminated while the LLC (Mothership) is continuing.

IX. Dissolution of a Series

A Series within a Series LLC may be terminated and wound up without terminating the LLC (Mothership). The converse is not true, and if the LLC (Mothership) is terminated, all Series within it must be terminated. Of course, the Company Agreement may specify the events or the time that will require a Series within the LLC to terminate and wind up.¹⁸ A Series may also be terminated and its affairs wound up upon

the occurrence of a majority vote of all of the members associated with the series approving the winding up of the series or, if there is more than one class or group of members associated with the series, a majority vote of the members of each class or group of members associated with the series approving the winding up of the series.¹⁹

If there are no members associated with a Series, then the managers associated with that Series may, again by majority vote, terminate the Series within the LLC and wind it up.²⁰ These statutory provisions on the events requiring the termination and winding up of a Series within the LLC may be varied by the Company Agreement. The issues of the percentage vote required to authorize the termination, and the issue of who may vote, are likely to be matters that are routinely varied. Since each Series within a Series LLC is likely to encompass only a portion of a project, it is also likely that the completion of the project will be a typical event in a Series LLC that causes the termination of one or more Series. Because there may be classes or groups within a Series, the issues of termination and related distributions will also likely be common issues in the drafting of Company Agreements.

Once the event requiring the winding up is triggered, the statutory provisions on Series incorporate by reference the general provisions—the “hub” provisions of the TBOC—to establish the procedures for the winding up of the Series. Thus, the procedures of Chapter 11 of the TBOC directly apply to Series within LLCs, with simple definitional changes in Section 101.617 to make the hub provisions work for the specific features of the Series within the LLC. A winding up of a Series within an LLC may be revoked voluntarily but, oddly enough, not by the members of the LLC (Mothership). The voluntary revocation may be accomplished by the majority vote of the members associated with the Series, or if there are no such members, then the managers associated with the Series.²¹ Presumably, all of this may be varied by the Company Agreement.

¹⁸ *Id.* § 101.616(2)(A)–(B).

¹⁹ *Id.* § 101.616(2)(C).

²⁰ *Id.* § 101.616(2)(D).

²¹ TEX. BUS. ORGS. CODE ANN. § 101.618 (West 2011).

X. What is Not Expressly Stated in the Statute about Series LLCs?

A. Questions about Management Structures

Now that we have explored the express statutory provisions governing the Series LLC in Texas, let's turn to what is not expressly discussed, and what you have to arrive at by analysis and implication. First and foremost, and the source of much controversy about Series LLCs, the statute does not really contain clear rules on the exact relationship between the LLC (Mothership) and the Series within the LLC. While the statute tells you what is possible to do and creates many alternatives and permutations, it is difficult to discern exactly what you should do. Because of the relative newness of this vehicle, and because the myriad of choices in the statute are confusing, you must consider your precise structure in the context of your business transaction before you indulge in the potential flexibilities offered by the statute. As set out in the beginning of the paper, the Series LLC is a mechanism to segregate assets within an existing structure (a management team or contract, a license or permit, a physical location, a project, etc.). If you begin with the concept that the Series within the LLC is not wholly separate (or a separate entity, if you will), then some of the many choices become less overwhelming, and can begin to make some sense.

If the LLC (Mothership) is the entity, and a Series within the LLC is not a separate entity, management and ownership structures begin to fall into place. On the issues of ownership, if you parse the Texas statutory provisions, the statute provides that the members are members of the LLC (Mothership), not actually members of any Series within the LLC. If you study the statute, this must be the case, because a Series within a Series LLC can have no members, and not be required to dissolve, while an LLC without members must dissolve.²² Therefore, a Series within a Series LLC does not actually have members. That being said, one of the main features of a Series LLC is the ability to segregate assets to particular Series within that Series LLC, and therefore segregate the economic benefits of those assets, such as allocations and distributions (and, heaven help us, losses). This must mean that members "associated with" a Series must receive the economic rights and obligations associated with the assets in that Series within the LLC. Such members must also be able to contribute to that Series, and receive allocations of income, gain, loss deduction and credit, and distribution of cash with respect thereto. This needs to happen with respect to regular operations and upon dissolution or sale of the underlying assets.

Next, you must consider the actual management of the LLC (Mothership) and the Series within it. There are many choices, and the particular fact situation will be an important factor. If, however, the Series within the LLC is an asset segregation device, by definition, there must be some common thread among the assets to suggest the efficacy of the use of a Series, and one frequent commonality is management. It may make more sense to have the managers at the LLC (Mothership) than at the Series, although one can easily think of cases where there is a person unique to one part of an entire project. Both member-managed and manager-managed LLCs may have officers. If your entity is manager-managed, you may have separate managers for the Series within the LLC or provide for member management of one or more Series, or conversely, use the managers from the LLC (Mothership) as the managers for a Series. A member-managed Series LLC may, in its LLC Agreement, provide that one or more

²² Unless continued pursuant to TEX. BUS. ORGS. CODE ANN. § 11.056(a).

Series will be manager-managed.²³ This is an area where the facts and the structure of the deal will guide your choices.

If management is divided by each Series and there is also management at the Series LLC (Mothership) level, in addition to thinking about who will manage and how, you must also think about and provide for expenses, fees, and/or compensation. All veil-piercing arguments scrutinize very carefully the financial arrangements between the various parts where the piercing is being attempted. Series LLCs are not likely to escape this long-standing case law. It would be wise to set out express provisions for allocation and payment of fees and expenses, including especially common or shared charges. Common or shared charges will likely include overhead, but there may be some costs, such as expenses for maintaining a common license, that would go beyond normal overhead allocation provisions, due to the nature of the Series within the LLC. Clean and crisp financial separation of each Series within the LLC and of each Series from the Mothership is going to be an important fact in respecting the separation of the assets. Records of common or shared charges and allocations of fees and expenses should be maintained as part of the internal records accounting for the assets of each series separately that are required to be maintained if the entity is to be entitled to the internal liability shield afforded by the TBOC Series provisions.

Finally, do not forget the long standing case law about liability of agents for entities, and the requirement that you identify the capacity in which an agent is serving. Once you determine your ownership and management structure, make sure that the documents correctly describe the precise authority of any agents.

Once the overall structure is established, you will need to set out the two main transactions that occur with respect to an “ownership interest”—voting it and selling it. Again, the flexibility of the statute is confusing at inception. Turning to voting, the first question is at what layer do you want the votes to count. If the members are all members of the LLC (Mothership), are the voting rights at that level, and/or are there matters that belong to a Series within the LLC that need to be handled at the Series level? On voting at the LLC (Mothership) level, you must provide for voting on the LLC (Mothership) level because there are certain transactions that require member vote that cannot be approved by a Series, such as mergers, conversions, and interest exchanges, so all of the equity holders need a vote, and you will need to figure out if “class-like” vetoes (i.e. requiring approval Series by Series, or approval by all of the members without distinction is appropriate for those “extra-Series” transactions).

Next, you must think about whether there are matters with respect to the assets of a Series within the LLC that should be controlled by the members associated with that Series, for example, the sale of all or substantially all of the assets of that Series. Then, are there transactions, such as budgets, borrowings, capital expenditures, and management of lawsuits, where you must decide whether they are best handled centrally or at the Series level? Remember also, that as you get further into details of management, the approval process could move from the equity holders to the managers (who may or may not be centralized). Then after you decide who you want to vote for on the transactions, you need to figure out by how much. Again, the statute is flexible, which means that you have to think through your percentage of voting structures with care. Turning to default rules, you are once again governed by Section 101.609, which will direct you to the main LLC statutory provisions. The Series rules say that you can establish voting regimes, but the default rules for voting are in the main LLC statute.

²³ TEX. BUS. ORGS. CODE ANN. § 101.608.

B. Amendment of the Series LLC Agreement

Amendment of the LLC Agreement is a particular subset of voting that should be covered. Again, the ability to amend a Series within a Series LLC is not contained in the Series LLC provisions. Therefore, if there are members associated with a Series, those members may not unilaterally amend the provisions regarding that Series under the authority of the statute. This harkens back to the fact that the members are members of the LLC (Mothership), not the Series. Again, you will need to determine what you want to do since Section 101.609 throws you back to the general amendment provision, Section 101.053, which requires the unanimous vote of the members (the LLC Agreement is a contract). You may vary the amendment provisions by agreement, and you will need to decide if the members associated with a Series within the LLC will be able to amend those Series provisions, or whether all members (at some percentage) will need to be involved, or some combination of the two possibilities that is in between. The authors can easily imagine some amendments that should remain at the Series level, and some that should involve all of the members because all would be affected. This determination will also depend on the deal.

C. Assignment of the Interests in the Series LLC

Assignment of interests is another matter that is not contained in the specific provisions applicable to Series LLCs, so Section 101.609 of the TBOC would point you to the main provisions of the LLC statute, which start in Section 101.108. Once again, the idiosyncratic provisions of the Series within the LLC must be thought through in connection with assignments of interests. First, you must consider the specific facts of the business deal, and whether or not the interests associated with a Series may be assigned separately. Also, you must always remember that there is a linkage between the membership interests associated with a Series and the LLC (Mothership). You must define in more detail what exactly is being assigned, and the approvals to assign these new rights. Will you be able to assign just the rights associated with a Series (even Section 101.108 expressly permits an assignment in part), and if so, would you permit the member to assign the rights to allocations and distributions from that Series, but not the rights to vote or otherwise participate in the LLC (Mothership) in connection with the assignment? Just as in a situation with classes of interests, will there be rights of the other members of the LLC (Mothership)—that means members associated with other Series, also, to purchase or acquire the interest associated with a Series before any other outside party could enter into the Series, at whatever level?

The provisions of Section 101.108, et seq., would require you to focus on several statutory issues after you have thought through the business transaction. The statute expressly states that an assignment of any part of an interest in an LLC does not entitle the assignee to become a member of the LLC, absent approval of all the members (that pesky unanimous vote again!). Would you want that rule, which would mean that all of the members at the LLC (Mothership) would have to vote, or would you want something less? If all of the other members of the LLC must vote on the admittance of an assignee, that would mean that any member associated with another Series within the LLC would have the right to vote on the admission of an assignee in a Series in which that member is not associated. Contribution obligations also need to be clarified. Section 101.108 states that assignees that are admitted as members take on the contribution obligations of the assignor. While it is likely that the assignor's liability for contributions is going to be specific to a Series, any assignment must be clear on the ongoing liabilities. The assignment provisions also state that the assignee has rights to require "reasonable inspections or a reasonable account of the transactions of the

company.”²⁴ Would this mean that the assignee would only have rights to the information about the particular Series, or would the assignee have rights to information about the rest of the LLC (Mothership) or other Series within that LLC? Finally, the assignor remains liable under the statute after the assignment, so you will need to consider how appropriate it would be to leave that liability in place in connection with any full or partial assignment of interests associated with a Series within the LLC.

D. Withdrawal and Rights to Cash Distributions

The right of a member to withdraw and consequences of withdrawal is another set of provisions incorporated into the Series LLC provisions by Section 101.609. The basic statutory provision, set forth in Section 101.107, states that members cannot withdraw or be expelled. This provision affects Series LLCs in much the same manner as a traditional LLC, in that you must consider how to have an appropriate exit for the members, both on a friendly basis and on a not so friendly basis. The existence of Series within an LLC raises issues on exits similar to assignments, and those issues are how separate are the rights of the members associated with a Series from the LLC (Mothership) as a whole? One unique question of a Series LLC is whether if a member who is associated with a Series within the LLC withdraws, does that member withdraw only with respect to that Series within the LLC, or also with respect to the LLC (Mothership)? The answer to that question is also likely to be based on the deal’s terms (such as whether the member has any economic interest in the Series LLC apart from that one Series), but there is again a linkage between the two that must be documented since the Series within the LLC is not a separate entity.

On the issue of friendly exits, you must consider how rights of first refusal, preemptive rights, drag along rights, and tag along rights would apply to an individual Series as well as the LLC (Mothership), considering the complexities of the legal restrictions on what transactions a Series within a Series LLC is authorized to transact within its parameters (e.g. sale of assets) and those transactions that must be approved at the level of the LLC (Mothership). For example, concepts like drag alongs and tag alongs of membership interests would necessarily have to be drafted at the level of the LLC (Mothership) in order to operate effectively, but rights to sell the assets of a Series (a drag-along or tag-along with respect to the assets of the Series) could be placed at the Series level.

The withdrawal provisions of the LLC statute also prohibit distributions in kind, Section 101.202. Because a Series within a Series LLC is associated with specific assets of the LLC, this particular basic rule may need to be analyzed, because in the context of a Series within the LLC, it may make perfect sense to permit a distribution in kind of a portion of the assets of that Series within the LLC to a departing member, rather than a cash distribution, and the structure of the Series within the LLC could facilitate the resolution of that conflict or transaction, as the case may be.

E. Books and Records

The books and records provisions of the main LLC statute are another section incorporated into the Series provisions by Section 101.609. This is another area that requires careful thought and drafting. Specifically, if you are a member associated with a Series within a Series LLC, do you have rights to the books and records of the LLC (Mothership) or the other Series within the LLC? The authors submit that the specific facts should be as influential

²⁴ *Id.* § 101.109.

as the theoretical underpinnings of the law on Series LLC. We would assert that if a Series within the LLC must look to the LLC (Mothership) for certain authorizations and related transactions, then it would be perfectly appropriate for the members associated with that Series to have access to the books and records of the LLC (Mothership) with respect to matters that are not within the authority of the Series but that must be decided at the LLC (Mothership) level. The learning from cases involving disputes over books and records of non-Series LLCs is that your LLC Agreement should spell out the rules applicable to the members associated with the Series within a Series LLC, so that a judge may enforce your agreement and not interpret the application of Section 101.609 to the books and records provisions of the LLC statute.

Turning to the books and records provisions themselves, parsing through the information that a member has a right to receive, Section 101.501, there are records applicable to the LLC (Mothership) that would necessarily affect each Series, for example, a copy of the Certificate of Formation and the LLC Agreement. The more difficult question is whether a member associated with a Series within the LLC should have access to the financial information about the other Series within the LLC. On first thought, you might conclude that if Series within the LLC are supposed to be asset “silos,” then the information about the assets and their operations should also be maintained separately. On the other hand, any competent auditor will tell you that you cannot determine the extent of separation or segregation without access to the records to the entities related to the separate entity, to check all of the interparty transactions. Currently, the proposed federal tax rules treat each Series within the LLC as a separate entity, so disputes over access to federal income tax records may be minimized. After the issues of actual ownership and management of the Series LLC, the issues of the books and records access presents a significant area of controversy and thought as the law and practice on the Series LLC matures.

F. Duties, including Fiduciary Duties

A larger question, but similar analysis, is the issue of the application of duties, including fiduciary duties, among and between the officers, managers and members of the Series LLC, as their rights and powers may be specifically delineated. Once again, a precise analysis of the problem will be dictated by the precise management structure, and due to the flexibility in that structure, a precise analysis will have to be made on a case-by-case basis. Several generalizations, however, may be helpful in this area. Because the LLC Agreement may reduce or increase the duties applicable to the officers, members, or managers, the LLC Agreement needs to address this issue overtly, and not rely on the statute. Next, if the Series LLC is truly going to function as a liability-limiting vehicle, the LLC Agreement needs to address the liabilities for the management team (in whatever structure or format you ultimately choose) across the LLC and its Series. Once again, if you have a Series LLC, it only makes sense that the LLC Mothership will have more than one Series, since you would not need the segregation if there is only one asset. If there is more than one Series, and there is “management” specifically assigned to a Series, it makes good sense to limit their liability to the members associated with the other Series. Conversely, if there is “management” that is common among all of the Series (which, in fact, will be likely), then it makes sense that the common management is liable to all of the Series that they can affect (or relieved of liability with respect to all such Series if that is the deal).

This is an area where there is both a specific rule in the provisions on Series LLCs, and where Section 101.609 incorporates general rules on duties in LLCs by reference, so you will have to start the analysis and drafting based on the Series provisions, Section 101.606, and then also consider the general rules on duties in LLC. An additional consideration would be

any type of drafting that would address the issues of management stepping out of the bounds of the LLC agreement, and exercising authority, especially as a manager or officer of the LLC (Mothership) that indirectly affects a Series in the LLC. Specifically, a governing person may not be directly a governing person of a Series within an LLC, but through the interrelationship, may make decisions that affect a Series for which that governing person does not have direct responsibility. The long reach of fiduciary duty principles makes the effort to delineate duties in the LLC Agreement rather complicated.

XI. Statutory Issues Other Than the LLC Statute – UCC, Bankruptcy and Tax

A. UCC

If the Series LLC is a vehicle for asset segregation, and a Series within the LLC may expressly enter into contracts (e.g. security agreements) and place liens on the assets of the Series, how does the Series LLC fit into the existing rules of the UCC and Bankruptcy Statutes? The short answer is that the fit is not perfect, but there are current answers that are workable and hopefully statutory clarifications will come. While the express provisions of the TBOC are clear that an individual Series within a Series LLC can place a lien on the assets placed into the Series, the relationship with the Texas UCC is not as seamless. Under Section 9.102(28), the definition of “debtor” for purposes of the UCC is a “person having an interest, other than a security interest or other lien, in the collateral, whether or not the person is an obligor.” So far so good. “Person” is defined in Section 1.201(b)(27) of the UCC as “an individual, corporation, business trust, estate, trust, partnership limited liability company, association, joint venture, government, governmental subdivision, agency, or instrumentality, public corporation, or any other legal or commercial entity.” So “Series LLC” is not specifically included in this definition, but it is reasonable to cover it under “any other legal or commercial entity,” since that is precisely what the catch-all provision is for. Turning to the next definition, Section 9.102(71) of the UCC, a “registered organization” is defined as “an organization formed or organized solely under the law of a single state or the United States” and as to which the state or the United States must maintain a public record showing the organization to be have been organized.

The going gets tougher as you turn to the specific section on financing statements. Under Section 9.503 of the UCC, there are rules for the name of the debtor that are divided into rules for “Registered Organizations” and “other cases.” Thus, the critical issue becomes whether the Series LLC is a “Registered Organization” under the UCC definition. The negative view is that since the Series LLC provisions do not make mandatory (i.e. “MUST”) the public record about the formation of the Series within the LLC, it does not qualify as a Registered Organization. The TBOC provision permits a notice to be filed, but there are no absolute requirements of a public record about the organization of a Series within the LLC itself. The counter argument is that the fact that there is a filing and a notice is sufficient to meet the mandatory requirements of the UCC, and that this argument over the definition of a “Registered Organization” is a tempest in a teapot. The uncertainty will be with us until the UCC or the TBOC is clarified or a case points to the correct direction.

There are several solutions to this problem. First, under the express provisions of the UCC, the LLC (Mothership) definitely qualifies as a “Registered Organization” and the filings may be made in its name, with a precise description of the assets. While not a perfect recognition of a Series within the LLC, this procedure works. Creditors have a long track record of limiting their security interests in specific assets, and the relative newness of Series

LLCs should not change a long established UCC practice. Second, if you want to include a Series within the LLC as your debtor, then we would suggest that precise information about the Series within the LLC be placed into the Certificate of Formation, and that such information must contain a distinct name and listing of the purpose and governing persons, if not the management structure. If you do not have the Series within the LLC established on the date of formation, then the Certificate of Formation should be amended to add the information to facilitate the UCC perfection process. If these two methods are not satisfactory, and perhaps in addition to simply naming the Series within the LLC, you may rely on the alternate provisions of the UCC, i.e. Section 9.503(a)(5)(A). This provision states that in “other cases: (A) if the debtor has a name, only if the financing statement provides the individual or organizational name of the debtor,” or under 9.503(a)(5)(B), “if the debtor does not have a name, only if the financing statement provides the names of the partners, members, associates, or other persons comprising the debtor.” Thus, in the worst case, you may properly perfect by providing the names of the members (and, to be safe, that would mean all of the members of the LLC (Mothership)) of the Series LLC.

While the UCC provisions are not perfectly clear, they certainly have provisions that may be used to properly perfect under the circumstances. Until the UCC law is clarified, compliance with filing under Section 9.503(a)(1) of the UCC with the LLC (Mothership) as the named debtor seems the most straightforward choice, but one could use Section 9.503(a)(1) of the UCC with the name of the Series within the LLC, and perhaps also comply with (a)(5). If you want to use the name of the Series, another possibility is to file an assumed name certificate for the name of the Series within the LLC, which is an alternate to directly using the name of the LLC (Mothership) as the name of the debtor. Notwithstanding the criticisms of the lack of UCC clarity, there is definitely a mechanism for proper perfection under the Texas UCC provisions.

There is one other point to consider with the perfection process. The UCC requires that the collateral be described, and this part of the perfection process is not adversely affected by the TBOC Series provisions. It would be bad, however, if the descriptions of the assets that are required to be maintained in the Series LLC records are markedly (or even a tiny bit) different from the UCC filings. The descriptions of the assets in the internal records and external records need to match as closely as possible.

B. Bankruptcy

The issues about bankruptcy of a Series in an LLC are also rather unclear. There are two major concerns about Series LLCs: (1) who decides to file, and how do you actually file, bankruptcy for an individual Series of a Series LLC, and (2) will the Series LLC separation of assets be respected by the Bankruptcy Code? On the first issue, we all know that the Bankruptcy Code is not clear on who is authorized to file bankruptcy for an LLC, and after a series of contested cases, rules on the issue became clearer. Lawyers drafting LLC Agreements became more careful about expressly stating who in the management structure of the LLC is actually authorized to file for protection under Chapter 11. The lesson for the Series LLC is to expressly state who and by what procedure (i.e. vote) may authorize the filing of a bankruptcy proceeding. Total caution would dictate that the approval be made at the LLC (Mothership) level, since the express provisions of the Series LLC rules do not mention bankruptcy. This problem, however, can be largely solved through careful drafting.

The larger question of the Bankruptcy courts respecting the Series LLC is more difficult. It would be wise to carefully review the statutory and case law on substantive consolidation in bankruptcy court. While drafting can create a format that helps maintain legal

separation of assets, the fact remains that the actual practice of the managers and owners of the assets is critical to any analysis of substantive consolidation. While a bankruptcy judge does not have the authority to rewrite or unilaterally revise the express provisions of the TBOC, that judge can examine how the parties behaved in connection with their respective rights and obligations, and make a determination concerning the relative rights of creditors to the assets of the debtor and persons related thereto. This is an area where careful records and concepts of “veil-piercing” need to be applied to the Series LLC operations to prevent consolidation.

In the preparation of documentation for Series LLCs, other traditional concepts applied among potential joint obligors need to be considered. In the LLC Agreement for a Series LLC that has any debt at the level of the Series within the LLC, indemnification provisions for that debt among and between the other Series and the LLC (Mothership) would be highly advisable. In Texas, we currently have a practice of placing an indemnification provision in our LLC agreements for liabilities relating to Texas franchise taxes. This concept can be modified for obligations among and between the various parts of the Series LLC. Similarly, there may be occasion to enter into provisions of an intercreditor agreement with outside creditors in connection with the various layers or levels of debt within the Series LLC. If the LLC (Mothership), for example, has obligations of record with respect to its several Series, it would be best that the creditors of the Series contractually recognize those relationships, much as we do now for obligations across subsidiaries.

C. Federal and State Taxation

1. Proposed federal tax regulations (“Proposed Regulations”) would treat each Series within a Series LLC as a separate entity for federal income tax purposes.²⁵ Each Series would be classified as a partnership, disregarded, or as an association taxable as a corporation. The Proposed Regulations state a beneficial rule in that they will allow the same income tax classification that would apply if separate juridical LLCs were established. The Proposed Regulations apply to Series created by “Series Organizations.”

a. Proposed Reg. § 301.7701-1(a)(5)(viii)(A) states:

A series organization is a juridical entity that establishes and maintains, or under which is established and maintained, a series (as defined in paragraph (a)(5)(viii)(C) of this section). A series organization includes a series limited liability company, series partnership, series trust, protected cell company, segregated cell company, segregated portfolio company, or segregated account company.

“Juridical entity” is the clunky, formal term for what is referred to elsewhere in this paper as the “Mothership.”

b. Proposed Reg. § 301.7701-(a)(5)(viii)(C) defines a “series” as follows:

A series is a segregated group of assets and liabilities that is established pursuant to a series statute (as defined in paragraph (a)(5)(viii)(B) of this section) by agreement of a series organization (as defined in paragraph (a)(5)(viii)(A) of this section). A series includes a series, cell, segregated account, or segregated portfolio, including a cell, segregated account, or

²⁵ Prop. Treas. Reg. § 301.7701-1, 75 Fed. Reg. 55699 (Sept. 14, 2010).

segregated portfolio that is formed under the insurance code of a jurisdiction or is engaged in an insurance business. However, the term series does not include a segregated asset account of a life insurance company. See section 817(d)(1); § 1.817-5(e). An election, agreement, or other arrangement that permits debts and liabilities of other series or the series organization to be enforceable against the assets of a particular series, or a failure to comply with the record keeping requirements for the limitation on liability available under the relevant series statute, will be disregarded for purposes of this paragraph (a)(5)(viii)(C).

c. Proposed Reg. § 301.7701-(a)(5)(viii)(B) defines “series statute” in such a way that each of the nine State Series LLC statutes and the District of Columbia Series LLC statute is a “series statute” within the meaning of the Proposed Regulations:

A series statute is a statute of a State or foreign jurisdiction that explicitly provides for the organization or establishment of a series of a juridical person and explicitly permits—

(1) Members or participants of a series organization to have rights, powers, or duties with respect to the series;

(2) A series to have separate rights, powers, or duties with respect to specified property or obligations; and

(3) The segregation of assets and liabilities such that none of the debts and liabilities of the series organization (other than liabilities to the State or foreign jurisdiction related to the organization or operation of the series organization, such as franchise fees or administrative costs) or of any other series of the series organization are enforceable against the assets of a particular series of the series organization.

d. The preamble to the Proposed Regulations states:

The proposed regulations do not address the entity status for Federal tax purposes of a series organization. Specifically, the proposed regulations do not address whether a series organization is recognized as a separate entity for Federal tax purposes if it has no assets and engages in no activities independent of its series.

An entity formed under local law is not always recognized as a separate entity for Federal tax purposes.²⁶ Moreover, classification of an organization as an entity separate from its owners is a matter of Federal tax law, not local law.²⁷

(1) Some state limited liability company statutes provide that the sole member may have no economic interest on the company. For example, title 6, section 8-301(d) of the Delaware Code states that “a person may be admitted as the sole member of a limited liability company without making a contribution to the limited liability company or without acquiring a limited liability company interest in the limited liability company.” If the juridical

²⁶ Treas. Reg. § 301.7701-1(a)(4) (as amended in 2011).

²⁷ Treas. Reg. § 301.7701-1(a)(1) (as amended in 2011).

limited liability company were such an entity, it would be treated as a nonentity for Federal tax purposes.²⁸

(2) Texas law does not permit a limited liability company with no members other than a noneconomic member.²⁹

(3) Even if a Series LLC has multiple economic members, if all of those members are associated with one or more Series and have no economic interest in the LLC apart from their interest in one or more Series, the Series LLC itself will be treated as having no economic members. For Federal tax purposes, the ownership of interests in a Series and of the assets associated with a Series is determined under general tax principles based on who is entitled to the benefits and burdens of the Series or assets. A Series organization is not treated as the owner for Federal tax purposes of a Series or of the assets associated with a series merely because the series organization holds legal title to the assets associated with the Series.³⁰ As stated in the preamble to the Proposed Regulations:

A series organization is not treated as the owner of a series or of the assets associated with a series merely because the series organization holds legal title to the assets associated with the series. For example, if a series organization holds legal title to assets associated with a series because the statute under which the series organization was organized does not expressly permit a series to hold assets in its own name, the series will be treated as the owner of the assets for Federal tax purposes if it bears the economic benefits and burdens of the assets under general Federal tax principles. Similarly, for Federal tax purposes, the obligor for the liability of a series is determined under general tax principles.

In general, the same legal principles that apply to determine who owns interests in other types of entities apply to determine the ownership of interests in series and series organizations. These principles generally look to who bears the economic benefits and burdens of ownership. See, for example, Rev. Rul. 55-39 (1955-1 CB 403), (see §601.601(d)(2)(ii)(b)). Furthermore, common law principles apply to the determination of whether a person is a partner in a series that is classified as a partnership for Federal tax purposes under §301.7701-3. See, for example, *Commissioner v. Culbertson*, 337 U.S. 733 (1949); *Commissioner v. Tower*, 327 U.S. 280 (1946).

2. The general default rule under the tax classification regulations is that a domestic entity formed under a non-corporate statute will be classified as a partnership if it has two or more owners and will be disregarded if it has only one owner. Such an entity may elect

²⁸ See PLR 200201024, holding that a limited liability company that had one member who owned all of the economic interest in the company and one nominal, noneconomic member would be a disregarded entity.

²⁹ TEX. BUS. ORGS. CODE ANN. § 101.102(c) (West 2011).

³⁰ Prop. Treas. Reg. § 301.7701-1(a)(5)(vi), 75 Fed. Reg. 55699, 55707 (Sept. 14, 2010).

to be taxed as a corporation.³¹ An otherwise disregarded single-owner entity will be regarded for certain employment and excise tax matters, however.³²

3. A special rule provides that an entity will be classified as a corporation if it is a state-chartered bank that is federally insured.

(a) Texas permits limited liability companies to be “limited banking associations.”³³

(b) The provisions governing the formation of limited banking associations do not contemplate Series LLCs. The TBOC applies to limited banking associations only to the extent consistent with the Finance Code for purposes of “the regulation of the internal affairs of the bank.”³⁴

(c) In a telephone conversation, Everette Jobe, Counsel, Bank & Trust Matters, Texas Department of Banking, stated that no one had ever applied to have a Series approved as a limited banking association, and he did not believe that the existing statute would permit that. He said any change would require the approval of the FDIC and the Federal Reserve as well as that of state banking officials. He did state that he was aware of banks that were forming Series LLCs for the purpose of holding loan participations.

4. The Proposed Regulations are only proposed; a Series LLC therefore could report now as single entity but would have to switch to separate reporting if the Proposed Regulations are finalized as written unless the transitional rule in the regulations applies.³⁵ This

³¹ Treas. Reg. § 301.7701-2 (as amended in 2011).

³² *Id.* § 301.7701-2(c)(2)(iv)-(v).

³³ TEX. FIN. CODE ANN. § 31.002(53) (West 1995).

³⁴ *Id.* § 32.002(12).

³⁵ (ii) Transition rule--(A) In general. Except as provided in paragraph (f)(3)(ii)(B) of this section, a taxpayer's treatment of a series in a manner inconsistent with the final regulations will be respected on and after the date final regulations are published in the Federal Register, provided that--

(1) The series was established prior to [September 14, 2010];

(2) The series (independent of the series organization or other series of the series organization) conducted business or investment activity, or, in the case of a series established pursuant to a foreign statute, more than half the business of the

series was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies, on and prior to [September 14, 2010];

(3) If the series was established pursuant to a foreign statute, the series' classification was relevant (as defined in § 301.7701-3(d)), and more than half the business of the series was the issuing of insurance or annuity contracts or the

reinsuring of risks underwritten by insurance companies for all taxable years beginning with the taxable year that includes [September 14, 2010];

(4) No owner of the series treats the series as an entity separate from any other series of the series organization or from the series organization for purposes of filing any Federal income tax returns, information returns, or withholding documents in any taxable year;

(5) The series and series organization had a reasonable basis (within the meaning of section 6662) for their claimed classification; and

(6) Neither the series nor any owner of the series nor the series organization was notified in writing on or before the date final regulations are published in the Federal Register that classification of the series was under examination (in which case the series' classification will be determined in the examination).

(B) Exception to transition rule. Paragraph (f)(3)(ii)(A) of this section will not apply on and after the date any person or persons who were not owners of the series organization (or series) prior to [September 14, 2010] own, in the

switch would be considered a conversion from a single entity to multiple entities for federal tax purposes. For a taxpayer who reports in accordance with the Proposed Regulations, however, they are “substantial authority.”³⁶ Note, however, as discussed below, the Proposed Regulations do not apply for purposes of employment taxes or employee benefits and, therefore, would not be substantial authority for a taxpayer’s treatment of those matters in a Series LLC.

5. The Proposed Regulations contain reporting requirements.
 1. Each Series (unless disregarded) and Series Organization (if recognized as an entity for tax purposes and not disregarded) would be required to file the appropriate income tax returns.
 2. In addition—
 - a. Proposed Regulation § 301.6011-6(a) would require each Series (whether or not disregarded) and each Series Organization (whether or not treated as an entity for tax purposes and whether or not disregarded) to file a statement for each taxable year with respect to the Series or Series Organization as prescribed by the IRS.
 - b. Proposed Regulation § 301.6071-2(a) would require that such statements be filed by March 15 of the year following the period for which the statement is made.

6. The Proposed Regulations do not address foreign entities (except for insurance businesses), employment taxes, or employee benefits.

- (a) The preamble to the Proposed Regulations discusses several perceived problems that could arise if a series is treated as a separate entity for employment tax purposes. The preamble’s discussion is set forth below with the authors’ comments in italics:

The domestic statutes authorizing the creation of series contemplate that a series may operate a business. If the operating business has workers, it will be necessary to determine how the business satisfies any employment tax obligations, whether it has the ability to maintain any employee benefit plans and, if so, whether it complies with the rules applicable to those plans. Application of the employment tax requirements will depend principally on whether the workers are employees, and, if so, who is considered the employer for Federal income and employment tax purposes. In general, an employment relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. See §§ 31.3121(d)-1(c)(2), 31.3306(i)-1(b), and 31.3401(c)-1(b).

aggregate, a fifty percent or greater interest in the series organization (or series). For purposes of the preceding sentence, the term interest means--

- (1) In the case of a partnership, a capital or profits interest; and
- (2) In the case of a corporation, an equity interest measured by vote or value.

³⁶ Treas. Reg. § 1.6662-4(d)(3)(iii) (as amended in 2003).

An entity must be a person in order to be an employer for Federal employment tax purposes. See sections 3121(b), 3306(a)(1), 3306(c), and 3401(d) and § 31.3121(d)-2(a). However, status as a person, by itself, is not enough to make an entity an employer for Federal employment tax purposes. The entity must also satisfy the criteria to be an employer under Federal employment tax statutes and regulations for purposes of the determination of the proper amount of employment taxes and the party liable for reporting and paying the taxes. Treatment of a series as a separate person for Federal employment tax purposes would create the possibility that the series could be an “employer” for Federal employment tax purposes, which would raise both substantive and administrative issues.

It is not clear what more the drafters of the Proposed Regulations thought might be necessary “to make an entity an employer for Federal employment tax purposes.” The statutory provisions cited in the preamble do use the term “person” in referring to employers. Moreover, the cited employment tax provisions sometimes use additional terms to describe who can be an “employer.” Thus, section 3121(h) of the I.R.C. defines “American employer” as, inter alia, an “employer which is... (3) a partnership, if two-thirds or more of the partners are residents of the United States... or (5) a corporation organized under the laws of the United States or of any State.” Unless a series is disregarded, under the Proposed Regulations, it will be either a partnership or an association taxable as a corporation for Federal tax purposes. Moreover, although Treas. Reg. § 31.3121(d)-2(a) states that “[e]very person is an employer if he employs one or more employees,” § 31.3121(d)-2(b) states that “[a]n employer may be an individual, a corporation, a partnership, a trust, an estate, a joint stock company, an association, or a syndicate, group, pool, joint venture, or other unincorporated organization, group, or entity.” It would not appear difficult to fit a series within that definition.

The series structure would make it difficult to determine whether the series or the series organization is the employer under the relevant criteria with respect to the services provided. For example, if workers perform all of their services under the direction and control of individuals who own the interests in a series, but the series has no legal authority to enter into contracts or to sue or be sued, could the series nonetheless be the employer of the workers? If workers perform services under the direction and control of the series, but they are paid by the series organization, would the series organization, as the nominal owner of all the series assets, have control over the payment of wages such that it would be liable as the employer under section 3401(d)?

These questions appear to be make-weights. Although there may be some circumstances in which it is not at first apparent who the employer is, an examination of the facts should almost always lead to a clear result, or at least as clear a result as is obtained in ambiguous employment situations outside of series entities. As noted above, at least for certain employment tax purposes, a “group” may be an employer.³⁷ It is not clear that a group would necessarily have the legal authority to enter into contracts or to sue and be sued, and it is not apparent why this factor should be a reason for not providing guidance in this area, at least for series organizations that do have such authority.

The structure of a series organization could also affect the type of employment tax liability. For example, if a series were recognized as a distinct person for Federal employment tax purposes, a worker providing

³⁷ Treas. Reg. § 31.3121(d)-2(b).

services as an employee of one series and as a member of another series or the series organization would be subject to FICA tax on the wages paid for services as an employee and self-employment tax on the member income. Note further that, if a domestic series were classified as a separate entity that is a business entity, then, under § 301.7701-3, the series would be classified as either a partnership or a corporation. While a business entity with one owner is generally classified as a corporation or is disregarded for Federal tax purposes, such an entity cannot be disregarded for Federal employment tax purposes. See § 301.7701-2(c)(2)(iv).

It is unclear how the fact that a worker might be considered to be the employee of more than one series is any different from the issues that arise if a worker is the employee of two or more separate juridical entities under some degree of common control.

Once the employer is identified, additional issues arise, including but not limited to the following: How would the wage base be determined for employees, particularly if they work for more than one series in a common line of business? How would the common paymaster rules apply? Who would be authorized to designate an agent under section 3504 for reporting and payment of employment taxes, and how would the authorization be accomplished? How would the statutory exceptions from the definitions of employment and wages apply given that they may be based on the identity of the employer? Which entity would be eligible for tax credits that go to the employer such as the Work Opportunity Tax Credit under section 51 or the tip credit under section 45B? If a series organization handles payroll for a series and is also the nominal owner of the series assets, would the owners or the managers of the series organization be responsible persons for the Trust Fund Recovery Penalty under section 6672?

Once again, the authors believe the drafters of the Proposed Regulations protest too much. In particular, it strikes us as somewhat disingenuous to ask how the common paymaster rules would work. The common paymaster rules allow certain commonly controlled corporations to use one of the corporations to pay employees who work for more than one of the controlled corporations, applying one wage base, etc.³⁸ The common paymaster rules apply only to corporations. It seems likely to the authors that the great majority of series that are treated as separate entities for Federal tax purposes will either be disregarded entities or will be partnerships for tax purposes. The common paymaster rules as currently written would have no application to such series, except possibly to a series that, because disregarded, was treated as a division of a corporation. It would seem to be a useful project for the Treasury department to revise the common paymaster regulations so that they would apply to all entities that are under common control as defined therein, whether or not incorporated.

Special administrative issues might arise if the series were to be treated as the employer for Federal employment tax purposes but not for state law purposes. For example, if the series were the employer for Federal employment tax purposes and filed a Form W-2, "Wage and Tax Statement," reporting wages and employment taxes withheld, but the series were not recognized as a juridical person for state law purposes, then administrative problems might ensue unless separate Forms W-2 were prepared for state

³⁸ Treas. Reg. § 31.3121(s)-1.

and local tax purposes. Similarly, the IRS and the states might encounter challenges in awarding the FUTA credit under section 3302 to the appropriate entity and certifying the amount of state unemployment tax paid.

These perceived problems also appear not to justify the absence of guidance. The authors do not know how many states would present the possible need for separate W-2s, since many, if not most states, simply piggyback on the taxpayer's federal taxable income.

In light of these issues, the proposed regulations do not currently provide how a series should be treated for Federal employment tax purposes.

(b) Employee benefit plans. The preamble to the Proposed Regulations state that to the extent a Series may maintain an employee benefit plan, the aggregation rules and employee leasing rules of Internal Revenue Code section 414 will apply. The authors do not see any reason why a Series should not be able to maintain an employee benefit plan on its own. As the preamble to the Proposed Regulations states, the analysis whether the Series is properly maintaining the plan should be the same analysis that is made when any entity that is under common control with a number of other entities maintains an employee benefit plan.

7. State tax issues are evolving.

(a) The Comptroller apparently intends to treat a Series LLC as a single entity for franchise tax purposes. The State Bar Tax Section has recommended that each Series be treated as a separate entity for margin tax purposes to avoid causing the difference that would otherwise result with respect to aggregating entities for margin tax purposes. Separate entities that are under common control do not have to file as a combined group unless they are engaged in a unitary business. However, under the Comptroller's approach, all Series created under the same Series LLC will in effect be combined for margin tax purposes even if the series are not engaged in a unitary business.

(b) The California Franchise Tax Board has announced it will treat each Series within a Series LLC as a separate LLC, thus subjecting each Series to minimum \$800 annual franchise tax.

D. Current Cases

The authors are aware of three published decisions in cases involving Series LLCs, but none of these opinions shed light on any of the issues discussed above. In a bankruptcy case arising in Montana, an individual Series of a Series LLC filed for bankruptcy, but the opinion does not contain any discussion of the propriety of filing on that basis.³⁹ A second bankruptcy case involved a fantastical Series LLC that included an automobile series, a jewelry series, and a personal residence series. The Series structure again was not in issue—the fraudulent transfer issues were so blatant that the court simply did not need to consider the Series structure.⁴⁰ Finally, in another case in which the Series structure was not at issue, the

³⁹ *In re Canyon Holdings, LLC Series 39*, No. 11–60814–11, 2011 WL 3679056, at *1 (Bankr. D. Mont. Aug. 23, 2011).

⁴⁰ *In re Mastro*, No. 09–16841, 2011 WL 4498834 at *1 (Bankr. W.D. Wash. Sept. 27, 2011).

Series structure may have clouded the court's consideration regarding whether an arbitration clause in an LLC Agreement bound a non-party to the agreement.⁴¹

XII. Other Limitations on Series LLCs

Series LLC have other limits that must be thought through, besides debtor/creditor issues. Most of these matters originate from the newness of the structure, and the lack of time to adjust other statutes that affect the operation of a Series LLC. Only a few states have legislation that authorizes the use of a Series LLC. Texas is one of only ten jurisdictions so far to enact Series LLC provisions. This raises two somewhat related questions about whether a jurisdiction without Series LLC legislation would respect the Series within an LLC. First, if an individual Series wishes to carry on activities in a non-Series State that will constitute "doing business" in that State for purposes of the registration of foreign entities, it is likely to be unclear precisely how the Series, or the Mothership, should comply. That is, should the filing be in the name of the Series or of the Mothership? The best practice surely must be to call the particular State filing office for guidance. Note that the form the Texas Secretary of State has promulgated for filing by a foreign Series LLC requires that the filing will be in the name of the Mothership in certain cases. The instructions to Form 313 state:

A series limited liability company that is treated as a single legal entity under the laws of its jurisdiction of organization is treated as a single legal entity for purposes of registration. The limited liability company rather than the individual series should register as the legal entity that is transacting business in Texas.

Does the language of the instructions to Form 313 mean by implication that an individual foreign Series that is treated as a separate legal entity by its jurisdiction of formation should file in the name of the Series? If you are called on to help with such a filing, the authors suggest calling the friendly folks at the Texas Secretary of State's office.

A more important question in most cases is whether a court in a non-Series State will respect the internal liability shields of Series LLC legislation. While the general rule is that the law of the state of formation should govern the regulation of the internal affairs of an entity, including the liability of an owner of the entity for obligations of the entity, it would appear to be a stretch for a jurisdiction without Series LLCs to recognize the liability limitation function of the Series within a Series LLC on the basis of the internal affairs doctrine—the effect of the liability limitation function applies to third party creditors of the Series LLC, not just to the internal affairs of the entity and its members *inter se* nor, unless a veil-piercing claim is involved, to the liability of a member for debts of the Series or the Mothership. If the internal affairs doctrine does not apply, the next question is whether a non-Series state would be required to recognize the internal liability shields of a Series LLC because of the Full Faith and Credit Clause of the United States Constitution.⁴² In other words, if an individual Series of a Texas Series LLC is doing business in a non-Series state, say Colorado, does the Full Faith and Credit Clause require a Colorado court to respect the internal liability shield of the Texas Series LLC legislation in a suit brought by a Colorado resident seeking to hold the Mothership and all its Series liable for an accident caused by the activities of one of the Series in

⁴¹ Carr v. Main Carr Dev., LLC, 337 S.W.3d 489 (Tex. Civ. App.—Dallas Mar. 31, 2011).

⁴² "Full faith and credit shall be given in each state to the public acts, records, and judicial proceedings of every other state. And the Congress may by general laws prescribe the manner in which such acts, records, and proceedings shall be proved, and the effect thereof." U.S. Const. Art. IV, Sec. 1.

Colorado? The short answer is no. Although it is well established that a state's statutes are "public acts" for purposes of the Full Faith and Credit Clause,⁴³ a state is not required "to substitute the statutes of other states for its own statutes dealing with a subject matter concerning which it is competent to legislate."⁴⁴ Further, "[a] rigid and literal enforcement of the full faith and credit clause, without regard to the statute of the forum, would lead to the absurd result that, wherever the conflict arises, the statute of each state must be enforced in the courts of the other, but cannot be in its own."⁴⁵ Accordingly, a court in a non-Series state could, without running afoul of the Full Faith and Credit Clause, refuse to uphold the internal liability shields of a Series LLC on the ground that the forum state's legislature, by not enacting series legislation, had expressed a public policy that internal liability shields within a single entity should not be recognized. By contrast, the Full Faith and Credit Clause applies quite differently to judgments of a sister state:

A valid judgment rendered in one State of the United States will be recognized and enforced in a sister State even though the strong public policy of the latter State would have precluded recovery in its courts on the original claim.⁴⁶

Accordingly, if a Colorado court were to render a money judgment against a Texas Series LLC because of an act of one Series of the Series LLC in Colorado, the Full Faith and Credit Clause would require a Texas court to recognize and enforce that judgment.⁴⁷

Even if you have a transaction that could go across state boundaries but remain in Series jurisdictions (a real estate developer that works in Texas and Chicago), the applicable legislation is not uniform. The most extreme examples are the District of Columbia, Kansas, Illinois, and Iowa, that permit the treatment of each Series within an LLC as a separate entity. Other differences exist, particularly with respect to Delaware, which was the first state to draft provisions, and upon which provisions other states have drafted "improvements." The bodies in charge of uniform laws, such as NCCUSL and the ABA, have only recently weighed in with uniform provisions in the Uniform Statutory Trust Entity Act. While it is not entirely clear how the controversy over entity/nonentity status of the Series within the LLC will work out, we do believe that the "entity" status argument has the weaker position, since that would be the functional equivalent of wholly owned subsidiaries, which we may already form.

XIII. What Are Circumstances Where Series LLCs May Be Helpful?

Now that we know more about how to form and operate a Series LLC, the next question becomes: when would you want to consider using one? The initial use for the Series LLC was in the context of regulated mutual funds, where the LLC (Mothership) contained all of the SEC compliance structures and management contracts and arrangements, and the Series, within the LLC, were used as different silos of managed assets under that management

⁴³ *Bradford Elec. Light Co. v. Clapper*, 286 U.S. 145, 154-55 (1932).

⁴⁴ *Pac. Emp'rs Indus. Co. v. Indus. Accident Comm'n*, 306 U.S. 493, 501 (1939). The Court cited *Pacific Employers* approvingly in 1998 in *Baker v. Gen. Motors Corp.*, 522 U.S. 222, 233 (1998) (Although a court may be guided by the forum state's public policy in determining the law applicable to a controversy, the Court's decisions support no roving "public policy exception" to the full faith and credit due judgments.).

⁴⁵ *Pac. Emp'rs Indus. Co.*, 306 U.S. at 501 (quoting *Alaska Packers Ass'n v. Indus. Accident Comm'n*, 294 U.S. 532, 547 (1935)).

⁴⁶ RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 117 (1971).

⁴⁷ See *Baker*, 522 U.S. at 233; *Fauntleroy v. Lum*, 210 U.S. 230, 237 (1908) (holding the Full Faith and Credit Clause required Mississippi court to enforce judgment of a Missouri court that, in a case brought in Missouri, enforced a contract entered into in Mississippi that was illegal under Mississippi law).

structure. Illinois adopted the rules on Series LLCs because the filing fees in Illinois for an LLC are quite high, and the Series LLC was a mechanism that avoided the filing fee expense of wholly owned subsidiaries. (Don't you wonder how long it will take the Illinois legislature to figure that one out?)

With a little imagination, you may think of other businesses where there is a common management thread or other common business thread that makes separate subsidiaries cumbersome. A business that must have a license, similar to the investment company act rules, would also be a good candidate. Real estate transactions where separate, but contiguous parcels are put together for a project would be a great candidate, especially if there is a business reason (which there often is when parcels are assembled from separate owners) that the parcels cannot all be identically owned or identically managed. In any business with different operating business divisions, the Series LLC may be used to create a legal separation that is not as difficult to manage as wholly-owned subsidiaries, but effective to isolate strategic or difficult assets, where the boundaries provided by the Series could provide a more effective solution than the black/white choice of a wholly-owned subsidiary or division. In the oil and gas world, development transactions, where there are ongoing capital expenditure obligations and the likelihood of different ownership percentages, would be another favorable fact pattern for Series LLCs.

XIV. Example – An Oil and Gas Development Agreement

While many choose to enter into contracts to develop oil and gas properties, many also choose to enter into these arrangements through partnerships and LLCs. This is particularly true when those participating in the development are passive investors relying on the expertise of an entrepreneur. The ability to rely on concepts of fiduciary duties in this context is important to investors. A Series within an LLC works quite well for the business problems presented by the ongoing development plans of a typical oil and gas prospect. Currently, development transactions are approached through a development agreement or participation agreement, where the parties are newly formed LLCs or other partnership vehicles. A Series LLC could be a more user friendly device for this particular fact pattern, when compared to a simple LLC or a set of parent-subsidiary or brother-sister LLCs.

To begin, development agreements contain agreements about the rights and responsibilities for the initial drilling of the prospect, and commitments, including both financial and affirmative covenants about the conduct of operations. If that initial group of wells in the first set of drilling is placed into a Series within a Series LLC, the future decisions about the development would be easier to both finance and manage. Later drilling on a prospect is always under changed conditions, both technically and financially, and a Series LLC would facilitate the management of the development.

Inevitably during the period of initial drilling, which may last as long as two years, the parties that are participating in the front end cannot remain through the life of the project. Over the period for the development, it is not uncommon for the financial position of the parties to change significantly (think the recession of 2008), or other management issues may arise that will alter views or opinions about the project as it matures. Thus, the second and third phases of drilling often require significant adjustments in the original terms of the entity that is participating, and to date, the only tools are to create special allocations or new classes in the first partnership or LLC, or to create an entirely new entity. The Series structure more elegantly solves this problem because a Series LLC allows you to alter both financing and

management within one entity. Much as a standard Joint Operating Agreement allows undivided interest owners to go non-consent on a well, the Series LLC would allow members to similarly go non-consent, through placing the next set of wells in a separate Series with different members, and if necessary, managers, for the partnership equivalent of a non-consent.

Another accommodating feature about using a Series LLC is that the LLC (Mothership) can act as operator and hold the permits, seismic licenses, bonds and other regulatory requirements for all of the Series, and there is still just one entity. Currently, if the next phase of the development is sufficiently different, a whole new entity is formed, and the existing operator must act as a contract operator since it will not likely have the requisite ownership under the Joint Operating Agreement. If all of the real property interests may be contained in one entity, the operatorship issue may be simplified. Similarly, the current custom of creating an operating subsidiary to hold all of the permits and bonds, and to actually conduct operations isolated from the entity that owns the properties is not needed. By placing the real property interests into a Series, the LLC (Mothership) may perform that function, and again obviate the need for contract operating agreements.

The Series LLC could also facilitate both equity and debt financing for the entire development. As development proceeds, the risk profile of the drilling operations must change. Later development drilling is always less risky than the initial wells to prove the prospect. The placement of the later wells into their own Series would allow for both equity and debt providers to finance the specific risk profile, which would both make the financing easier, by being more focused and faster. Properties that are acquired after the commencement of the development drilling through Area of Mutual Interest provisions could also be placed into a separate Series, since the pricing terms of leases after the development has been successful, have been known to be different from the original leasing rates. The ability to segregate properties acquired at different prices would also facilitate the financing of drilling that acreage. Similarly, required midstream projects to treat and transport the product could also be placed in a separate Series, again separating the risks and the nature of the financing. A Series LLC, however, would permit you to establish one entity for an exit, where currently, there are several commonly controlled entities that must be tied together contractually through tag along and drag along agreements, and similar contractual provisions in Joint Operating Agreements.

Finally, the segregation of different phases of the drilling of a development is a simple mechanism to isolate old fashioned drilling risks. The “silos” created by a Series should offer the same liability limitations as a separate LLC, without actually making a separate legal entity that must be dealt with through contracts. The Series LLC can hold all of the phases of the development agreement under one entity, while permitting both different economics and related financing, and different management structures (mid-stream separated from upstream, for example), leaving the entire prospect in one entity. Thus, the authors believe that Series LLCs will prove quite useful as a structure for oil and gas exploration.

XV. Conclusion

While the Series LLC is a new vehicle that has some unanswered questions, it is a solution to problems of management of assets that have common, but not identical features. The statute makes very clear the ability to deal with assets and the transactions surrounding assets that may be held by an entity. If you focus on the feature of asset management and commonality, but not identity, the confusion caused by the flexibility permitted in the TBOC provisions falls away, and you are able to focus on fact patterns that are truly facilitated by this structure. The single most “common” commonality is management, but the commonality may

be the nature of the asset (such as the accumulation of one large asset from divided parts) or the development of an asset over time, where ownership may shift. We would like to encourage you to join the ranks of the optimists and urge you to study and think about this new vehicle. Consider embracing the good points of a Series LLC in transactions appropriate for the solutions that it provides.

**BANKRUPTCY LAW –
MAY A CREDITOR INTERNALLY ALLOCATE
COLLATERAL TO BECOME OVERSECURED AFTER
THE BANKRUPTCY PETITION HAS BEEN FILED?**

By Alanna Beck^{*}

In re Geijssel, 480 B.R. 238 (Bankr. N.D. Tex. 2012).

In August 2012, the United States Bankruptcy Court for the Northern District of Texas, Fort Worth Division, rejected a secured creditor's contention that it could internally allocate the collateral that secures the debt, becoming effectively oversecured regarding one or more of the claims, after the bankruptcy petition had been filed.¹ The Court ultimately followed the analysis in *In re T-H New Orleans Ltd. P'ship*² and applied the cash on hand and adequate protection payments, for collateral that did not depreciate in value, to reduce the amount of the secured claim, resulting in the creditor becoming oversecured anyway and entitled to attorney's fees and interest.³

Arjen and Kimberly Geijssel (the "Geijsels") are the sole owners of a limited liability company, The Luckie Dutchman, LLC (the "LLC"), and the Geijsels together with the LLC own and operate a dairy farm and are collectively referred to as the Debtors.⁴ Throughout the years 2006-2009 the Debtors took out numerous loans, nine of which were outstanding at the time the bankruptcy petition was filed; eight of the loans were from two separate entities, Lone Star, FLCA (FLCA) and Lone Star, PCA (PCA), collectively referred to as Lone Star.⁵ The Debtors secured these loans with "all of the real and personal property [they] owned," which included, among other things, their ranch and dairy facility.⁶ During the pendency of the bankruptcy, the Debtors continued to remain in possession of and operate the dairy business.⁷ The value of the dairy facility at the time of filing was approximately \$3,380,000.⁸ The debt owed to Lone Star by the Geijsels at the filing of bankruptcy was approximately \$8,425,000 and the debt owed by LLC to Lone Star totaled \$1,463,000.⁹ All the loans were cross-collateralized between both Debtors and each Lone Star entity.¹⁰

On June 15, 2010, the Debtors each filed separate petitions for relief under Chapter 11 of Title 11 of the United States Code (the "Bankruptcy Code"); the cases were jointly administered.¹¹ At the time of filing, the value of all the collateral securing Lone Star's claim totaled \$8,595,313.26.¹² PCA filed a proof of claim in the Geijssel's case totaling approximately

^{*} Alanna Beck is a 2013 J.D. Candidate at South Texas College of Law.

¹ *In re Geijssel*, 480 B.R. 238 (Bankr. N.D. Tex. 2012).

² 116 F.3d 790 (5th Cir. 1997).

³ *Id.* at 263.

⁴ *Id.* at 243.

⁵ *Id.* at 244.

⁶ *Id.*

⁷ *Id.*

⁸ *Id.* at 262.

⁹ *Id.* at 245.

¹⁰ *Id.* at 247.

¹¹ *Id.* at 243.

¹² *Id.* at 248.

\$5,317,000.¹³ FLCA filed a proof of claim in the Geijsel's case totaling approximately \$4,571,000, which includes the debt owed by LLC.¹⁴ The total value of the indebtedness claimed by Lone Star as of the petition filing is \$9,774,086.90.¹⁵

On September 15, 2010, the Debtors were required to start making adequate protection payments of \$50,000 per month to Lone Star, which were in fact made through June 2012.¹⁶ Although the total amount of debt owed exceeds the total value of the collateral, "after credit [was] given for accumulated cash on hand...and adequate protection payments," Lone Star became an oversecured creditor by the time of the confirmation hearing.¹⁷

In determining whether to confirm the Debtor's Chapter 11 plan, the Court began its analysis with an examination of Lone Star's claim.¹⁸ The Court first addressed Lone Star's contention that it can internally allocate collateral within PCA and FLCA to become oversecured with regard to some claims, allowing Lone Star to be able to collect interest and attorney's fees from the equity cushion.¹⁹ Specifically, Lone Star wanted to internally allocate collateral causing the \$1,463,000 FLCA claim to become oversecured by the security interest in the dairy facility, which was valued at \$3,380,000.²⁰ The effect would be Lone Star maximizing the amount it can collect through the bankruptcy proceeding. Lone Star argued that this was proper even though allowing it would effectively disregard the fact that the dairy facility was also collateral for prior loans by Lone Star that were involved in the Geijsel's individual case.²¹

In rejecting Lone Star's contention that it can internally allocate the collateral, as addressed in footnote 18 of the opinion, the Court began with the notion that a creditor's claims in bankruptcy are determined at the time the debtor files the bankruptcy petition.²² In this case, at the time the Debtors filed the petitions, Lone Star's claims exceeded the total value of the collateral by \$1,178,773.64.²³ This remainder of the claim would then become an unsecured debt, and Lone Star would share with the other unsecured creditors on a pro rata basis of the balance left in the estate.²⁴ Also, in this scenario, because there would be no equity cushion on the collateral, Lone Star would not be entitled to interest or attorney's fees.²⁵

The Court reasoned that allowing Lone Star to internally allocate collateral after the Debtors filed their bankruptcy petition would disrupt the distributional structure of the Bankruptcy Code.²⁶ The distributional structure is in place to protect the rights of all creditors in the bankruptcy proceeding.²⁷ Allowing Lone Star to add to their secured claim after the petition is

¹³ *Id.* at 245.

¹⁴ *Id.*

¹⁵ *Id.* at 247–48.

¹⁶ *Id.* at 251.

¹⁷ *Id.* at 262.

¹⁸ *Id.* at 261.

¹⁹ *Id.* at 262.

²⁰ *Id.*

²¹ *Id.*

²² *Id.* at 275, note 18.

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

filed would be at the expense of the other unsecured creditors.²⁸ This would be at the expense of the other unsecured creditors because it would create one oversecured claim for Lone Star, to which interest and attorney's fees would be added, not exceeding the value of the collateral securing the claim. In this case the potential interest and fees could be up to \$1,917,000—the value of the dairy facility minus FLCA's claim against the LLC.²⁹ That would in effect increase the amount of unsecured debt regarding Lone Star's other claims and decrease the likelihood of the other unsecured creditors receiving anything.³⁰

The Court acknowledged that the purpose of section 506 of the Bankruptcy Code is “to protect the creditor's interest in the property securing its claim; it is not to protect something more than that.”³¹ This means the protection of the secured creditor extends only to the value of the collateral securing the claim at the time the petition is filed.³² The Court rejected Lone Star's contention by stating that allowing Lone Star to internally allocate collateral post-bankruptcy petition filing would disrupt the equitable distribution structure of the Bankruptcy Code.³³

In defining Lone Star's claim, the Court applied the analysis articulated in *In re T-H New Orleans Ltd. P'ship*.³⁴ The court in *In re T-H* applied a two part test: 1) “whether the secured creditor was entitled to accrue interest under § 506(b),” and 2) “if it can, when does interest begin to accrue and to what extent is the creditor entitled to post-petition interest?”³⁵ The *In re T-H* court posited that the “secured creditor's entitlement to accrue interest under § 506(b) matures at the point in time where the creditor's claim becomes oversecured[,]” and the determination is “not limited to a single point in time.”³⁶ In addressing the second part of the test, the court in *In re T-H* held that a secured creditor may add post-petition interest but not to exceed the value of the collateral securing the claim.³⁷

In applying this analysis with regard to Lone Star's claim, the Court concluded that the adequate payments paid from the post-petition cash collateral, which is the income from operation of the dairy business, can be applied to reduce the amount of debt.³⁸ The determination of the date Lone Star became oversecured, and subsequently entitled to accrue interest and attorney's fees, was calculated by subtracting the monthly adequate protection payments from the total amount of the claim, the date that the value of the collateral exceeded the amount of the claim is the date the right to accrue began.³⁹

Although, the Court ultimately determined that Lone Star would be entitled to post-petition interest and attorney's fees, the Court refused to accept the contention that creditors could internally allocate collateral to become oversecured regarding certain claims. The potential oversecurity under the Court's analysis would be approximately \$653,000 (the difference

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ *Id.*

³⁴ *Id.* at 263 (citing *In re T-H New Orleans Ltd. P'ship*, 116 F.3d 790 (5th Cir. 1997)).

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.* at 266–67 (discussing the majority “addition” view).

³⁹ *Id.* at 268 and addendum chart following the opinion.

between the \$9,477,000 collateral value and the \$8,824,000 secured claim)⁴⁰—significantly less than the \$1,917,000 potential oversecurity under Lone Star’s analysis.

⁴⁰ *Id.* at 262.

GUARANTY AND SURETYSHIP LAW – WHETHER AN INDIVIDUAL MAY AVOID OBLIGATIONS UNDER A PERSONAL GUARANTY CONTRACT WHEN A COMPANY CONVERTS TO A DIFFERENT ORGANIZATIONAL FORM

By Kerri Dobbins^{*}

Wasserberg v. Flooring Servs. of Tex., LLC, 376 S.W.3d 202 (Tex. App.—Houston [14th Dist.] 2012, no pet. h.).

What is a Personal Guaranty?

A guaranty agreement between parties creates a secondary obligation that is separate from a primary obligor's promise to pay.¹ The secondary obligation is comprised of a promise by the guarantor to be responsible for the primary obligor's debt.² Upon failure of the primary obligor to pay their share of the contract, the guarantor in the guaranty agreement is liable for the debt.³

A recent case from the Fourteenth Court of Appeals of Texas took another look at the qualifications for personally guaranteeing the debts of a company and the repercussions of doing so for individuals.⁴ The court in *Wasserberg* held that the individuals were personally liable for the debts owed by the corporation because they had executed a valid guaranty agreement.⁵ Although the defendants cited other cases where the personal guaranties were insufficient, the court distinguished between the case at hand, and the cases cited; finding that the defendants' arguments were insufficient.⁶

Test for a Guaranty Contract

The test to recover under a guaranty contract requires a showing of:

- (1) The existence and ownership of a guaranty contract;
- (2) The terms of the underlying contract by the holder;
- (3) The occurrence of the conditions upon which liability is based; and
- (4) The failure or refusal to perform the promise by the guarantor.⁷

Under the rule of *strictissimi juris*, a guarantor is entitled to have the terms of the guaranty agreement be strictly construed and not interpreted beyond its terms.⁸ In order to ap-

^{*} Kerri Dobbins is a 2013 J.D. Candidate at South Texas College of Law.

¹ *Wasserberg v. Flooring Servs. of Tex., LLC*, 376 S.W.3d 202, 205 (Tex. App.—Houston [14th Dist.] 2012, no pet. h.)

² *Id.*

³ *Id.*

⁴ *See generally id.*

⁵ *Id.* at 209.

⁶ *Id.* at 207.

⁷ *Id.* at 205.

⁸ *Id.* at 206; *see also* McKnight v. Va. Mirror Co., 463 S.W.2d 428, 430 (Tex. 1971) (explaining how a guarantor is permitted to rely on the terms of the contract being strictly followed, and thus if the terms of the guaranty are changed, the guarantor will no longer be liable because a new contract has essentially been formed).

ply such a rule, the court must first ascertain the terms of the agreement by reviewing the language of the guaranty de novo.⁹

The validity of a guaranty agreement does not cease to exist upon conversion of a limited liability company to a limited partnership.¹⁰ In Texas, upon conversion of an entity, the entity simply continues to exist without interruption in the new organizational form rather than in its prior.¹¹ A personal guarantor may not escape liability merely because an entity changes its name or form.¹²

Wasserberg's Approach

The case of *Wasserberg* arose when Jonathan Wasserberg and Jason Felt personally guaranteed any debt owed by Waterhill Companies Limited (WCL) in their individual capacities in order to obtain a line of credit with Flooring Services of Texas, LP (FST).¹³ When FST was unable to obtain payment from WCL, FST brought suit against WCL for payments due, as well as against Wasserberg and Felt based on their personal guaranties.¹⁴ The underwriter of the title insurance policies, Stewart Title, also sued seeking indemnity from Wasserberg for amounts of settled claims on the liens on behalf of the homeowners.¹⁵ The affidavits Wasserberg signed allegedly made him “personally liable for any damages resulting from [falsified] information [with]in the affidavits.”¹⁶ In order to avoid liability, Wasserberg and Felt argued that the guaranty contracts were insufficient due to a lack of express language that named the companies for which they would be liable.¹⁷

The issue before the court was whether conversion of organizational forms discharges individuals of their obligations to repay any debt incurred by the company as a result of the personal guaranty contracts that they signed.¹⁸ The court found that prior cases, and the Texas Business Organization Code supported the finding that such conversion does not affect the liability of an individual who signed an affidavit and who created a guaranty contract agreeing to take on such responsibility.¹⁹ The court addressed three arguments in its reasoning for holding the defendants liable.²⁰

First, the court found that the Texas Business Organization Code does not permit the guaranty contracts created for one entity to cease to exist simply because that entity converts its form of liability or changes its name.²¹ So long as the company drafts a plan of conversion prior to implementation, any personal guaranty contracts relating to the prior company will carry over to the new company.²² The court further stated that there was no evidence that Wasserberg and Felt’s debt at issue was incurred on behalf of Waterhill Company, LLC (the original company) and that the guaranties were applicable to any debts incurred after Waterhill Company, LLC converted to WCL, LP.²³

⁹ *Wasserberg*, 376 S.W.3d at 206.

¹⁰ *Id.* at 207.

¹¹ *Id.* at 206 (citing TEX. BUS. ORGS. CODE ANN. § 10.106 (West 2011)).

¹² *Id.* at 207.

¹³ *Id.* at 204.

¹⁴ *Id.*

¹⁵ *Id.* at 204–05.

¹⁶ *Id.* at 205.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.* at 206–07.

²⁰ *See generally id.*

²¹ *See* TEX. BUS. ORGS. CODE ANN. §§ 10.103, 10.106 (West 2011).

²² *Id.*

²³ *Wasserberg*, 376 S.W.3d at 207.

Second, the court found that specific language permitting the succession or assignment of a guaranty is not necessary for its enforcement.²⁴ The plaintiffs relied on two cases, *Marshall* and *Gifford-Hill*, to support their argument; but the court distinguished said cases from the case at hand.²⁵ In *Marshall*, the court held that it could only enforce the contract according to its precise terms and could not extend beyond.²⁶ Because the guaranty contract at hand expressly states that no unpaid labor would remain, *Marshall* is distinguished from the guaranty contract in this case, and Wasserberg remains liable for the debt.²⁷ In *Gifford-Hill*, the court determined that express language was not required despite the court finding that the contract was insufficient.²⁸

Finally, the court addressed the fact that Wasserberg admitted that he signed the affidavits regarding debts owed and that the plaintiffs gave no additional evidence to merit an affirmative defense pleading.²⁹ The affidavit stated that all bills were paid and that there would be no unpaid labor or material claims against the improvements or the property.³⁰ Upon signing such an affidavit, Wasserberg expressly represented their affirmation of his guaranty to the company.³¹ The court found that Wasserberg had no defense available to him to relieve him of his obligations because to testify otherwise would be fraud.³² Defendants' argument that the trial court erred by not permitting them to give additional testimony was irrelevant and overruled.³³

The court's reasoning led to its conclusion that the guaranty clause was valid and enforceable against the personal guarantors, and that the creditors were able to enforce it.³⁴ The conversion of the organizational form of the company did not adversely affect the enforceability of the guaranty contract made by the personal guarantors on behalf of the company.³⁵ By upholding the enforcement of the guaranty contract, the court was not extending the contract's terms beyond its strict enforcement because the guaranty was made with regard to any and all debts that the company sustained, rather than being limited to specific goods and services that were provided by the original creditor.³⁶

What Does This Mean To You?

Wasserberg is significant for several reasons, but most importantly it supports the near-absolute validity of personal guaranty contracts. For practicing attorneys in Texas, this case gives guidance as to how future courts in Texas may rule on this issue, and has affirmed prior cases that have upheld personal guaranties for the same reasons.³⁷ Furthermore, this case emphasizes the notion that practicing attorneys should advise their clients to be specific when drafting guaranty contracts and expressly state the terms. The reason is because the court appears to favor upholding personal guaranties, rather than extinguishing obligations due to tech-

²⁴ *Id.* at 208.

²⁵ *Id.* at 207–08.

²⁶ *Id.* at 207 (citing *Marshall v. Ford Motor Co.*, 878 S.W.2d 629, 631 (Tex. App.—Dallas 1994, no writ)).

²⁷ *Id.* at 208.

²⁸ *Id.* (citing *Peters v. Gifford-Hill & Co.*, 794 S.W.2d 856, 860 (Tex. App.—Dallas 1994, writ denied)).

²⁹ *Id.* at 208.

³⁰ *Id.*

³¹ *Id.*

³² *Id.* at 209.

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ See also *Tenneco Oil Co. v. Gulshy Eng'g, Inc.*, 846 S.W.2d 599, 605 (Tex. App.—Houston [14th Dist.] 1993, writ denied); *Marshall*, 878 S.W.2d at 630; *Gifford-Hill*, 794 S.W.2d at 863 (all illustrating rulings and policies consistent with the holding in *Wasserberg*).

nicalities, such as changes in a company's organizational form or lack of naming the newly formed company in the personal guaranty contract.

**PARTNERSHIP LAW –
DOES A PARTNER’S DESIRE TO TERMINATE
THE PARTNERSHIP AT A LATER DATE
CONSTITUTE DISSOLUTION?**

By Thomas Horton^{*}

Buck v. Palmer, 381 S.W.3d 525 (Tex. 2012).

The Supreme Court of Texas recently issued an opinion in *Buck v. Palmer* on the issue of whether statements of intent to discontinue a joint venture cause automatic dissolution of the venture as a matter of law. The Court held that statements expressing intent to dissolve at a future date does not terminate the partnership immediately as a matter of law.¹

The withdrawal of partners from a partnership agreement are governed by Section 152.501 of the Texas Business Organizations Code, which states that a person ceases to be a partner on the occurrences of an event of withdrawal.² An event of withdrawal occurs upon the receipt by the partnership of notice of the partner’s express will to withdraw on the date the notice is received.³

The issue in this case arose when the outstanding debt of the joint venture was consolidated and reduced to a \$600,000.00 note.⁴ Soon after the settlement Buck allegedly promised to transfer to Palmer his remaining interest in the venture in exchange for a discharge of indebtedness.⁵ Two years later, Palmer sued Buck for breach of an oral agreement; however, Buck denied the existence of the contract and sought a declaratory judgment confirming his interest in the partnership.⁶

The central piece of evidence was a letter dated June 16, 1995, where Buck stated “I have no desire to embark into any QID land development scenario with you.”⁷ Palmer contends that Buck surrendered his interest on June 16, 1995, whereas Buck contends that he never intended to relinquish his interest in the joint venture.⁸

The trial court denied Buck’s motions and granted Palmer’s motion for summary judgment. The Court of Appeals affirmed the trial court, holding that the letter was conclusive evidence of dissolution of the joint venture. The Supreme Court of Texas granted review of summary judgment under a *de novo* standard.⁹

Palmer’s contention relied on a single case, *Woodruff v. Bryant*, which supported the proposition that dissolution occurs “automatically” when a partner expresses the intent to dis-

^{*} Thomas Horton is a 2013 J.D. Candidate at South Texas College of Law.

¹ *Buck v. Palmer*, 381 S.W.3d 525, 526 (Tex. 2012).

² TEX. BUS. ORGS. CODE ANN. § 152.501(a) (West 2011).

³ *Id.* § 152.501(b)(1).

⁴ *Buck*, 381 S.W.3d at 526.

⁵ *Id.*

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.* at 527.

solve.¹⁰ The Texas Supreme Court, after examining the *Woodruff* decision, acknowledged that the court in *Woodruff* held that an expression of will to dissolve the partnership is legally sufficient evidence of dissolution.¹¹ Further, the court in *Woodruff* stated that a letter expressing a desire to cease the partnership is only some evidence supporting dissolution.¹² In fact, the *Woodruff* court overturned the jury's finding and held that the evidence was insufficient due to the "overwhelming evidence" that the partner retained her partnership interest.¹³

It is true that the June 16, 1995 letter from Buck is some evidence that the partnership had dissolved. However, Buck presented contradicting evidence, which included 1) the settlement agreement listing Buck as a twenty percent owner, after the alleged dissolution, which was signed by Palmer; 2) an amended joint venture agreement, adopted after the alleged dissolution, still listing Buck as an owner; and 3) Buck's affidavit stating he did not intend to dissolve the venture.¹⁴ When the letter is viewed in conjunction with all of the evidence presented, summary judgment is inappropriate because reasonable jurors could differ on the issue of whether Buck intended to dissolve the partnership.¹⁵

The Texas Supreme Court held that a partner's statements expressing his lack of a desire to embark are not legally sufficient evidence of dissolution. These expressions could merely be a partner's desire to relinquish his right at a later date or an expression of frustrations with the entity's performance.¹⁶

Partners must be explicit when intending to dissolve or terminate a joint venture of partnership if they desire their expression to be upheld as a legally sufficient termination.

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*