Current Developments in Texas Business Organizations Law

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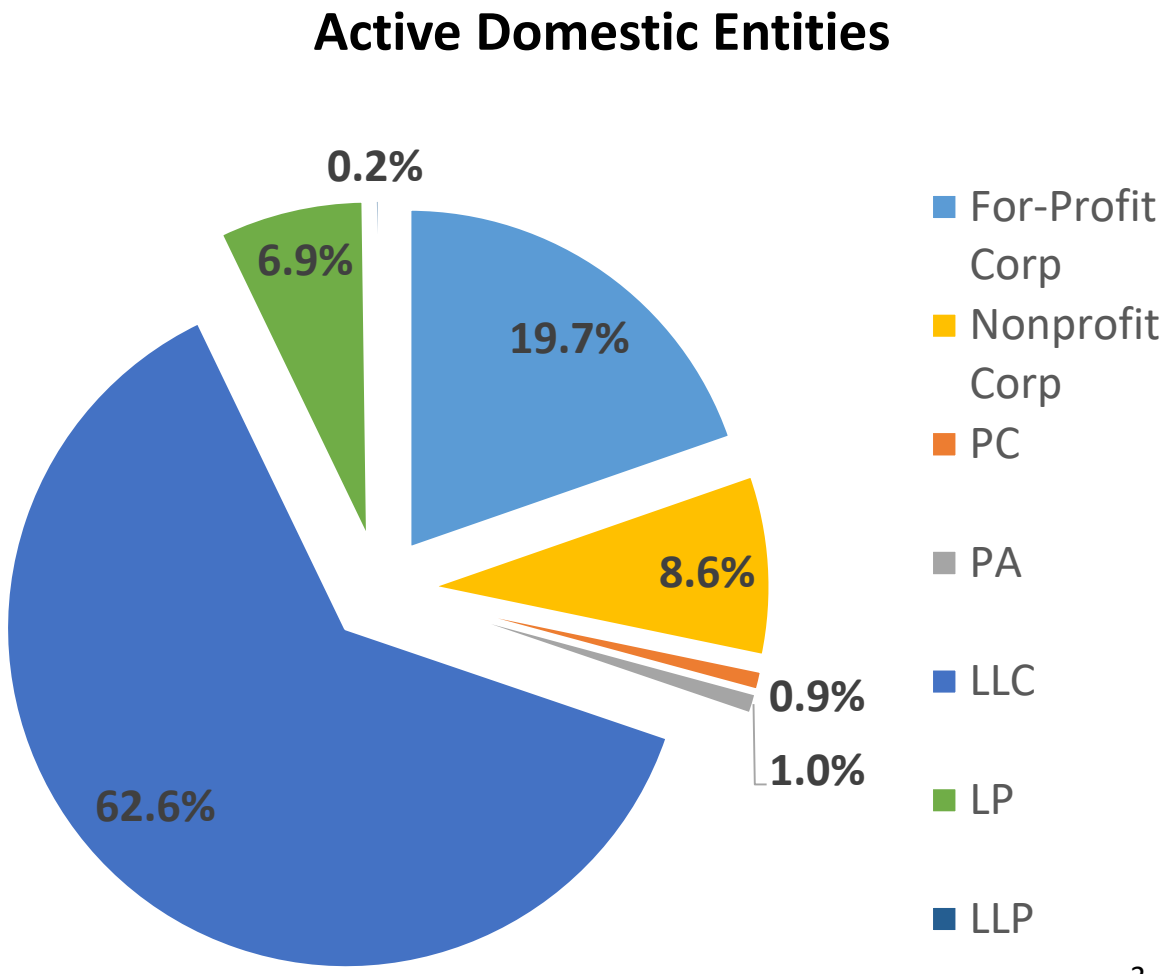
New Texas Business Entity Filings

	2018	2019	% Change
For-Profit Corporations	24,459	22,122	-9.555
Professional Corporations	704	580	-17.614
Professional Associations	412	307	-25.485
Limited Liability Companies	192,875	204,065	+5.802
Limited Partnerships	4,699	4,603	-2.043
Limited Liability Partnerships (initial registrations)	414	364	-12.077

SOS Census
January 1, 2020

For-Profit Corp	365,455
Nonprofit Corp	159,560
Prof. Corp	17,470
Prof. Ass'n	18,810
LLC	1,163,299
LP	128,726
LLP	4,039



Active Texas Business Entity Census

	2019	2020	% Change
For-Profit Corporations	352,760	365,455	+3.599
Nonprofit Corporations	146,389	159,560	+8.997
Professional Corporations	17,282	17,470	+1.088
Professional Associations	19,027	18,810	-1.140
Limited Liability Companies	979,663	1,163,299	+18.745
Limited Partnerships	127,993	128,726	+0.573
Limited Liability Partnerships (initial registrations)	4,141	4,039	-2.463

New Foreign Business Entity Filings

	2019	% Change (CY 2018)
For-Profit Corporations	5,184	+3.329
Nonprofit Corporations	460	+2.679
Professional Corporations	146	-8.750
Professional Associations	10	-28.571
Limited Liability Companies	11,572	+4.544
Limited Partnerships	761	+5.841
Business Trusts	16	-15.789
Real Estate Investment Trusts	4	+33.333
Other Foreign Entities	27	+58.824

Legislative Developments Regarding Business Organizations:

What changed September 1, 2019, and how significant were the changes?

Bills Amending TBOC and Assumed Business or Professional Name Act

- Senate Bill No. 1859—miscellaneous amendments regarding delayed effectiveness of filings, electronic systems, LLCs, and partnerships
- Senate Bill No. 1969—new provisions added to Chapter 22 of TBOC providing for ratification of defective acts of nonprofit corporations
- Senate Bill No. 1971—miscellaneous amendments regarding corporations, voting agreements, and back-end tender-offer mergers
- House Bill No. 3603—numerous amendments to derivative proceeding provisions of corporations and LLCs and complete re-write of derivative proceedings of limited partnerships
- House Bill No. 3609—deleted county-level assumed name filing requirements for corps, LLCs, LPs, and LLPs under Chapter 71 of TB&CC

It just got a lot easier to adopt a business nickname!

House Bill No. 3609—Assumed Name Filings

- H.B. 3609 eliminated the county-level filing requirement for an assumed name certificate of a domestic or foreign corporation, limited partnership, limited liability partnership, or limited liability company.
- On or after September 1, 2019, such an entity need only file its assumed name certificate with the Secretary of State.
- County level filings (but not SOS filings) continue to be required for individuals (i.e., sole proprietorships), joint ventures, general partnerships (that are not LLPs), estates, and REITs.

It’s not your grandfather’s derivative suit!

House Bill No. 3603—Derivative Proceedings

- TBCA Article 5.14 was completely rewritten in 1997 to eliminate the demand futility exception, add detailed provisions regarding stay and dismissal, and create a broad exception for "closely held corporations." The new provisions also authorized a court to determine that a shareholder plaintiff in a derivative suit on behalf of a closely held corporation should recover directly. These provisions also applied to LLCs under the TLLCA and were carried forward for corporations and LLCs in the TBOC.
- HB 3603 includes various clean-up amendments in existing corporate and LLC provisions.
  - Clarifies application of certain procedural requirements to foreign LLCs and corporations
  - Clarifies standing of shareholder or member to institute or maintain a derivative proceeding if a conversion of the entity occurs after the act or omission that is the subject of the claim
- HB 3603 makes some significant changes to the scope of the special provisions applicable to closely held corporations and LLCs.

House Bill No. 3603—Derivative Proceedings

- Between September 1, 1997 and September 1, 2019, a broad exception provided that the statutory requirements regarding standing, demand, and stay and dismissal did not apply to a "closely held corporation" or a "closely held limited liability company" (defined for these purposes as having fewer than 35 shareholders or members and no shares or membership interests listed on a national securities exchange or quoted in an OTC market).
- Although most derivative suits involve claims against management/insiders, the exception applied to any action in which a shareholder or member asserted a claim on behalf of the entity (thus permitting an owner to assert a derivative claim on behalf of the entity against third parties such as lenders, landlords, customers, etc. without any means for management to assert any control over the decision to pursue the claim).
- H.B. 3603 narrows the "closely held" exception to claims against governing persons, officers, and owners. The exception is broadened in these cases to exclude the requirement of court approval of settlements. Derivative claims on behalf of closely held entities against defendants other than owners, governing persons, and officers are subject to the requirements regarding standing, demand, stay and dismissal, and court approval of settlements.

House Bill No. 3603—Derivative Proceedings

- The provisions regarding derivative proceedings in the Texas Revised Limited Partnership Act (which contained a demand futility exception but no carve-out for closely held limited partnerships) were similar to the Revised Uniform Limited Partnership Act and the Delaware Revised Uniform Limited Partnership Act. The TRLPA provisions were not rewritten when the TBCA provisions were rewritten, and the TRLPA provisions were carried forward in Chapter 153 of the TBOC.
- HB 3603 completely rewrote the provisions on derivative proceedings in Chapter 153 so that the limited partnership provisions now follow the approach in the corporate and LLC contexts (universal demand requirement, stay and dismissal provisions, closely held limited partnership carve-out).

House Bill No. 3603—Derivative Proceedings

- Other notable amendments under HB 3603 affecting LLCs and limited partnerships include:
  - The definitions of a “member” and a “limited partner” for purposes of bringing a derivative suit now include an assignee. Texas case law in the limited partnership context had held that assignees could not bring a derivative suit because the statutory provisions only conferred the right on a “limited partner.” Whether an assignee was included in the definition of a “member” in the LLC derivative suit provisions prior to September 1, 2019 was not entirely clear.
  - Because governing persons of LLCs and limited partnerships are not necessarily individuals, new provisions in the LLC and limited partnership subchapters on derivative proceedings address multi-level governance structures by providing that disinterested and independent individuals must make determinations for an LLC or limited partnership when a governing person is an entity or one or more entities own a governing entity.

Legislative Developments Regarding Business Organizations:

Delaware developments include something old, something new, something borrowed, and something. . .a bit confusing

Delaware creates a buzz with “divisions” and “registered series”

Delaware makes a splash with LLC “divisions”—wait a minute, we’ve had that in Texas for corps, LLCs, and LPs for 30 years!

- New Section 18-217 of the DLLCA permits an LLC to divide into two or more LLCs, with the dividing LLC either continuing its existence or terminating as part of the division.
- A division is effected by (i) the adoption of a plan of division setting forth the terms and conditions of the division, including, among others, the allocation of assets, property, rights, series, debts, liabilities and duties of the dividing LLC among the resulting LLCs and, if it survives, the dividing LLC, and (ii) the filing with the Delaware Secretary of State of a certificate of division and a certificate of formation for each newly formed LLC.
- The TBOC, like the predecessor statutes, authorizes a domestic entity to effect a merger and defines a “merger” to include “the division of a domestic entity into two or more new domestic entities or other organizations or into a surviving domestic entity and one or more new domestic entities or other non-code organizations.”
- A divisive merger under the TBOC is effected by adoption of a plan of merger and the filing with the Texas Secretary of State of a certificate of merger with a certificate of formation for each newly created domestic entity. When the merger becomes effective, all rights, title, and interests to all real estate and other property owned by the merging (i.e., dividing) entity are allocated and vested in one or more of the surviving or new entities as provided in the plan of merger, and all liabilities and obligations of the dividing entity are allocated to one or more of the surviving or new entities as provided in the plan.

Delaware adds provisions for “registered series” and renames the original type of series as “protected series”

- The DLLCA and the TBOC permit LLCs to establish “series” of members, managers, membership interests, or assets. If certain statutory requirements are met, the liabilities of a particular series are only enforceable against the assets of that series, and the liabilities of the LLC or any other series are not enforceable against the assets of any other series.
- The TBOC provisions were modeled after the Delaware provisions and provide for the establishment of a “series” without any public filing. (There are assumed name filing requirements in Texas, but the filing is not a condition of or requirement for the formation of a series.)
- Due to the nature of a series, secured lenders that acquire a security interest in the assets of a series face uncertainty as to how to properly perfect the security interest in those assets.

Delaware adds provisions for “registered series” and renames the original type of series as “protected series”

- In order to address the uncertainty regarding the pledge of collateral by a series, the DLLCA has been amended to create a new type of series—a “registered series.”
- Registered series are similar to the original series under Delaware law except for the following notable differences:

1. New Section 18-218 of the DLLCA requires that in order to form a “registered series,” a certificate of registered series must be filed in accordance with the DLLCA.
    - A registered series will be a “registered organization” as defined in the UCC since it is formed by the filing of a public organic record, and the location of the series and place of filing the financing statement to perfect a security interest in its assets will thus be clear.
2. The name of each “registered series” will need to be distinguishable from the names of other Delaware business entities or entities qualified or registered to do business in Delaware.

Delaware adds provisions for “registered series” and renames the original type of series as “protected series”

- The DLLCA continues to provide for the establishment of “series” without a filing with the Delaware Secretary of State, but this type of series is now referred to as a “protected series” in the DLLCA.
- The Uniform Protected Series Act (UPSA), which has been adopted in a few states and introduced in several others, provides for the establishment of “protected series” in LLCs and requires a filing with the Secretary of State to establish a protected series. Thus, a protected series under the UPSA is more like a Delaware “registered series” than a Delaware “protected series.”

Judicial Developments:

A few recent cases of interest to business lawyers

Enforceability of contractual waiver of punitive damages

Enforceability of contractual waiver of punitive damages

Bombardier Aero. Corp. v. SPEP Aircraft Holdings (Tex. 2019)

- Purchaser of an aircraft learned that parts of the aircraft it had purchased were used and sued for breach of contract and fraud based on representations regarding whether the aircraft was new or used. The jury found for the plaintiff and awarded actual damages and punitive damages. The court of appeals affirmed.
- The Texas Supreme Court reversed the award of punitive damages based on a limitation-of-liability clause in the contract. Because the plaintiff did not seek to rescind the purchase agreement, but instead sought damages while enforcing the purchasing agreement, the plaintiff could not evade the reach of the limitation-of-liability clause, which read as follows: “Flexjet will not be liable to either customer for any indirect, special, consequential damages or punitive damages arising out of any lack or loss of use of any aircraft, equipment, spare parts, maintenance, repair or services rendered or delivered under this purchase agreement.”

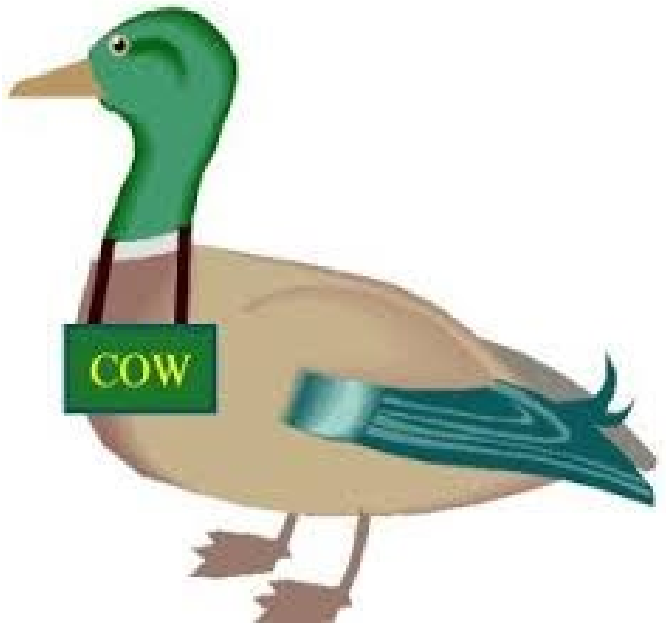
Enforceability of contractual waiver of punitive damages

Bombardier Aero. Corp. v. SPEP Aircraft Holdings (Tex. 2019)

- The court stated: "Bombardier and the purchasing parties—sophisticated entities represented by attorneys in an arms-length transaction—bargained for the limitation-of-liability clauses to bar punitive damages. In balancing the competing interests between protecting parties from 'unintentionally waiving a claim for fraud' and 'the ability of parties to fully and finally resolve disputes between them,' we believe parties can bargain to limit exemplary damages. . . . We note that the purchasing parties did not waive a claim for fraud; they only waived the ability to recover punitive damages for any fraud. As such, the valid limitation-of-liability clauses must stand."
- The contract had a power-of-attorney clause, but the plaintiff did not assert a claim for breach of fiduciary duty. The court remarked: "Because there is no breach of fiduciary duty claim and the plaintiffs did not seek exemplary damages on that basis, we decline to decide whether a breach of fiduciary duty for fraudulent conduct would affect the validity of a limitation-of-liability clause."

If it walks like a duck…

(inadvertent, de facto, disputed general partnerships)



If it walks like a duck…
(inadvertent, de facto, disputed general partnerships)

- Whether a general partnership was created (so as to result in duties among partners, buyout on withdrawal, personal liability of partner, or some other consequence of partnership relationship) is a frequently litigated issue.
- Five statutory factors considered under the TBOC: (1) receipt or right to receive a share of the profits; (2) expression of an intent to be partners; (3) participation or right to participate in control; (4) sharing or agreeing to share losses or liabilities; and (5) contributing or agreeing to contribute money or property. Proof of all factors not required, but proof of only one ordinarily insufficient.
- Totality-of-the-circumstances analysis.

If it walks like a duck…

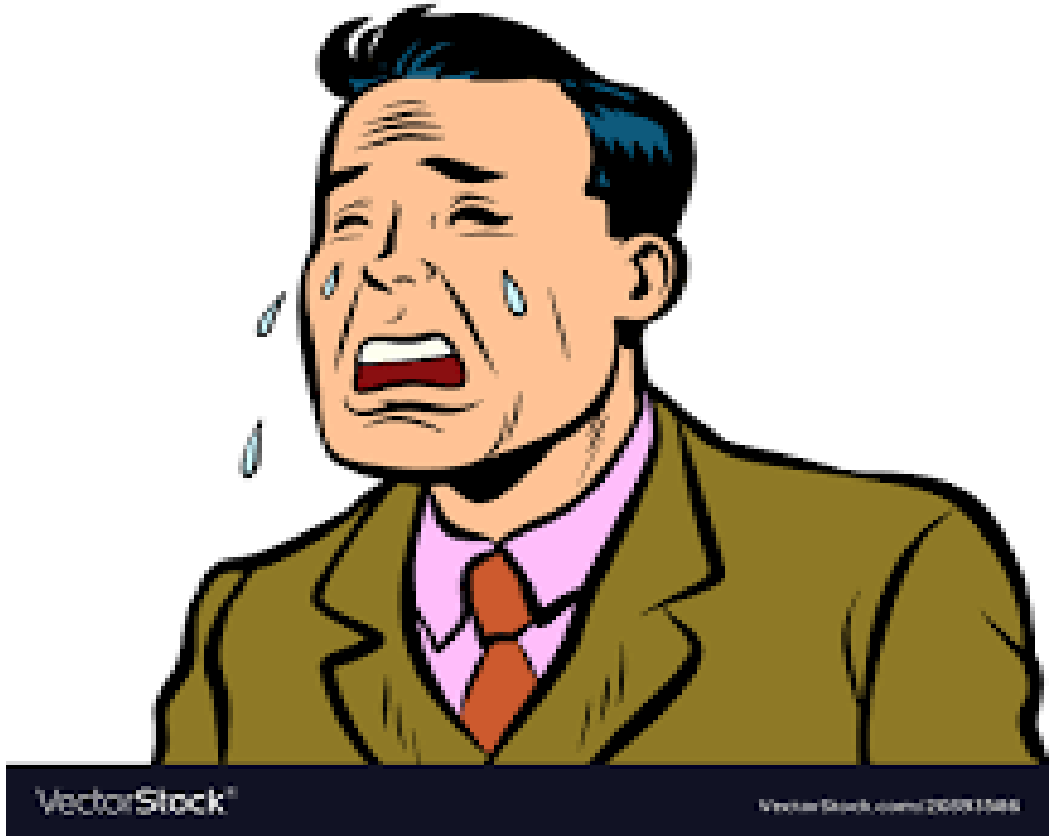
(inadvertent, de facto, disputed general partnerships)

On June 28, the Texas Supreme Court granted the petition for review in ***Enterprise Prods. Partners, L.P. v. Energy Transfer Partners, L.P.,*** and the court heard oral argument on October 8, 2019.

ETP sued Enterprise alleging that the parties' dealings amounted to a general partnership and that Enterprise breached its duty of loyalty as a partner. ETP obtained a judgment in the trial court for more than $500 million based on the jury's finding of a partnership under the 5-factor statutory test and a breach of the statutory duty of loyalty.

Dallas Court of Appeals reversed based on unmet conditions precedent in preliminary agreements of parties.

A tsunami of regret . . .
(mandatory expense advancement)



A tsunami of regret . . .
(mandatory expense advancement)

L Series, L.L.C. v. Holt (Tex. App.—Fort Worth 2019)

- Holt, a terminated employee of several LLCs and limited partnership car dealerships of which the LLCs were general partners, counterclaimed for advancement of his expenses after being sued for fraud and breach of fiduciary duty by the LLCs and dealerships.
- Based on the advancement provisions of the LLC agreements, the trial court ordered that the LLCs pay Holt's attorney's fees and expenses already incurred in the litigation and those incurred in the future (on a monthly basis upon submission of invoices), and the LLCs appealed.
- The court of appeals first held that no interlocutory appeal was available.
- In the course of addressing the LLCs' procedural argument regarding the availability of an interlocutory appeal, the court commented that Texas law was just as expansive as Delaware law in allowing advancement in the LLC context ("Texas allows a limited liability company the same broad freedom to craft its own advancement provisions as does Delaware.").

A tsunami of regret . . .
(mandatory expense advancement)

L Series, L.L.C. v. Holt (Tex. App.—Fort Worth 2019)

- The court stated: "[A]lthough we apply Texas procedure, we have no qualms looking to Delaware law to inform our understanding of the nature of and policies underlying an advancement claim . . . ."
- Because the LLCs alternatively sought mandamus relief, the court of appeals proceeded to consider the LLCs' argument that the trial court abused its discretion in ordering advancement.
- The court examined the advancement provisions of the LLC agreements, which provided for a right to be paid for reasonable expenses incurred by a person **"of the type entitled to be indemnified"** under the agreements **"in advance of the final disposition"** of the proceeding and **"without any determination as to the Person's ultimate entitlement to indemnification."**

A tsunami of regret . . .
(mandatory expense advancement)

L Series, L.L.C. v. Holt (Tex. App.—Fort Worth 2019)

- The LLC agreements required the LLCs to indemnify **a person who is made a party to a proceeding "by reason of the fact that he or she . . . is or was serving at the request of the Company and an officer, trustee, employee, agent, or similar functionary of the Company . . . to the fullest extent permitted by the Act and the [Texas Business Corporation Act]."**
- The LLCs argued that Holt was not entitled to advancement because he would not be entitled to indemnity for his alleged ultra vires acts.
- The court relied on Delaware case law (referring to the "admittedly maddening" aspect of advancement clauses and "the tsunami of regret that has swept over corporate America regarding mandatory advancement contracts").

A tsunami of regret . . .
(mandatory expense advancement)

L Series, L.L.C. v. Holt (Tex. App.—Fort Worth 2019)

- The court concluded that Holt was entitled to advancement because he was a person "of the type" entitled to indemnity under the LLC agreements.
- Requiring Holt to prove that he was ultimately entitled to indemnity as the LLCs argued would violate the "clear directive" that the right to advancement was not dependent on a determination of the right to indemnity.
- The allegations of misconduct did not change the nature of the right the LLCs bargained to give Holt. Because at least some of the allegations in the suit were based on his service as a member and manager of the LLCs, the trial court did not abuse its discretion in concluding that Holt was entitled to advancement under the LLC agreements.

Membership has its privileges
(information and inspection rights of former members)

Membership has its privileges

(“member” includes former member for purposes of access to books and records)

Davis v. Highland Coryell Ranch, LLC (Tex. App.—Amarillo 2019)

- The court held that a former member was entitled to inspect the books and records of the LLC because the BOC provides a “member” has inspection rights for a “proper purpose” and defines a “member” as “a person who ***is a member*** or ***has been admitted as a member*** in the limited liability company under its governing documents” (emphasis added).
- The court noted that inspection rights may not be “unreasonably restricted,” and indicated that a complete prohibition of a former member’s access for a “proper purpose” would be unreasonable.
- “We do not purport to generally say that once an entity or person becomes a member it is always a member for all purposes as the dissent insinuates and irrespective of whatever the legislature may have meant when stating that a member may not withdraw.”
- “Years ago, a famed rock and roll band sang, ‘I'm just a soul whose intentions are good. Oh Lord, please don't let me be misunderstood.’ No doubt the intentions of the Texas legislature were good in enacting the statutes at play here, and we endeavor to not misunderstand what they were. Yet, the juxtaposition of words within a statute do not always result in clarity. Should our disposition of this appeal fall short of capturing what the legislature intended, we would welcome its clarification of the matter.”

You can’t sue me!
(the limits of limited liability in a corporation or LLC)

You can't sue me!
(the limits of limited liability in a corporation or LLC)

Recap of Texas case law on personal liability of agents acting in representative capacity and veil piercing in corporate and LLC context:

- Veil-piercing principles apply equally to corporations and LLCs.
- Veil may not be pierced to impose liability on an owner or affiliate for a contractually-based obligation of the entity unless the owner or affiliate caused the entity to be used to perpetrate an actual fraud for the owner's or affiliate's direct personal benefit; failure to follow formalities not a factor (prior to 2011, by analogy to BOC § 21.223; since 2011, BOC § 101.002 expressly applies § 21.223 to LLCs).
- Corporate or LLC agents are ordinarily directly liable for their own torts committed in the course of the entity's business.

You can’t sue me!
(the limits of limited liability in a corporation or LLC)

Recent cases have begun to delve more deeply into the issue of what constitutes “direct personal benefit” for purposes of veil piercing as well as the question of whether the statutory limitations on veil piercing limit a claimant’s ability to hold corporate and LLC agents directly liable for their own torts in certain cases.

You can't sue me!
(the limits of limited liability in a corporation or LLC)

Bates Energy Oil & Gas v. Complete Oilfield Services (W.D. Tex. 2019)

- In a dispute arising out of the sale of frac sand by Bates Energy Oil & Gas to Complete Oilfield Services (COFS), COFS asserted claims against an LLC's managing member, Naumann, for fraud and other torts based on actions taken by Naumann in connection with an escrow agreement among the LLC (as escrow agent), Bates Energy Oil & Gas, and COFS.
- Texas has long recognized that corporate officers and agents may be directly liable for tortious acts taken in the course of employment (and has applied this principle in the corporate and LLC context).
- Naumann relied on the preemption provision of BOC § 21.224 for the proposition that he could not be held liable absent proof of the conditions specified by BOC § 21.223(b) for veil piercing, i.e., use of the entity for actual fraud for the direct personal benefit of the owner or affiliate.

You can't sue me!
(the limits of limited liability in a corporation or LLC)

Bates Energy Oil & Gas v. Complete Oilfield Services (W.D. Tex. 2019)

- The court reviewed the history of the statutory provisions addressing veil piercing in the corporate context (pointing out that the provisions apply in the LLC context by virtue of BOC § 101.002), which protect owners and affiliates from liability for any contractual obligation of the corporation or matter arising out of the obligation on the basis of alter ego, actual or constructive fraud, sham to perpetrate a fraud, or other similar theory; except that the owner or affiliate is not shielded from liability if the owner or affiliate caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud for the direct personal benefit of the owner or affiliate. BOC § 21.223(a), (b).
- BOC § 21.224 preempts any common-law liability for obligations referred to in § 21.223, but § 21.225 provides exceptions to the limitation of liability in §§ 21.223 and 21.224 where the person expressly assumes, guarantees, or contracts to be personally liable or is otherwise liable under the BOC or other applicable statute.

You can't sue me!
(the limits of limited liability in a corporation or LLC)

Bates Energy Oil & Gas v. Complete Oilfield Services (W.D. Tex. 2019)

- The court next explained that direct liability and vicarious veil-piercing liability of corporate agents have "coexisted for decades" in Texas, but "recent cases have muddled the distinction" and "fail to demonstrate any consensus."
- Some cases (e.g., *Kingston v. Helm*) recognize that direct liability may be imposed on corporate agents for their tortious acts relating to a contractual obligation of the corporation without requiring a showing that the agent caused the corporation to be used to perpetrate actual fraud for the agent's direct personal benefit; however, other cases (e.g., *Teclogistics, Inc. v. Dresser Rand Group*) require the additional showing of actual fraud and direct personal benefit that is required when imposing veil-piercing liability.

You can’t sue me!
(the limits of limited liability in a corporation or LLC)

Bates Energy Oil & Gas v. Complete Oilfield Services (W.D. Tex. 2019)

- The court thoroughly discussed and analyzed the divergent lines of case law in this area and disagreed with *TecLogistics* and followed *Kingston v. Helm*.
- The court reasoned that the history and wording of the statute indicate that the statute applies to veil-piercing theories (for both contract and related tort claims) but not to direct liability claims for an individual’s own tortious conduct.

You can’t sue me!
(the limits of limited liability in a corporation or LLC)

Bates Energy Oil & Gas v. Complete Oilfield Services (W.D. Tex. 2019)

- Complete Oilfield Services (COFS) asserted claims against Equity Liaison Company, LLC (ELC), and its managing member, Naumann, in connection with an escrow agreement among ELS (as escrow agent), Bates Energy Oil & Gas, and COFS. The claims against Naumann included claims based on veil-piercing theories.
- The court concluded that COFS failed to sufficiently plead facts demonstrating that the alleged fraud was primarily for Naumann’s direct personal benefit where the allegations referred to wrongful transfers of funds to “ELC” or accounts of “ELC/Naumann.” The court stated that case law interpreting “primarily for the direct personal benefit” indicates that there must be evidence that funds derived from the fraudulent conduct of the entity must be pocketed by or diverted to the individual defendant, and that use of the funds for the entity’s benefit is insufficient, even if such use by the entity indirectly benefits the individual and even if the individual is the sole owner of the entity.

You can't sue me!
(the limits of limited liability in a corporation or LLC)

Stover v. ADM Milling Co. (Tex. App.—Dallas 2018)

- Two members of an LLC were held liable for the LLC's breach of contract and fraud under the alternative veil-piercing theories of sham to perpetrate a fraud and alter ego.
- On appeal, the court held that the members did not have standing to challenge the findings of the LLC's liability on the claims for breach of contract and fraud against the LLC. The LLC did not appeal its liability, and the members only had standing to appeal the findings related to their liability under veil-piercing principles.
- The members challenged the sufficiency of the evidence to support the jury's findings imposing veil-piercing liability, arguing that the evidence did not show that they used the LLC to perpetrate an actual fraud for their direct personal benefit as required by BOC § 21.223.
- The court explained that "actual fraud" for purposes of veil piercing is not the equivalent of the tort of fraud. "Actual fraud" in the veil-piercing context involves "dishonesty of purpose and intent to deceive."
- The court explained that the requirement that the actual fraud be perpetrated "primarily for the direct personal benefit" of the defendant has been met when funds derived from the fraudulent conduct of the entity have been "pocketed by or diverted to" the individual defendant.