Practical Issues in Drafting Texas Limited Liability Company Agreements

By
Elizabeth S. Miller
Professor of Law
Baylor University School of Law

State Bar of Texas
Tax Law 101
August 15, 2012
Dallas, TX

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. She frequently appears on continuing legal education programs and is co-author of a three-volume treatise on *Business Organizations* published by Thomson/West as part of its Texas Practice Series. Professor Miller has served as Chair of the LLCs, Partnerships and Unincorporated Entities Committee of the Business Law Section of the American Bar Association as well as the Partnership and Limited Liability Company Law Committee of the Business Law Section of the State Bar of Texas. She has also served as Chair of the Council of the Business Law Section of the State Bar of Texas. Professor Miller has been involved in the drafting of legislation affecting Texas business organizations for many years and has served in an advisory or membership capacity on the drafting committees for numerous prototype, model, and uniform statutes and agreements relating to unincorporated business organizations. She has received the American Bar Association Business Law Section Jean Allard Glass Cutter Award and is an elected member of the American Law Institute and a Fellow of the American Bar Foundation and the Texas Bar Foundation.

Table of Contents

Selected Issues in Drafting Texas
Limited Liability Company Agreements

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]

---

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

[2] TEX. BUS. ORGS. CODE ANN. § 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 TEX. BUS. ORGS. CODE ANN. §§ 101.101(b), (c); 101.355; 101.356(a), (e).

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

[4] TEX. BUS. ORGS. CODE ANN. § 101.105.

[5] TEX. BUS. ORGS. CODE ANN. § 101.154.

[6] TEX. BUS. ORGS. CODE ANN. § 101.552(b).

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

[8] TEX. BUS. ORGS. CODE ANN. §§ 101.356(c), 101.552(a).

[9] TEX. BUS. ORGS. CODE ANN. §§ 1.002(12), 101.356(c).

(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]

(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]

---

[10] TEX. BUS. ORGS. CODE ANN. § 101.356(c).

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

[12] TEX. BUS. ORGS. CODE ANN. § 101.552(a)(2). If the LLC has no members, a majority vote of all of the managers is required.

[13] TEX. BUS. ORGS. CODE ANN. § 101.552(a)(3). If the LLC has no members, a majority vote of all of the managers is required.

[14] TEX. BUS. ORGS. CODE ANN. § 101.356(b).

[15] TEX. BUS. ORGS. CODE ANN. § 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 TEX. BUS. ORGS. CODE ANN. §§ 6.001-6.053, 101.352.

[16] TEX. BUS. ORGS. CODE ANN. § 101.358.

[17] TEX. BUS. ORGS. CODE ANN. § 101.359.

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 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-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

---

[18] TEX. BUS. ORGS. CODE ANN. § 101.359(1).

[19] TEX. BUS. ORGS. CODE ANN. § 101.359(2).

[20] See Paul v. Delaware 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.

[22] See TEX. BUS. ORGS. CODE ANN. §§ 101108(b)(2), 101.109(b).

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. <u>Contribution Provisions</u>

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 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 canceled to reflect the release.[26] Additionally, a member is obligated to return to the LLC a distribution that the member knows was improperly

---

[23] See Section VI of this paper 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] 534 S.W.2d 668 (Tex. 1976).

[26] TEX. BUS. ORGS. CODE ANN. § 101.155.

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, 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]

---

[27] TEX. BUS. ORGS. CODE ANN. § 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. dism'd), 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] TEX. BUS. ORGS. CODE ANN. § 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 v. Clay Ward Agency, Inc., 320 S.W.3d 654 (Ky. 2010). 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 which a court could order a capital call.

[33] In Canyon Creek Development, LLC v. Fox, 263 P.3d 799 (Kan. 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

Drafting Tips:

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 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]

---

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.

[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

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. <u>Admission of Initial Members in Manager-Managed LLC (the "Shelf LLC")</u>

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 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 then 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.

---

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.

[36] TEX. BUS. ORGS. CODE ANN. § 101.101(b) (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 TEX. BUS. ORGS. CODE ANN. § 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] TEX. BUS. ORGS. CODE ANN. § 101.103(b).

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 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. <u>Withdrawal of a Member</u>

The Business Organizations Code 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"

---

38 TEX. BUS. ORGS. CODE ANN. §§ 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." TEX. BUS. ORGS. CODE ANN. § 101.001(1).

40 See TEX. BUS. ORGS. CODE ANN. §§ 101.051, 101.052, 101.054.

41 TEX. BUS. ORGS. CODE ANN. § 101.107.

42 TEX. BUS. ORGS. CODE ANN. § 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. TEX. BUS. ORGS. CODE ANN. § 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." 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. TEX. BUS. ORGS. CODE ANN. § 101.052.

44 See TEX. BUS. ORGS. CODE ANN. §§ 152.002(b)(5), 152.501(b)(1), 152.503(b) (general partnership context); 153.155(b), 153.157 (limited partnership context).

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 perspective[46] and may well reflect the 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 partnership[47] or a shareholder of a corporation[48] 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

---

[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. TEX. BUS. ORGS. CODE ANN. §§ 101.051, 101.052, 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 (Tex. App.—Houston [1st Dist.] 1988, writ denied). In Pinnacle Data Services, Inc. v. Gillen, 104 S.W.3d 188 (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) of the Internal Revenue Code, an applicable restriction does not include any restriction imposed by state law. 26 U.S.C.A. § 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. However, the statute does not provide for withdrawal of a member absent a provision in the company agreement. 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 issue is not undertaken here.

[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." TEX. BUS. ORGS. CODE ANN. § 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. A minority shareholder may have an equitable right to a buyout if the shareholder has suffered "oppression" at the hands of the majority. See Davis v. Sheerin, 754 S.W.2d 375 (Tex. App.—Houston [1st Dist.] 1988, writ denied).

[49] See Section VI of this paper.

[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); TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 6.03 (expired). As noted in the text, 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. 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.

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 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

---

[51] Contracts involving the performance of personal services are generally not specifically enforceable. See E.M. Goodwin, Inc. v. Stuart, 125 Tex. 212, 82 S.W.2d 632 (1935).

[52] TEX. BUS. ORGS. CODE ANN. § 101.205. The BOC does not define "fair value." The term is also used in similar contexts in the general partnership and limited partnership contexts. TEX. BUS. ORGS. CODE ANN. §§ 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), 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 TEX. BUS. ORGS. CODE ANN. § 10.362.

[55] TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 6.04 (expired). 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

be any cases in Texas construing that provision.[56]

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

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). 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 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), 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); TEX. REV. CIV. STAT. ANN. art. 6132b-6.01(b) (expired).

[58] TEX. BUS. ORGS. CODE ANN. § 101.205.

[59] TEX. REV. CIV. STAT. ANN. art. 1528n, art. 5.06A (expired).

[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 (Del. Ch. 2006).

[61] See TEX. REV. CIV. STAT. ANN. art. 1528n, art. 5.05A (expired) (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 September 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

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 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]

---

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).

[63] TEX. BUS. ORGS. CODE ANN. § 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 TEX. BUS. ORGS. CODE ANN. § 101.052.

[64] TEX. BUS. ORGS. CODE ANN. § 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. TEX. BUS. ORGS. CODE ANN. §§ 101.103(c), 101.109(b). These sections state default rules that will apply if the company agreement does not otherwise provide. See TEX. BUS. ORGS. CODE ANN. § 101.052.

[65] TEX. BUS. ORGS. CODE ANN. § 101.109(a)(1).

[66] TEX. BUS. ORGS. CODE ANN. § 101.109(a)(2).

[67] TEX. BUS. ORGS. CODE ANN. § 101.109(a)(3), (4).

[68] TEX. BUS. ORGS. CODE ANN. § 101.109(c).

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 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]

---

[69] TEX. BUS. ORGS. CODE ANN. § 101.111(a).

[70] TEX. BUS. ORGS. CODE ANN. § 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. 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.

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. TEX. BUS. ORGS. CODE ANN. §§ 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

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

---

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. App'x 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 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 acquired 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 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 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

---

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 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), recodified in TEX. BUS. ORGS. CODE ANN. § 152.204(a).

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

estate surely has no greater rights than the member to complain.[78] Even if the company agreement requires 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

---

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 also 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).

[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 v. Box, 910 F.2d 255 (5th Cir. 1990) (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 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), recodified in TEX. BUS. ORGS. CODE ANN. § 152.204(a).

[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.

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 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

---

[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).

[82] See, generally, 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 9.1-9.12 (2012); 2 CARTER BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW §§ 10.01-10.09 (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; see also Restatement (Second) of Agency **§** 379. 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; see also Restatement (Second) of Agency §§ 387-398. 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, LLC, 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, 3.103, 3.105, 8.002(b), 101.255, 101.401, 101.402, 101.451-101.463.

[84] TEX. BUS. ORGS. CODE ANN. § 101.401.

[85] See TEX. BUS. ORGS. CODE ANN. §§ 21.418, 101.255.

[86] TEX. BUS. ORGS. CODE ANN. §§ 3.102, 3.105.

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]

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]

---

[87] TEX. BUS. ORGS. CODE ANN. § 101.402.

[88] TEX. BUS. ORGS. CODE ANN. §§ 101.451-101.463.

[89] In Pinnacle Data Services, Inc. v. Gillen, 104 S.W.3d 188 (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. The court of appeals concluded that the trial court erred in granting summary judgment to the defendants on the breach of fiduciary duty claim. 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.

In an unpublished opinion, the Dallas Court of Appeals concluded that members of an LLC do not necessarily owe *one another* fiduciary duties. The court relied on Texas case law rejecting the notion that co-shareholders in a closely-held corporation are necessarily in a fiduciary relationship. 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. Suntech Processing Sys., L.L.C. v. Sun Commc'ns, Inc., 2000 WL 1780236 (Tex. App.—Dallas 2000, pet. denied). In Allen v. Devon Energy Holdings, L.L.C., __ S.W.3d __, 2012 WL 880623 (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. 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. In Federal Insurance 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. 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.

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 (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 (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 (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).

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 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.

---

[90] See Restatement (Third) of Agency §§ 8.01-8.06, 8.08; see also Restatement (Second) of Agency §§ 379, 387-398 and cases cited in note 82 supra.

[91] See note 89 supra.

[92] See Allen v. Devon Energy Holdings, L.L.C., __ S.W.3d __, 2012 WL 880623 (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. See TEX. BUS. ORGS. CODE ANN. § 152.204(a). 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., __ S.W.3d __, 2012 WL 880623 (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. In Cox v. Southern 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.*, __ S.W.3d __, 2012 WL 880623 (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*, __ S.W.3d __, 2012 WL 112253 (Tex. App.—Houston [1st Dist.] 2012, no pet. h.). 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.*, 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.*, __ S.W.3d __, 2012 WL 880623 (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? *See In re Kilroy (Guerriero v. 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 In re Heritage Org., L.L.C. (Faulkner v. Kornman)*, 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. h.) (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).