CHOICE OF ENTITY CONSIDERATIONS IN FORMING A NEW BUSINESS AND AVOIDING PERSONAL LIABILITY IN BUSINESS ENTITIES

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I.
Choice of Business Entities in Texas

A. What types of business entities are available in Texas?

Generally, businesses are created and operated in one of the following forms:

- **Sole proprietorship**
- **General partnership**
- **Limited Partnership**
- **Registered Limited Liability Partnership**
- **Limited Liability Company**, **and**
- **Corporation**.

The most advantageous business entity in a particular situation depends on the objectives of the business for which the entity is being organized. In most situations, the focus will be on how the entity and its owners will be taxed and the extent to which the entity will shield the owners of the business from liabilities arising out of its activities.

The focus of this paper will be on Texas law. Today, all business entities formed after January 1, 2006 are governed by the TBOC, which was enacted by the Texas legislature in 2003. Entities in existence prior to this date may continue to be governed by prior Texas law, which was otherwise repealed on January 1, 2010. Prior applicable Texas law includes the following statutes:

1. Texas Revised Partnership Act (―TRPA‖)[1];
2. Texas Revised Limited Partnership Act (―TRLPA‖)[2];
3. Texas Limited Liability Company Act (―TLLA‖)[3]; and

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[1] Article 6132b, § 1.01 et seq., V.A.C.S.
[2] Article 6132a, § 1.01 et seq., V.A.C.S.

4. Texas Registered Limited Liability Partnership Act (—TLLP)[4].

5. Texas Business Corporation Act (—TBCA‖)[5],

The TBOC states that its provisions applicable to corporations may be officially and collectively known as —Texas Corporation Law.[6]

B. Overview and Comparison of Entities

1. Sole Proprietorship

In a sole proprietorship, a single individual engages in a business activity without formal organization. One can create a sole proprietorship just by going into business unless the business is incorporated or organized as another business entity recognized in Texas.

If a sole proprietorship is conducted under an assumed name (a name other than the surname of the individual), an assumed name certificate (commonly referred to as a —d/b/a‖) should be filed with the office of the county clerk in the county where a —business premise‖ is maintained. If no business premise is maintained, then an assumed name certificate should be filed in all counties where business is conducted under the assumed name.

It is difficult to maintain a sole proprietorship that is growing with need for capital, since investors coming into the business typically require an equity participation in the business. However, the individual is generally entitled to use business losses against other types of income.

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[3] Article 1528n, § 1.01 et seq., V.A.C.S.
[4] Tex.Rev.Civ.Stat.Ann., art. 6132b, § 1.01, et seq. (Vernon Supp. 1999)
[5] Tex.Bus.Corp.Act arts. 1.01 et seq., V.A.C.S.
[6] TBOC § 1.008(b).

2. General Partnership

A Texas general partnership is an oral or written association among two or more principals with a community of interest in a venture, with an agreement to share profits and losses, and a mutual right of control or management of the enterprise.[7] A partnership may merge with a corporation, LLC or another partnership and convert from one form of entity to another without going through a merger or transfer of assets.

3. Limited Partnerships

A limited partnership is a partnership formed by two or more persons, having one or more general partners, and one or more limited partners.[8] A limited partnership is not currently subject to franchise tax, and a limited partner‘s share of income (other than a guaranteed payment for services) is generally not subject to self-employment tax.[9] One downside to a limited partnership is the additional record keeping and tax returns required when another entity is created to be the general partner.

Unless otherwise provided, a partnership interest is assignable in whole or in part, and the assignment will not dissolve the limited partnership.[10] If a general partner assigns all or part of its rights as a general partner, a majority in interest of the limited partners may terminate the general partner‘s status as a general partner.[11]

Texas law permits a limited partnership to merge with a corporation, LLC or another partnership, and to convert from one form of entity to another without going through a merger or transfer of assets.[12]

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7 See *Schlumberger Technology Corp. v. Swanson*, 959 S.W.2d 171 (Tex. 1997).
8 TRPA § 1.02(6) TBOC § 1.002(50).
9 IRC § 1402(a)(13).
10 TRLPA § 7.02; TBOC § 153.251.
11 TRLPA § 7.02(a)(4); TBOC § 153.252(b).
12 TRLPA § 2.11; TBOC § 10.009. TRLPA § 2.15; TBOC §§ 10.106, 10.101.

A certificate of formation must be filed containing the name of the entity, stating it is a limited partnership, with the name and address of the general partner, the address of the registered office and the name and address of the registered agent, and the address of the principal office where books and records are kept.[13] A filing fee of $750.00 must be paid with the filing of the certificate of formation.[14]

Family Limited Partnership

A family limited partnership is a limited partnership created by a family, usually the owners of a family business or investment portfolios. The general partner, often a parent, controls the partnership and is subject to unlimited liability while the limited partners, usually children, have minimal input and are only liable for the amount they invested. FLPs often form for federal and state gift and tax benefits and can be powerful estate planning tools when used correctly. "The problem is:FLPs are almost never correctly utilized, and because of this they often fail to produce their promised benefits," advises The Asset Protection Book.

A family limited partnership is often costly and complicated to set up, so make sure you do all your research first. Read all relevant contracts before transferring any assets to the FLP in order to prevent triggering a due-on-sale clause. Finally, you need two separate appraisals for any assets you plan to transfer -- one to determine the property worth and another to determine the general or limited partnership interest. Maintain your FLP by transferring all significant assets to it, paying annual fees and creating and following your operating agreement. Failure to do any of the preceding will lead to the dissolution of the partnership.

4. Limited Liability Partnership

A Limited Liability Partnership (LLP) is a general partnership in which the individual liability of partners for partnership obligations is limited. LLPs were initially available only to certain professionals pursuant to the provisions of the Texas Professional Corporation Act.[15] Criticisms of this limitation lead to the enlargement of LLP provisions to apply to all partnerships, and to the addition of the requirements of LLP registration, use of LLP status or initials in the partnership name, and maintenance by LLPs of liability insurance.

To attain LLP status, 3 requirements must be met: 1) the LLP must include in its name the words ―registered limited liability partnership‖ or the abbreviation ―L.L.P.‖ as the last words or letters of the name;[16] 2) a partnership must file with the Secretary of State an application plus a fee of $200.00 per partner[17]; and 3) the partnership must carry insurance, or provide funds of $100,000.00 to cover errors, omissions, negligence, incompetence, or malfeasance.[18]

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[13] TBOC §§ 3.001, 3.005, 3.011. See also, TRLPA § 2.01.
[14] TBOC § 4.155(1).
[15] Tex.Rev.Civ.Stat.Ann., art.1528e.
[16] TRPA § 3.08(c); TBOC § 5.063. Neither ―R.L.L.P.‖ nor ―L.P.‖ is acceptable.
[17] TRPA § 3.08(b)(3); TBOC § 4.158. For a foreign LLP, the fee is $200.00 per Texas partner, not to exceed $750.00. TRPA § 10.02(c). Registration is effective for a period of one year. TRPA § 3.08(b)(5).
[18] TRPA § 3.08(d)(1); TRPA § 3.08(d)(1).

5. Limited Liability Companies ("LLCs")

An LLC is created when one or more persons file a Certificate of Formation, similar to a certificate of limited partnership and articles of incorporation, with the Texas Secretary of State with a $300.00 filing fee.[19] The existence of the LLC begins when its certificate of organization is issued by the Secretary of State.[20] The name of an LLC must contain words or an abbreviation to designate the nature of the entity, whether the words ―Limited Liability Company,‖ or ―Limited Company,‖ or the acronyms LLC or LC.[21]

The LLC may be structured to be governed by Managers, who are generally equivalent to directors of a corporation, and are elected by the Members in the same manner as directors are elected by shareholders.[22] However, the LLC may also be structured so that management is performed by the Members, analogous to a close corporation or a general partnership.[23] Any ―person‖ may be a Member or a Manager of an LLC.[24] Because of the broad definition of a ―person‖ under the Act[25], any individual, corporation, partnership, LLC or other person may become a Member or Manager. Managers may designate officers and other agents to act on behalf of the LLC.[26] The management and operation of the LLC are usually specified in a written agreement referred to as the Regulations of the LLC, which are similar to the bylaws of a

[19] TBOC § 3.001, 4.152(1), 4.154.
[20] Id., § 3.04.
[21] Id., § 2.03A(1). Limited may be abbreviated as ―Ltd.,‖ and Company can be shortened to ―Co.‖
[22] TLLCA § 2.13; TBOC §§ 101.302 – 101.304, and 101.306.
[23] Id., § 2.12; TBOC §§ 1.002(51), 3.101, 101.251, 101.253, 101.302.
[24] Id., §§ 2.13; TBOC §§ 101.302 - 101.304. TLLCA 4.01C; TBOC § 101.102.
[25] Id., § 1.02(4). See TBOC §§ 1.001(51, 53).
[26] Id., §§ 2.12; TBOC §§ 1.002(51), 3.101, 101.251, 101.253, 101.302. TLLCA § 2.21; TBOC §§ 3.103 and 101.254.

corporation or a limited partnership agreement.[27] The regulations may expand or restrict the duties (including fiduciary duties) and liabilities of Members, Managers, officers, and agents of an LLC, and provide for their indemnification.[28]

If an LLC has members, managers, and officers, it may function similar to a corporation. However, one advantage of an LLC is the ability to dispense with some of the formalities required for operating a corporation, such as formal documentation of meetings, or having annual meetings.

Limited liability companies are available by statute in all 50 states, with some significant variances among state laws. An LLC must be created and filed with a state to have effect. The owner of an LLC is called a member. LLCs can either be managed by members, or by managers, who operate similarly to a board of directors. Texas allows one member LLCs, though other states do not. In Texas, it is optional whether a member‘s interest in an LLC is reflected by a membership certificate.

By default, an LLC with two or more members is taxed as a partnership, while a single member LLC is disregarded for tax purposes, unless an election is made to be taxed as a corporation. For an LLC selected to have corporate status, a subchapter S election may be filed for members who qualify. LLCs may be treated as a corporation for corporate income tax purposes, or be subject to a franchise tax like a corporation[29], unlike a limited partnership.

The advantage of an LLC is that it brings together in a single business the best features of all other business forms—a corporate-styled liability shield, and the pass-

[27] Id., § 2.09A; TBOC §§ 101.051 - 101.053.
[28] Id., § 2.20; TBOC §§ 8.002, 101.402, 101.401.
[29] In Texas, an LLC is subject to the corporate franchise tax. Tex. Tax Code Ann. § 171.001.

through benefits of a partnership, in which all members can participate in the management of the company without loss of protected liability status.

A member‘s interest in an LLC is personal property,[30] but does not confer any interest in specific LLC property.[31] Membership interest may be evidenced by a certificate if the Regulations of the LLC so provide.[32] The Act generally allows even more flexibility in structuring classes of members than is available in structuring classes of corporate stock or classes of limited partnership interests.

An LLC membership interest is ordinarily considered to be a ―security‖ for purposes of the Securities Act of 1933, and state blue sky securities laws. Thus, a sale of an interest may be required to be registered under applicable securities laws, or through a private offering, or other transaction structured to be exempt from registration requirements. LLC interests are not ―securities‖ governed by Chapter 8, Texas Business & Commerce Code, unless the interests are dealt in or traded on securities exchanges or markets, or the parties expressly agree to treat them that way.[33] Instead, such interests should be classified as ―intangibles,‖ and a security interest would be perfected by a financing statement filing.[34] Generally, assignment of an LLC interest is similar to that for assignment of a limited partnership interest, and does operate to terminate or dissolve the LLC.

6. Series LLC

Series LLCs began in Delaware in 1996, arrived in Texas in 2009, and are now available in 13 states. A series LLC allows a business to hold assets and liabilities within separate cells or series which effectively operate as sub-entities. However, the series are *not* stand-alone legal entities in their own right (Tex. Bus. & Com. Code §101.622), but in many respects each series operates as if they are.

An individual series is statutorily empowered to file and defend lawsuits; enter into contracts; buy, sell and hold title to property; grant liens and security interests; and "exercise any power or privilege as necessary or appropriate to the conduct, promotion, or attainment of the business, purposes, or activities of the series." Tex. Bus. & Com. Code §101.605(5).

A series can obtain its own EIN if it chooses and be treated separately for federal tax purposes. A series may (but is not required) to have its own bank account. A series can (and should) operate under its own assumed name.

The Texas Comptroller, for its purposes, states that a "series LLC is treated as a single legal entity. It pays one filing fee and registers as one entity with the Texas Secretary of State. It files one franchise tax report as a single entity, not as a combined group, under its Texas taxpayer identification number."

The series LLC shares the advantages of a traditional LLC, including the benefit of informal management, an effective liability shield, and pass-through taxation; but a series LLC also has the ability to segregate and compartmentalize assets and liabilities within individual series. This offers significant protection and operational flexibility to the business.

Good record keeping is both important and required. In fact, series insulation is preserved only so long as "records maintained for that particular series account for the assets associated with that series separated from the other assets of the company or any other series." Tex. Bus. Orgs. Code § 101.601(b)(1). In other words, records must be maintained "in a manner so that the assets of the series can be reasonably identified by specific listing, category, type, quantity, or computational or allocational formula or procedure." Tex. Bus. Orgs. Code § 101.603(b). Implicit in the statute is the idea that assets and liabilities of a series can and should be separate both from the assets and liabilities of other series *and* those of the company at large. Commingling among these categories should be avoided.

Generally speaking, one should not place an asset or enterprise in one series that:

(1) creates a much higher level of liability or potential for legal action than businesses in other series;
(2) has a significantly different debt structure (involving development loans, personal guarantees, and the like) than that in other series;
(3) receives significantly different tax treatment from other series or is involved in a payment plan with the IRS;
(4) serves as a management entity with exposure to the public (tenants, vendors, contractors, and the like) since this function is better placed in a separate LLC altogether.

Entities with any of the foregoing characteristics should be placed in separate, stand-alone LLCs (either traditional or series), referred to among asset protection advisors as "single purpose entities" or "SPEs." Examples are restaurants, retail stores, and apartment complexes. Merely because the BOC permits entirely different enterprises to be contained within the same entity does not mean that one actually should do so.

7. Corporations

A corporation is an independent legal entity, separate from the people who own, control and manage it. The owners of a corporation are called shareholders. A

[30] Id., § 4.04; TBOC §§ 1.002(54), 101.106.
[31] Id.
[32] Id., 4.05B; TBOC § 3.201.
[33] B&CC §§ 8.102, 8.103(c).
[34] B&CC §§ 9.106, 9.302(a).

corporation is managed by a board of directors (only one required, and a director must be a natural person). The daily affairs are administered by officers (two officers are required, president and secretary – one person may serve as both officers and be the sole director). Generally, only shareholders who are also officers or directors have any role in management of the corporation.

Corporations are formed to shield the shareholders, officers, and directors from personal liability for the debts and obligations of the entity. Generally, shareholders have limited personal liability for the business debts of the corporation.

The primary advantages of operating a business as a corporation include: i) limited liability to shareholders; ii) centralization of management; iii) flexibility in capital structure; and iv) status as a separate legal entity. Primary disadvantages are: i) expense and formation; ii) statutorily required formalities; iii) tax treatment-double taxation for C-corporations and restriction on the S-corporation; and iv) franchise taxes.

The Texas Secretary of State does not distinguish between corporations using these designations. When a certificate of formation is filed with the state of Texas, either a business corporation or a non-profit is created. Designations such as C, S, or 501(c)(3) relate only to federal tax provisions. The taxable treatment of corporations is beyond the scope of this paper.

A corporation, however, must comply with certain formalities to maintain this limited liability protection. First, a business corporation is created by filing a certificate of formation with the Texas Secretary of State. A Texas corporation is also required to continuously maintain a registered agent <u>and</u> a registered office for the purpose of service of p rocess. Other corporate formalities, such as the creation of bylaws (sets forth rule governing the operation of the corporation), issuance of stock (ownership in the corporation), annual shareholder and director meetings, documentation of these meetings and important directors' decisions, filing of separate corporate tax returns, must be observed. The only restriction the Texas Business Corporation Act and the Texas Nonprofit Corporation Act place on who can incorporate or own shares in a corporation is that the incorporator must be at least 18 years old.

II. Avoiding Personal Liability in Entities

A. Comparison of Entities

1. Sole proprietorship

Because there is no formal structure, the owner of a sole proprietorship is personally liable to creditors for all business debts and any judgments, subject to available exemptions under Texas law

This is not the entity of choice to avoid personal liability for business transactions. A single member LLC would be a better choice, even if taxed as a sole proprietorship.

2. General Partnership

Like a sole proprietorship, general partners are personally liable for the debts of the business, and for wrongful acts or omissions while acting in the ordinary course of business or with authority for the partnership.[35]

Generally, all partners of a general partnership are jointly and severally liable for all debts and obligations of the partnership.[36] However, a partner who pays more than his

[35] TRPA § 3.03; TBOC § 152.303.
[36] TBOC § 152.304.

pro rata share has a right of contribution from the partnership or the other partners who did not pay their allocable share.[37]

Prior to the enactment of the TRPA[38], Texas common law provided that the relationship between partners was ―fiduciary‖ in nature, and that each partner owed the other the fiduciary duties of ―complete loyalty,‖ ―due care,‖ and ―absolute disclosure.‖[39] The courts also treated a joint venture[40] as a general partnership, with each joint venturer owing the same fiduciary duties to the other joint venturers.[41]

One of the stated goals of the 1994 Texas Revised Partnership Act was to reject the strict fiduciary standards and duties imposed on general partners and joint venturers under the common law, and to bring Texas law in line with modern business practices. An agreement to share losses is no longer a necessary element of a partnership under the TRPA.[42] The Bar Committee comment to Section 4.04 of the TRPA specifically states that the term ―fiduciary‖ is inappropriate to describe the duties of a partner, who, unlike a trustee, can pursue that partner‘s own self-interest, and not solely the interest of fellow partners or the partnership itself. However, the courts have not completely abandoned the concept of fiduciary duty since the enactment of the TRPA.[43] A common theme to these cases is the lack of a written partnership agreement which addresses the ―conduct‖

[37] TRPA § 4.01(c); 8.06(c); TBOC § 152.203(d); § 152.708.
[38] The TRPA governs all partnerships after 1999.
[39] *Johnson v. Peckham*, 120 S.W.2d 786 (Tex. 1938).
[40] A partnership formed for a specific purpose, such as developing land, rather than a general partnership.
[41] *Rankin v. Naftalis*, 557 S.W.2d 940 (Tex. 1977).
[42] TRPA § 2.03(c); TBOC § 152.053.
[43] See, e.g., *Bohatch v. Butler & Binion*, 977 S.W.2d 543 (Tex. 1998) (―We have long recognized as a matter of common law that ‗[t]he relationship between …partners…is fiduciary in character…‖).

in issue. Past attempts to lower the ―fiduciary‖ standard in a written agreement have met with resistance from some courts.[44]

The new standards of partnership conduct are set forth in TRPA §§ 4.03 and 4.04. Under these provisions, each partner owes the other: 1) a duty of care; 2) loyalty; 3) an obligation of good faith; and 4) duty of disclosure, i.e., the right of each party to obtain access to the books and records of the partnership, and the duty of each party, upon request, to provide complete and accurate information regarding the partnership. These standards are considered to be ―minimum‖ standards which cannot be completely eliminated by agreement of the partners, but can be specifically altered and defined by the parties if not ―manifestly unreasonable.‖[45]

Any general partner has the power to bind the partnership for acts in the ordinary course of the partnership‘s business, if the party with whom the partner is dealing is not aware that such partner lacks authority to do so.[46] The TBOC prohibits any restriction on the rights of third parties dealing with the partnership.[47] However, the partnership agreement can include specific provisions for dealing with a partner who exceeds its authority, including expulsion.[48]

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[44] See, e.g., *Spiritas v. Robinowitz,* 544 S.W.2d 710 (Tex.Civ.App.-Dallas 1976, writ ref‘d n.r.e.) (managing partner not protected by exculpatory clause in agreement for unilateral actions taken in ―good faith‖ that required unanimous consent of all partners).

[45] TBOC § 152.002; TRPA § 1.03. This section provides the **general rule** that the terms of the partnership agreement will govern the relationship of the partners and partnership, and that the TRPA will apply **only** to the extent that it is not covered by the agreement or is in conflict with the agreement‘s express terms. What is ―manifestly unreasonable‖ is to be determined by the courts. See Bar Committee Comment to § 1.03(b).

[46] TBOC §§ 152.301, 152.302; TRPA § 3.02;

[47] TBOC § 152.002(b)(7).

[48] TRPA, § 6.01; TBOC § 152.501.

Unless the partnership agreement provides otherwise, each partner has the equal right to participate in the management of the business.[49] A managing partner stands in a higher fiduciary relationship to other partners.[50]

Unless otherwise provided, a partnership interest is freely transferable.[51] However, mere ownership of a partnership interest does not necessarily make the owner a partner.[52] A general partner always has the power to withdraw from the partnership, even if the partnership agreement denies the partner the right to do so.[53] Upon withdrawal, unless the partnership agreement provides otherwise, the partnership interest of the withdrawing partner is required to be redeemed.[54] Dissolution is referred to as ―winding up‖ in the TRPA.[55] Withdrawal, bankruptcy, death of a partner, or transfer of a partnership interest do not require a winding up of the partnership *unless* the agreement provides otherwise.[56] Winding up and termination are not synonymous.[57]

Under § 3.03 of the TRPA (TBOC § 152.303) a partnership is liable for loss or injury to a person, or a penalty caused by or incurred from a wrongful act or omission of any partner: 1) acting in the ordinary course of business of the partnership or 2) with authority of the partnership. Except as to a registered limited liability partnership, all partners are jointly and severally liable for all debts and obligations of the partnership

[49] TRPA § 4.01(d); TBOC §§ 3.101, 152.203.
[50] See, *Hughes v. St. David's Support Corp.*, 944 S.W.2d 423 (Tex.App.-Austin 1997, writ denied).
[51] TRPA § 5.03(a)(1); TBOC § 152.401.
[52] See TRPA §§ 5.03(a)(4), (b); TBOC § 152.402(3).
[53] See TRPA §§ 1.03(b)(5); TBOC § 152.002(b)(5), TRPA 6.02; TBOC §152.503.
[54] See TRPA §7.01; TBOC §§ 152.601 - 152.612.
[55] TRPA § 8.01; TBOC §§ 11.051, 11.054, 11.057, 11.151, 11.314, 152.709.
[56] Id.
[57] See TRPA § 2.06; TBOC § 152.503. TRPA § 8.02; TBOC §§ 11.103, 152.701. A partnership continues after an event requiring winding up, until the winding up of the business is completed, at which time the partnership is terminated.

unless otherwise agreed by the claimant or as otherwise provided by law.[58] Attempts to allocate liability among the partners are generally ineffective against third party creditors. A new partner admitted into an existing partnership does not have personal liability for obligations of the partnership which arose prior to admission, so long as such liability relates to an action taken, or omission occurring prior to admission, or the obligation arises under a contract or a commitment made prior to admission.[59] A partner withdrawing from a partnership in violation of the partnership agreement is liable to the partnership and the other partners for damages caused by the wrongful withdrawal.[60] The withdrawing partner may also be liable for actions committed by the partnership while he was a partner.[61]

Under the TRPA, a creditor must exhaust partnership assets before collecting a partnership debt from an individual partner, except in limited circumstances.[62] Generally, the creditor must obtain a judgment against the partnership, which is a change from prior law. Also, a judgment against the partnership is not automatically considered to be a judgment against its partners, who must be served individually in the action to be bound.[63]

Even with these restrictions on collection of partnership assets, the unlimited liability exposure of partners in a general partnership makes it a poor choice for liability protection of its members.

3. Limited Partnerships

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[58] TRPA § 3.04; TBOC § 152.304(a). See *E. & J. Gallo Winery v. Spider Webs, Ltd.*, 129 F.Supp.2d 1033 (S.D.Tex. 2001).
[59] TRPA §3.07; TBOC § 152.304(b).
[60] TRPA §6.02(c); TBOC § 152.503(c).
[61] *In re Keck, Mahin & Cate*, 274 B.R. 740, 745-47 (Bky. N.D. Ill. 2002) (malpractice claim).
[62] TRPA § 3.05; TBOC § 152.306.
[63] TRPA § 3.05(c); TBOC § 152.306(a).

A general partner in a limited partnership has the same unlimited liability as does a partner in a general partnership.[64] A limited partner's liability for debts of or claims against the partnership is limited to the limited partner's capital contribution to the partnership, plus any additional amounts agreed to be contributed.[65] However, the limited partner's protection may be withdrawn if the partner participates in the management of the partnership.[66]

Safe harbor provisions in the statute allow a limited partner to consult with and advise the general partner, acting as a contractor for or an agent or employee of the limited partnership or of a general partner, proposing, approving or disapproving certain specified matters relating to partnership business, or the winding up of the partnership business, or guaranteeing specific obligations of the partnership.[67]

A limited partner who knowingly permits its name to be used in the name of the partnership will be liable to creditors who extend credit to the partnership without knowledge that the limited partner is not a general partner.[68] A corporation may serve as the general partner of a limited partnership, but the piercing of the corporate veil doctrine may be applied to reach shareholders of the corporate partner.[69]

The statute authorizes a limited partnership to register as an LLP by complying with the provisions of the TRPA or TBOC, where the general partner's liability would be limited to the debts or obligations of the limited partnership only as provided in TRPA § 3.08(a) or TBOC § 152.801.

[64] TRPA § 4.03(a); TBOC § 153.152.
[65] TRPA § 3.03; TBOC § 153.102.
[66] In Texas, a partnership may be pierced to impose liability on its owners who are either general partners or limited partners who participate in the control of the business. TRPA, § 3.03(a); TBOC § 152.303(a).
[67] TRLPA § 3.03(b); TBOC §153.103.
[68] TRLPA § 3.03(d); TBOC § 153.102.
[69] *Grierson v. Parker Energy Partners 1984-I,* 737 S.W.2d 375, 377-78 (Tex.App.-Houston [14th Dist.] 1987, no writ).

Assets of the limited partnership are protected from the limited partners' own individual creditors. A judgment creditor's sole remedy against a limited partner who does not actively manage partnership business is to seek a charging order against that limited partner's interest. Under a charging order, distributions attributable to that partner will instead be made to the judgment creditor who has obtained a charging order. However, the judgment creditor usually has no right to compel distributions or to demand that the limited partnership interest be liquidated, or to participate in the management or operation of the partnership. More importantly, a judgment creditor pursuant to a charging order becomes an assignee of the partner's interest, and therefore is subject to income tax on its pro rata share of the partnership income—whether distributed or not.

The general partner of the partnership controls the timing of distributions, making the attachment of a partner's interest through a charging order less attractive to a judgment creditor who may wind up paying substantial income tax on an asset that has not been actually received.

It remains to be seen whether Texas will adopt new section 703 of the Uniform Limited Partnership Act (2001), which would allow a judgment creditor with a charging order to foreclose on that partner's or member's interest. The current version of section 703 adopted in Texas appears to be internally inconsistent, in that it provides that a judgment creditor's sole remedy is a charging order, yet states that a partner's interest may be redeemed before foreclosure occurs.[70] This may be explained by Tex.Civ.Prac.&Rem.Code § 31.002, which allows a court to otherwise apply a judgment debtor's property to the satisfaction of the judgment, which would include foreclosure as a remedy.

[70] Tex.Rev.Civ.Stat.Ann., art. 6132a-1, § 7.03; TBOC §§ 153.256, 153.25.

Managers of the limited partnership have a higher fiduciary duty to the limited partnership and the limited partners because of the manager‘s control over partnership affairs.[71] Unless otherwise provided in the partnership agreement, limited partners do not owe a fiduciary duty to the other partners of the partnership. By agreement, the liability of the general partner to the partnership and the other partners may be limited in the same manner as in a general partnership.[72]

Family limited partnerships

Three common structuring flaws in FLPs include: parent as general partner, parent as both GP and only limited partner, and parent's living trust as GP. The most common mistake is making the parent the general partner since it can undermine the charging order protection that prevents the GP from distributing an LP's interest for a creditor. When the parent is both the GP and the only LP, the courts can decide that the parent owns all the interests and so the partnership does not really exist; this would remove both charging order protection and tax benefits. Finally, placing the parent's living trust as the GP is dangerous. Creditors can ask the court to require the parent to revoke the trust, which puts the parent back in place as the GP.

FLP taxation is full of traps and pitfalls, so make sure you get an accountant or tax specialist to look over your assets and liabilities. Since FLPs are relatively new, the IRS watches them closely to make sure they serve a valid business purpose, and the burden of proof for any tax discount lies with the partnership. An FLP is a business entity, so you cannot use it to pay normal family expenses such as mortgage on the family home, utilities, educational expenses, and so forth. “The use of the FLP for personal purposes could result in the entity being disregarded for tax and asset protection purposes," reports The Asset Protection Book.

4. Limited Liability Partnership

LLPs do not protect a partner from liability arising from the partner‘s own negligence, wrongful acts or misconduct, or from that of any person acting under that partner‘s direct supervision and control. However, a LLP partner will not be liable for the debts and obligations of the partnership incurred while the partnership is a registered LLP. A LLP partner may still be liable if liability is imposed by contract independently of the partner‘s status as a partner (e.g., a guarantor), or if imposed by law, including torts committed by the partner while acting on behalf of the partnership.[73] Two recent unpublished cases illustrate these principles. In *Deyoe v. Gray, Jansing & Associates, Inc.,*[74] a proposal for engineering services was presented the president and sole shareholder of a corporation, who also was the registered agent for limited partnerships. He signed the proposal as ―approved‖ without any representative designation. He was held personally liable on the contract following a bench trial. On appeal, he argued that he had signed the proposal as the agent for the limited partnerships, which the

[71] See *Palmer v. Fuqua,* 641 F.2d 1146, 1155 (5th Cir. 1981).
[72] TRLPA § 4.03(b); TBOC § 153.152.
[73] TRPA, § 3.08(a); TBOC § 152.801.
[74] 2005 Tex.App. LEXIS 1975 (Tex.App.-Austin, March 17, 2005) (unpub. opn.).

engineering firm was aware of. Following traditional agency principles, the court of appeals affirmed the judgment against the individual, holding that to avoid personal liability, the person must sign in a representative capacity, as well as identify the principal to whom the representative is signing on behalf of.

In *Acar Inv. Partners VI Ltd. v. Gaus,*[75] two partners in a registered limited liability partnership had signed a lease on behalf of the LLP and also a limited two year guaranty. The partnership breached the lease agreement, and the landlord sued the two partners individually under the lease and on their guarantees. On appeal, the court of appeals reversed a summary judgment in favor of the two partners, holding that although the lease was done in the name of the LLP, the two partners were individually liable because they had *failed to renew* the LLP's registration at the time the lease was executed. The court of appeals rejected the partners' argument that the landlord was on notice that the lease was with a LLP, because the language of the statute, Article 6132b- 3.08(a)(1), specifically stated that a partner in a LLP ―is not individually liable for debts and obligations of the partnership incurred…while the partnership is a limited liability partnership.‖ Since the lease was signed after the LLP's registration had lapsed, the individual partners and guarantors were personally liable for the partnership's obligations.[76]

[75] 2005 Tex.App. LEXIS 379 (Tex.App.-Eastland, Jan. 20, 2005) (unpub. opn.).

[76] In contrast, the court of appeals in *Suttles v. Thomas Bearden Co.*, 152S.W3d 607 (Tex.App.-Houston [1st Dist.] 2004), reversed a summary judgment against a corporation's president who signed a promissory note in a representative capacity on behalf of his corporation, which was not identified in the body of the note, but was identified in the signature block of the note.

5. Limited Liability Company (LLC)

One advantage of an LLC is that a member, unless otherwise provided, may participate in the management of the company without losing its protected limited liability status, as that member would in a limited partnership.

An LLC is treated as a stand-alone entity for contract and tort purposes. Generally, a member's personal assets may not be attached for an LLC debt, whether in tort or in contract. However, the protection of personal assets would not apply if the member guaranteed a debt, or committed an intentional tort. A judgment creditor, as in limited partnerships, is generally limited to a charging order against the member's interest.[77]

The duties of Managers (or Members in a Member-only LLC) are generally assumed to be fiduciary in nature, similar to fiduciary duties of corporate directors. The LLC statute allows company agreements to expand or restrict the duties (including fiduciary duties) and liabilities of Members, Managers, officers and other persons affiliated with the LLC.[78]

6. Series LLC

How does a series LLC differ from a traditional LLC? The answer is found in one word: *exposure*. In the case of a judgment against a traditional company, *all* assets of the LLC are available for purposes of satisfying that judgment. Not so with a series LLC. If a series is sued, liability is contained within that series and does not spill over to other series or the company at large.

Good record keeping is both important and required. In fact, series insulation is preserved only so long as "records maintained for that particular series account for the assets associated with that series separated from the other assets of the company or any other series."

Tex. Bus. Orgs. Code § 101.601(b)(1). In other words, records must be maintained "in a manner so that the assets of the series can be reasonably identified by specific listing, category, type, quantity, or computational or allocational formula or procedure." Tex. Bus. Orgs. Code § 101.603(b). Implicit in the statute is the idea that assets and liabilities of a series can and should be separate both from the assets and liabilities of other series *and* those of the company at large. Commingling among these categories should be avoided.

Generally speaking, one should not place an asset or enterprise in one series that:

(1) creates a much higher level of liability or potential for legal action than businesses in other series;
(2) has a significantly different debt structure (involving development loans, personal guarantees, and the like) than that in other series;
(3) receives significantly different tax treatment from other series or is involved in a payment plan with the IRS;
(4) serves as a management entity with exposure to the public (tenants, vendors, contractors, and the like) since this function is better placed in a separate LLC altogether.

Entities with any of the foregoing characteristics should be placed in separate, stand-alone LLCs (either traditional or series), referred to among asset protection advisors as "single purpose entities" or "SPEs." Examples are restaurants, retail stores, and apartment complexes. Merely because the BOC permits entirely different enterprises to be contained within the same entity does not mean that one actually should do so.

7. Corporations

A corporation protects shareholders since their liability is generally limited to their invested capital. Officers and directors are ordinarily protected from personal liability arising from the activities of the corporation. However, corporate officers and/or directors can always be held personally liable for torts that they personally committed.[79]

In exceptional circumstances, a court will ―pierce the corporate veil‖ or ―disregard the corporate entity‖ to find a shareholder personally liable for the activities of a corporation.[80] Failure to observe corporate formalities coupled with preference to shareholders of an insolvent corporation can result in fraudulent transfer liability under the Texas Fraudulent Transfer statute[81], and in some cases, individual liability under veil-piercing theories.

Directors of a corporation owe fiduciary duties of care, loyalty and obedience to the corporation.[82] The ―business judgment rule‖ makes a presumption that directors have satisfied their fiduciary duties in making a business decision, so long as there is no conflict of interest and the action is not *ultra vires* or tainted by fraud.[83] If the business judgment presumption is overcome or not applicable, then the burden shifts to the director to justify the fairness of the transaction to the corporation.[84]

Generally, absent contrary language in a shareholder agreement, minority shareholders have little say in the day to day management of the business. Management is by a board of directors, unless delegated in part under bylaws to officers who report to the board. Closely held corporations may dispense with the board or restrict the board's powers to act automatically. Controlling shareholders owe a fiduciary duty to deal fairly with minority shareholders.[85]

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77 See discussion of charging orders in reference to a limited partnership, infra.
78 TLLCA § 2.20.B; TBOC § 101.401.
79 See, *Kingston v. Helm,* 82 S.W.3d 755, 758 (Tex.App.-Corpus Christi 2002, pet. denied). See also, *Gore v. Scotland Golf, Inc.*, 136 S.W.3d 26, 32 (Tex.App.-San Antonio 2003, pet. denied) (following *Kingston*).

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80 See TBCA article 2.21 which defines circumstances under which the court may pierce the corporate veil in contract cases. The amendments to Article 2.21(A); TBOC § 21.223, preserved the right to establish individual shareholder liability by a showing of actual or common law fraud. See, *Farr v. Sun World Sav. Ass'n*, 810 S.W.2d 294, 296 (Tex.App.-El Paso 1991, no writ).
81 Texas Uniform Fraudulent Transfer Act (TUFTA).
82 See *Gearhart Ind. Inc. v. Smith Intern. Inc.*, 741 F.2d 707 (5th Cir. 1984).
83 *Gearhart*, 741 F.2d at 719-21.
84 *Id.*, 741 F.2d at 720.
85 See *In re Pure Res., Inc.*, 808 A.2d 421, 433 (Del. Ch. 2002).

Directors must make proper disclosure of any self-dealing and present corporate opportunities to the board, which must approve this activity. Absent a provision to the contrary in the bylaws, it is a breach of fiduciary duty of loyalty for a director to engage in undisclosed self-dealing or usurping a corporate opportunity for his personal benefit. Texas law permits a corporation to renounce in its certificate of formation or by action of its board of directors any interest in business opportunities presented to the corporation or one or more of its officers, directors or shareholders.[86] Shareholders are personally liable for their failure to make agreed upon contributions.[87]

The directors and shareholders vote on the dissolution of the corporation. Failure to provide for payment of creditors upon dissolution may result in personal liability.

Corporate stock under state law is transferable, but shareholder agreements may place restrictions on transfer.

B. Indemnity Provisions

Like corporations, members of a partnership, limited partnership, and LLC may agree that their good faith actions undertaken in the best interests of the entity will be indemnified by the entity in the event of a third party claim.

The TBOC expressly provides that a partner is not individually liable for partnership obligations by contribution or indemnity, unless otherwise provided.[88] A written or oral partnership agreement setting forth indemnification or contributions inconsistent with the statute may result in the loss of the limited liability shield.

[86] TBCA art. 2.02(20); TBOC § 2.101(21).
[87] This holds true with respect to partnerships and LLCs.
[88] TRPA § 3.08(a); TBOC § 152.801.

A limited partnership is prohibited from indemnifying a general partner who is found liable to the limited partners or the partnership or for an improper personal benefit if the liability arose out of willful or intentional misconduct.[89]

A LLC may indemnify any of its Managers, Members, officers or other persons subject to the standards, if any, set forth in the certificate of formation or company operating agreement.[90] The restrictions on indemnification applying to regular corporations do not apply to a LLC.[91]

C. Impact of Management on Liability

As noted above, management may have serious consequences on any protection from third party liability, dependent upon the entity involved.

Management does not have an impact for general partnerships or an LLC. It does impact the protection afforded to a limited partner, who will protected status by participating in non-safe harbor management activities of the partnership. For LLPs, management will render that person responsible for his own acts or omissions, or those employees which he directly supervises and controls, but the partner will not generally be held responsible for the acts or omissions of other partners, or employees which they directly supervise and control.

D. Other Sources of Liability

1. Merger or Conversion

Under Texas corporation law, the acquirer of a general partnership may not be accountable for pre-closing liabilities. A merger or acquisition requires the approval of specific persons in advisory and ownership roles. Corporations must obtain approval by

[89] TRPA §§ 11.03, 11.05; TBOC § 8.102(b).
[90] TLLCA § 2.20.A; TBOC § 101.402.
[91] TBOC § 8.002(a).

the directors and shareholders. LLCs and LPs have freedom to contract the provisions governing mergers or acquisitions, and any required approvals. If the LLC is controlled by Managers, they must approve the action. Both the general partner and the limited partners generally approve a limited partnership's acquisition or merger, subject to contractual variances. Unless otherwise provided, both LLCs and LPs have no appraisal rights or other formal structure for minority dissent.

Conversion of an entity does not generally impair prior creditors, since liability flows through to the new entity without requiring further action.

2. Impact of Bankruptcy, Insolvency or Near Insolvency

If an entity nears insolvency, additional fiduciary duties accrue to management and advisors. Ignoring these duties may lead to the imposition of personal liability. If a corporation is insolvent, a fiduciary arises for both officers and directors to creditors of an entity, who stand ahead in the line to get paid before the owners of the entity itself. Generally such duties are analyzed in bankruptcy court, in adversary actions for fraudulent transfers in contemplation of bankruptcy. If the managers and advisors were advised and assisted by professionals, i.e., accountants and attorneys, then personal liability may be imposed on them as well. If the entity is a public entity, then those professionals now have to worry about potential criminal and civil responsibility under Sarbanes-Oxley.[92]

[92] The Sarbanes-Oxley Act of 2002, 107 P.L. 204; 116 Stat. 745; 2002 Enacted H.R. 3763; 107 Enacted H.R. 3763. The intricacies of counsel's responsibilities under this Act are beyond the scope of this paper, but have already spawned a cottage industry of writers, prognosticators, and attorneys' fees for lawyers specializing in advising on corporate governance.

3. Corporate Manager of a Partnership, LP, or LLC:

If a corporation manages a partnership, limited partnership, or LLC, do the directors of the corporation owe a fiduciary duty not only to the corporation's shareholders, but also to the partners, limited partners, or members of the LLC that they manage?

LLC Managers owe at least fiduciary duties of loyalty and care to their LLC members, although the scope of that duty may be modified by contract. If a corporation manages an LLC, then the starting point is whether the Regulations adopted impose a fiduciary duty for the corporate manager to the members of the LLC.

Even if the corporate manager of an LLC, LP, or partnership owes a fiduciary, or modified, duty to the members under the terms of the governing contract, it remains unclear whether that duty also flows to the directors of the corporation as well, although there is case law developed in Delaware to suggest that the duty may exist in the limited partnership context.[93]

A Delaware limited partner case, *In re USACafes, L.P. Litigation*[94], provides some guidance on this issue. The limited partner investors in the USACafes limited partnership sued the partnership, the corporate general partner, and the corporation's individual shareholders and directors for breach of fiduciary duty in authorizing the sale of the partnership's assets for a deficient price because they allegedly received substantial side payments from the buyer. The director defendants moved to dismiss the suit for failure to state a claim, arguing they owed no duty of loyalty and care to the limited partners, and that such duty was owed by the corporate general partner. The court

[93] This discussion is principally based on an article published in the ABA Journal, Vol. 12, #6 (July/Aug. 2003) authored by Victor Peterson & Alison N. Zim, entitled ―Corporate Directors, LLCs and Liability.

rejected this argument, holding that ―[t]he assertion by the directors that the independent existence of the corporate general partner is inconsistent with their owing fiduciary duties directly to the limited partners is incorrect.[95]‖ The conclusion of the court was based by analogy to trust law that one who controls property of another may not, without implied or express consent, intentionally use or dispose of that property in a way that benefits the holder of the control to the detriment of the property or its beneficial owners.[96]

The reasoning of *In re USA Cafes,* can easily be extended from the limited partnership context to other forms of partnership or an LLC, to prevent self-dealing that is detrimental to the interest of the entity being managed, or its members. Another limited partnership case, *Gotham Partners, LP v. Hallwood Realty Partners, LP*[97]*,* reached a similar conclusion, holding that where the breach of a corporate general partner's fiduciary duties are caused by its directors and controlling shareholder, they are liable to the partnership and its members. *Kahn v. Icahn*[98]*,* concerned a derivative suit brought by limited partners against the corporate general partner and its sole shareholder, CEO, and certain affiliates, claiming a breach of fiduciary duty by usurping business opportunities of the limited partnership. However, the limited partnership agreement permitted the general partner to compete with the business of the limited partnership, which the court concluded created a safe harbor insulating the general partner from breaching its fiduciary duties by competing with the limited partnership. In contrast, investors in *Wallace v. Wood*[99], filed a derivative suit against the corporate general partner for breach of fiduciary duty by seeking to circumvent a contractual ceiling on

95 Id., at 48.
96 Id.
97 795 A.2d 1,34 (Del. Ch. 2001).
98 24 Del. J. Corp. L. 738, *aff'd,* 746 A.2d 276 (Del. 2000).

indebtedness for acquisitions. Following *In re USACafes,* the court held that ―officers, affiliates and parents of a general partner *may owe* fiduciary duties to limited partners if those entities control the partnership's property.‖[100]

If a fiduciary duty is found to exist to the members of a partnership, LP, or LLC being managed by a corporate partner, the fiduciary duties of the directors of the corporation may also conflict with the fiduciary duties owed to that entity's members. Fiduciary duties may be imputed ―upward.‖ As the court stated in *In re Monetary Groups,*[101]:

> A general partner in a limited partnership stands in a fiduciary relationship with the limited partners of that limited partnership. [cites omitted] Atkins was a general partner of TSG. Thus, Atkins owed a fiduciary duty to TSG's limited partners. Additionally, TSG was a general partner of Groups. Therefore, because Atkins owed a fiduciary duty as a general partner of TSG and TSG was a general partner of Groups, Atkins' fiduciary duty extended to Groups.

The courts may also impute fiduciary duties ―downward.‖ Delaware's Chancery Court has concluded that ―fiduciary duties may be imputed to a separate entity formed and controlled by fiduciaries for the purpose of engaging in a transaction with an entity to whom those duties are owed.‖[102]

In Texas, the Northern District Court recently discussed the *In re USACafes* holding. While *In re ParkCentral Global Litigation*[103] did not reject the idea of fiduciary duties flowing upward or downward, the court held that potential plaintiffs must allege

[100] Id. At 1178.
[101] 2 F.3d 1098, 1103 (11th Cir. 1993).
[102] *Barbieri v. Swing-N-Slide Corp.*, 1997 Del. Ch. LEXIS 9.
[103] 2010 WL 3119403 (N.D. Tex. 2010).

specific facts that lead to a reasonable inference‖ that there is a fiduciary duty that has been breached.[104]

The basic lesson is that fiduciary duties, unlike liability to third parties for entity obligations, may not be avoided structurally by interposing entities, and claiming that the controlling members of those entities are immune from responsibility because the fiduciary duty does not flow up or down to them.

4. Liability for Attorney's Fees

The choice of entity has a critical impact on whether a business may be held liable for attorney‘s fees should a judgment be rendered against the business. In *Baylor Health Care System v. National Elevator Industry Health Benefit Plan*, [105] the District Court for the Northern District of Texas examined the plain language of Section 38.001 of the Texas Civil Practice and Remedies Code. Section 38.001 provides, in pertinent part, that ―a person may recover reasonable attorney‘s fees from an ***individual or corporation***, in addition to the amount of a valid claim.‖ Notwithstanding this express language, the Texas Supreme Court and many other appeals courts have allowed for the recovery of attorney‘s fees from business entities other than individuals or corporations.[106] However, none of these cases ever raised the issue of recoverability of statutory attorney‘s fees from a defendant under the ―individual or corporation‖ language because the issue was not presented on appeal. The sole federal case that does discuss the recoverability of statutory attorney‘s fees concluded that partnerships are not included among the defined

[104] *Id.* at *7.
[105] 2008 WL 2245834 (N.D. Tex. 2008).
[106] *See, e.g., Bohatch v. Butler & Binion*, 977 S.W.2d 543, 547 (Tex. 1998) (affirming award of statutory attorney‘s fees against a law firm partnership under Tex Civ. Prac. & Rem.Code §38.001); *see also Apache Corp. v. Dynergy Midstream Servs., Ltd. P'ship*, 214 S.W.3d 554 (Tex.App.-Houston [14th Dist.] 2006, no pet.) (awarding attorney‘s fees against a limited liability company under Tex Civ. Prac. & Rem.Code §38.001)

parties against whom a claim for attorney‘s fees may be made. [107] The Code Construction Act defines ―person‖ to include ―partnerships.‖[108] It follows that Section 38.001 was drafted to intentionally exclude those who by definition are not ―individuals‖ or

—corporations.‖ Yet because this issue is rarely raised on appeal, many business entities may be held liable for attorney‘s fees that they may not be required to pay.

III.
Final Advice

From a limited liability perspective, the entity of choice for most small businesses would be a LLC, whether single-member or otherwise. If passive investors are going to be involved, then consider a limited partnership. Both of these vehicles allow for flexible operations of the business without the formalities required of a corporation, and provide a shield of protection from third-party creditors. The downside to a limited partnership is that it must have a general partner, and limited partners cannot participate in the management without losing their protected status. To avoid these problems, having a corporation or LLC be the general partner allows for some measure of personal protection from individual liability.

It is important and essential to have a written partnership or operating agreement that states the essential rules governing the operation of the business, especially in the case of member withdrawals. In the absence of such written agreements, governance defaults to the statutory provisions, which may not cover all issues which may arise in the operation or termination of the business.

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[107] *Ganz v. Lyons P'ship, L.P.*, 173 F.R.D. 173, 173-175 (N.D. Tex. 1997).
[108] TEX. GOV. CODE. §311.005 (2005).