

Individual Members and Partners: Getting Granular

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**“Entrepreneurship is neither a science nor an art. It is a practice.”
Peter Drucker**

The above quote from Peter Drucker provides an apt description of “entrepreneurship,” which more and more seems to be the thing individuals are striving to achieve. How many times have you talked with a client about the multi-million-dollar real estate deal, the brilliant patent idea, or the next big coffee shop chain? We have encountered several clients who we would describe as “idea people.” Those clients have the great idea and grand plan, but they don’t necessarily know how to put it into practice. The legal requirements surrounding the creation of a new business are only part of the practice that Drucker refers to, but we believe it is important and often overlooked by many budding entrepreneurs. For those who do seek legal advice during the creation of a new business, many still struggle to understand the nuanced implications of creating a new entity and the need to plan for future, but unknown and quite often unpredictable events. But this is where lawyers can provide value.

On that note, we thought a quote from Drucker was appropriate here because he was also the person who coined the term “knowledge worker,”² which refers to workers whose main capital is knowledge, those workers who think for a living.³ The legal profession is one of many that falls within that definition, but “knowledge work” is the value we seek to bring to clients. In other words, lawyers assisting a client with forming a new entity or changing the structure of an existing entity, can provide knowledge of the law but can also help clients brainstorm potential challenges and create or modify strategies moving forward. Even more specifically, lawyers can help individual partners and members evaluate and plan for events that may cause the partners or members to go their separate ways. When new businesses are being formed, the excitement and anticipation can make individual partners and members turn a blind eye to potential, future problems. We have all encountered those business partners who are so thrilled to be working together that

¹ A special thank you to Josh Candelario and Trey Torres for their help in getting this paper and presentation off the ground. Kayla has had the pleasure to work with Josh and Trey during their time at Baylor Law School. They are both examples of why teaching is so rewarding. Josh and Trey are hardworking, competent, attentive, and most importantly, kind. Josh will be moving on from Baylor Law School very soon and we wish him all the best. Professor Beth Miller convinced Trey to stay in Waco one more year after graduation to serve as the next Transactional Law Associate. He actually didn’t need much convincing because like Josh, Baili, and Kayla (and probably many of you reading this paper), he is incapable of saying “no” to any request that Professor Miller makes. We are excited to have his assistance this coming school year (even though we know he really had no choice).

² Wikipedia, https://en.wikipedia.org/wiki/Peter_Drucker

³ Wikipedia, https://en.wikipedia.org/wiki/Knowledge_worker

talking about one partner eventually selling out or breaching the terms of a company agreement brings about discomfort that the partners would rather ignore. In their minds, it will never happen so why spend time planning for it?

However, as people who “think for a living,” we know that such situations occur often and must be addressed through governing documents when the entity is formed or addressed later through amendments to those documents (assuming the partners/members will agree to do so). Because we also know, that if the governing documents don’t specifically address some of those situations, the provisions of the Texas Business Organizations Code (“TBOC”) or common law will come into play which can greatly advantage some members and disadvantage others.

In this paper and the corresponding presentation, we focus on members in a Texas limited liability company, specifically focusing on those situations that could lead to one member seeking to withdraw from the LLC or sell/assign its membership interest, as well as the situation where one or more members may seek to expel another member. We also discuss some provisions that may be helpful in protecting the LLC after a membership split such as confidentiality obligations and intellectual property protections.

The specific provisions you decide to include will depend on the circumstances surrounding each entity, but the overall message of this paper and the presentation is that you must go through the process of deciding which provisions are appropriate. We all have great company agreement forms that have been revised and reused, but don’t forget that each entity and transaction can provide unique challenges (or potential challenges) that may not be adequately covered by those form documents. We must continue to bring that value and knowledge to clients by specifically evaluating those situations that could lead to a member or partner separation and adequately addressing those situations in the governing documents.

The remainder of the paper is drafted in outline format with each section discussing specific TBOC sections and company agreement provisions and how those should be evaluated or revised when considering overall management of the LLC as well as potential member disputes and departures. Many of the sections below begin with a list of relevant TBOC sections (with a short summary of the section) and then discuss specific considerations in the context of those listed sections.⁴

⁴ In preparing this paper and presentation, we spent time reviewing the paper titled “*Model Company Agreements for Closely Held LLCs*” by Cliff Ernst and Prof. Elizabeth Miller which was presented at the State Bar of Texas 15th Annual Essentials of Business Law Course in March 2024. This paper sticks closely to the advice you will also find in the Ernst and Miller paper but with an emphasis on specific issues and provisions. We have not included sample company agreement language because Ernst and Miller covered that sufficiently in the model agreements included with their paper. We encourage you all to review those model agreements but as Ernst and Miller state at the beginning of each model agreement, they should not be considered a form to be completed by filling in the blanks and drafters must be certain that the model agreement is appropriate for a particular transaction. The model agreements are excellent resources. However, it is still necessary to go through the process of deciding which specific provisions are needed or should be revised.

I. COMPANY AGREEMENTS UNDER THE BOC: “WRITTEN, IMPLIED, OR ORAL”

a. Applicable TBOC Sections:

- i. TEX. BUS. ORGS. CODE ANN. § 101.052(a)(1) - The company agreement of a limited liability company governs “the relations among members, managers, and officers of the company, assignees of membership interests in the company, and the company itself.”
- ii. TEX. BUS. ORGS. CODE ANN. § 101.001(1) - Company agreements may be “written, implied, or oral,” and “a written company agreement may consist of one or more agreements, instruments.”
- iii. TEX. BUS. ORGS. CODE ANN. § 101.052(d) – “The company agreement may contain any provisions for the regulation and management of the affairs of the limited liability company not inconsistent with the law.”

b. There is no hierarchy between a company agreement and the certificate of formation.

- i. Prior to September 1, 2021, TEX. BUS. ORGS. CODE ANN. § 101.052(d) provided: “The company agreement may contain any provisions for the regulation and management of the affairs of the limited liability company not inconsistent with law *or the certificate of formation*.” (emphasis added). *See Pinnacle Data Servs., Inc. v. Gillen*, 104 S.W.3d 188 (Tex. App.—Texarkana 2003, no pet.) (holding that the voting provision in a limited liability company’s articles of organization controlled over a conflicting voting provision in the company’s regulations).
- ii. Effective September 1, 2021, the words “or the certificate of formation” have been removed from TEX. BUS. ORGS. CODE ANN. § 101.052(d). S.B. 1203, 87th Leg., eff. Sept. 1, 2021.

c. *Planning ahead:*

- i. As we all know, the best practice is to have a written company agreement and ensure that the company agreement serves as the entire agreement of the parties. In other words, avoid multiple instruments or agreements.
- ii. Practitioners have a good amount of flexibility when drafting company agreements so long as the provisions in the company agreement are not inconsistent with applicable law. *See* TEX. BUS. ORGS. CODE ANN. § 101.052(d). This allows for inclusion of the provisions discussed below and others to address member disputes and departures proactively in the company agreement.
- iii. If no written company agreement exists, look for oral agreements or implied agreements. If you are working with a new client in this situation, advise that the members consider adopting a written company agreement governing the management and organization of the business. It will be necessary to understand how the LLC has been operating to date and compare that with the provisions of the TBOC that would govern.
- iv. Even though there is no hierarchy, it is important to avoid inconsistencies between the certificate of formation and the company agreement. Many practitioners are comfortable using the form certificate of formation promulgated by the Secretary

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First appeared as part of the conference materials for the
33rd Annual LLCs, LPs and Partnerships session

"Individual Members and Partners Part 2: Getting Granular"