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Is This Really the Law?

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The Texas Business Organizations Code ("TBOC") provides a substantial amount of flexibility and freedom in drafting limited liability company ("LLC") agreements and limited partnership agreements. The drafters of the TBOC intended to allow parties to form and govern LLCs and limited partnerships in a manner deemed most appropriate for the particular members/partners involved and for their industries. However, even with increased flexibility in drafting, default rules provided under the TBOC that pertain to LLCs and limited partnerships are often overlooked or even ignored, causing members/partners to be stuck in unintended and unforeseen situations limiting the ability of the governing persons and owners to effectively run their entities. This paper provides an overview of ten common drafting mistakes that, if not given the necessary attention, could create issues in LLC company agreements and limited partnership agreements. This paper is intended to provide practitioners with ideas for drafting around and/or using the default rules, and includes some sample provisions. The ten main issues addressed in this paper are: (i) the withdrawal rights of members/partners; (ii) buy-sell agreements to ensure continuity of ownership and control of an entity upon certain purchase events; (iii) default rules on voting and how "majority" is defined in an LLC context; (iv) indemnification of persons in actions related to their management capacity or membership/partnership interests; (v) defining or disclaiming fiduciary duties owed by members and limited partners to the company/partnership and to other members/limited partners; (vi) contribution obligations of members and partners in LLCs and partnerships; (vii) differences between assignees and substitute members/partners in the context of transfers of interests; (viii) tax distributions for pass-through entities; (ix) assumed names and proper signature blocks; and (x) miscellaneous approval provisions.

TABLE OF CONTENTS

1. WITHDRAWAL OF A MEMBER/PARTNER

Unless a company agreement or partnership agreement permits withdrawal, the default rule is that members and partners may not unilaterally withdraw from an LLC or a limited partnership. The reason for this is primarily financial in that the company/partnership does not want to allow its members/partners to unilaterally withdraw and receive the value of their interest at a time that may be inconvenient to the entity. If an LLC or limited partnership decides to permit withdrawal, it must be provided in writing in the governing document (LLC company agreement or agreement of limited partnership).

1.1 LLCs.

Absent an agreement to the contrary in the company agreement the default rule under the TBOC regarding withdrawal of a member from an LLC is that members may not withdraw or be expelled from an LLC. TEX. BUS. ORGS. CODE § 101.107. This default rule may be changed by including provisions for withdrawal and expulsion in the company agreement. Therefore, if desired, it is important to include not only the ability for members to withdraw in the company agreement, but also to define what events trigger withdrawal or are grounds for expulsion. Examples of trigger events are death or divorce of a member, a member's bankruptcy, or voluntary withdrawals. On the death of a member, the default rule is that death is not a voluntary exercise of withdrawal, so the deceased member's spouse or other heir or successor becomes an assignee of the deceased member's interest. *See* TEX. BUS. ORGS. CODE § 101.1115. However, the company agreement may provide that upon a member's death, the deceased member's interest in the LLC must be purchased at a predetermined value (however defined in the company agreement) from the deceased member's spouse, heirs, or other successors.

The company agreement should also define the *procedure* for withdrawal or expulsion, as well as include either a fixed price or a method for determining a formulaic purchase price. Unless the company agreement specifies the purchase price upon withdrawal, withdrawals that are permitted under the company agreement entitle the withdrawing member to receive the fair value of his or her interest determined as of the date of withdrawal. *See* TEX. BUS. ORGS. CODE § 101.205. The TBOC does not define how to determine the fair value of a member's interest, so the method for determining the fair market value should be defined in the company agreement. Some courts have determined the fair value of a member's interest by subtracting the total liabilities of the LLC from its total assets to arrive at a total equity figure, and then multiplying the total equity figure by the withdrawing member's membership interest percentage. *See Kennebrew v. Harris* discussed below.

1.2 Limited Partnerships.

As is the case with any partner in a general partnership, the general partner of a limited partnership may withdraw at any time by giving written notice to the other partners. *See* TEX. BUS. ORGS. CODE § 153.155(b). The withdrawing general partner may, however, be in breach of the partnership agreement if it attempts to withdraw prior to the expiration of its required term, if any. *See* TEX. BUS. ORGS. CODE § 153.157. Under the TBOC, upon withdrawal of a general partner, the remaining general partner(s), or if none, then a majority in interest of the limited partners may: (1) convert the withdrawing general partner's partnership interest to a limited partnership interest, or (2) pay the general partner the value of its partnership interest minus any damages caused if the withdrawal was a breach of the partnership agreement. TEX. BUS. ORGS. CODE § 153.158.

Unlike a general partner, a limited partner may not withdraw from a limited partnership unless specified in a written partnership agreement. *See* TEX. BUS. ORGS. CODE § 153.110. If withdrawal is permitted, absent written agreement, the default rule is that a withdrawing limited partner gets the fair value of its interest in the limited partnership. *See* TEX. BUS. ORGS. CODE § 153.111. In a situation where withdrawal is explicitly permitted, the triggering events, withdrawal procedure, and method for determining the fair market value of the partnership interest should all be outlined in the partnership agreement as discussed above with respect to LLCs.

1.3 Case Law.

In *Kennebrew v. Harris*, the trial court concluded that a withdrawing member of an LLC was within his express rights to withdraw from the LLC, and because the parties could not agree on the fair value of the withdrawing member's interest, the court engaged an accountant who used the total member's equity (by subtracting the total liabilities of the LLC from its total assets) multiplied by the member's interest percentage to determine the fair value buyout price. *Kennebrew v. Harris*, 425 S.W.3d 588 (Tex. App.—Houston [14th Dist.] 2014).

1.4 Drafting Tips.

Most company agreements and partnership agreements either expressly deny the ability to withdraw or simply fail to address withdrawal rights. If the reason for not permitting withdrawal is financial (i.e., the entity wants the capital committed indefinitely), then the governing document could permit a member/partner to withdraw, but unless the withdrawal is approved by a majority or a super majority of the remaining members/partners, the withdrawing member/partner simply becomes an assignee, without any voting rights or obligations to the other members/partners, but not stuck in the entity indefinitely. However, having your capital stuck indefinitely is part of the risk that one takes in going into business and/or investing in others.

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