

- SUBJECT:** Revising business organization laws
- COMMITTEE:** Business and Industry — committee substitute recommended
- VOTE:** 7 ayes — Brimer, Brady, Crabb, Eiland, Giddings, Janek, Rhodes
0 nays
2 absent — Corte, Solomons
- WITNESSES:** For — Curtis W. Huff and Alan Bromberg, Texas Business Law Foundation
Against — None
- BACKGROUND:** Business organizations may be formed in a number of different ways. Each business form is regulated by a separate statute. The various forms include: corporations (Texas Business Corporation Act - TBCA); non-profit corporations (Texas Non-Profit Corporation Act - TNPCA); limited liability companies (Texas Limited Liability Company Act - TLLCA); limited partnerships, (Texas Revised Limited Partnership Act - TRLPA); partnerships and limited liability partnership (Texas Revised Partnership Act - TRPA). Additionally, the Texas Miscellaneous Corporate Laws Act (TMCLA) sets some requirements applicable to a number of corporate forms.
- DIGEST:** CSHB 1425 would amend the various business organization statutes (TBCA, TNPCA, TLLCA, TRLPA, TRPA, and TMCLA).
The primary substantive changes include conversion, merger requirements, shareholder agreements and shareholder derivative suits.
(Conversion is the process by which a business organized in one form could, upon a plan approved by the decision makers of the organization, change its organizational form without having to dissolve its current form and re-form itself as another organization.) CSHB 1425 would allow a business organization seeking to convert to another form of organization to use the same formalities and decision making process that it might use to

dissolve or form the business or, for corporations, to take over another business. In order to convert from a foreign organization to another domestic form, the laws governing the place of origin and where the converted entity is established must allow for such a process. Conversion from one domestic business organization form to domestic form would be permitted with only the requisite filings to the office of the secretary of state.

(Merger is the process by which one business organization combines with another to create a new organization.) CSHB 1425 would allow mergers between various forms of businesses.

(Shareholder agreements are contracts between shareholders to have their shares voted in a block.) CSHB 1425 would amend the TBCA to conform with the Revised Model Business Corporation Act (RMBCA) regarding such agreements. Essentially, these agreements would have a broader range over what could be agreed to and their enforceability.

(Shareholder derivative suits are a form of class-action litigation.) The shareholders, or any large number of them, are allowed to act on the corporation's behalf and sue the officers, directors, or other person's in charge of the corporation. CSHB 1425 would adopt the new language regarding shareholder derivative suits in the RMBCA adding requirements of fair representation, demand for action, 120-day waiting periods and various procedures based on special committees of inquiry.

Other changes to the business organization statutes included in CSHB 1425 include:

- changing the majority vote requirements from majority of those entitled to cast a vote to a majority of votes cast or expressly abstained as recommended by the RMBCA;
- allowing a corporation to vote its shares as a fiduciary for the shareholders;
- revising language regarding conflicts to allow transactions not to be held void or voidable solely because a director with a conflict was present at the

vote taken so long as there is disclosure of the conflict or the conflict is determined to be a disinterested conflict;

- revising language regarding what is considered a disinterested transaction including when the director is not a party and not materially involved in the conduct;
- establishing procedures for filing with the office of the secretary of state whenever a business organization converts to another form;
- adopting the Business Combination Act, which allows different forms of businesses to become associated or affiliated in a process involving the exchange of shares of the two organizations;
- allowing directors to consider long-term and short-term implications of corporate decisions;
- amending the TMCLA to allow corporations to incur indebtedness for any consideration including future services;
- removing the statutory right of a limited partner to withdrawal on six months notice from a limited partnership;
- allowing limited partnerships to continue after a general partner's withdrawal so long as there is an agreement to do so and another general partner remains in the partnership;
- allowing a partner in a limited liability partnership to share losses which that partner is not liable for only to the extent of capital investment of that partner; and
- establishing bankruptcy as a wrongful withdrawal for partnerships.

This bill would take effect on September 1, 1995. The provision regarding changing the ability of a limited partner to withdraw from a limited partnership would apply only to limited partnership formed on or after September 1, 1995. This bill would not affect any action or proceeding commenced before the effective date of the act.

SUPPORTERS
SAY:

CSHB 1425 would revise the laws regarding business associations based on suggestions by the Corporation Law Committee of the Business Law Section of the state bar. The committee set three goals in their revisions:

- increase flexibility among business forms and allow the easy but stable transition or conversion from one business form to another;
- harmonize the laws governing the different business association forms, establishing similar procedures for each form to convert to another form; and
- provide greater clarity and predictability in the rules regarding the various business forms.

The majority of the changes include technical, corrective and clean-up language to unify various provisions within the various statutes. One significant change is the development of the doctrine of business organization form conversion and mergers among different business forms. Whenever a business is started, the most important decision to be made is how that business should be formed. There are now at least seven different forms of business organizations recognized by Texas law. Additionally, each of these forms may be domestic (formed inside Texas) or foreign (formed in any other state or internationally). Each of these organizational forms carries different benefits and drawbacks. The problem is that once a business is organized in one form, it cannot change to another business form without dissolving in its current form and re-forming in a new one. The expenses involved in the dissolution of a business in one form and the start-up costs of organizing in a different form limit such conversions unless they are absolutely necessary.

To solve this problem, CSHB 1425 would allow the process of conversion and conversion merger. A conversion would require the approval of the decision makers of the business organization in order to make a major change in the organization. For example, for a corporation to convert from a foreign corporation to a domestic corporation, or vice versa, two-thirds (unless otherwise specified by the articles of incorporation) of the voting shareholders must approve the plan, but in order for a partnership to convert, all of the partners must approve the plan for conversion. In order

for an entity to convert from a domestic organization to a foreign one, it is necessary that the laws of both states, or state and foreign country, allow the conversion to take place. The conversion scheme established is one that is fair and equitable to those in the organization as it is currently formed and would ensure that the rights of those who are in an organization will not be taken away by the conversion of the organization.

The process of merger that is established by CSHB 1425 would also allow conversions concurrent with mergers. When a domestic corporation wishes to merge with a partnership or a foreign corporation, one of the businesses must dissolve and re-form in the same form as the other in order to begin a merger. CSHB 1425 would allow for the merger of two different entities so long as a conversion of the entities took place concurrent with the merger.

The conversion scheme in CSHB 1425 represents a new standard for other states to follow. Texas has led the way in the development of the Limited Liability Partnership as a organizational form, and it is hoped that these changes would be as well received by other states.

The remainder of the changes made by CSHB 1425 are clean-up language or adding conforming amendments. The few other major changes are meant to conform to the RMBCA, the model act for corporations, upon which Texas' Business Corporation Act is based. These changes involve shareholder agreements and derivative suit procedures.

Shareholder agreements under CSHB 1425 would be given broader authority to control the business of the corporation. In order to ensure that such agreements do not create a conflict, though, the shareholder agreements would have to be included in the articles of incorporation or bylaws, be in writing and signed by all shareholders involved in the agreement.

Derivative suit proceedings allow the shareholders of a corporation to sue the officers or directors of the corporation on behalf of the corporation. The primary change to the law regarding such suits would be the addition of procedures relating to special committees of inquiry. Such committees are established by the board of directors to review the allegations stated in

the demand given by the shareholders. If the special committee established is found to be disinterested (without any conflicts) and that committee finds in good faith, after a reasonable inquiry, that the actions of the directors or officers were not violative of the interests of the corporation, the suit could be dismissed. In order to avoid dismissal based upon the recommendation of the special committee, the plaintiff would have the burden of proving that the special committee is not independent and disinterested or that the determination of the committee was not a good faith decision.

**OPPONENTS
SAY:**

Business organizations are established under certain parameters that determine how that business will be taxed as well as the general structure regarding the liability and responsibilities of the members of the organization. If these organizations were allowed to change their form of operation more easily, it could be used strategically by the business to avoid taxes, avoid liability, or remove the control that a particular member of that business has. The decision to change business form should be taken with great caution and should be discouraged so that it is not used merely for strategic reasons, but only when essential to the operation of the business.

A second concern in this bill relates to the establishment of special committees of inquiry in derivative suit proceedings. While it may be beneficial to have such committees investigate the allegations and create a report, if an independent, disinterested committee finds no wrongdoing, that alone should not create a presumption that there was no wrongdoing. If the committee makes such a finding the plaintiff has no ability to challenge it, the plaintiff could only challenge the impartiality of the committee or whether the determination was made in good faith.

NOTES:

The committee substitute would return to current law proposed modifications dealing with corporate formalities. Additionally, language in the original version regarding state corporate taxes was deleted and new language was added at the suggestion of the state comptroller.