SUBJECT: Revising business organization laws

COMMITTEE: Business and Industry — favorable, with amendment

VOTE: 8 ayes — Brimer, Rhodes, Corte, Elkins, Giddings, Janek, Solomons, Woolley

0 nays

1 absent — Dukes

WITNESSES: For — Alan Bromberg, Texas Business Law Foundation; Curtis Huff

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 and the applicable statute 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); and
- 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.

The Texas secretary of state is responsible for maintaining a registration of certain business forms in Texas.

The TBCA was modeled on the Model Business Corporation Act of 1969, a national model adopted by most states. The MBCA was revised in 1984.

DIGEST:

HB 1104, as amended, would revise the various business organization statutes (TBCA, TNPCA, TLLCA, TRLPA, TRPA, and TMCLA), with substantive changes primarily addressing conversions, merger requirements, shareholder agreements, and shareholder derivative suits.

The bill also would adopt the Business Combination Act, allowing different forms of businesses to become associated or affiliated in a process to exchange shares, and establish a foreign limited liability partnership law, allowing out-of-state LLPs to operate in Texas under Texas law once they filed a statement of qualification with the Secretary of State.

It would amend various provisions affecting limited liability partnerships. It would eliminate a limited partner's right to withdraw on six months notice from the partnership and allow limited partnerships to continue after a general partner's withdrawal so long as there was an agreement to do so and another general partner remained in the partnership. The bill also would allow a limited liability partners to share losses for which they were not liable only to the extent of their capital investment in the partnership.

Conversions. HB 1104 would allow a business entity to convert from one organizational form to another without having to dissolve and reform itself. The conversion would have to be approved by organizational decision makers. The conversion process would be guided by same formalities governing formation or dissolution of an entity or, in the case of corporations, acquiring another business. A foreign organization could convert to another domestic form only if the laws of the entity's place of origin and its established location allowed for such a process. Entities converting from one domestic business organization form to another would have to file certain documents with the Secretary of State Office.

Mergers. HB 1104 would establish processes by which a business organization of one form could combine with another organization of a different form to create a new organization. This procedure essentially would allow for conversion concurrent with the process of merger.

Shareholder agreements. HB 1104 would amend the TBCA to conform to provisions in the Revised Model Business Corporation Act (RMBCA) regarding contracts between shareholders to vote their shares in a block.

The bill would permit a broader range of items that could be covered by such agreements and their enforceability.

Shareholder derivative suits. HB 1104 would adopt RMBCA provisions regarding shareholder derivative suits, a form of class-action litigation that allows all or a large number of shareholders to act on the corporation's behalf and sue the officers, directors, or other persons in charge of the corporation. The bill would add requirements of fair representation, demand for action, 120-day waiting periods, and various procedures based on special committees of inquiry.

Other provisions. HB 1104 also would:

- change the majority vote requirements from a majority of those entitled to cast a vote to a majority of votes cast or expressly abstained, as recommended by the RMBCA.

- allow a corporation to vote its shares as a fiduciary for the shareholders.

- revise language regarding conflicts to hold that transactions would not be void or voidable solely because a director with a conflict was present at the vote taken, so long as the conflict was disclosed or was determined to be a disinterested conflict.

- include as disinterested transactions those in which a director was not a party and not materially involved in the conduct.

- establish filing procedures to be followed when a business organization converted to another form.

- allow documents relating to business organizations to be electronically filed with the Secretary of State.

- allow directors to expressly consider both long-term and short-term implications of corporate decisions.

- amend the TMCLA to allow corporations to incur indebtedness for any consideration, including future services subject to constitutional limitations.

- establish bankruptcy as a wrongful withdrawal for partnerships.

- amend the various business organization statutes for administrative purposes as recommended by the Secretary of State.

HB 1104 would take effect September 1, 1997. The provision regarding changing the ability of a limited partner to withdraw from a limited partnership would apply only to a limited partnership formed on or after September 1, 1997. The bill would not affect any action or proceeding commenced before the effective date of the act or impair the obligations under any contract entered into before that date.

SUPPORTERS SAY:

HB 1104 would revise the laws regarding business associations based on suggestions by the Corporation Law Committee of the Business Law Section of the State Bar. Objectives behind the recommendations were to:

- 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 proposed by HB 1104 would accomplish these objectives through technical, corrective and clean-up language to unify various provisions within the various statutes.

HB 1104 is substantially similar to CSHB 1425 by Brimer, which passed the House during the 74th Legislature. CSHB 1425 was reported favorably by the Senate Economic Development Committee but failed to make it to the Senate Floor for consideration before the end of the regular session. New provisions included by HB 1104 would adopt new case law and make

administrative and technical changes recommended by the Office of the Secretary of State.

One significant change would provide for conversion and merger of different business forms. Texas law recognizes at least seven different forms of business organizations, in both domestic and foreign forms, each of which carries different benefits and drawbacks. However, 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. In a healthy economy, businesses are dynamic, not static, and there should be flexibility to assume new forms. However, the expenses required to dissolve a business in one form and start up in another now limit such conversions.

To solve this problem, HB 1104 would allow a process of conversion and conversion merger. A conversion making a major change would require the approval of the decision makers of the business organization. For example, for a corporation to convert from a foreign corporation to a domestic corporation, or vice versa, two-thirds of the voting shareholders would have to approve the plan unless otherwise specified by the articles of incorporation. In order for a partnership to convert, all of the partners would have to approve the plan for conversion. For an entity to convert from a domestic organization to a foreign one, the laws of both states, or state and foreign country, would have to allow for the conversion. The conversion scheme would be fair and equitable to those in the organization as currently formed and would ensure that their rights would not be lost in the conversion.

The merger process established by HB 1104 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 first dissolve and re-form in the same form as the other. HB 1104 would allow for two different entities to merge so long as a conversion of the entities took place concurrent with the merger.

The conversion scheme in HB 1104 would represent a new standard for other states to follow, just as other states have increasingly adopted the limited liability company business form first developed in Texas.

HB 1104 also would implement in Texas what was proven useful in other states by conforming existing statutes to the RMBCA, the revised model act for corporations. The state's Business Corporation Act is based on the original model, and it makes sense to incorporate the suggested revisions involving shareholder agreements and derivative suit procedures.

Shareholder agreements under HB 1104 would be given broader authority to control the business of the corporation. In order to prevent conflict, however, 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 shareholders to sue the officers or directors 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 established by the board of directors to review allegations by the shareholders. These procedures would ensure quick and fair resolution of issues. A suit could be dismissed if a disinterested committee found in good faith after a reasonable inquiry that the actions of the directors or officers did not violate the interests of the corporation. Plaintiff could avoid dismissal based on the committee's recommendations if they could prove that the special committee was not independent nor disinterested or that its determination was not made in good faith.

OPPONENTS SAY:

While some flexibility in allowing businesses to change their forms of business organization may be desirable, HB 1104 would make business form conversion too easy. Business organizations are established under certain parameters that determine how that business will be taxed and the liability and responsibilities of its members. Procedures allowing organizations to change their form of operation more easily could be used strategically by a business to avoid taxes, avoid liability, or remove control from a particular member. The decision to change business form 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 allegations and create a

report, the fact that an independent, disinterested committee found no wrongdoing in and of itself should not create a presumption that there was no wrongdoing. A plaintiff would be unable to challenge such a finding, but only the impartiality of the committee or whether the determination was made in good faith.

NOTES:

The committee amendments to HB 1104 would:

- remove real estate investment trusts and non-profit corporations from the list of organizations for which a corporation must determine if it has created a deceptively similar name;
- change the minimum ownership interest necessary for a guarantee of benefit to be denominated from over 50 percent to 50 percent;
- establish a ceiling of $750 on the fees charged a foreign LLP; and
- delete provisions pertaining to the liability of corporate officers in cases of non-payment of state taxes and fees.

The companion bill, SB 555 by Sibley, passed the Senate on May 1.

A related bill, HB 1633 by Solomons, would establish the provisions relating to the registration of foreign limited liability corporations contained in this bill. HB 1633 passed the House on April 30 and has been referred to the Senate Economic Development Committee.