

- SUBJECT:** Derivative proceedings for limited partnerships
- COMMITTEE:** Judiciary and Civil Jurisprudence — committee substitute recommended
- VOTE:** 8 ayes — Leach, Farrar, Julie Johnson, Krause, Meyer, Neave, Smith, White
- 0 nays
- 1 absent — Y. Davis
- WITNESSES:** For — Michael Tankersley, Texas Business Law Foundation; (*Registered, but did not testify*: David Harrell, John Kuhl, and Chuck Mains, Texas Business Law Foundation)
- Against — (*Registered, but did not testify*: Adam Cahn, Cahnman's Musings)
- On — Briana Godbey, Texas Secretary of State
- BACKGROUND:** A derivative proceeding is a legal action brought by a business entity owner, such as a shareholder, partner, or member, on behalf of the business entity against a third party or parties. These proceedings allow shareholders, limited partners, or members of certain companies to pursue a claim in the right of the company itself and to recover damages for injuries the company suffered.
- Business Organizations Code ch. 21, subch. L governs derivative proceedings applicable to corporations; ch. 101, subch. J governs such proceedings for limited liability companies; and ch. 153, subch. I governs such proceedings for limited partnerships.
- Interested parties have suggested that the law governing derivative proceedings for different organizational types was developed from diverse sources of law, causing the current statutes to be inconsistent. In particular, provisions governing derivative proceedings for limited

partnerships differ significantly from those applicable to the other two organizational types.

DIGEST:

CSHB 3603 would modify certain aspects of derivative proceedings involving corporations, limited liability companies (LLCs), and limited partnerships (LPs).

Standing to bring proceeding. The bill would prohibit a shareholder, member, or partner from instituting a derivative proceeding against a corporation, LLC, or LP after a conversion for an act or omission that occurred prior to the date of conversion unless:

- the shareholder, member, or partner was an equity owner of the converting entity at the time of the act or omission; and
- the shareholder, member, or partner fairly and adequately represented the interest of the business in enforcing its right.

The bill also would change other criteria for determining whether a limited partner could institute or maintain a derivative proceeding to conform to criteria used for partners in LCs and shareholders of corporations under current law.

Demand. Under the bill, a plaintiff in a case involving an LP would no longer be required to file a complaint with a court showing what effort, if any, the plaintiff had made to secure initiation of the action by a general partner or the reasons for not making that effort. Instead, the limited partner would be required to file a written demand with the limited partnership stating with particularity the act, omission, or other matter that was the subject of the claim or challenge and requesting that the limited partnership take suitable action.

A limited partner could not institute a derivative proceeding until the 91st day after filing the written demand. The 90-day waiting period would not be required or would terminate if the limited partner was notified that the demand had been rejected by the LP, the limited partnership was suffering irreparable injury, or irreparable injury to the limited partnership would

result by waiting for the expiration of the waiting period.

Determination by independent persons. The bill would modify how a corporation lawfully determined how to proceed on allegations made in a demand or petition relating to a derivative proceeding. The bill would eliminate a prohibition on holding a meeting and vote to determine this in the presence of interested directors, provided that all of the independent and disinterested directors were present, regardless of whether they constituted a quorum of the board. These directors would decide the question by majority vote.

Alternatively, one or more of the independent and disinterested directors by majority vote could appoint a committee of one or more independent and disinterested directors to decide the issue. The bill would eliminate a requirement for this vote to be taken at a meeting of the board of directors.

The bill would require similar determination processes for LLCs and LPs. For an LLC, a majority of independent and disinterested governing persons could make an affirmative vote on how to proceed on allegations, regardless of whether those persons were a majority of the governing persons of the LLC. Alternatively, an appointed committee of one or more disinterested governing persons could make the determination, even if the independent and disinterested governing persons who appointed the committee were not a majority of the governing persons of the LLC.

For an LP, a determination of how to proceed would have to be made by an affirmative vote of the majority of:

- the independent and disinterested general partners of the limited partnership, whether one or more, even if the partners were not a majority of the LP's general partners;
- a committee consisting of one or more independent and disinterested individuals appointed by a majority of the independent and disinterested general partners; or
- a panel of one or more independent and disinterested individuals appointed by the court on a motion by the limited partnership.

Stay of proceeding. The bill would clarify that an initial stay of a derivative proceeding concerning a corporation or LLC could not last more than 60 days. On motion, the stay could be reviewed every 60 days for continuation if the corporation or LLC provided the court and the shareholder or member with a written statement for the status of the review and reasons why an extension for a period of not more than 60 additional days was appropriate. The court would be required to grant the extension if the court determined that the continuation was appropriate in the interests of the corporation or LLC. The court would no longer be allowed to renew such stays for an indefinite number of 60-day periods.

The bill would apply the same process for granting and extending stays of proceedings that governs derivative proceedings involving corporations and LLCs to derivative proceedings involving LPs.

Discovery. If an LP proposed to dismiss a derivative proceeding, discovery by a limited partner would be limited to:

- facts relating to whether the individual or group making a decision to dismiss the complaint were independent and disinterested;
- the good faith of the inquiry by that person or group; and
- the reasonableness of the procedures followed by the person or group in conducting the review.

A court could not expand discovery to include the subject matter of the derivative proceeding itself unless the court determined after notice and hearing that a good faith review of the allegations had not been made by an independent and disinterested person or group in accordance with the bill's requirements.

Tolling of statute of limitations. The bill would revise the period for which a written demand to a corporation, LLC, or LP would toll the statute of limitations on the derivative proceeding-related claim for which the demand was made. A demand would toll the statute of limitations for the later of either the 31st day after the expiration of any statutory waiting

period or the 31st day after the expiration of any granted stay.

Dismissal. The bill would establish requirements for dismissal of derivative proceedings concerning LPs similar to those applicable to LLCs and corporations. A court would be required to dismiss a derivative proceeding on a motion by an LP if the independent and disinterested person or group of persons responsible for determining how to proceed determined in good faith, after conducting a reasonable inquiry, that continuation of the proceeding was not in the best interests of the LP.

In determining whether a derivative proceeding should be dismissed, the burden of proof would be on the plaintiff limited partner if the LP's finding with regard to a derivative proceeding was made by qualified independent or disinterested individuals or if the decision was made by a court-appointed panel. In any other circumstance, the burden of proof would be on the LP.

The bill also would require a court to be sitting in equity as the finder of fact in order to grant a motion to dismiss by a corporation, LLC, or LP.

Discontinuance or settlement. A derivative proceeding concerning an LP could not be discontinued or settled without court approval. A court would have to direct that notice be given to the affected partners of an LP if the court determined that a proposed discontinuance or settlement would substantially affect the interests of other partners.

Payment of expenses. In derivative proceedings concerning LPs, the bill would establish certain requirements relating to the payment of attorney's fees, investigative costs, or other expenses.

Foreign entities. Certain provisions of the bill would not apply to the internal affairs of foreign corporations, LLCs, or LPs. Rather, such companies would be governed under the laws of the jurisdiction of their formation, except as provided in the bill.

Closely held companies. The bill would narrow existing procedural

exemptions for closely held corporations and LLCs, defined as those having fewer than 35 shareholders or members and not listed on a national securities exchange or regularly quoted in an over-the-counter market. Procedural exemptions for such entities would apply only to a claim against certain company members, shareholders, or office holders.

The bill would apply the same requirements to proceedings involving closely held LPs, and would allow a court to treat a derivative proceeding brought by a partner in a closely held LP as a direct action for the limited partner's own benefit. A court in this circumstance could order payment of a recovery directly to the plaintiff.

No direct cause of action. The bill would stipulate that other provisions of state law governed whether a shareholder, partner, or LLC member had a direct cause of action or right to sue a company director, officer, member, partner, or other applicable person affiliated with the company and the derivative proceeding in question. Provisions of the bill that related to closely held corporations, LLCs, or partnerships could not be construed to create a direct cause of action or right to sue.

The bill would take effect September 1, 2019, and would apply only to a derivative proceeding instituted after the effective date of the bill.