

TEXAS LLC FORMATION

TBOC PROVISIONS THAT MIGHT SURPRISE YOUR CLIENTS.

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

This quote from Peter Drucker provides an apt description of “entrepreneurship,” which more and more seems to be the thing individuals are striving to achieve. We have encountered several clients who we would describe as “idea people.” Those clients have the great idea, 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 exactly where lawyers can provide value.

Most clients we have encountered (primarily small business owners) are unaware of the need for governing documents or the existence of the Texas Business Organizations Code (TBOC). It is incumbent upon us, as their legal advisers, to discuss with those clients the need for a company agreement that clearly outlines the members’ intentions, because we know that if the company agreement doesn’t address certain matters or if there is no company agreement, the provisions of the TBOC or common law will come into play, which can greatly advantage some members and disadvantage others.

With this knowledge in mind, below is a list of TBOC provisions that our clients might find surprising and that highlight the need for discussion upon entity formation and the need for a detailed company agreement. To start, clients should understand that the company agreement governs the relationship of the members, managers, and officers of the company, and the company itself.¹ Also, clients might be surprised to know that without a company agreement, their oral statements may become binding or certain agreements may be implied by conduct.² As we all know, the best practice is to have a written company agreement that addresses the specific issues outlined below and many others.

NATURE AND ASSIGNMENT OF A MEMBERSHIP INTEREST

- a. TEX. BUS. ORGS. CODE ANN. § 101.108—A membership interest may be “wholly or partly” assigned. An assignee of a membership interest is not entitled to participate in management of the company, become a member, or otherwise act like a member.
- b. TEX. BUS. ORGS. CODE ANN. § 101.109—An assignee is entitled only to the economic rights associated with the assigned membership interest. An assignee may become a member of the company on the

approval of “all the company’s members”—a unanimous vote of the members.

- c. TEX. BUS. ORGS. CODE ANN. § 101.111—The assignor of a membership interest “continues to be a member of the company and is entitled to exercise any unassigned rights or powers of a member of the company until the assignee becomes a member of the company.”

Considering the TBOC sections covering the nature and assignment of membership interests, it is necessary to think through the conditions under which an assignment of membership interests is permissible and the effect of that assignment. We believe that the company agreement should explicitly address those conditions and the effect of any assignment, including the rights of an assignee and the vote required for an assignee to become a member (whether that is the unanimous vote of all members, all members other than the assignor, or some other voting structure). Also, consider and address how assignment of interests between members and assignment of interests held in (or assigned to) a trust will be handled.

MANAGEMENT OF THE COMPANY AND VOTING

- a. TEX. BUS. ORGS. CODE ANN. § 101.356—Consent or approval of a majority of all members is required for fundamental business transactions (*i.e.*, merger, interest exchange, conversion, sale of substantially all of the LLC’s assets) and a majority is determined on a per capita basis, *i.e.*, one member, one vote.
- b. TEX. BUS. ORGS. CODE ANN. § 101.355—The affirmative vote of the majority of governing persons, members, or committee members present at a meeting at which a quorum is present constitutes an act of the governing authority, members, or committee of the company.
- c. TEX. BUS. ORGS. CODE ANN. § 101.358—Action required or authorized to be taken at a meeting may be taken without a meeting, notice, or taking of a vote if a written consent or consents stating the action is signed by the number of persons necessary to have a minimum number of votes that would be required to take action at a meeting at which all persons entitled to vote were present.
- d. TEX. BUS. ORGS. CODE ANN. § 101.359—An action is effective if taken by the affirmative vote of those persons having not fewer than the minimum number of votes that would be necessary to take the action at a meeting at which each member or manager, as appropriate, entitled to vote on the issue is present and votes. This authorizes action to be taken by informal votes.

As the person assisting with the entity formation, it is critical that we explain to the members of the LLC that the default rules of the TBOC provide that each member’s vote is equal, regardless of the member’s ownership interest. This may come as a surprise to many members, especially those who negotiated for a larger percentage membership interest in the hopes of acquiring control over the company when it came to major decisions. Further, the TBOC recognizes that many LLCs operate informally. However, the TBOC likely provides a level of informality that is undesirable to most people. Under the informal decision-making provisions, a required number of members may assent to an action through a series of informal consents (*e.g.*, emails, texts, or phone calls). And considering the first point, the number of members needed to consent to an action may be much less than what a client had in mind. Remember that the company agreement may create multiple classes of membership interests with differing rights including voting rights, and the company agreement may contain any provisions related to the regulation and management of the LLC so long as those provisions are not inconsistent with the law.³ This gives us a good amount of flexibility when it comes to drafting provisions related to management of the company and voting procedures.

WITHDRAWAL AND EXPULSION OF A MEMBER

- a. TEX. BUS. ORGS. CODE ANN. § 101.107—A member of an LLC may not withdraw from the company and a member of an LLC may not be expelled from the company.
- b. TEX. BUS. ORGS. CODE ANN. §§ 101.052, 101.054—Members may change both of the default rules in § 101.107 within the company agreement.

We have all run into situations where a business relationship has gone south, and a member or members want to rid themselves of another member or we have a member or members that want to exit the company themselves. These situations can be even more complicated if the company agreement doesn’t provide for withdrawal or expulsion, and we are stuck with the TBOC provisions (which greatly limit our options).

If the company agreement does allow for a member to withdraw, the TBOC provides that the withdrawn member is entitled to the fair value of their interest within a reasonable time after withdrawal.⁴ The right to compensation can cause issues for the LLC if the LLC does not have the liquidity to pay the withdrawn member, especially in the context of the remaining member(s) hoping to carry on the business. As such, the company agreement should address how a member may withdraw and how the withdrawn member is to be compensated for their interest.

Of equal importance to member withdrawal is member expulsion. The members of an LLC are humans (or other entities operated by humans), and humans are prone to make mistakes or bad decisions. Those mistakes or bad decisions may or may not be directly related to the LLC and its business. It is easy to imagine actions a member could take that are related to the operation of the business that might be a breach of the company agreement or cause injury to the company, such as fraud perpetrated on the company or theft of company property. But we must also try to imagine those member actions that are unrelated to the operation of the company but that might be equally harmful to the company.

While the hope is that such provisions are never needed, spending the time to consider withdrawal and expulsion provisions when the entity is formed and the company agreement is drafted may save significant time and resources in the future.

CONCLUSION

A thorough understanding of TBOC Chapter 101 is necessary when working with members and managers of an LLC, and the provisions cited above are not an exhaustive list of those important sections to consider when drafting

a company agreement. Our goal was to point out specific, important issues that are often overlooked or not addressed in sufficient detail in many company agreements. **TBJ**

NOTES

1. See TEX. BUS. ORGS. CODE ANN. § 101.052(a)(1).
2. See TEX. BUS. ORGS. CODE ANN. § 101.001(1).
3. See TEX. BUS. ORGS. CODE ANN. § 101.052(d); § 101.104.
4. See TEX. BUS. ORGS. CODE ANN. § 101.205.



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