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Limited Liability Companies

New Business Structure Allows Flexibility

By Judon Fambrough

What offers the limited liability of both a corporation and a limited partnership, yet is neither? What allows the flow-through tax of a subchapter S corporation, yet is not bound by its restrictions? And what has the flexibility of either democratic management like a partnership or centralized authority like a corporation? The answer is one of the newest forms of business recognized in Texas—the limited liability company (LLC).

LLCs merit serious consideration for anyone forming a real estate firm or a homeowners' association. Texas was the eighth state to officially recognize LLCs when the 72nd Texas Legislature passed the Texas Limited Liability Company Act. As of August 26, 1991, a business could be created as an LLC. The 73rd legislature, however, made substantial changes—effective September 1, 1993—that are reflected in this article.

LLCs do not just happen. Like corporations and limited partnerships, LLCs are legal entities, separate and distinct from their owners. Both their legal life and identity spring from recognition by the secretary of state.

To form an LLC, the law requires one or more persons 18 years of age or older, better known as organizers, to file articles of organization (articles) with the secretary of state along with a \$200 filing fee.

Before filing the articles, the organizers must understand the enabling statute, better known as the Limited Liability Company Act.

The act requires some provisions to be placed in the articles, some in either the articles or regulations (similar to bylaws), and others entirely in the regulations.

The act also provides that the statute shall control or resolutions may be passed to govern some items not addressed in either the articles or regulations.

When given the choice, the organizers should place desired provisions in the regulations, not the articles. The regulations are not public record and are less costly and easier to change.

As a minimum, the articles must contain the:

- name of the LLC, which cannot be the same or deceptively similar to another registered LLC, a registered corporation or a registered limited partnership; it must contain the words "Limited Liability Company" or "Limited Company" or the abbreviations thereof as described in the act, depending on whether formed before September 1, 1993;

- period of duration, which may be perpetual if formed after September 1, 1993;
- address of its initial registered office for service of process and the name of its initial registered agent at that address;
- name and address of each initial manager (similar to a corporate officer) if the LLC is to be run by managers; otherwise the name and address of each initial member (similar to corporate stockholder); the articles must state whether the LLC will or will not have managers;
- purpose for which the LLC is organized, which may be broadly stated so as to engage in any lawful business or purpose and
- name and address of each organizer.

Effective September 1, 1993, professional LLCs may be created by doctors, attorneys, accountants, real estate brokers and other professionals who are required to obtain a license, permit, certification of registration or other legal authorization to render personal services. If created, the articles must also include a:

- statement that the LLC is a professional LLC and
- description of the specific kind of professional service to be rendered.

The name of a professional LLC must contain the words "Professional Limited Liability Company" or the abbreviation "P.L.L.C." or "PLLC" and any other words required by law. The professional LLC can render only one kind of professional service and the members, managers or officers must be licensed or otherwise authorized to render that service.

The regulations, similar to a corporation's bylaws, represent the internal guideline for managing the LLC. They are optional, not mandatory. The initial regulations, if any, must be adopted by either the managers or members, whichever the case.

Except as reserved to the members, LLC management is vested in one or more persons known as managers. Their role is similar to directors of a corporation. Managers need not be Texas residents nor members of the LLC unless the regulations require it. Managers are elected by the members. Each manager can receive service of process, along with the registered agent, whenever the LLC is sued.

If the organizers of the LLC opt to have managers, it is imperative to draft regulations. According to the act, the regulations, among other things, may establish the:

- number of managers, if any;
- term of the managers,
- time managers are elected (they need not be elected annually or at regularly scheduled meetings); and
- classes of managers based on election by particular groups of members.

From their ranks, managers may designate committees by resolution to conduct certain business if the regulations allow. Likewise, the managers (or members if there are no managers) may designate one or more persons to serve as officers. The officers need not be managers or members.

Ownership of an LLC is vested in its members. Members are the person or persons, similar to stockholders, who contribute cash, property, services, a promissory note

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or other obligation to pay cash or transfer property to the LLC. A certificate of membership, corresponding to a stock certificate, may be issued to evidence the member's interest.

The regulations may establish classes or groups of one or more members having certain rights, powers and duties including voting rights. Each class may have the exclusive right to elect one or more managers.

The LLC's profits and losses are apportioned among the members and among classes of members as specified in the regulations. If the regulations do not otherwise provide, the profits and losses must be allocated according to the members' current percentage or other interest in the LLC.

All officers, agents, managers and members of the LLC have authority to manage the LLC as provided in the regulations or as they determine by resolutions. According to the act, the following are **agents** of the LLC for business purposes:

- officers who are vested with actual or apparent authority,
- managers, to the extent management is vested in that manager, and
- members, to the extent management is reserved in that member.

Any act executed by an **agent** in the name of the LLC for the purpose of apparently carrying on in the usual way of business binds the LLC unless the agent lacks the authority to act for the limited liability company and the person with whom the agent dealt knew it.

As with corporations, an owner's limited liability is subject to exceptions. A member or the member's legal representative or successor is personally liable to the LLC to perform any enforceable written promise to contribute, to pay cash or to transfer property to the LLC. The

obligation for such contributions may be waived by consent of all members or by the articles or regulations.

Personal liability continues, however, even after all members have waived the obligation if a creditor has extended credit to the LLC in reasonable reliance on the member's obligation to make the contribution. In addition, a member must restore any distributions that were received when the LLC's debts exceeded its assets. However, the restoration is required only if the member knew of the deficiency at the time of distribution.

As the name indicates, LLCs afford both members and managers limited liability. The law states, "Except as and to the extent the LLC's regulations specifically provide otherwise, a member or manager is not liable for the debts, obligations or liabilities of a limited liability company including under a judgment decree, or order of a court." Nothing is said about limiting the liability of officers and agents.

A lingering question confronting both organizers and attorneys is whether the same factors that "pierce the corporate veil" can pierce the LLC veil. By implication, some attorneys believe that the act gives the impression that LLCs were meant to be equal to, but not greater than, corporations. The statutory language suggests that personal liability will be cast upon officers, agents, managers and members who act beyond the scope or purpose of the LLC's regulations, the LLC's articles or the laws of Texas (explicitly including the Texas anti-trust laws.)

Once created, an LLC appears as a closely held corporation that limits the transfer of ownership. Unless otherwise provided by the regulations, an LLC member may assign membership interest in whole or in part, but the assignment does not of itself: (1) dissolve the LLC, (2) entitle the assignee to participate in the management and affairs of the LLC or (3) enable the assignee to become or exercise any rights of a member.

The assignment does entitle the assignee to be allocated income, gain, loss, deduction, credit or similar items and to receive distributions to which the assignor was entitled. Also, the assignee may require reasonable information, require an accounting of a transaction and may make a reasonable inspection of the books and records.

Until an assignee becomes a member, the assignor continues to be the member and to have the power to exercise any rights or privileges, except those assigned. The assignee does not have, however, any membership liability.

Like corporations, LLCs may last forever. However, by law, an LLC dissolves when:

- the period specified in the articles expires,
- an event specified in the articles or regulations that can cause dissolution occurs,
- a member dies, is expelled, declares bankruptcy or otherwise ends the membership,
- the qualified number of members consent to dissolve or
- a decree of judicial dissolution is entered.

One exception exists. If one of the first three events causes the dissolution, and if at least one member remains, the LLC's business can continue by consent of the

given number of members or class stated in the articles or regulations. If none are stated, all remaining members must consent. The consent must be made within 90 days after the event occurs. If one of the first two described events causes the dissolution, an additional requirement must be met. Within three years, the LLC's articles must be amended to change the duration of the LLC or to delete the described event that would otherwise dissolve the LLC.

Probably the chief disadvantage of forming an LLC in Texas is the annual state franchise tax. The franchise tax has been billed as a partial business income tax.

Only a complete reading of the Texas Tax Code explains the tax. Briefly stated, it is calculated by

In Texas, the chief disadvantage of forming an LLC may be the annual state franchise tax.

multiplying the net taxable capital by .25 percent (step 1) and the net taxable earned surplus by 4.5 percent (step 2). The difference between the two amounts added to the dollar amount derived in step 1 equals the tax.

To give some idea of the impact of the tax, the net taxable capital is basically the net assets of the LLC. The net taxable earned surplus is basically the amount of income reported for federal income tax purpose with adjustments for compensation paid to officers and directors.

An attractive feature of Texas limited partnerships is that they are not subject to the franchise tax. However, the \$750 filing fee is much higher than the fee for LLCs. Also, the general partner of a limited partnership faces personal liability in the business venture.

According to the tax code, nonprofit homeowners' associations are exempt from the franchise tax if:

- the corporation (which includes an LLC) is organized and operated primarily to obtain, manage, construct and maintain the property in or of a condominium or residential real estate development and
- voting control of the corporation is vested in the owners of individual lots, residences or residential units and not in the developer.

Another concern is conducting business in the some 30 states that have not recognized LLCs. Can Texas LLCs conduct business in these states and maintain their limited liability? The most convincing arguments say they can. However, only time and the courts will resolve this issue.

This article mentions little about the income tax aspects of LLCs. For this information, see "Business Tax Break" by Jerrold J. Stern in the *Real Estate Center Journal*, January 1993.

LLCs offer a new and unique way to do business in Texas. They combine the limited liability aspects of a corporation with the beneficial income tax aspects of subchapter S corporations and limited partnerships. However, with the exception of qualified homeowners' associations, LLCs are plagued by the Texas franchise tax, the uncertainties caused by "piercing the corporate veil" and the status of doing business in states where LLCs are not recognized.

For more information on LLCs, see "Limited Liability Companies" in the *Texas Bar Journal*, July 1992.

This article is for information only; it is not a substitute for legal counsel. ☐

Fambrough is an attorney, member of the State Bar of Texas and a senior lecturer with the Real Estate Center at Texas A&M University.

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