

CORPORATE GOVERNANCE ALERT

NEW TEXAS BUSINESS ORGANIZATIONS CODE TO TAKE EFFECT JANUARY 1, 2006



Enacted during the Texas Legislature's 2003 regular session and refined during its 2005 regular session, the Texas Business Organizations Code has been adopted as part of an ongoing legislative mandate to reorganize all Texas statutes into centralized codes grouped by subject matter. For the most part, the Code is not intended to effect substantive changes in the Texas law governing business organizations. Instead, its stated purpose is to rearrange the disparate business statutes into a more logical order, employ a consistent format and numbering system, eliminate duplicative and ineffective provisions, and restate the law in modern American English.

STRUCTURE OF THE CODE

The Code combines the legal principles of the Texas Business Corporation Act, Non-Profit Corporation Act, Limited Liability Company Act, Revised Partnership Act, Revised Limited Partnership Act and a variety of other statutes governing lesser-known entities into a single set of rules. The Code is organized into eight titles, and each title is further organized into chapters and sections. The eight titles are as follows:

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| Title 1 | General Provisions |
| Title 2 | Corporations |
| Title 3 | Limited Liability Companies |
| Title 4 | Partnerships |
| Title 5 | Real Estate Investment Trusts |
| Title 6 | Associations |
| Title 7 | Professional Entities |
| Title 8 | Miscellaneous and Transition Provisions |

The utility of the Code comes into play in Title 1. There, a centralized set of provisions applicable to all entities (regardless of type) is found regarding the following topics:

- Definitions and Other General Provisions
- Purposes and Powers of Domestic Entity
- Formation and Governance

- Filings
- Names of Entities; Registered Agents and Registered Offices
- Meetings and Voting
- Liability
- Indemnification and Insurance
- Foreign Entities
- Mergers, Interest Exchanges, Conversions and Sales of Assets
- Winding Up and Termination of Domestic Entity
- Administrative Powers (of Secretary of State)

Thus, an entity looking to make a filing, engage in a merger, indemnify an agent or undertake any of the other enumerated transactions need look only in one place in the Code. For example, under prior law a domestic entity that desired to complete a conversion into another form of domestic entity may have had to consider at least four different statutory mechanisms concerning this process. By way of contrast, under the Code, a converting entity need only review one set of rules.

NEW TERMS OF ART

The Code's centralized approach is somewhat unique relative to other jurisdictions and necessitates a consolidated set of defined terms to facilitate cross-references among various sections of the Code. Accordingly, the Code creates an entirely new vocabulary for practitioners. A synopsis of some of the more common terms follows.

- An “entity” may either be “domestic” (i.e., formed under Texas law) or “foreign” (i.e., formed under the laws of another jurisdiction).
- A domestic entity may either be a “filing entity” (i.e., corporations, limited partnerships, limited liability companies, professional associations, professional corporations, cooperatives and real estate investment trusts) or a “non-filing entity” (i.e., general partnerships and nonprofit associations).
- Domestic and foreign entities are also characterized as conducting business “for-profit” and “nonprofit.”
- Filing entities must file a “filing instrument” with the “filing officer” (i.e., the secretary of state for all entities other than real estate investment trusts, and in the case of real estate investment trusts, the county clerk in the county in which the entity's principal office is located) as a condition of formation; non-filing entities do not.
- The most common filing instrument is the “certificate of formation,” which replaces articles of incorporation, articles of organization, certificates of limited partnership and similarly styled documents. Likewise, a “certificate of merger” replaces articles of merger, “certificate of conversion” replaces articles of conversion, “certificate of exchange” replaces articles of exchange, “certificate of amendment” replaces articles of amendment and “certificate of termination” replaces articles of dissolution and certificates of cancellation.
- A “fundamental business transaction” means a merger, interest exchange, conversion, or sale of all or substantially all of an entity's assets.
- A “governing authority” is the person or group of persons entitled to manage and direct the affairs of an entity. Examples include the board of directors of a corporation, general partner or general partners of a general or

limited partnership, and managers or managing members of a limited liability company. The term does not include an officer acting solely in that capacity. Instead, each person serving as part of a governing authority is a “governing person,” and “managerial official” means an officer or a governing person.

- “Officer,” which is used but undefined under prior law, is defined under the Code to mean any individual elected, appointed or designated as an officer of an entity by the entity’s governing authority or under its governing documents.
- “Governing documents” include an entity’s certificate of formation and other documents or agreements (such as corporate bylaws or a partnership agreement) governing an entity’s internal affairs. In the case of a limited liability company, “company agreement” replaces the term “regulations” to refer to the agreement, written or oral, of the members concerning the conduct of the entity’s business.
- “Limited liability partnerships” are no longer referred to as “registered limited liability partnerships,” the use of the term “registered” being viewed as redundant. The Code also clarifies that a limited partnership may be governed as a limited liability partnership and as such is referred to as a “limited liability limited partnership.”
- “Non-code organization” means an organization other than a domestic entity and is used primarily in the Code provisions governing mergers to address Texas banks and insurance companies (which continue to be governed primarily by the Finance Code and Insurance Code, respectively), as well as foreign organizations.
- “Organization” means a corporation, limited partnership, general partnership, limited liability company, business trust, real estate investment trust, joint venture, joint stock company, cooperative, association, bank, insurance company, credit union, savings and loan association, or other organization, regardless of whether it is for-profit or nonprofit, domestic or foreign.
- “Owner” means (1) with respect to a corporation or real estate investment trust, a shareholder, (2) with respect to a limited partnership or general partnership, a partner, (3) with respect to a limited liability company or professional association, a member and (4) with respect to all other foreign and domestic entities, an owner of an equity interest in that entity.
- “Ownership interest” means an owner’s interest in an entity, but refers only to the owner’s share of profits and losses, right to receive distributions and similar economic rights; the term does not include an owner’s right to participate in management.

As a savings provision, the Code also permits the use of the following synonymous terms:

- a reference to “articles of incorporation,” “articles of organization,” “articles of association,” “certificate of limited partnership” and “charter” includes a “certificate of formation”
- a reference to “authorized capital stock” includes “authorized shares”
- a reference to “capital stock” includes “authorized and issued shares,” “issued shares,” and “stated capital”
- a reference to a “certificate of registration,” “certificate of authority,” and “permit to do business” includes “registration”
- a reference to “stock” and “shares of stock” includes “shares”
- a reference to “stockholder” includes “shareholder”
- a reference to “no par stock” includes “shares without par value”
- a reference to “paid-up capital” includes “stated capital”

- a reference to “articles of merger” includes a “certificate of merger”
- a reference to “articles of exchange” includes a “certificate of exchange”
- a reference to “articles of conversion” includes a “certificate of conversion”
- a reference to “articles of amendment” includes a “certificate of amendment” and
- a reference to “articles of dissolution” includes a “certificate of dissolution.”

NEW SHORT TITLES

To the extent certain provisions of the Code are applicable to a particular type of entity, the Code provides for new short titles:

- Texas Corporation Law
- Texas For-Profit Corporation Law
- Texas Nonprofit Corporation Law
- Texas Limited Liability Company Law
- Texas General Partnership Law
- Texas Limited Partnership Law
- Texas Real Estate Investment Trust Law
- Texas Cooperative Association Law
- Texas Professional Entities Law
- Uniform Unincorporated Nonprofit Association Act
- Texas Professional Association Law
- Texas Professional Corporation Law
- Texas Professional Limited Liability Company Law

SIGNIFICANT DEPARTURES FROM EXISTING LAW

For the sake of brevity, a section-by-section comparison of the Code with prior law is beyond the scope of this Alert. Though the Code is generally not intended to effect substantive changes in existing law, there are nonetheless a number of areas in which the Code diverges from prior law. These differences are most pronounced with respect to filing mechanics. The Code affects most filing forms, and this Alert provides an overview of the more commonly used filing procedures.

With respect to entity formation, a filing instrument under the Code is deemed effective when the filing instrument is delivered to the secretary of state and is not dependent on the issuance of an official certificate by a filing officer. Upon receipt, the secretary of state must determine that the filing instrument conforms to applicable law and that all required fees have been paid. At that time, the secretary of state must accept the filing instrument into its filing system and send a written or electronic acknowledgment of the acceptance to the filing entity or its representative.

The Code provides for a streamlined application process for foreign entities registering in Texas to transact business. A single application for registration is now required for all foreign entities, and foreign entities are no longer required to provide a certificate of existence from their home jurisdiction as part of the application process. Also, foreign entities without counterparts under Texas law, such as business trusts and limited companies, may register in Texas as that type of entity, in contrast to prior law that required registration as an LLC if no comparable entity was authorized. The process for filing a certificate of withdrawal is also made easier.

The Code further provides for a simplified and standardized process in effecting a merger, exchange or conversion. As to filing instruments, the Code does away with the need under prior law for certain entities to attach a plan of merger, exchange or conversion, as the case may be, and eliminates the need to specify actual voting results. Shareholder dissenter rights are harmonized for corporate entities across all types of merger transactions. Moreover, multiple copies of the filing instrument need not be filed, as was required under prior law. Instead, only one copy need be filed.

As to termination procedures, the Code establishes a common form of certificate of termination for all domestic filing entities, and shortens the amount of disclosure that the entity must make. Among other things, the Code also clarifies existing law that requires a certificate of termination to be filed after expiration of an entity's stated period of duration if an entity's governing documents specify a finite existence. The Code also extends the time period to reinstate a voluntarily terminated entity from 120 days to three years under certain specified circumstances.

TRANSITION PROVISIONS

The Code applies to all domestic entities formed on or after January 1, 2006. Likewise, the Code also applies to all foreign nonfiling entities and all foreign filing entities that register with the secretary of state to transact business in Texas on or after January 1, 2006. In general, domestic entities formed before the Code's effective date and foreign filing entities that registered with the secretary of state before that date do not become subject to the Code until January 1, 2010. Therefore, the existing business organization statutes will continue to govern the internal affairs of pre-2006 entities until 2010.

Between 2006 and 2010, domestic entities formed before January 1, 2006, and foreign filing entities that registered with the secretary of state before January 1, 2006, may voluntarily elect to become subject to the Code. In the case of a domestic entity, early adoption is accomplished by filing a statement of early adoption with the secretary of state and, if need be, amending its governing documents to comply with the Code. Similarly, a foreign filing entity electing early adoption of the Code must file a statement with the secretary of state and amend its application for registration so as to comply with the Code.

On January 1, 2010, domestic and foreign filing entities subject to prior law that have not elected to be governed by the Code will automatically become subject to it. After January 1, 2010, all pre-2006 business organization statutes will be repealed except in isolated instances (e.g., certain fundamental business transactions and indemnity claims) concerning matters that straddle the January 1, 2010, date, in which case the prior law may continue to survive after 2010 until completion of the affected transaction or proceeding. After January 1, 2010, pre-2006 entities will not be considered to have failed to comply with the Code if their certificates of formation (in the case of domestic entities) and applications for registration (in the case of foreign filing entities) do not comply with the Code. However, if after January 1, 2010, a pre-2006 entity amends its certificate of formation or application for registration, as the case may be, it must conform the applicable filing instrument to the Code in situations where it is noncompliant.

The Code does not clearly state which provisions of a pre-2006 governing document must be changed in order to conform it to the Code, and the State Bar of Texas Revisor's Report on the Code is equally silent. The Code does not specify, for example, whether obsolete provisions in a pre-2006 filing instrument must be deleted from a Code-

compliant certificate of formation. Nonetheless, we believe that in most cases such deletions would not be necessary, and expect that many pre-2006 entities will not be required to amend their certificates of formation as they become Code-compliant. The Texas secretary of state has not yet released its revised filing guidelines under the Code, but as the Code's effective date approaches we anticipate that it will clarify these points.

IMPLICATIONS OF TRANSITION PROVISIONS

Pre-2006 entities that determine they would be required to amend their governing documents in connection with becoming Code-compliant should consider the contractual implications of doing so. For example, many credit agreements prohibit these kinds of amendments without consent of the lenders. In addition, the consent of stakeholders in the entity is typically required to amend the charter documents. Private equity investors often have separate voting rights with respect to charter amendments, and many partnership and joint venture agreements prohibit such an amendment without the consent of at least a majority of the entity's owners. The Code does not appear to make provision for entities that are required to amend their certificates of formation to become Code-compliant in the event owners or other third parties do not approve the necessary changes.

We recommend that pre-2006 entities begin planning for the effectiveness of the Code immediately. To the extent possible, we suggest that during the course of preparing new contracts restrictive covenants affecting entity formation or amendments to governing documents include liberal carve-outs to permit changes necessitated by the Code. Similarly, to the extent possible, governing documents prepared for pre-2006 entities should be drafted with a view toward the future effectiveness of the Code. Finally, insofar as third-party consents will be required in the future, managerial officials should begin making plans now so that necessary approvals may be sought in a manner that is most cost-effective and least disruptive to business operations.

CONTACT INFORMATION

If you have questions or would like to learn more about this topic, please contact the partner who represents you, or:

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