

- SUBJECT:** Omnibus recodification and adoption of Business Organizations Code
- COMMITTEE:** Business and Industry — favorable, without amendment
- VOTE:** 8 ayes — Giddings, Elkins, Kolkhorst, Bohac, J. Moreno, Oliveira, Solomons, Zedler
- 0 nays
- 1 absent — Martinez Fischer
- WITNESSES:** For — Daryl Robertson, Texas Business Law Foundation; Elizabeth Miller; J. Leon Lebowitz; Curtis Huff; (*Registered but did not testify:*) Bill Hammond, Texas Association of Business
- Against — None
- On — Carmen Flores, Secretary of State’s Office
- BACKGROUND:** Numerous Texas statutes govern the formation and internal management of business entities, including the Texas Business Corporation Act (TBCA), Texas Non-Profit Corporation Act (TNPCA), Texas Revised Partnership Act (TRPA), Texas Miscellaneous Corporation Laws Act (TMCLA), Texas Limited Liability Company Act (TLLCA), Texas Revised Limited Partnership Act (TRLPA), Texas Real Estate Investment Trust Act (TREITA), Texas Uniform Unincorporated Nonprofit Associations Act (TUUNAA), Texas Professional Corporation Act (TPCA), Texas Professional Associations Act (TPAA), and Cooperative Associations Act (CAA). Types of business entities include business corporations, limited liability companies, professional corporations, professional associations, real estate investment trusts, for-profit and nonprofit business development corporations, nonprofit corporations, cooperative associations, lodges, church benefit plans, general partnerships, limited partnerships, and limited liability partnerships.
- Each type of entity is governed by a primary statute, and each primary statute incorporates by reference one of the three major statutes — the TBCA, TNPCA, and TRPA — to cover gaps in the primary law. For example, a

limited partnership is governed by the TRLPA and TRPA. Thus, the statutes are intertwined, and many different types of entities are governed by similar default rules. The only stand-alone statute for business entities in Texas is the TUUNAA, which is uniform with the laws of other states.

Currently, limited liability companies (LLCs) and corporations must declare a time limit for their existence in their articles of incorporation. Articles of incorporation, the entity's formation documents, are filed with the secretary of state and address the entity's duties and powers. Most LLCs and corporations declare that their duration is "perpetual."

To form a corporation or real estate investment trust (REIT) in Texas, an entity must have at least \$1,000 in stated capital. Shareholders invest an amount in the entity when beginning the business and must state the amount in the articles of incorporation.

Current statutes contain liability provisions, some of which are specific to a particular entity, while others apply generally to all entities of that type. For example, it is a Class A misdemeanor (punishable by up to one year in jail and/or a maximum fine of \$4,000) to sign or direct the filing with the secretary of state of a filing instrument that the person knows is materially false on behalf of any entity. Under the TRLPA, a person may recover damages, court costs, and attorney's fees for loss incurred because of a forged filing instrument that is a criminal offense or that the person has relied upon. However, that statute governs only limited partnerships, and other business statutes do not address civil damages in this situation.

Cumulative voting is allowed unless specifically prohibited by articles of incorporation. Cumulative voting rights enable minority shareholders to obtain representation on a board of directors. For example, if five director positions are open, a shareholder who owns 25 percent of the shares receives one vote per share owned for each director position. If a total of 1,000 shares are outstanding, that person owns 250 shares and receives 1,250 votes. Under cumulative voting, that person may cast all 1,250 votes for one director candidate. Because directors are elected by plurality — that is, the five candidates who receive the highest number of votes are elected — the minority shareholder is guaranteed to elect at least one director, because the other

shareholders could not muster enough votes against that candidate and still elect the other four.

Shareholders have preemptive rights unless an entity expressly denies them in its articles of incorporation. Preemptive rights enable shareholders to buy shares of stock whenever the entity decides to issue more shares. Shareholders with preemptive rights may buy a pro-rata portion of the new shares according to what they already own, provided that they do so within a certain time frame. For example, if a corporation issues 1,000 new shares of stock, a shareholder who owns 25 percent of the existing shares may buy up to 250 new shares.

Foreign entities of a type that has no counterpart under Texas law, such as business trusts, must register with the secretary of state to do business in Texas. Such entities generally register as foreign LLCs. LLCs, like many corporations, are subject to the state franchise tax, but limited partnerships are not.

DIGEST:

HB 1156 would enact the Texas Business Organizations Code (TBOC), which would incorporate statutes now contained in the TBCA, TNPCA, TRPA, TMCLA, TLLCA, TRLPA, TREITA, TUUNAA, TPCA, TPAA, CAA, and other existing provisions of Texas laws governing private entities. It would repeal all of these codes as they now exist. It would not incorporate or repeal the Texas Franchise Tax Act or the Texas Securities Act. It would not apply to a sole proprietorship.

The bill would apply a “hub and spoke” structure to the code. Provisions common to all entities, such as definitions and filing procedures, would appear in the central “hub,” and the separate “spokes” would contain provisions governing specific types of entities that were not common or similar.

Title 1, the “hub,” would contain various provisions applying to all types of business organizations, including definitions, purposes and powers, formation and governance, record keeping, filing requirements, liability, and merger and termination procedures. These items now are addressed in the statutes relating to each entity type. Titles 2 through 8 would address specific types of business entities and other provisions.

Title 1 would change filing fees for certain entities. For example, it generally would increase fees for LLCs while reducing fees for limited partnerships.

New fees would apply to certain entities. For example, a foreign professional association would have to pay a registration fee of \$750, whereas no fee now exists for this type of filing.

The bill would establish electronic filing procedures and would reduce requirements for filing paper documents with the secretary of state. Entities' owners could use electronic communication methods, such as e-mail notices of meetings to shareholders. Entities also could hold electronic meetings in certain circumstances.

HB 1156 would make all domestic corporations and LLCs "perpetual" unless otherwise stated in the articles of incorporation. It would eliminate the requirement that corporations and REITs have a stated capital of \$1,000 at the time of beginning business.

The bill would change some liability provisions for entities. One change would extend the civil remedy for filing a false or misleading document with the secretary of state to include all entity types under the new code. Another change would increase the criminal penalty from a Class A misdemeanor to a state jail felony (punishable by 180 days to two years in a state jail and an optional fine of up to \$10,000) if the actor's intent was to defraud or harm another or if a person signed or directed the filing with the secretary of state of a filing instrument that the person knew was materially false.

Title 2 would govern corporations and would combine law from the TBCA, TNPCA, and TMCLA. It also would govern the formation and operating provisions for corporations created by special law, but the provisions would apply only by default or if the special statute expressly required their use.

The TBOC would reverse the default rules for statutory preemptive rights and cumulative voting rights of shareholders. It would "grandfather" both of these rights for corporations formed before the effective date of the new code, unless they were prohibited in the corporation's articles of incorporation.

Title 3 would govern LLCs. It would allow a foreign entity of a type with no counterpart in Texas to register to do business in Texas as that type of business without having to qualify to do business as an LLC.

Title 4 would govern partnerships, including general partnerships, limited partnerships, and registered limited liability partnerships (LLPs). It would incorporate portions of the TRPA and TRLPA.

Title 5 would govern REITs and would incorporate portions of TREITA.

Title 6 would incorporate the CAA and TUUNAA, governing cooperative associations and unincorporated nonprofit associations.

Title 7 would incorporate the TPAA and TPCA, governing professional associations, professional corporations, and professional LLCs.

Title 8 would contain miscellaneous and transition provisions.

This bill would take effect January 1, 2006. Entities formed on or after that date would have to comply with the TBOC, while those formed before that date could elect to be governed by the new code. However, the provisions relating to filing fees would take effect January 1, 2006, for all entities, regardless of when formed. All entities would be regulated under the TBOC as of January 1, 2010, and all current statutes that would be incorporated into the TBOC would be repealed as of that date.

**SUPPORTERS
SAY:**

HB 1156 would reorganize and reclassify the statutes relating to business organization, eliminate outdated provisions, and improve the draftsmanship of current law. It also would modernize, simplify, and standardize filings and other procedures. Although it once made sense for each type of business entity to be governed by its own statute, this is no longer the case because of the creation of many new entity types (such as LLCs, limited partnerships, and professional associations) since the enactment of the current laws and since many of these entities overlap each other.

This is the third consecutive session in which the Business and Industry Committee has considered this legislation. During each interim, diverse groups have reviewed and revised it, creating legislation that is both comprehensive and more favorable to all Texans, not simply to a particular group. The length of time over which this legislation has evolved and the lack of systematic opposition offers assurance about its quality and fairness.

The current business statutes are scattered and difficult to locate. A researcher must check several statutes to find the answer to a simple question. Putting all of the statutes in a single code would reduce greatly the confusion and time required to research the business laws. This simplified approach would make it easier for people other than lawyers to create business entities. By simplifying filing procedures, HB 1156 would reduce filing mistakes that may cause the secretary of state to reject documents. This would reduce reliance on the secretary of state's resources for help in creating new entities and would cut down on the inquiries that the secretary receives.

HB 1156 would reduce the redundancy in current statutes. For example, Title 1, Chapter 4, Subchapter A, Sec. 4.001(b) would codify in three lines a simple filing provision that is referenced in so many sections of current law that the bill requires more than a page to list all the references.

The proposed changes to business organization law are primarily technical and include minor substantive changes aimed at reorganizing, modernizing, and simplifying the law. Many of these changes address different treatment of entities in the same circumstances due to the separate evolution of statutes over time. Many provisions in the "hub" apply to all entities and exist in multiple statutes that say the same thing.

The provision in current law requiring a corporation or REIT to have a stated capital of \$1,000 at the time of beginning business is outdated. It was intended to ensure that if the entity is held liable for damages, some capital exists in the corporation from which to pay damages and to protect against inadequately capitalized corporations and REITs. It is unrealistic to expect that \$1,000 would protect adequately against undercapitalization, because buying a single computer for the corporation would meet the stated capital requirement. Also, other states do not impose this requirement, so in order to do business in Texas, a foreign entity must amend its articles of incorporation to include a minimal stated capital, even though the requirement is outdated.

It makes sense to standardize filing fees for all business entities. The proposed new fees are based on a determination of how much it costs the secretary of state to process these documents. Fees are different under current law only because they were enacted at different times. For example, LLCs, when created in the 1991 regular session, had the same fee amount as corporations because

both types of entities are subject to the franchise tax and operate in similar fashions. However, a revenue bill enacted in the second called session reduced the fee for LLCs to the current levels; HB 1156 would realign fees for LLCs with those for corporations. As both are subject to the franchise tax, both would be charged lower fees than entities not subject to the franchise tax. This makes sense because it would prevent taxing entities twice. The bill also would increase the fee for forming a professional association. That fee, which has not risen since 1983, would increase from \$200 to \$750, in line with fees for similar entities. Overall, HB 1156 would generate a modest amount of additional revenue for the state in the future.

It would be sensible and logical to allow foreign business entities to register to do business in Texas as the type of entity they represent, rather than forcing them to become a foreign LLC for purposes of doing business in Texas. This would not create a “loophole,” because an entity still would be subject to the franchise tax if the state in which it was created subjected that type of entity to the tax. This would remove a barrier to relocation in Texas, because a foreign entity would not become subject to a new set of laws.

In the past, liability provisions have been added to each statute at different times, and sometimes not at all. A person could be found criminally or civilly liable for malfeasance in relation to a particular type of entity that would extend logically to others, but because the other statutes may not provide for this, the person may not be held liable. The new TBOC would resolve this problem by extending liability, such as for falsifying filing documents, to all entity types. Adding civil liability would provide an additional deterrent to filing false documents.

The delay in the statute’s effective date would enable the Legislature to meet again in the 2005 regular session to fix any problems that might arise before the statute took effect. It also would give the secretary of state time to prepare for the changes, to revise its current information, and get the new system up and working on its website.

**OPPONENTS
SAY:**

The “hub and spoke” method of organizing a code is confusing and not very practical. One must flip back and forth between the spokes and hub, because the spokes do not contain complete lists. People may read the spokes and think

that they have covered everything and may neglect to consult the hub. This could create a trap for the unwary.

Practitioners would have a difficult time adjusting to a new code. The new format might cause people to overlook provisions that could result in detriment to their businesses. This new approach could increase confusion and could cause more reliance on the secretary of state, rather than less.

The “hub” contains too many provisions. For example, provisions relating to the winding up of entities are more entity-specific and properly belong outside of the hub. The definitions would be overly broad because they would apply to all sections of the code. The breadth of the definitions and the inclusion of elements that address many different types of entities could result in inconsistent rulings from courts, which would spur more litigation.

HB 1156 would create an additional loophole for avoiding the franchise tax. A foreign entity doing business in Texas would not have to register as a foreign LLC and thus would not be subject to the franchise tax. This would encourage businesses that incorporate in states that are favorable to big business, such as Delaware, to come to Texas, use the state’s resources, and return no money into state coffers. This loophole, like the “Delaware sub,” could cause a significant revenue problem if legislators enact HB 1156 without also changing the franchise-tax law.

**OTHER
OPPONENTS
SAY:**

Although filing a false document should be a criminal offense for any type of entity, the current penalty, a Class A misdemeanor, offers a sufficient deterrent. The bill should not enhance the penalty for this offense to a state jail felony.

NOTES:

The bill’s fiscal note projects a general revenue gain of about \$1.2 million in fiscal 2006 and of \$1.8 million in both 2007 and 2008.

Similar bills in the two previous sessions, HB 2681 by Bosse (76th Legislature) and HB 327 by Bosse (77th Legislature), were reported favorably by the House Business and Industry Committee but died in the House Calendars Committee.