HUNTON& WILLIAMS

CLIENT ALERT

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Contacts

Dallas
1445 Ross Avenue
Suite 3700
Dallas, Texas 75202-2799
(214) 979-3000

Daryl B. Robertson
(214) 468-3371
drobertson@hunton.com

L. Steven Leshin
(214) 468-3348
sleshin@hunton.com

Brian R. Marek
(214) 468-3351
bmarek@hunton.com

Mandatory Application Date Arrives for Texas Business Organizations Code

For domestic entities formed in Texas before January 1, 2006, the date has finally arrived for the automatic change in their governing statutes to the Texas Business Organizations Code (the "Code"), as a result of the repeal of the prior Texas statutes on that date and the Code's provisions governing mandatory application of the Code. Texas entities should now consider what steps should be taken to amend their governing documents to conform to the requirements of the Code and to eliminate potential issues in interpretation and operative effect of various provisions in those documents.

Automatic Application of Code to All Domestic Entities and Foreign Filing Entities

The Code's effective date was January 1, 2006.[1] Any domestic entity formed in Texas after that date has been formed under and governed by the Code.[2] Domestic entities existing before January 1, 2006, became subject to the Code on January 1, 2010, with limited exceptions, unless they elected to be governed by the Code before that date.[3] The Code also applied after January 1, 2006, to foreign filing entities that were not previously registered with the Texas Secretary of State to transact business in Texas and to all foreign non-filing entities transacting business in Texas.[4] Foreign filing entities registered with the Texas Secretary of State to transact business in Texas before January 1, 2006, became subject to the Code on January 1, 2010, with limited exceptions, unless they elected to be governed by the Code before that date.[5]

On January 1, 2010, the statutes that governed pre-2006 entities (i.e., the Texas Business Corporation Act, the Texas Nonprofit Corporation Act, the Texas Limited Liability Company Act, etc.) were repealed.[6]

Safe Harbor for Non-Complying Certificate of Formation

If the entity is a domestic filing entity, the Code provides a safe harbor by stating that the entity is not considered to have failed to comply with the Code if its certificate of formation does not comply with the Code. However, the entity must conform its certificate of formation to the requirements of the

[1] Texas Business Organizations Code §1.002(20). The Texas Business Organizations Code is cited in subsequent footnotes as "TBOC."

[2] TBOC §402.001(a).

[3] TBOC §402.005(a).

[4] TBOC §402.001(2) and (3).

[5] TBOC §402.005(a).

[6] See e.g., Texas Business Corporation Act art. 11.02.B.

Code when it next files an amendment to its certificate of formation.[7]

With respect to a foreign filing entity, the Code also provides a safe harbor by stating that the entity is not considered to have failed to comply with the Code if its application for registration does not comply with the Code. However, the foreign filing entity must conform its application for registration to the requirements of the Code when it next files an amendment to its application for registration.[8]

As a result of these safe harbors, a domestic Texas filing entity is not required to amend its certificate of formation, and a non-Texas filing entity is not required to amend its application for registration, to comply with the Code, until either files an amendment to such instrument. The valid existence of a Texas filing entity and the valid registration of a non-Texas filing entity are thus not called into question. Nevertheless, the Code does not have a comparable safe harbor for other governing documents (e.g., bylaws and partnership agreements) of domestic entities. Provisions of any other governing documents of a domestic entity that do not technically comply with the Code may raise legal and other issues that should be addressed.

Non-Compliance and Interpretation Issues

There is at least one area where most certificates of formation of pre-2006 Texas entities could be found not to comply with the Code. The Code requires a statement in a filing entity's certificate of formation of the type of filing entity that is being formed.[9] That statement was not required by prior Texas statutes. The Texas Secretary of State's office has taken a liberal position in this regard and is of the view that if this information can be gleaned from other provisions of the certificate of formation, a separate explicit statement in this regard is not required. The Secretary of State's view provides some comfort if the decision is made, in reliance on the safe harbor discussed above, to wait to amend the certificate of formation to bring it into clear conformance with the Code's requirements.

There are many differences in terminology between the prior Texas statutes and the Code. In most instances, these differences do not create interpretive issues because of the useful "synonymous terms" provisions found in Code Section 1.006. For example, Section 1.006 specifies that references in governing documents to "articles of incorporation," "articles of association," "certificate of limited partnership," "charter" and "articles of organization" include a "certificate of formation," "incorporator" includes an "organizer" and "business corporation" includes a "for-profit corporation." As a result, uses of these synonymous terms should not cause significant interpretive or non-compliance issues.

On the other hand, when not covered by the synonymous terms set forth in Section 1.006, differences in terminology may create issues as to the interpretation or operative effect of a provision. For example, the Code does not use the term "dissolution," and the term is not included in the synonymous terms addressed in Section 1.006 of the Code, because its meaning varies under the prior Texas statutes. The variation in usage of the term "dissolution" under the prior Texas statutes led the drafters of the Code to adopt the concepts of "event requiring winding up" and "termination" for the Code. The use of the word "dissolution" in the governing documents of a pre-2006 Texas entity could result in interpretive problems in connection with entity's winding up and termination. Thus, such governing documents should be carefully reviewed to determine if and how the term "dissolution" is used, and amendments should be considered to clarify the operative effect of the provisions using that term.

Other common interpretive issues arise from the frequent references in governing documents of pre-2006 entities to prior Texas statutes or particular provisions of those statutes. The Code provides that a reference **in a law** to a prior Texas statute or part of a prior Texas statute is considered a reference to the part of the Code that revises that prior Texas statute or part of the prior Texas statute,[10] but there is no explicit Code provision that deems references to a prior Texas statute **in a governing document** of a pre-2006 entity to be references to the comparable Code provisions. As a result, an operative provision in a governing document that ties the entity's purposes, indemnification or exculpation obligations or other governance issues to the prior Texas statutes may present interpretation issues as to the rights and obligations of interested parties. As to indemnification in particular, Section 402.007 specifies that Chapter 8 of the Code governs any proposed indemnification by a domestic entity after the Code became applicable to the entity **regardless** of whether the events on which the indemnification is based occurred **before or after** the Code's application to the entity. Interpretive issues may already be minimized if the governing documents were originally drafted in such a manner as to contemplate the

[7] TBOC §402.005(a)(2) and (3).

[8] TBOC §402.005(a)(2) and (4).

[9] TBOC § 3.005(a).

[10] *See* TBOC § 1.052.

Code as a successor statute in any references to the prior Texas statutes. However, that simple solution is often not the case. Absent a clear indication that a reference to a prior Texas statute in a governing document is intended to be a reference to the laws contained in that statute as it then existed (for example, "the Texas Business Corporation Act as in existence on the date of this instrument"), a reference to a prior Texas statute, in most cases, should reasonably be interpreted to be a reference to the law previously embodied in that statute, which law is now embodied in the Code. Therefore, it appears that the most reasonable interpretation of that reference should be to the corresponding laws found in the Code. Nevertheless, because of the uncertainty created, any reference to the repealed statutes should be examined to determine whether a clarifying amendment would be advisable.

Many provisions of the governing documents of pre-2006 Texas entities tend to parrot the language of the prior Texas statutes. For example, bylaws of a Texas business corporation may have tracked verbatim some of the provisions concerning indemnification from the Texas Business Corporation Act's provisions. Because the language of the Code is different in many ways from the repealed statutes, there arise issues of whether the governing document's language based on the prior statute or the different Code language should be given priority in application. As a result, the governing documents should be reviewed carefully to determine if they should be amended to conform their language to the applicable Code provisions where it is apparent that the governing documents are attempting to track a statutory provision.

Finally, there are certain substantive changes and improvements that have been made to the Code and that were not contained in the prior Texas statutes. As part of any good legal compliance program, entities should regularly review their governing documents to determine if any of these changes or improvements might be beneficial to the entity. Now would be a good time to conduct that review, especially if a review is being undertaken in connection with the switchover to the Code as the governing statute.

Some Continuing Transition Issues

Even though the prior Texas statutes have been repealed, the Code continues to provide for the applicability of those statutes in certain transition situations. These instances may create issues in the particular circumstances of any entity. For example, and most importantly, the prior Texas statutes continue to govern the acts, contracts or transactions of the domestic entity or its managerial officials, owners or members that occurred before the Code became applicable to the entity.[11] The prior Texas statutes can also apply to:

- meetings of owners, members or governing persons that were originally called for a date before the Code commenced to apply to the entity.
- mergers, conversions, interest exchanges and sales of assets if a required approval of the owners and members of the entity was given before the date that the Code began to apply to the entity or was given after that date but at a meeting of owners or members initially called for a date before such date.
- a voluntary winding up and termination proceeding initiated before the date the Code first began to apply to the entity.

Conclusion

Because of the issues that can arise if the governing documents of a Texas entity are not in compliance with the Code or if the governing documents continue to use outmoded language and concepts, entities formed in Texas before January 1, 2006, should now consider promptly reviewing their governing documents because the provisions of the Code have become applicable to such entities after January 1, 2010. If this review uncovers some issues or problems, steps should be taken to amend the governing documents to conform with the Code or otherwise to avoid unnecessary interpretive issues.

[11] TBOC §402.006.