

UNDERSTANDING CORPORATE STRUCTURES

NACM of South Texas

March Super Days
March 19, 2008

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I. Introduction

Determining whose creditworthiness legally matters is crucial to the due diligence supporting the decision to extend business credit. Life was so simple when only proprietorships, partnerships, and corporations were the available entities. But with the advent of L.P.'s, L.L.P.'s, and L.L.C.'s, a much more complex analysis became required. This presentation will explain in detail the similarities and differences distinguishing the six different forms of business organizations most frequently encountered by credit professionals, highlighting not only who will be liable for the contractual debts, but also legal devices (such as guaranties) aimed at expanding the universe of potential collection lawsuit Defendants.

In the 2003 Texas Legislative Session, the various statutes regulating the different forms of business organization were brought together and codified in a single new Texas Business Organizations Code, which is quoted liberally below to illustrate the concepts. The new Code which formally took effect January 1, 2006, is a much more logical and straightforward elucidation in modern American English than previously existed. You may want to have online searchable access to the entire Business Organizations Code, which can be found at <http://www.capitol.state.tx.us/statutes/bo.toc.htm>.

II. Forms of Business Organization: Who Is the Customer?

1. Proprietorship

A proprietorship is legally identical to its individual owner.

2. Partnership

A partnership is an association of two or more parties to operate, as co-owners, a business for profit.

§ 1.00 Definitions

- (34) “General partnership” means a partnership governed as a general partnership under Chapter 152. The term includes a limited liability partnership.

§ 152.051. Partnership Defined

- (b) Except as provided by Subsection (c) and Section 152.053(a), an association of two or more persons to carry on a business for profit as owners creates a partnership, regardless of whether:

- (1) the persons intend to create a partnership; or

- (2) the association is called a “partnership,” “joint venture,” or other name.

3. Corporation

A corporation is a creature of statute that has an independent legal existence as a person, separate and apart from its shareholders, if the requisite statutory formalities are followed.

§ 1.002 Definitions

- (14) “Corporation” means an entity governed as a corporation under Title 2 or 7. The term includes a for-profit corporation, nonprofit corporation, and professional corporation.

4. Limited Partnership

A limited partnership is a form of partnership, created by statute, which has two types of partners: general partners who have duties and liabilities similar to a general partnership, and limited partners who do not, but instead are more like shareholders of a corporation.

§ 1.002 Definitions

- (33) “General partner” means:
 - (A) each partner in a general partnership; or
 - (B) a person who is admitted to a limited partnership as a general partner in accordance with the governing documents of the limited partnership.
- (49) “Limited partner” means a person who has been admitted to a limited partnership as a limited partner as provided by:
 - (A) in the case of a domestic limited partnership, Chapter 153; or
 - (B) in the case of a foreign limited partnership, the laws of its jurisdiction of formation.

5. Limited Liability Partnership

- a. Available in Texas since 1991.
- b. With the exception of the liability limitations discussed below, an LLP is treated as a general partnership.
- c. The partnership name must reflect LLP status.
- d. The partnership must file a registration with the Secretary of State identifying the name of the partnership, the address of its principal office, the number of partners, and a brief statement of its business.

e. Under the Texas statute, \$100,000 of liability insurance must be obtained, or \$100,000 bond must be posted for satisfaction of tort liabilities.

§ 1.002 Definitions

(48) “Limited liability partnership” means a partnership governed as a limited liability partnership under Title 4.

6. Limited Liability Company

a. Available in Texas since 1991.

b. A creature of statute very similar to a limited partnership, except that an LLC need not have a general partner; all of the members of an LLC enjoy the protections of the shareholders of a corporation.

c. One or more organizers must file articles of organization with the Secretary of State, much like articles of incorporation.

d. The name of the entity must reflect LLC status.

§ 1.002 Definitions

(46) “Limited liability company” means an entity governed as a limited liability company under Title 3 or 7. The term includes a professional limited liability company.

§ 101.251. Membership

The governing authority of a limited liability company consists of:

- (1) the managers of the company, if the company’s certificate of formation states that the company will have one or more managers; or
- (2) the members of the company, if the company’s certificate of formation states that the company will not have managers.

III. Who Is The Debtor?

1. Proprietorship

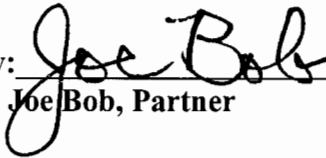
The individual proprietor is personally liable for the debts of the proprietorship.

2. Partnership

All partners in a Texas general partnership are liable jointly and severally for all debts and obligations of the partnership (including liabilities arising from harmful acts or omissions by a fellow partner).

BOB PARTNERSHIP: Joe Bob and Billy Bob

BOB PARTNERSHIP

By: 
Joe Bob, Partner

Joe Bob and Billy Bob are both debtors

§ 152.301. Partner as Agent

Each partner is an agent of the partnership for the purpose of its business.

§ 152.302. Binding Effect of Partner's Action

- (a) Unless a partner does not have authority to act for the partnership in a particular matter and the person with whom the partner is dealing knows that the partner lacks authority, an act of a partner, including the execution of an instrument in the partnership name, binds the partnership if the act is apparently for carrying on in the ordinary course:
 - (1) the partnership business; or
 - (2) business of the kind carried on by the partnership.
- (b) An act of a partner that is not apparently for carrying on in the ordinary course a business described by Subsection (a) binds the partnership only if authorized by the other partners.
- (c) A conveyance of real property by a partner on behalf of the partnership not otherwise binding on the partnership binds the partnership if the property has been conveyed by the grantee or a person claiming through the grantee to be a holder for value without knowledge that the partner exceeded that partner's authority in making the conveyance.

§ 152.303. Liability of Partnership for Conduct of Partner

- (a) A partnership is liable for loss or injury to a person, including a partner, or for a penalty caused by or incurred as a result of a wrongful act or omission or other actionable conduct of a partner acting:
 - (1) in the ordinary course of business of the partnership; or
 - (2) with the authority of the partnership.
- (b) A partnership is liable for the loss of money or property of a person who is not a partner that is:
 - (1) received in the course of the partnership's business; and
 - (2) misapplied by a partner while in the custody of the partnership.

§ 152.304. Nature of Partner's Liability

- (a) Except as provided by Subsection (b) or Section 152.801(b), all partners are liable jointly and severally for a debt or obligation of the partnership unless otherwise:
- (1) agreed by the claimant; or
 - (2) provided by law.
- (b) A person who is admitted as a partner into an existing partnership does not have personal liability under Subsection (a) for an obligation of the partnership that:
- (1) arises before the partner's admission to the partnership;
 - (2) relates to an action taken or omission occurring before the partner's admission to the partnership; or
 - (3) arises before or after the partner's admission to the partnership under a contract or commitment entered into before the partner's admission.

§ 152.305. Remedy

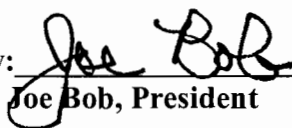
An action may be brought against a partnership and any or all of the partners in the same action or in separate actions.

3. Corporation

When a creditor elects to do business with a corporation, it is transacting with that fictional legal entity alone, and the shareholders of the corporation will not be liable for its debts.

BOB CORPORATION: Joe Bob and Billy Bob

BOB CORPORATION

By: 
Joe Bob, President

Only the corporation is a debtor

§ 21.107. Liability of Shareholder

The existence of or a performance under a shareholders' agreement authorized by this subchapter is not a ground for imposing personal liability on a shareholder for an act or obligation of the corporation by disregarding the separate existence of the corporation or otherwise, even if the agreement or a performance under the agreement:

- (1) treats the corporation as if the corporation were a partnership or in a manner that otherwise is appropriate only among partners;

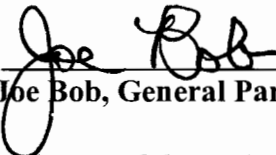
- (2) results in the corporation being considered a partnership for purposes of taxation; or
- (3) results in failure to observe the corporate formalities otherwise applicable to the matters governed by the agreement.

4. Limited Partnership

In a limited partnership, the limited partners are not personally liable for the debts of the partnership, while a general partner will be.

BOB PARTNERSHIP, LTD.:
Joe Bob, General Partner, and Billy Bob, Limited Partner

BOB PARTNERSHIP, LTD.

By: 
Joe Bob, General Partner

Joe Bob and the partnership are debtors, but Billy Bob is not

§ 153.102. Liability to Third Parties

- (a) A limited partner is not liable for the obligations of a limited partnership unless:
 - (1) the limited partner is also a general partner; or
 - (2) in addition to the exercise of the limited partner's rights and powers as a limited partner, the limited partner participates in the control of the business.
- (b) If the limited partner participates in the control of the business, the limited partner is liable only to a person who transacts business with the limited partnership reasonably believing, based on the limited partner's conduct, that the limited partner is a general partner.

§ 153.152. General Powers and Liabilities of General Partner

- (a) Except as provided by this chapter, the other limited partnership provisions, or a partnership agreement, a general partner of a limited partnership:
 - (1) has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners; and
 - (2) has the liabilities of a partner in a partnership without limited partners to the partnership and to the other partners.
- (b) Except as provided by this chapter or the other limited partnership provisions, a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners to a person other than the partnership and the other partners.

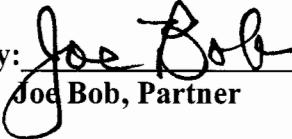
5. Limited Liability Partnership

In an LLP, the general partnership rule that all partners are liable jointly and severally for all debts and obligations of the partnership is modified to shield innocent partners from personal liability created by another partner's errors, omissions, negligence, incompetence, or malfeasance, in which they did not participate; however, with respect to contractual debts, the general partnership rule may apply in some states. In Texas, since 1997, a partner in an LLP is not individually liable for contractual debts and obligations of the partnership incurred while it is an LLP.

**LLP = Liability Like a Partnership
(in some states)**

BOB PARTNERSHIP, L.L.P.: Joe Bob and Billy Bob

BOB PARTNERSHIP, L.L.P.

By: 
Joe Bob, Partner

*Joe Bob and Billy Bob are both debtors
(in some states, but not in Texas since 1997)*

§ 152.801. Liability of Partner

- (a) Except as provided by Subsection (b), a partner in a limited liability partnership is not personally liable, directly or indirectly, by contribution, indemnity, or otherwise, for a debt or obligation of the partnership incurred while the partnership is a limited liability partnership.
- (b) A partner in a limited liability partnership is not personally liable for a debt or obligation of the partnership arising from an error, omission, negligence, incompetence, or malfeasance committed by another partner or representative of the partnership while the partnership is a limited liability partnership and in the course of the partnership business unless the first partner:
 - (1) was supervising or directing the other partner or representative when the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative;
 - (2) was directly involved in the specific activity in which the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative; or
 - (3) had notice or knowledge of the error, omission, negligence, incompetence, or malfeasance by the other partner or representative at the time of the occurrence and then failed to take reasonable action to prevent or cure the error, omission, negligence, incompetence, or malfeasance.

6. **Limited Liability Company**

All member-owners of an LLC are shielded from liability for the company's debts, just like shareholders of a corporation.

LLC = Liability Like a Corporation

BOB LIMITED LIABILITY COMPANY: Joe Bob, Member, and Billy Bob, Member

BOB LIMITED LIABILITY COMPANY

By: 
Joe Bob, Member

Only the L.L.C. is a debtor (not Joe Bob or Billy Bob)

§ 101.113. Parties to Actions

A member of a limited liability company may be named as a party in an action by or against the limited liability company only if the action is brought to enforce the member's right against or liability to the company.

§ 101.114. Liability for Obligations

Except as and to the extent the company agreement specifically provides otherwise, a member or manager is not liable for a debt, obligation, or liability of a limited liability company, including a debt, obligation, or liability under a judgment, decree, or order of a court.

IV. Who Do We Sue?

1. **True Names vs. Assumed Names**

a. Each of the above-mentioned forms of business organization will have a true legal name, but may choose to do business under an assumed name, which may or may not bear any resemblance to the true name.

b. Registration of an assumed name does not create an entity, but simply puts the world on notice of a party's decision to use a fictitious name.

c. Any entity may sue or be sued in its assumed name.

d. The entity behind the assumed name, and the parties who are debtors for that type of entity, may be sued for the debt created in the transaction.

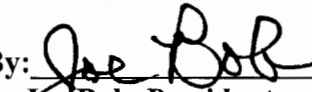
2. Undisclosed Principals

a. An undisclosed principal is liable for debts created by its agent if the agent is acting within the scope of authority, and may be liable even when the agent acts without authority if the principal retains the benefits of the transaction.

b. While the creditor may pursue undisclosed principals (and the parties who are debtors for that type of entity) for collection of debts, the putative agent may not hide behind principals who are undisclosed.

XYZ CORP. D/B/A JOE'S LIQUOR STORE

JOE'S LIQUOR STORE

By: 
Joe Bob, President

*Joe Bob can be a debtor (as well as XYZ Corp.)
because the true principal has not been disclosed*

3. Agents

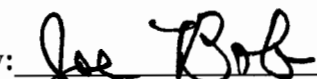
a. As a general rule, agents, or persons who with authority act for another who is their principal, are protected from personal liability for debts undertaken through their agency.

b. However, this general rule visiting liability for debts on the principal while shielding the agent, only applies (1) if the representative capacity of the agent is well documented and (2) if the true principal is well disclosed. If an agent would avoid personal liability, he has the duty to disclose not only that he is acting in a representative capacity, but also the identity of his principal; the creditor with whom the agent deals has no duty to discover the principal.

c. The same rule of personal liability will apply if the principal that is named is non-existent, such as, for example, a corporation which has lost its charter prior to the time of the transaction. An agent does not escape liability by purporting to act for a non-existent principal.

XYZ CORP. D/B/A JOE'S LIQUOR STORE

XYZ CORP.

By: 
Joe Bob, President

*Joe Bob can be a debtor if XYZ Corp. lost its
corporate charter before this contract was signed*

d. For the purpose of disclosing the true principal, it is not sufficient to protect the purported agent that an assumed name of the principal is used. It is incumbent upon the agent to protect himself by disclosing the true principal. It is not incumbent upon the creditor to research assumed name records to discover connections between names and entities.

4. **Guarantors**

a. Persons or parties who would not otherwise be liable for a primary undertaking of liability for debt, may nonetheless be made liable contractually for the debt, increasing the number of obligors. Payment guaranties, which are drawn to make the guarantor's liability coextensive with the primary obligor's, create joint and several liability.

b. Since the 1994 abolition of the Deprizio Rule in bankruptcy, there is no reason not to take as many personal guaranties as you can get.

THE DEPRIZIO RULE IS DEAD: TAKE AS MANY GUARANTIES AS YOU CAN GET!

c. Guaranties must be in writing and signed to be enforceable.

5. **Changes in Composition**

a. Each debt transaction stands on its own for purposes of establishing who has liability at that time. Liability for a given debt transaction cannot be altered after-the-fact by merely reorganizing a business. The new form of business entity can only affect liability implications of transactions going forward.

b. To protect yourself fully, you must know who your debtor is at all times. The creditor has the practical burden of maintaining such knowledge; however, as indicated above, the debtor has the legal burden associated with failing to adequately disclose the information to the creditor at any point.

c. The Texas Assumed Business or Professional Name Act (Chapter 36, Tex. Bus. & Comm. Code) requires parties doing business under assumed names to register publicly. The same statute requires new assumed name certificates to be filed when material changes in information occur, such as a change in the name, identity, entity, form of organization, or location of a registrant. Violation of this statute does not change the rules of liability for civil debt set out above, but does carry a criminal fine of up to \$2,000. Debtors would be well advised to keep their assumed name filings up to date and their creditors well informed as to their true status at all times.

V. Conclusion

As a review of the full Business Organizations Code will reveal, this is a complex area of the law, riddled with exceptions, which is continuously under scrutiny by numerous Courts seeking to apply the concepts to particular fact settings. Therefore, this educational outline should not be misconstrued as legal advice. Seek legal advice from competent counsel to address the needs of your particular problems and issues concerning the L's, P's, and C's of your real world extensions of credit.

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