LLC Bootcamp: Things You Need to Understand in Order to Write Effective Operating Agreements

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1. The Operating Agreement as a Contract

The rights of a shareholder in a corporation are dictated by the Applicable Business Corporation Act, the terms of the articles/certificate of incorporation detailing the rights of the respective classes of stock, and to the extent entered into, the buy-sale/stock restriction agreement. Compared to most other organizational forms, the corporation is substantially inflexible; customization exist only at the margins. In contrast, the limited liability company, like other unincorporated organizational forms, is exceptionally flexible. Any question as to rights or responsibilities must be made in the context of a particular operating agreement. In addition, there must be a particular examination of the Limited Liability Company Act. As compared to business corporation statutes, the various LLC acts across the state are hugely varied from one another.

As such:

- an LLC does not dissolve consequent to the death, resignation or bankruptcy of a member, unless the operating agreement says it does;

- members in an LLC enjoy limited liability from its debts and obligations, except when the operating agreements says they do not.

It is the obligation of the attorney crafting the operating agreement to address the expectations of its members and as well address those issues which are peculiar to our training such as the need for dispute resolution mechanisms and (of course) particular issues with respect to tax classification, compliance with a substantial economic effect (here assuming the LLC in question is neither a disregarded entity nor a corporation) and the partnership audit rules.

2. Who is the Client?¹

It is absolutely crucial at the outset of the relationship that there be defined who is the client. Are you, in drafting the operating agreement, working on behalf of the company, on behalf of one of the members, on behalf of a subset of the members or on behalf of all of the members? If you are representing one or more members, are you also representing the company? If the company has not yet been formed, how is it your client?

Many aspects of an LLC’s formation, as embodied in its operating agreement, constitute a zero-sum game. When rights are afforded one member or some subset of the members, corresponding rights are either taken away from the others or they are saddled with an obligation. It is only by clearly identifying who is your client that you will know whose interest you should be promoting. Just as important as is a clear and unambiguous engagement letter specifying who is the client our “I am not your lawyer” letters to the other constituents in the venture making clear you are not their attorney. Those parameters need to be reaffirmed from time to time, and

¹ See also Rutledge and Phuc Lu, No Good Deed Goes Unpunished: Pitfalls for Counsel to a Partnership About to be Governed by a New Law, 45 BRANDEIS LAW JOURNAL 755 (2007) (with Phuc H. Lu); Rutledge, When Your Client is an Organization – Some of the Problems Not Resolved by Rule 1.13, 40 NORTHERN KENTUCKY LAW REVIEW 357 (2012-13).
you, as the attorney, need to be exceptionally careful if you begin representing in any way someone to whom a “I am not your lawyer” letter was sent.

In a recent decision, *Furtado v. Oberg*, the defendant attorneys were granted summary judgment on a claim that they failed to represent the interest of the plaintiff, it being determined he was not the firm’s client. The attorney did not make it easy. Rather:

Attorney Oberg was Ms. Dreier’s long-time friend and attorney so Ms. Dreier engaged her to provide legal services in forming that limited liability company. Ms. Dreier told Mr. Furtado that Attorney Oberg intended to represent the three owners of the gym. Attorney Oberg did not supply a written engagement letter or engagement agreement to Ms. Dreier or to Mr. Furtado about her representation or the formation of the gym. Attorney Oberg never talked to Mr. Furtado about any conflict of interest issues and never asked him to sign a waiver.

She did, however, draw up an Operating Agreement (OA) governing the formation of the LLC.

Do not plan on being so lucky (if you count summary judgment as being lucky) when you fail to document your position in the relationship.

3. **LLC Formation**

The steps for the organization of most LLCs will involve two steps. On the public record, articles/certificate of organization/formation will be filed with the appropriate secretary, thereby bringing the LLC into existence either immediately upon the filing or upon the passage of an effective date and time. Many state laws provide that, by this filing, the LLC is formed.

In addition, typically the members will enter into a written operating agreement. It is not necessary that they enter into a written agreement, in which instance the default rules of the LLC Act, supplemented by any course of contract agreement, will function as the operating agreement. Of course, having the agreement in writing avoids many evidentiary questions as to what is the operating agreement. As well, many LLC Acts (although Florida does not fall into this rule) provide the default rules of the act may be amended only in a written agreement with respect to those rules, oral and commercial contract agreements are ineffective to alter the default rules. It is in drafting the operating agreement that the attorney is in a position to add value to the transaction, modifying the default rules to respond to the objectives of the participants in this particular adventure. To that end, the *Model LLC Organizational Checklist*, product of the Committee on LLCs, Partnership and Unincorporated entities of the Section of Business Law,

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3 Generally speaking, with respect to this topic see Larry E. Ribstein, Robert R. Keatinge and Thomas E. Rutledge, Ribstein & Keatinge on Limited Liability Companies, ch. 4.

4 See, e.g., Fla. Stat. § 605.0201(4).
ABA is a guide to issues that should be consider. That checklist is reproduced as Exhibit A to this outline.

4. **Funding**

   - Capital Contributions (initial)
     - Cash
     - Property
     - Services
   - Capital Contributions (ongoing)

   Issues with respect to funding an LLC can be challenging. Only the most simple ventures will involve an initial cash contribution by each of the members, and then the company will be off and running. Rather, often funding will involve periodic infusions of cash. The operating agreement will need to detail:

   - who will determine that additional capital is to be contributed;
   - what standards, if any, will be applied by those making the decision in deciding that additional capital is necessary;
   - minimum notice to the members of the need to contribute additional capital;
   - what are the consequences suffered by a member who fails to satisfy a capital contribution called; and
   - what are the additional benefits enjoyed by a member who contributes more than their pro rata portion of an additional capital contribution?\(^5\)

   Property contributions very their own particular challenges. Initially, there is the question of valuation. The member making the contribution, of course, wants to ascribe the highest possible value to the property where, however, voting and economic rights in the venture are determined in accordance with contributed capital, the balance of the members will want to

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\(^5\) Generally speaking, with respect to this topic see Larry E. Ribstein, Robert R. Keatinge and Thomas E. Rutledge, *Ribstein & Keatinge on Limited Liability Companies*, ch. 5.

\(^6\) *See also* Bradley T. Borden and Thomas E. Rutledge, *Interest Dilution and Damages as Contribution-Default Remedies in Failing LLCs and Partnerships*, *Business Law Today* (November 27, 2018).
ascribe as little value as possible to the property. In addition to value, there is the issue of making sure that the assignor has valid title to the asset being contributed to the LLC.

5. Operations

- Member versus manager managed
- Allocation of voting control
  - Members (majority, super-majority and unanimous)
  - Members (majority, disinterested majority, super-majority, disinterested super-majority, and unanimous)
  - Members versus Managers

First, it is important to understand what is meant by an LLC being “member-managed” or “manager-managed.” The labels do not entirely mean what they would indicate they mean. This distinction, which is often elected in the article/certificate of organization/formation, addresses who, ab initio, has apparent agency authority on behalf of the company. Where the LLC is a member-managed, each member has apparent agency authority to bind the LLC in its ordinary course transaction. In contrast, where the LLC is manager-managed, only those persons who are managers, and not the member or members, have apparent agency authority to bind the LLC in transactions in its ordinary course. Irrespective of this election, how the LLC makes decision as to its management and direction will be made as provided in the operating agreement. As a

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7 Note that this valuation is separate and distinct from the value ascribed to the property for purposes of the Code § 704 capital account value. As set forth in WHITMIRE, STRUCTURING AND DRAFTING PARTNERSHIP AGREEMENTS: INCLUDING LLC AGREEMENTS (3rd Ed.) ¶ 3.02[2][a]:

Non-cash property contributions present peculiar drafting and planning problems, whether the contributions are part of the entity’s initial capital or are contributed later. If property is contributed, the following information should be obtained:

1. A description of the property;
2. The agreed gross value of the property to be contributed to the contributing partner’s or LLC member’s capital account;
3. The contributing partner’s or LLC member’s tax basis in the property, which will carry over to the entity under § 723; and
4. The amount of liabilities, if any, encumbering the contributed property that will be assumed, or taken subject to, by the partnership or LLC in connection with the contribution.

8 See, e.g., Decco U.S. Post-Harvest, Inc. v. Mirtech, Inc., C.A. No. 2018-0100-J TL, 2018 WL 6264574 (Del. Ch. Nov. 28, 2018 (dissolution of an LLC was ordered where, while the company was formed to commercialize certain intellectual property, the member who purported to transfer the license for that technology in fact did not have the right to do so).

9 Generally speaking, with respect to this topic see LARRY E. RIBSTEIN, ROBERT R. KEATINGE AND THOMAS E. RUTLEDGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES, ch. 8.
useful planning vehicle, an LLC may elect to the manager-managed, thereby depriving all the members of apparent agency authority on behalf of the LLC, while not appointing any managers. In that context, all agency will need to be via grants of actual agency authority.\(^\text{10}\)

As is detailed in the LLC Organizational Checklist, it is absolutely necessary that an operating agreement clearly define the requirements for any vote/consents on matters that may need to be resolved. The provision “all decisions with respect to the business and affairs of the Company shall be resolved by a majority vote of the Managers.” both passes spellcheck and is an invitation for litigation. Does this statement: (i) vest in the Managers the authority to amend the operating agreement?; (ii) does this provision vest in the Managers the authority to determine their own compensation?; and (iii) does this provision vest in the managers the ability to approve a merger of the company?

If the company is manager-managed, and has managers with day-to-day decision-making authority, the operating agreement needs to clearly delineate as to what matters the managers control, and in contrast with issues are reserved to the members. With respect to the managers, what constitutes a conflict of interest transaction and what particular rules will apply in that context?

With respect to member votes, on what basis do members vote: in proportion to contributed capital, in proportion to capital accounts, per capita? Will the required voting threshold be a majority of a quorum, a majority of the total membership interests, a super majority or unanimity? Particularly with respect to votes requiring unanimity, and will particular members or managers be precluded from voting thereon. In one case, the operating agreement required a unanimous vote for the removal of a manager (also a member) from that position. In that case, the court held that the unanimity requirement was of the members other than the member-manager as the member-manager would never vote for their own removal, which would mean that the provision was otherwise without effect. You should not count on being so fortunate when you write an ambiguous provision.

6. **Fiduciary duties**

- Modification
- Owed by whom
- Owed to whom
- When Owed
- When waived

\(^{10}\) See generally Stephen G. Frost and Thomas E. Rutledge, *RULLCA Section 301 - The Fortunate Consequences (and Continuing Questions) of Distinguishing Apparent Agency and Decisional Authority*, 64 BUSINESS LAWYER 37 (Nov. 2008).
The following statement may be all that, with absolute certainty, can be said about fiduciary duties and LLCs:

In many LLCs, but certainly not all, certain constituents are subject to varying fiduciary obligations.

Be aware that, with respect to the modification of fiduciary duties, it is crucial that your efforts begin with an investigation of the underlying statute. LLC Acts based upon either the original or the Revised Uniform Limited Liability Company Act impose limitations on the degree to which the default fiduciary obligations may be modified, and they do not allow for elimination.\(^{11}\) In contrast, other LLC Acts, including those of Delaware and of Kentucky, permit the elimination of fiduciary duties.\(^{12}\)

Set forth as Exhibit B is an outline, written in the context of Kentucky law, of fiduciary duties, including issues incident to their modification.

7. **Transfers of Ownership**\(^{13}\)

An assignee of an LLC interest does not have a right to become a member (i.e., to enjoy management rights) in the LLC.\(^{14}\) The vesting of the management rights of membership in an assignee of an LLC interest requires the consent of the other members, and it is only subsequent to such consent that an assignee succeeds to all of the rights of the assignor member.\(^{15}\) Different statutes employ different defaults as to the requirement to admit an assignee as a member.\(^{16}\)

There is a subtle but important point as to the admission of an assignee and a member and the management rights they receive; they are not the rights formerly held by the assignor member. Upon the disassociation of the assignor member, the management rights previously enjoyed evaporated. When (if) the assignee is admitted as a member, the management rights afforded are newly created; they are not those held by the assignor. The “rights and powers” assigned to the assignee\(^{17}\) may, by coincidence, be equivalent to those afforded the assignor, or they may be different from those enjoyed by the assignor. For example, an assignor member with a 10% voting right could be succeeded by her assignee admitted as a member with a 5% voting right, the other 5% being distributed among the other members. Alternatively, the assignee, upon admission as a member, could be treated as non-voting.

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\(^{11}\) See, e.g., RULLCA § \___________________.

\(^{12}\) See DEL. CODE ANN. tit. 6 § ____; KY. REV. STAT. ANN. § 275.____; id. § 275.____.

\(^{13}\) Generally speaking, with respect to this topic see LARRY E. RIBSTEIN, ROBERT R. KEATINGE AND THOMAS E. RUTLEDGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES, ch. ___.

\(^{14}\) See, e.g., KY. REV. STAT. ANN. § 275.255(1)(c) (“An assignment of a [LLC] interest shall not ... entitle the assignee ... to become ... a member ...”).

\(^{15}\) A written operating agreement could provide that the right to participate in management is freely assignable.

\(^{16}\) Ribstein & Keatinge, § 7.4; id. Appendix 7-8.

\(^{17}\) See KY. REV. STAT. ANN. § 275.265(2).
Upon becoming a member, an assignee has the rights and powers of a member, and similarly is subject to the restrictions and liabilities of a member as determined pursuant to the articles of organization, any operating agreement and the LLC Act. If the assignor was liable to make a contribution to the LLC, the assignee member succeeds to liability on that obligation, provided the assignee had knowledge of the liability at the time of becoming a member or such obligation could be ascertained from the articles of organization or a written operating agreement. Regardless of whether the assignee becomes liable on the assignor’s obligation to make a contribution to the LLC, the assignor member remains liable to the LLC for the contribution; this rule may be amended by a written operating agreement.

Upon the admission of the assignee to membership, the assignor ceases to be a member.

This rule may be amended by a written operating agreement.

8. Creditor Rights / Charging Orders

The charging order is a remedy provided to the judgment-creditor of a member or assignee by which he or she may attach the distributions (interim and liquidating) made to a member or assignee, thereby diverting that income stream in satisfaction of the judgment. The charging order is a rather involved concept that may morph through redemption and foreclosure, the effect of which is relativistic. Charging orders present particular challenges in the context of a single-member LLC.

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19 Ky. Rev. Stat. Ann. § 275.265(2). The commentary to § 706 of the Prototype LLC Act (1992) discusses the compromise reached on the assignee’s succeeding to the assignor’s liabilities to the LLC:

It is not clear as a policy matter that the assignor’s obligations to the LLC should pass to the assignee, at least as long as the assignor remains obligated. Adding an obligor obviously benefits non-assigning members and creditors (which, in turn, may reduce the LLC’s credit costs). At the same time, transfer of obligations reduces the marketability of LLC interests. This cost may exceed the benefit to the LLC because of the assignee’s uncertainty about the extent of the assigned liabilities. Accordingly, perhaps the statute should provide that obligations are not assigned unless the parties so provide, or allow the members to contract around this consequence. At the least, as provided in this section, the statute should minimize the assignee’s risk by eliminating liability for unknown contribution obligations not reflected in the LLC’s official records.


23 In other words, the implications of a charging order - for example, the process of redemption and foreclosure - may be viewed differently depending upon whose perspective (LLC, member, assignee, or creditor) is being examined.

24 See e.g., Louis T. M. Conti, ________________; Thomas E. Rutledge, Kentucky Responds Not to Olmstead, But to the Problem of Asset Protection SMLLCs, XXVIII PuboGram 17 (April 2011) (available on SSRN, abstract 1829385); Thomas Earl Geu, Thomas E. Rutledge and John W. DeBruyn, To Be Or Not To Be Exclusive:
Essentially, the charging order is a lien attaching to any distributions that might be made to a member or assignee. The objective of the charging order is to secure the judgment-creditor’s receipt of those distributions while at the same time precluding that judgment-creditor from interfering with the activities of the LLC as a going concern. While the charging order also protects the in delectus personae rule otherwise embodied in LLC law, its sine qua non is asset partitioning and the preservation of the venture’s assets and operations. The charging order is subject to redemption prior to foreclosure, and the LLC interest to which the charging order relates is subject to foreclosure.

9. Disassociation

9.1 Disassociation - Generally

Disassociation is the label applied to the termination of the status as a member in an LLC. Disassociation of a member, unless they are the only member and a successor does not elect to become a member, does not cause the dissolution of the LLC. The effect of disassociation is that the former member becomes, to the extent not otherwise assigned, an assignee of their own limited liability company interest and has with respect thereto only the rights of an assignee.

Statutory Construction of the Charging Order In the Single Member LLC, 9 DEPAUL BUS. & COM. L.J. 83 (Fall, 2010).

25 KY. REV. STAT. ANN. § 275.260(3) (“A charging order constitutes a lien on and the right to receive distributions made with respect to the judgment-debtor’s limited liability company interest.”).

26 KY. REV. STAT. ANN. § 275.255(1)(c) (stating that “[a]n assignment of [an LLC] interest shall not dissolve the [LLC] or entitle the assignee to participate in the management and affairs of the [LLC] or to become or exercise any rights of a member other than the right to receive distributions pursuant to subsection (1)(b) of this section”).

27 KY. REV. STAT. ANN. § 275.240(1) (providing that the LLC, and not individual LLC members, has title to LLC property).


29 KY. REV. STAT. ANN. § 275.260(5).

30 KY. REV. STAT. ANN. § 275.260(4).

31 See KY. REV. STAT. ANN. § 275.280(1) (“A person shall disassociate from and cease to be a member of a limited liability company upon the occurrence of one (1) or more of the following events”). See also id. § 275.180(4) (“Upon the effective date of the resignation, the resigning member shall be dissociated from and cease to be a member of the limited liability company and shall be with respect to the resigning member’s limited liability company interest an assignee thereof.”)

32 See also KY. REV. STAT. ANN. § 275.255(1)(c); id. § 275.285(4). This treatment is a significant change in the LLC Act as contrasted with the treatment under the original 1994 Act, whereunder a dissociation effected (unless waived) the LLC’s dissolution.

33 See KY. REV. STAT. ANN. § 275.280(5).

34 See KY. REV. STAT. ANN. § 275.255(1)(b); id. § 275.255(1)(c).
The statute lists a variety of events upon which a member is disassociated; each deserves particular attention.

9.2 Voluntary Resignation.

A member is disassociated upon a permitted voluntary resignation from the LLC. This provision is effective if and only if the member is permitted to withdraw; by default under the Act, the right to withdraw is restricted to member-managed companies. If the right to withdraw has been either expanded or restricted in the operating agreement, this provision applies to the extent of that private ordering. This provision does not of itself create a right of resignation. Upon resignation the former member becomes an assignee of their own interest in the LLC, and there is no right to a liquidating distribution.

9.3 Admission of the Member’s Assignee as a Member.

Assignment of the economic rights of membership does not, of itself, terminate the assignor’s position as a member of the LLC. If, however, the assignee is admitted as a member in the LLC, that admission has the effect of disassociating the assignor. If the operating agreement provides that assignment of all (or substantially all) interests in the LLC has the effect of disassociating the assignor, this provision lacks application.

The statute contains a latent lacuna in that it contemplates only a single assignee. If a member assigns the economic rights in the LLC by dividing them between two assignees, it is possible one will be admitted as a member and the other will not. The statute does not address that eventuality.

The requirements for admission of an assignee into membership are set forth in KRS § 275.265.

35 See KY. REV. STAT. ANN § 275.280(1)(a) (“Subject to the provisions of subsection (3) of this section, the member withdraws by voluntary act from the limited liability company.”)

36 See KY. REV. STAT. ANN. § 275.280(3) (“Unless otherwise provided in a written operating agreement: (a) in a member-managed limited liability company a member may resign from a limited liability company upon thirty (30) days’ prior written notice to the limited liability company; and (b) in a manager-managed limited liability company, a member may not resign without the consent of all other members.”). See also Rutledge, The 2010 Amendments to Kentucky’s Business Entity Laws, 38 NORTHERN KENTUCKY LAW REVIEW 383, 399-403 (2011).

37 See KY. REV. STAT. ANN. § 275.280(4) (“Upon the effective date of the resignation, the resigning member shall be dissociated from and cease to be a member of the limited liability company and shall be with respect to the resigning member’s limited liability company interest an assignee thereof.”); id. § 275.280(5) (“The successor-in-interest of a disassociated member shall be an assignee.”); id. § 275.280(6) (“Except as set forth in a written operating agreement, the dissociation of a member does not entitle the former member or any assignee thereof to any distribution.”).

38 See KY. REV. STAT. ANN. § 275.255(1)(d) (“Until the assignee of a limited liability company interest becomes a member pursuant to KRS 275.265(1), the assignor shall continue to be a member and to have the power to exercise any rights of a member, subject to the members’ right to remove the assignor pursuant to KRS 275.280(1)(c)2.”).

39 See KY. REV. STAT. ANN. § 275.280(1)(b) (“The member ceases to be a member of the limited liability company as provided in KRS 275.265”).
9.4 Removed as a Member.

Initially, a written operating agreement may provide that a member is disassociated upon whatever terms are set forth in the agreement. If an event so defined comes to pass, the member is disassociated.

Assuming the LLC had at least two members, if (i) a member assigns all of his/her/its interest in the LLC and (ii) a majority-in-interest of the other members consent, the assigning member is disassociated. Note that this is a two-step process; assignment of all interests in the LLC without more does not effect disassociation.

A different rule is provided with respect to what is a single member LLC. As noted above, in a multiple member LLC, disassociation is effective upon assignment of all interest in the company if and only if a majority-in-interest of the other members (i.e., those who have not assigned their interest in the LLC) approved that transaction. With respect to a single member LLC, the “other members” is a null set. In that circumstance, no consent is required, and the unilateral assignment of all interest in the company automatically effects the assignor’s disassociation. The fourth component of the statute; namely “upon resignation as a member,” is something of an artifact of the original statute; this provision should be understood to be superseded by KRS § 275.280(1)(a). Again, this provision does not create a substantive right to withdraw, but merely defines the effect of a permitted withdrawal.

9.5 Bankruptcy.

The LLC Act provides that unless waived by a majority-in-interest of the other members or in a written operating agreement, the financial reorganization of a member, including pursuant to the bankruptcy code, effects that member’s disassociation from the LLC.

Both in Kentucky and nationwide, there is almost no judicial attention to these provisions except in the context of bankruptcy. There the treatment is unsettled, but the trend is that bankruptcy does not effect disassociation.

In the context of a single-member LLC, the courts have held that the bankruptcy estate include the right to manage the LLC. As such, the bankruptcy estate is not treated as a mere

40 See KY. REV. STAT. ANN. § 275.255(1)(c)1; see also id. § 275.003(1).
41 The consent to the assigning member’s disassociation must be in writing.
42 See KY. REV. STAT. ANN. § 275.255(1)(c)2.
43 The consent is to the dissoociation, not to the assignment.
44 See KY. REV. STAT. ANN. § 275.255(1)(c)3.
45 See KY. REV. STAT. ANN. § 275.255(1)(c)4.
46 This provision was deleted in 2017. See 2017 Ky. Acts, ch. 193, § 14; see also Rutledge, The 2017 Amendments to Kentucky’s Business Entity Statutes, 56 LOUISVILLE L. REV. 55 (Fall 2017).
47 See KY. REV. STAT. ANN. § 275.280(1)(e); id. § 275.280(1)(e).
assignee of the former member. In the context of a multiple-member LLC, the courts generally reject the notion that the estate holds only the economic rights of membership without management rights. Rather, the ipso facto clause of the bankruptcy code preserve those rights.\(^{49}\)

The commencement of a bankruptcy proceeding creates an estate comprised of all legal and equitable interests of the debtor in property as of the commencement of the case\(^ {50}\) as well as other properties. That estate is then managed for the benefit of the bankrupt’s creditors. The Bankruptcy Code disfavors statutory and contractual provisions triggered by the bankruptcy filing - such provisions punish the debtor and make it more difficult to satisfy the creditors. The Bankruptcy Code § 541(c)(1) expresses this disfavor by precluding so called “ipso facto” clauses: clauses triggered by the bankruptcy limiting the prospective value of the debtor’s interest in property.\(^ {51}\) Bankruptcy Code § 365(b)(2) also addresses ipso facto provisions\(^ {52}\) and

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\(^{50}\) Bankr. Code § 541(a)(1).

\(^{51}\) Bankr. Code § 541(c)(1) provides:

Except as provided in paragraph (2) of this subsection [dealing with interests in a trust], an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law --

(A) that restricts or conditions transfer of such interest by the debtor; or

(B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor’s interest in property.

\(^{52}\) Bankr. Code § 365(b)(2) provides:

Paragraph (1) of this subsection [dealing with cure of defaults and adequate assurances of performance] does not apply to a default that is a breach of a provision relating to --

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title;

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement; or

(D) the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.
addresses the cause of defaults in and the ability of a trustee to assume an “executory agreement.”

A crucial provision is Bankruptcy Code § 365(c)(1)(A), which allows the other contracting parties to reject any effort by the trustee to assume a contract of the debtor. For this blocking right to exist, the contract must be “executory” and applicable law must allow the other parties to reject performance by anyone but the original party, now the debtor.

The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if --

(1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such other party does not consent to such assumption or assignment.

Bankr. Code § 365(b)(1) provides:

If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee --

(A) cures, or provide adequate assurance that the trustee will promptly cure, such default;

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

(C) provides adequate assurance of future performance under such contract or lease.


(e)(1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on --

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

(2) Paragraph 1 of this subsection does not apply to an executory contractor or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if --

(A)(i) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such
These provisions provide, *inter alia*, that notwithstanding Bankruptcy Code § 541(a)(1), an agreement cannot be assumed by the trustee or assigned by the estate to a third party where the agreement is executory and applicable law allows the other parties to the agreement to refuse to accept performance from anyone but the original party.

The executory nature of the operating agreement was the crux of the matter in *Ehmann*. Before turning to *Ehmann*, however, it is worth reviewing the case law on the executory contract issue as it has developed to date. *In the Matter of Daugherty Construction, Inc.*55 was the first published ruling to examine the bankruptcy of an LLC member and the member’s continuing relationship with the LLC. Daugherty was the general contractor on the LLC’s projects and its capital contribution was in the form of general contractor services. The court, relying on the *Cardinal* line of cases,56 held that the operating agreements in the case were executory contracts that could be assumed by the debtor in possession under Bankr. Code § 365. Further, it held that Bankr. Code § 365(e) prevented the termination or modification of the operating agreements any time after the commencement of the bankruptcy despite the existence of a provision specifically dealing with the insolvency or bankruptcy of members.

The opposite conclusion was reached in *Broyhill v. DeLuca (In re DeLuca)*57 an operating agreement was held to be executory and not assumable. In that instance the debtors, Robert and Marilyn DeLuca, were the managing members of the LLC. The operating agreement was determined to be executory because it required continuing personal services by the DeLucas and, thus, were executory under Bankr. Code §§ 365(c) and 365(e)(2).58 Ergo, the bankruptcy trustee could not substitute himself for the DeLucas as managing members over the objection of the other members.59

Reaching a different conclusion than the *DeLuca* rulings was *In re Garrison-Ashburn, L.C.*60 Therein a member of a Virginia LLC filed bankruptcy, and the court concluded that the LLC operating agreement was not an executory contract; and, thus, the trustee could not enforce provisions of Bankr. Code § 365(c) and (e) which prevent the enforcement of certain ipso facto clauses. The court explained the history of and reasons for post “Check the Box” amendments to the Virginia LLC Act that eliminated reference to events that would automatically dissolve an

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58 *Id.* at 75.
59 *Id.* at 78.
LLC. Pursuant to the amendments, events that formerly triggered dissolution of the entity became events of disassociate of a member from the entity. Under the amended statute, bankruptcy of a member results in disassociate, and the dissociated member stands in the same relationship to the LLC as an assignee of a membership interest. The court distinguished the *Broyhill v. DeLuca* case as having been decided prior to the “Check the Box” regulations and complimentary changes to the Virginia statute. The *Garrison* court pointed out that its case did not involve an entity whose organic documents or enabling statute dissolved the LLC in the event of the member’s bankruptcy and the operating agreement merely provided for the management structure of the LLC. It imposed no additional duties or responsibilities on members and permitted a member to resign from all management functions at any time without breaching the agreement. The court stated that such a person would stand in an analogous position to the LLC as a shareholder to a corporation. Under these circumstances, the court said the operating agreement was not an executory contract.

Bringing us to the *Ehmann* decision. Gregory Ehmann, a member of Fiesta Investments, LLC, was in a chapter 7 bankruptcy. His trustee in bankruptcy filed suit against Fiesta, an Arizona limited liability company seeking: (i) a declaration that as trustee he had succeeded to all rights of Ehmann as a member of the LLC; (ii) a determination that the assets of the LLC were being wasted, misapplied, or diverted; and (iii) an order for the dissolution/liquidation of or the appointment of a receiver for Fiesta. In response, Fiesta argued that that the trustee had only the rights of a transferee, namely the “right to receive a distribution that might have been made to the Debtor if and when [the LLC] decides to make such a distribution.” It is important to note that this decision was rendered in response to a motion to dismiss, and as such examined whether the trustee could prove any set of facts that would entitle the trustee to some remedy.

Fiesta had been organized by Ehmann’s parents for estate planning purposes to “remove assets from our estate for estate planning purposes, and to accumulate investments for the benefit of our children after our deaths,” and it appears that its only assets were interests in other operating businesses. One of those businesses was liquidated resulting in a cash distribution to Fiesta shortly after Ehmann’s bankruptcy was filed. The opinion is not entirely clear as to whether Fiesta was a member- or a manager-managed LLC because Ehmann’s father was alternatively described as the “managing member” and as the “manager.” As recited by the court, while no distributions had been made to the members as such, funds had been disbursed by the LLC in the form of loans to members or corporations controlled by members, a payment to one member whose application is not described, and a redemption of another member’s interest for $124,000.

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61 Id. at 704.
62 Id. at 708.
63 Id.
64 *Ehmann*, 2005 WL 78921 at *1.
65 Id.
66 Id.
67 Id.
The operating agreement provided that in the event a trustee in bankruptcy acquired a member’s interest, “any such assignee [would not be entitled] to participate in the management of the business and affairs of the company or to exercise the right of a member unless such assignee is admitted as a Member.”66 Fiesta argued that these limitations on the rights of a transferee are authorized by the Arizona LLC Act,69 that the trustee was a mere assignee and not a member, and posited, but in the court’s view did not argue well,70 that the operating agreement was an executory agreement containing transfer restrictions effective under Bankr. Code § 365. The trustee argued that, under Bankr. Code §§ 541(a) and (c)(1), he succeeded to all of Ehmann’s rights as a member free and clear of “certain conditions and restrictions that would otherwise devalue the assets in the hands of any other assignee.”71

The Ehmann court analyzed the operating agreement to determine if it was executory. If executory, Bankr. Code § 365 would apply and the “conditions and restrictions that would devalue the asset” would be inapplicable. If not executory, Bankr. Code § 541 would apply and those conditions and restrictions would be ignored. Applying the “Countryman Test”72 to determine whether the operating agreement contained bi-lateral, as contrasted with merely unilateral, continuing obligations, the court decided that while the LLC owed a number of obligations to members like Ehmann, the individual members owed no duties to the LLC or to the other members. Consequently, the operating agreement was determined not to be executory, and Bankr. Code § 365 was held not to be at issue.73 Then the court determined:

Code § 541(c)(1) expressly provides that an interest of the debtor becomes property of the estate notwithstanding any agreement of applicable law that would

66 Id. at *2. The operating agreement provided as well that “Such an assignee that has not become a Member is only entitled to receive to the extent assigned the share of distributions … to which such Member would otherwise be entitled with respect to the assigned interest.” While not recited in the opinion, counsel to Ehmann advised the author that the Trustee had sought the consent of the other members to the Trustee’s admission as a member, and consent was denied.

69 Id. at *2, citing ARIZ. REV. STAT. § 29-732(A).

70 “Nowhere, however, does Fiesta ever establish, much less even attempt to demonstrate, that the Trustee’s complaint seeks to enforce rights under an executory agreement.” Id. at *2. “[I]n its briefing on the motion to dismiss Fiesta has not attempted to demonstrate that the Operating Agreement is in fact an executory agreement, much less to demonstrate exactly what material obligation is owed to the company by its members.” Id. at *3. In fairness to Fiesta’s counsel, it should be noted that the trustee’s Response to Motion to Dismiss did not argue that the operating agreement was not an executory agreement.

71 Id. at *2.

72 “A contract is executory if ‘the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other.,’” citing Unsecured Creditors’ Comm. v. Southmark Corp. (In re Robert L. Helms Constr. And Dev. Co., Inc.), 139 F.3d 702 at 705 (9th Cir. 1998). The “Countryman Test” is derived from the work of Professor Vern Countryman as set forth in Executory Contracts in Bankruptcy, 57 MINN. L. REV. 439 (1973). See also 2 KING, COLLIER ON BANKRUPTCY, ¶ 365.02, note 3 (15th Ed.).

73 Ehmann, 2005 WL 78921 at *4 (“Because there are no obligations imposed on members that bear on the rights the Trustee seeks to assert here, the Trustee’s rights are not controlled by the law of executory contracts and Bankr. Code § 365. Consequently the Trustee’s rights are controlled by the more general provision governing property of the estate, which is Bankr. Code § 541.”)
otherwise restrict or condition transfer of such interest of the debtor. All of the
limitations in the Operating Agreement, and all of the provisions of Arizona law
on which Fiesta relies, constitute conditions and restrictions upon the member’s
transfer of his interest. Code § 541(c)(1) renders those restrictions inapplicable.
This necessarily implies the Trustee has all the rights and powers with respect to
Fiesta that the Debtor held as of the commencement of the case.74

While this case was decided on a motion to dismiss, it appears that a dispositive question,
and in the abstract as applied to general business entity law the most important question, has
been answered; namely, whether the trustee should be admitted as a member of Fiesta and
permitted to pursue the substantive rights of a member. The opinion then recites that the trustee
might be entitled to some remedy including:

[A] declaration of the Trustee’s rights, redemption of the Debtor’s interest,
appointment of a receiver to operate the partnership in accordance with its
purposes and the members’ rights, or dissolution, wind (sic) up and liquidation.75

9.6 Death or Incompetency.

The death or determination of the incompetency of a member effects disassociation.76
Either of these events may be waived by a majority-in-interest of the other members.77 This
express right of waiver is somewhat confusing. If death is waived as an event of disassociation,
what is the consequence? Is the decedent still a member whose rights as a member may be
exercised by the estate? But the estate is clearly an assignee; is the waiver of disassociation by
reason of death the equivalent of the admission of the estate as a member? Does the waiver need
to satisfy the otherwise applicable statutory requirements in order to effect the admission of the
estate as a member?78

As to an incompetent member, a waiver of disassociation has the same problems. Is the
waiver of disassociation to have the effect that the guardian or conservator has the ability to
participate in the LLC’s management, exercising the voting rights otherwise enjoyed by the
member?79

74 Id. at *5.
75 Id.
76 See KY. REV. STAT. ANN. § 275.255(1)(f).
77 See KY. REV. STAT. ANN. § 275.280(1)(f) (“Unless otherwise provided in a written operating agreement or by
written consent of a majority-in-interest of the members remaining at the time”).
78 See KY. REV. STAT. ANN. § 275.265(1) (“Until the assignee of a limited liability company interest becomes a
member pursuant to KRS 275.265(1), the assignor shall continue to be a member and to have the power to exercise
any rights of a member, subject to the members’ right to remove the assignor pursuant to KRS 275.280(1)(c)2.”).
79 See also Rutledge, Adding Insult to Death, __ J. PASSTHROUGH ENTITIES __ (2019) (forthcoming).
9.7 Termination of a Trust.

If a trust is a member of the LLC, the termination of the trust will effect the trust's disassociation from the LLC. In consequence thereof, the beneficiaries of the trust to whom, presumably, its net assets have been distributed will not enjoy the status as members. Rather, each will be an assignee of the assigned proportionate economic interest in the company.

The disassociation of the trust upon termination may be waived by majority-in-interest of the other members. However, how this would operate in is unclear. As to the terminated trust, what would be the effect of a waiver of the disassociation?; irrespective of any action by the remaining members, there is no trust that could continue as a member. Alternatively, would the waiver of the trust’s disassociation be treated as the admission of the beneficiaries as members into the LLC? In light of the use of trust as vehicles to hold interest in LLCs, often for estate planning purposes, particular attention needs to be given to these concerns.

9.8 Dissolution of an LLC Member.

If another LLC is a member of an LLC, the dissolution of the other LLC and the commencement of its winding up effects its disassociation. As with most of the other provisions of this section of the LLC act, the disassociation may be waived by a majority-in-interest of the other members. It is important to note that mere dissolution is not enough to effect disassociation; rather, dissolution of the LLC, combined with the commencement of its winding up, is required.

As has elsewise been the case, what is the effect of a waiver of the disassociation is unclear. As to the dissolved and wound up LLC, what would be effect of a waiver of the disassociation; irrespective of any action by the remaining members, there is no other LLC that could continue as a member. Alternatively, would the waiver of the LLC’s disassociation be treated as the admission of the dissolved LLC’s members into the LLC.

9.9 Dissolution of a Corporate Member.

If a corporation is a member of an LLC, the dissolution of the corporation effects its disassociation. As with most of the other provisions of this section of the LLC Act, the disassociation may be waived by a majority-in-interest of the other members. It is important to contrast this provision with that applied to other LLCs that are members. With another LLC, mere dissolution is not enough to effect disassociation; rather, dissolution of the LLC, combined with the commencement of its winding up, is required. In the case of a corporation, commencement of liquidation is not a condition precedent to disassociation. Assuming the

80 See KY. REV. STAT. ANN. § 275.280(1)(g).
81 See KY. REV. STAT. ANN. § 275.255(5).
82 Id.
83 See KY. REV. STAT. ANN. § 275.255(1)(h).
84 See KY. REV. STAT. ANN. § 275.255(1)(i).
ninety-day period has transpired, a corporation’s dissolution effects the disassociation even if winding up is never commenced. For example, if a corporation is administratively dissolved, and that dissolution is not cured within 90 days but is thereafter cured (the effect of that cure being retroactive), the corporation is still disassociated from the LLC notwithstanding the reinstatement. The reinstated corporation will be its own assignee.

9.10 Termination of an Estate Member.

If an estate is a member of the LLC, the termination of the estate will effect the estate’s disassociate from the LLC. In consequence thereof, the beneficiaries of the estate to whom, presumably, its net assets have been distributed will not enjoy the status as members. Rather, each will be an assignee of the assigned proportionate economic interest in the company.

The disassociate of the estate upon termination may be waived by majority-in-interest of the other members. However, how this would operate in is unclear. As to the terminated estate, what would be the effect of a waiver of the disassociate?; irrespective of any action by the remaining members, there is no estate that could continue as a member. Alternatively, would the waiver of the estate’s disassociation be treated as the admission of the beneficiaries as members into the LLC?

9.11 Other Events Defined in the Operating Agreement.

The operating agreement may define either events that will effect a member’s disassociation. Examples of the application of this provision include:

- disassociation of an attorney from a law firm PLLC upon being disbarred;
- disassociation of an accountant from an accounting firm PLLC upon losing the license to practice accounting; and

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87 See also CF SBC Pledgor 1 2012-1 Trust v. Clark/School, LLC, 78 N.E.3d 381 (Ill. App. 4th Dist. 2016) (notwithstanding subsequent reinstatement, where LLC was administratively dissolved, loan default triggered by dissolution was effective notwithstanding subsequent reinstatement). See also Bender and Frost, Illinois Courts Have Difficulty with the Effect of Dissolution on an LLC’s Existence, J. PASSTHROUGH ENTITIES, May-June 2017, 19.
91 Id.
• disassociation of a member who is convicted of a DUI from an LLC that holds a liquor license.

9.12 Judicial Expulsion

Many LLC Acts provide a mechanism for the judicial expulsion of a member.\(^\text{93}\) Rather, expulsion of a member could be effected if and only if provided for in a written operating agreement.\(^\text{94}\) Absent the foresight to include a provision in the operating agreement, there was no right to effect a member’s expulsion from the LLC.\(^\text{95}\) A typical expulsion requires a showing that the member:

(a) has engaged, or is engaging, in wrongful conduct that has adversely and materially affected, or will adversely and materially affect, the company’s activities;

(b) has willfully or persistently committed, or is willfully and persistently committing, a material breach of the operating agreement or the person’s duties or obligations under KRS 275.170; [or]

(c) has engaged or is engaging in conduct relating to the company’s activities which makes it not reasonably practicable to carry on the activities with the person as a member.\(^\text{96}\)

In addition, and departing from RULLCA, the operating agreement may if in writing provide additional standards for judicial expulsion.\(^\text{97}\) While this provision is complimentary of the already existing law that a written operating agreement may provide for events upon which a

\(^{93}\) See, e.g., REV. PROTOTYPE LLC ACT §§ 602(e)(1)-(3), 67 BUS. LAW. 117 at 170 (Nov. 2011); REV. UNIF. LTD. LIAB. CO. ACT § 602(5), 6B U.L.A. 502 (2008); TENN. CODE § 48-249-503(a)(6).

\(^{94}\) See e.g., Page v. ADS Investments, LLC, C.A. No. NM-2006-0334 (R.I. Superior Ct. Aug 5, 2014) (“absent a provision in an operating agreement allowing for the involuntary removal of members, the parties seeking removal are left to the default rules [of the LLC Act].”); Man Choi Chiu v. Chiu, 896 NYS2d 131, 132 (Sup. Ct. App. Div. 2 2010) (provision of LLC Act addressing expulsion of a member only indicated that operating agreement could provide for expulsion; absent having done so there is no right to expel a member); Brazil v. Rickerson, 268 F. Supp.2d 1091, 1099 (Mo. D.C. 2003); David Mortuary, LLC v. David, 194 So.3d 826, 830 (La. Ct. App. 3rd Cir. 2016) (“While Louisiana law does not include a provision allowing members to expel another member, members of a limited liability company can alleviate this problem by including relevant provisions in its articles of organization or an operating agreement. Absent a contractual basis for doing so, a member of a limited liability company may not be expelled.”); Rutledge, It’s Not Me, It’s You – Planning for Expulsion of Members from LLCs, 19 J. PASSTHROUGH ENTITIES 43 (July/Aug. 2016).

\(^{95}\) See, e.g., Page v. ADS Investments, LLC, C.A. No. NM-2006-0334 (R.I. Superior Ct. Aug 5, 2014) (“absent a provision in an operating agreement allowing for the involuntary removal of members, the parties seeking removal are left to the default rules [of the LLC Act].”);

\(^{96}\) Statutory rights of expulsion, on limited bases, exist in the partnership and limited partnership acts. See KY. REV. STAT. ANN. § 362.1-601(4)(a) (“The partner's expulsion by the unanimous vote of the other partners if: (a) It is unlawful to carry on the partnership business with that partner;”); id. § 362.2-601(2)(d)(1) (“It is unlawful to carry on the limited partnership's activities with that person as a limited partner”). Under the Uniform Partnership Act, upon similar circumstances, the partnership itself dissolved. See id. § 362.300(3).

\(^{97}\) Compare with REV. UNIF. LTD. LIAB. CO. ACT § 602(5).

member will be disassociated, it is not duplicative. The new provision provides for judicial supervision of and concurrence to give final effect to expulsion. The previously existing provision is self-effectuating. In the drafting of an operating agreement, persons may be more comfortable accepting expulsion provisions that contemplate judicial supervision rather than an equivalent standard that gives rise only to an action for breach of the operating agreement.

Examples of the application of those standards include *IE Test LLC v. Carroll*, *Medical College of Aruba* and *Kenny v. Fulton Associates, LLC*.

The statute is silent and indeed is agnostic as to the manner in which judicial intervention will be sought. For example, the LLC could expel a member and coincident with doing so bring a declaratory judgment action seeking confirmation that the expulsion was justified. Alternatively, a company could expel a member and then the expelled member could initiate an action against the LLC seeking a determination that the expulsion was invalid on the basis that the standards were not satisfied.

Going forward, operating agreements should provide for who in the LLC may cause it to effect a judicial expulsion. If no provision is made, presumably the general default will apply, but if the approach selected is to expel and then seek a declaratory judgment on to the expulsion, compliance with the provision governing suit brought on behalf of the LLC may be applicable. The merits of the latter, at least from the perspective of those seeking to effect the expulsion, is that it is arguably a disinterested vote; the member being expelled does not participate therein.

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98 See Ky. Rev. Stat. Ann. § 275.280(1)(c)1 (“In accordance with a written operating agreement”).

99 *IE Test LLC v. Carroll*, 140 A.3d 1268 (N.J. 2016). In this instance, involving a three member LLC, two of the members asserted that the third, Carroll, was acting in opposition to the best interests of the LLC and, on that basis, sought his expulsion by judicial order. The New Jersey Supreme Court, reversing both the trial court and the intermediate appellate division, held that Carroll’s actions were not adverse to the interests of the LLC or otherwise in violation of the statutory standard for expulsion.


101 2016 IL App (1st) 152536 (Dec.27, 2016).

102 See also *Harrod v. HTH Auto, LLC*, Civil Action No. 13-CI-00192, Order entered July 15, 2014 (Franklin Circuit Ct. Div. II (J. Wingate)) at 7 (no requirement of a prior judicial ruling before effecting expulsion of member from LLC under terms of its operating agreement).

103 See Ky. Rev. Stat. Ann. § 275.175(1) (“Unless otherwise provided in the articles of organization, a written operating agreement, or this chapter, the affirmative vote, approval, or consent of a majority-in-interest of the members or a simple majority of the managers, each having a single vote, shall be required to decide any matter connected with the business affairs of the limited liability company.”).


105 See Ky. Rev. Stat. Ann. § 275.335(3). There is, admittedly, something of a chicken and egg problem in this analysis. The member being expelled has an interest adverse to the LLC only after the vote to expel has been made.
Conversely, the member whose expulsion is being sought, who could be a majority owner, may view a default of a disinterested vote as being inappropriate. As always, careful drafting for the particular deal is not only appropriate but necessary.

Left to be resolved is whether the determination of expulsion (or not) may be referred to an arbitrator. While clearly an arbitration agreement in the operating agreement is possible, some may question whether the statutory grounds for judicial expulsion are able to be effectuated by an arbitrator. Conversely, on the basis of both federal and state policy in favor of enforcement of agreements to arbitrate, it appears referral to arbitration should be permissible.106

As is the case with any other disassociation, upon judicial expulsion the member becomes their own assignee107 and is not entitled, unless a written operating agreement provides to the contrary, to a liquidating distribution.108

10. Partnership Taxation (capital accounts et al.)
   - S-corp LLCs

11. Organic transactions
   - Merger
   - Consolidation
   - Division
   - Amendment of the operating agreement

Benefits of Statutory Transactions

Several important benefits are realized by the inclusion in the LLC Act of provisions authorizing statutory transactions involving LLCs. The provisions permit business combinations involving LLCs (and other designated business entities) to be effected by means of streamlined, statutory procedures. Absent such provisions, business combinations equivalent to conversions, mergers or share exchanges either would not be possible or would require increased

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106 See also Duke v. Graham, 158 P.3d 540 (Utah 2007) (the provisions of the Utah LLC Act providing for judicial expulsion of members and judicial removal of managers did not strip arbitrators of the authority to remove members and managers.)

107 See KY. REV. STAT. ANN. § 275.280(5).

documentation. In this regard, statutory transactions, where appropriate, can replace the following transactions:

- a sale (or purchase) of assets by an LLC to or from another entity;
- a contribution of assets by (or to) an LLC in exchange for an ownership interest in that other entity, followed by a liquidation of the contributing entity;
- the acquisition by (or issuance from) an LLC of an ownership interest in another entity (or the LLC), followed by liquidation of the acquired entity; or
- a liquidation of an LLC (or other entity) followed by a sale or contribution of the assets by the former owners to another entity (or LLC).

Furthermore, statutory transactions often circumvent costs or conditions not otherwise avoided in the case of transactions structured differently, including real estate transfer or recordation taxes, other transfer taxes, automatic novation of debts, third-party consents to assignment or assumption of contracts, leases, financing arrangements, etc.

Conversions Generally

The LLC Act permits a general or limited partnership or a business corporation to convert directly to a domestic LLC via a simple statutory mechanism.\(^\text{109}\) It is also possible for an LLC to convert into a limited partnership.\(^\text{110}\)

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\(^{109}\) KY. REV. STAT. ANN. § 275.370.

\(^{110}\) Outside the scope of this chapter are provisions enabling the conversion of a general partnership into a limited partnership or a limited partnership into a general partnership. While a partnership or limited partnership may convert into a statutory trust, see KY. REV. STAT. ANN. § 386A.7-060, there is no mechanism by which an LLC may convert into a statutory trust.
Approval of a Conversion

[8.4.1] General Partnership into LLC

The conversion of a general partnership into an LLC requires the approval of either all partners or that threshold set forth in the partnership agreement for approval of a conversion.\(^ {111} \)

[8.4.2] Limited Partnership into LLC

The conversion of a limited partnership into an LLC requires the unanimous consent of all partners (general and limited); this threshold may not be reduced in the agreement of limited partnership or otherwise.\(^ {112} \)

[8.4.3] Business Corporation into LLC

The conversion of a business corporation into an LLC requires the consent of a majority of the board of directors and a majority of the shareholders and, if there is class voting, a majority of each class.\(^ {113} \) No provision permits an LLC to convert into a corporation, and the provision allowing the conversion into an LLC is limited to business, and does not include non-profit, corporations.

The approval of the conversion requires a plan of conversion\(^ {114} \) setting forth:

- The name of the converting corporation;
- The terms and conditions of the conversion including the articles of organization of the converted LLC and, if any, its writing operating agreement;
- The mechanism by which the corporate shares will be converted into membership interests, obligation of other securities of the converted LLC or into cash or other property.\(^ {115} \) The plan of conversion may set forth any other desired provision.\(^ {116} \)

\(^{111}\) KY. REV. STAT. ANN. § 275.370(2). See also id. § 362.1-401(10); id. § 362.235(8) (transactions outside the ordinary course of the partnership require consent of all partners).

\(^{112}\) KY. REV. STAT. ANN. § 275.370(2).

\(^{113}\) KY. REV. STAT. ANN. § 275.376. The conversion of a cooperative association with shares into an LLC should be permitted. See id. § 272.042.

\(^{114}\) There is no statutory requirement that the plan be in writing or otherwise in record form, but the benefits of such are obvious.

\(^{115}\) KY. REV. STAT. ANN. § 275.376(3).

\(^{116}\) KY. REV. STAT. ANN. § 275.376(4).
**LLC into Limited Partnership**

The conversion of an LLC into a limited partnership requires the unanimous consent of all members; this threshold may not be reduced in the operating agreement or otherwise.\(^{117}\) The LLC must adopt a written\(^ {118} \) plan of merger setting forth:

- The name of the converting LLC;
- The name of the to be converted LP;
- The terms and conditions of the conversion, including the terms of conversion of the interests in the LLC into interests in the LP, into cash or other property or other consideration; and
- The organizational documents of the converted LP.\(^ {119} \)

The converted LP may be an LLLP.

**Nonprofit Corporation into Nonprofit LLC**

A provision added to the LLC Act in 2015 permits a nonprofit corporation to convert into a nonprofit LLC.\(^ {120} \) The limitation upon this provision is that the only permitted member of the converted nonprofit LLC must be a section 501(c)(3) or 501(c)(4) organization; an affirmative statement to that effect is required in the articles of organization filed to effect the conversion.\(^ {121} \) This conversion mechanism is available for all nonprofit corporations organized in Kentucky. It is as well available to foreign nonprofit corporations unless the law of the jurisdiction of incorporation forbids a conversion as contemplated by this provision.\(^ {122} \) To provide an example, consider an affiliated group of nonprofit hospitals, each organized as a nonprofit corporation and having a common nonprofit corporate parent. Using this new capacity, each subsidiary could reorganize as a single member LLC in which the parent is the sole member.

The conversion of a nonprofit corporation into a nonprofit LLC will require the approval of the corporation’s board of directors.\(^ {123} \) While members of a nonprofit corporation may have

\(^ {117} \) KY. REV. STAT. ANN. § 275.372(2).

\(^ {118} \) The statute requires that the plan of merger be “in a record.” See also KY. REV. STAT. ANN. § 362.2-102(12).

\(^ {119} \) KY. REV. STAT. ANN. § 362.2-1102(5).

\(^ {120} \) See KY. REV. STAT. ANN. § 275.376(13), created by 2015 Ky. Acts, ch. 34, § 47.

\(^ {121} \) Id.

\(^ {122} \) Id.

\(^ {123} \) See KY. REV. STAT. ANN. § 273.283(1); id. § 275.376(2).
the right to vote as to a merger,\textsuperscript{124} as a manager is not a conversion (and vis versa) that right does not carry forward in a conversion.\textsuperscript{125}

Conversion Filing Requirements

\textbf{[8.5.1] General Partnership into LLC}

Once approved, the converting partnership files Articles of Organization with the Secretary of State.\textsuperscript{126} These Articles of Organization must set forth the basic information called for in Articles of Organization filed when forming an LLC,\textsuperscript{127} plus certain additional information relating to the conversion. The additional information required for the conversion of a general partnership into an LLC is:

- a statement that the partnership was converted to an LLC;
- the former name of the converted partnership; and
- a statement evidencing that the requisite number or percentage of votes necessary to approve the conversion was obtained.\textsuperscript{128}

The conversion is effective at the later of the time of the Secretary of State’s filing of the Articles of Organization or a delayed effective date provided for therein.\textsuperscript{129}

\textbf{[8.5.2] Limited Partnership into LLC}

Once approved, the converting limited partnership files Articles of Organization with the Secretary of State.\textsuperscript{130} These Articles of Organization must set forth the information called for in Articles of organization filed when forming an LLC,\textsuperscript{131} plus certain additional information relating to the conversion. The additional information required for the conversion of a limited partnership into an LLC is:

- A statement that the limited partnership was converted to an LLC;
- The former name of the converted limited partnership; and

\textsuperscript{124} See KY. REV. STAT. ANN. § 273.283.
\textsuperscript{125} See also KY. REV. STAT. ANN. § 275.003(5).
\textsuperscript{126} KY. REV. STAT. ANN. § 275.370(3).
\textsuperscript{127} See KY. REV. STAT. ANN. § 275.025.
\textsuperscript{128} Id.
\textsuperscript{129} See KY. REV. STAT. ANN. § 275.370(4); id. § 14A.2-070.
\textsuperscript{130} KY. REV. STAT. ANN. § 275.370(3).
\textsuperscript{131} See KY. REV. STAT. ANN. § 275.025.
A statement that the vote necessary to approve the conversion was obtained.\textsuperscript{132}

The conversion is effective at the later of the time of the Secretary of State’s filing of the Articles of Organization or a delayed effective date provided for therein.\textsuperscript{133}

\section*{8.5.3 Business Corporation into LLC}

Once approved, the converting corporation files Articles of Organization with the Secretary of State.\textsuperscript{134} These Articles of Organization must set forth the information called for in Articles of organization filed when forming an LLC,\textsuperscript{135} plus certain additional information relating to the conversion. The additional information required for the conversion of a corporation into an LLC is:

\begin{itemize}
  \item A statement that the limited partnership was converted to an LLC;
  \item The former name of the converted limited partnership; and
  \item A statement that the vote necessary to approve the conversion was obtained.\textsuperscript{136}
\end{itemize}

The conversion is effective at the later of the time of the Secretary of State’s filing of the Articles of Organization or a delayed effective date provided for therein.\textsuperscript{137}

\section*{8.5.4 LLC into Limited Partnership}

Upon approval of the plan of conversion, the converting LLC delivers for filing by the Secretary of State a certificate of limited partnership setting forth the information typically required to organize a limited partnership\textsuperscript{138} and as well as setting forth:

\begin{itemize}
  \item A statement that a LLC was converted into the LP;
  \item The name of the LLC and its jurisdiction of organization;
  \item A statement that the conversion was approved as required by KyULPA;
\end{itemize}

\textsuperscript{132} KY. REV. STAT. ANN. § 275.370(3)(a)-(e).
\textsuperscript{133} See KY. REV. STAT. ANN. § 275.370(4); id. § 14A.2-070.
\textsuperscript{134} KY. REV. STAT. ANN. § 275.376(11).
\textsuperscript{135} See KY. REV. STAT. ANN. § 275.025.
\textsuperscript{136} KY. REV. STAT. ANN. § 275.376(11)(a)-(c).
\textsuperscript{137} See KY. REV. STAT. ANN. § 275.376(12); id. § 14A.2-070.
\textsuperscript{138} See KY. REV. STAT. ANN. § 362.2-201; id. § 14A.2-070.
• A statement that the conversion was approved as required by the statute governing the converting LLC;¹³⁹ and

• If the converting LLC was a foreign LLC, the address the Secretary of State may utilize for purposes of KRS § 362.2-1105(3).¹⁴⁰

The conversion is effective at the later of the time of the Secretary of State’s filing of the certificate of limited partnership or a delayed effective date provided for therein.¹⁴¹

[8.5.5] Nonprofit Corporation into Nonprofit LLC

Upon approval of the plan of conversion, the converting corporation delivers for filing by the Secretary of State articles of organization setting forth the information typically required to organize a LLC¹⁴² and as well as setting forth:

• A statement that a nonprofit corporation was converted into the LLC;¹⁴³

• The former name of the converted corporation;¹⁴⁴

The conversion is effective at the later of the time of the Secretary of State’s filing of the articles of organization or a delayed effective date provided for therein.¹⁴⁵

Effect of Conversion

[8.6.1] Partnership or Limited Partnership into LLC

A LLC formed pursuant to the conversion mechanism shall, for all purposes, be the same “entity” (i.e., the partnership, or limited partnership) as existed before the conversion.¹⁴⁶ Conversion is not therefore deemed an event of dissolution or termination of the partnership for purposes of partnership law. Any LLP election¹⁴⁷ made by the predecessor partnership is

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¹³⁹ See also KY. REV. STAT. ANN. § 275.372(2).
¹⁴⁰ KY. REV. STAT. ANN. § 362.2-1104(1).
¹⁴¹ KY. REV. STAT. ANN. § 362.2-1104(2); id. § 14A.2-070.
¹⁴² See KY. REV. STAT. ANN. § 275.025(1)
¹⁴³ See KY. REV. STAT. ANN. § 275.376(11)(a).
¹⁴⁴ See KY. REV. STAT. ANN. § 275376(11)(b).
¹⁴⁵ KY. REV. STAT. ANN. § 275.376(12); id. § 14A.2-070.
¹⁴⁶ KY. REV. STAT. ANN. § 275.375(1).
¹⁴⁷ See KY. REV. STAT. ANN. § 362.555; id. § 362.1-1001.
cancelled by the conversion, as is any statement of partnership authority. The certificate of limited partnership of any converting limited partnership is cancelled by the conversion.

The LLC, as an entity, shall own all property previously owned as partnership property and be liable for all partnership liabilities or obligations, including pending actions and proceedings, of the converted entity without any further filing requirements. The LLC Act specifically provides that title to all partnership property remains “vested” in the converted entity. No further act or deed to vest title is required and title vests without reversion or impairment.

All assumed names of the converting partnership become assumed names of the converted LLC. The name of the LLC may be substituted for that of the predecessor partnership or limited partnership in any action pending by or against the partnership or limited partnership as of the time of conversion.

Upon the conversion being effective, each partner (limited or general) in the converting partnership becomes a party to and bound by any written operating agreement.

The effect of a conversion on the individual personal liability of the former partners varies according to the former status of the partners as general or limited.

Former general partners remain fully liable for all obligations which were incurred by the partnership before the effective date of the conversion. This serves to ensure that existing creditors who extended credit to a partnership or limited partnership in complete or partial reliance upon the personal credit of the general partners remain in the same position following a conversion of the partnership to an LLC. Furthermore, third parties who transact business with the converted partnership unaware of the new status of the former partners as LLC members are protected for 90 days after the conversion. With respect to these transactions occurring during

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149 Id. See also KY. REV. STAT. ANN. § 362.1-303.
150 KY. REV. STAT. ANN. § 275.370(3)(e).
151 KY. REV. STAT. ANN. § 275.375(2).
152 KY. REV. STAT. ANN. § 275.375(2)(a).
153 See KY. REV. STAT. ANN. § 362.015(8).
154 See KY. REV. STAT. ANN. § 275.375(2)(c).
155 KY. REV. STAT. ANN. § 275.375(2)(d).
156 See KY. REV. STAT. ANN. § 362.220(1) (personal liability of partners in KyUPA general partnership); id. § 362.220(2) (personal liability in KyUPA LLP); id. § 362.447 (personal liability of general partners in KyRULPA limited partnership); id. § 362.437(1) (potential personal liability of limited partners in KyRULPA limited partnership); id. § 362.1-306(1) (personal liability of partners in KyRUPA general partnership); id. § 362.1-306(3) (personal liability of partners in a KyRUPA LLP); id. § 362.2-404(1) (personal liability of general partners in KyULPA limited partnership); id. § 362.2-303(1) (personal liability of limited partners in KyULPA limited partnership); and id. § 362.2-404(3) (personal liability of general partners in KyULPA LLLP).
157 KY. REV. STAT. ANN. § 275.370(5).
the 90-day period immediately following the conversion, former general partners may be personally liable for LLC obligations if the other party to such transaction reasonably believed the member was entering into such transaction as a general partner of a partnership or a limited partnership. 158 A former general partner can avoid the 90-day exposure to liability by notifying those transacting business with the LLC of the conversion of the entity from a partnership and his new status as a member of the LLC. 159

Former limited partners shall remain liable only as limited partners for all obligations of the converted partnership incurred prior to conversion, that is, only to the extent of their capital contributions to the former partnership. 160

[8.6.2] Corporation into LLC

A LLC formed pursuant to the conversion of a business or nonprofit corporation shall, for all purposes, be the same “entity” as existed before the conversion. 161 The converted LLC, as an entity, shall own all property, including contract rights, and as well all rights, privileges and immunities of the converting corporation remain vested in the converted LLC without there having taken place any assignment, reversion or impairment. 162 At the same, all obligations of the converting corporation continue as obligations of the converted LLC. 163 Actions or proceedings against the converting corporation may be continued notwithstanding the conversion with the name of the converting LLC substituted in its place. 164 Any written operating agreement of the LLC 165 shall upon the conversion become binding upon each person who is a member in the converted LLC. 166

[8.6.3] LLC into Limited Partnership

A limited partnership formed by the conversion of a LLC is for all purposes the same entity that existed before the conversion. 167 Upon the conversion taking effect, all property and contract rights of the converting LLC as well as all its rights, privileges and immunities remain

158 KY. REV. STAT. ANN. § 275.370(5). Still, limited partners in a limited partnership providing a “control rule” (see, e.g., KRS § 362.437(1); id. § 362.470 (repealed 1988)) may have continuing liability thereunder for pre-conversion liabilities.

159 This 90 day provision, though present in the 1992 ULLCA draft (utilized in drafting the LLC Act), was deleted in the subsequent 1993 ULLCA draft.

160 KY. REV. STAT. ANN. § 275.370(5).

161 KY. REV. STAT. ANN. § 275.377(1).

162 KY. REV. STAT. ANN. § 275.377(2)(a).

163 KY. REV. STAT. ANN. § 275.377(2)(b).

164 KY. REV. STAT. ANN. § 275.377(2)(c).

165 See also KY. REV. STAT. ANN. § 275.376(3)(b).

166 KY. REV. STAT. ANN. § 275.377(2)(d).

167 KY. REV. STAT. ANN. § 362.2-1105(1).
vested in the converted limited partnership without assignment, reversion or impairment. At the same, all obligations of the converting LLC continue as obligations of the converted limited partnership. An action or proceeding pending against the converting LLC is continued notwithstanding the conversion, and the name of the converted limited partnership may be substituted in any pending action or proceeding. The written partnership agreement of the converted limited partnership becomes binding upon each person who becomes a partner in the converted limited partnership.

**Dissenter Rights in a Conversion**

[8.7.1] **Corporation into LLC**

Shareholders in a business corporation converting into an LLC are afforded the right to dissent set forth in subchapter 13 of the KyBCA.

Upon a conversion, the shareholders in the corporation should have the dissenter rights provided for in the business corporation act.

[8.7.2] **LLC into Limited Partnership**

If the converting LLC’s articles of organization or operating agreement, or the plan of conversion provide for a right to dissent (a most curious provision in light of the requirement that the conversion be pursuant to an irreducible unanimous vote of the members), a member may exercise those rights. Absent such a contractual right, there is no right to dissent.

[8.7.3] **Partnership or Limited Partnership into LLC**

Unless provided for in the partnership agreement of the converting partnership or the plan of conversion, partners do not have a right to dissent from a conversion.

[8.7.4] **Nonprofit Corporation into Nonprofit LLC**

There exists no right to dissent in the event of the conversion of a nonprofit corporation into a nonprofit LLC.

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168 KY. REV. STAT. ANN. § 362.2-1105(2)(a).
169 KY. REV. STAT. ANN. § 362.2-1105(2)(b).
170 KY. REV. STAT. ANN. § 362.2-1105(2)(c).
171 KY. REV. STAT. ANN. § 362.2-1105(2)(d). See also id. § 362.2-1102(5)(d).
174 KY. REV. STAT. ANN. § 275.372(2).
175 See also Rutledge, The 2007 Amendments, supra note 65 at 248.
176 KY. REV. STAT. ANN. § 362.1-904(3); id. § 362.2-1103(3).
Mergers Involving LLCs – Generally

Two or more LLCs may merge, and LLCs may merge with certain other business organizations.

- Two or more domestic LLCs may merge.\(^{177}\)
- A domestic LLC may merge with a foreign LLC (so long as the merger is permitted under the foreign law) with either entity as that surviving the merger.\(^{178}\)
- A domestic LLC may merge with a:
  - domestic business corporation;\(^{179}\)
  - domestic limited partnership governed by the Kentucky Uniform Limited Partnership Act (2006);\(^ {180}\)
  - domestic limited partnership governed by the Kentucky Revised Uniform Limited Partnership Act;\(^{181}\) and
  - domestic general partnership governed by the Kentucky Revised Uniform Partnership Act (2006).\(^{182}\)

Approval of the Merger

Unless otherwise provided in a written operating agreement, the merger of a domestic LLC may be approved by a majority-in-interest of the members.\(^ {183}\) With respect to foreign entities that may be parties to a merger involving a Kentucky LLC, irrespective of whether the surviving entity is or is not to be organized in Kentucky, the transaction must be approved in accordance with the rules applicable to that foreign entity.\(^ {184}\) The organic law of each other domestic entity party to the merger must be satisfied in connection with any merger.\(^ {185}\)

\(^{177}\) KY. REV. STAT. ANN. § 275.345(1).
\(^{178}\) See KY. REV. STAT. ANN. § 275.345(1).
\(^{179}\) See KY. REV. STAT. ANN. § 275.345(1); id. § 271B.11-080.
\(^{180}\) See KY. REV. STAT. ANN. § 275.345(1); id. § 362.531.
\(^{181}\) See KY. REV. STAT. ANN. § 275.345(1); id. § 362.2-1106.
\(^{182}\) See KY. REV. STAT. ANN. § 275.345(1); id. § 362.1-908.
\(^{183}\) KY. REV. STAT. ANN. § 275.350(1).
\(^{184}\) KY. REV. STAT. ANN. § 275.350(2).
\(^{185}\) See, e.g., KY. REV. STAT. ANN. § 271B.11-030(2) (approval by board of directors and the shareholders); id. § 362.2-1107(1) (all partners); id. § 362.1-905(3)(a) (all partners).
constituent parties to the merger are required to enter into a written plan of merger setting forth:

- The name of each constituent business entity to the merger;
- The name of the business entity surviving the merger;
- The terms and conditions of the merger, including a statement as to whether limited liability is retained by the surviving business entity;
- The manner and basis of converting the interests of each LLC and other business entity that is a party to the merger into interests, securities or obligations of the surviving entity or into cash or other property;
- Amendments to the articles of organization of the LLC, assuming it is an LLC that is surviving the merger, or the articles of incorporation of a corporation or certificate of a limited partnership of the surviving business entity, as the case may be or, in the alternative, a statement that no amendments are being effected; and
- Such other provisions as may be desired.

It is important to appreciate that the LLC Act does not provide the same notice and procedural requirements vis-à-vis the consideration and approval of a merger as is mandated by the Business Corporation Act. In the Business Corporation Act, in order for a merger to be effected, the transaction must be approved and recommended to the shareholders by the board of directors or, in the alternative, transmitted to the shareholders without a recommendation where the shareholders are invited to review and either approve or not approve the transaction. The notice to the shareholders must provide that a purpose of the shareholder meeting is to consider the plan of merger, which notice must as well include a copy or a summary of that plan. The LLC Act contains no such requirements.

The determination that the LLC Act should not contain these or similar requirements is in no manner a deficiency in the LLC Act or a drafting oversight. The rules embodied in the Business Corporation Act are not the normative standard against which the rules embodied in other business entity statutes are to be measured. Rather, in the Business Corporation Act,

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186 KY. REV. STAT. ANN. § 275.355(1).
187 KY. REV. STAT. ANN. § 275.355(2).
188 KY. REV. STAT. ANN. § 271B.11-030(2)(a).
189 KY. REV. STAT. ANN. § 271B.11-030(2)(b).
190 KY. REV. STAT. ANN. § 271B.11-030(4).
191 See Pannell v. Shannon, 425 S.W.3d 58, 67 (Ky. 2014) (LLCs “are creatures of statute controlled by Kentucky Revised Statutes (KRS) Chapter 275.”); see also KNC Investments, LLC v. Lane’s End Stallions, Inc., 2011 WL
consequent to the mandated utilization of the board of directors,\textsuperscript{192} it being separate and distinct from the body of shareholders, various notice requirements have been mandated.\textsuperscript{193} In contrast, LLCs are governed by the LLC Act,\textsuperscript{194} and the LLC Act allows the determination, by private agreement, amongst the parties to the venture as to these matters.\textsuperscript{195} There is simply no validity to the assertion that the same rules that govern a corporate merger should apply as well to the merger of an LLC.\textsuperscript{196} Rather, in the case of an LLC, whatever rules and procedures have been dictated by the operating agreement will control.

**Merger Filing Requirements**

After approval of the plan of merger, the entity surviving the merger is to deliver to the Secretary of State for filing Article of Merger that have been executed by each business entity constituent to the merger.\textsuperscript{197} It should be recognized that the filing requirements for mergers involving LLCs (and business corporations) were simplified in 2015.\textsuperscript{198} The import of the 2015 amendments were to (a) eliminate the requirement that the plan of merger be filed along with the articles of merger and (b) modify the mandatory requirements of the articles of merger to make of public record certain information that would previously have been in only the plan of merger.\textsuperscript{199}

The Article of Merger must set forth:

- The name and jurisdiction of organization of each business entity constituent to the merger;

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\textsuperscript{192} See KY. REV. STAT. ANN. § 271B.8-010(1).

\textsuperscript{193} See KY. REV. STAT. ANN. § 275.003(1).

\textsuperscript{194} See KNC Investments, LLC v. Lane’s End Stallions, Inc., 2011 WL 5507395 (E.D. Ky. 2011) (“No justification exists to extend Kentucky law that by its own terms is strictly limited to corporations to non-corporate entities such as the LDK Syndicate.”).

\textsuperscript{195} See Rutledge The 2015 Amendments to the Kentucky Business Entity Statutes, 43 NORTHERN KENTUCKY LAW REVIEW 129 (2015-16).
• The name of the business entity surviving the merger;

• The information required by KRS § 275.355(2)(d);\(^{200}\)

• Any amendment to the articles of organization of the surviving entity;

• A statement that the plan of merger was duly authorized and approved by each business entity constituent to the merger; and

• If the entity surviving the merger is not organized under the laws of the Commonwealth of Kentucky, a statement that it agrees and may be served with process in Kentucky for any proceeding to enforce an obligation of the business entity constituent to the merger that was organized under Kentucky law, as well as the enforcement of obligations of the surviving business entity arising from the merger and an appointment of the Secretary of State as the agent for service of process in connection therewith and providing an address to which that process may be forwarded to the Secretary of State.\(^{201}\)

The merger is effective upon the later of the filing by the Secretary of State of the Articles of Merger or any delayed effective date set forth therein.\(^{202}\)

Effect of a Merger

Upon a merger taking effect:

• all of the business entities constituent to the merger become a single entity, that being the entity designated in the plan of merger as the surviving business entity;

• each business entity who is a party to the merger, except the surviving business, ceases to exist;

• the business entity surviving a merger possesses all rights, privileges, immunities and powers of each of the constituent business entities come into the possession of the surviving business entity even as it becomes subject to all the restrictions, disabilities and duties of each of those constituents;

\(^{200}\) See KY. REV. STAT. ANN. § 275.355(2)(d) requires “The amendments to the articles of organization of a limited liability company, or articles of incorporation of a corporation or certificate of limited partnership, as the case may be, of the surviving business entity as are desired to be effected by the merger, or that no changes are desired”.

\(^{201}\) KY. REV. STAT. ANN. §§ 275.360(1)(a)-(e).

\(^{202}\) KY. REV. STAT. ANN. § 275.360(2); id. § 14A.2-070.
all property, whether real, personal or mixed, and all debts of the 
constituent business entities are vested in the surviving business 
entity;

title to all real property and any interest therein that was vested in a 
constituent business entity, while being vested in the surviving 
entity, does so without any impairment or reversion;

the surviving business entity is liable for all liabilities and 
obligations of each of the constituent business entities and any 
claim existing or pending against any of the constituent entities 
may be prosecuted as if the merger had not taken place, or the 
name of the surviving business entity may be substituted in the 
action;

creditor rights and liens on property of any constitute business 
entity are not impaired by the merger;

interest in any business entity are converted as provided for in the 
plan of merger;

amendments to the articles of organization and operating 
agreement of the surviving business entity as set forth in the plan 
of merger become effective; and

any written operating agreement provided for in the plan of merger 
becomes binding upon each member in the surviving limited 
liability company, but obligations to make additional capital 
contributions provided for there are binds only if and to the degree 
the subject member has approved same.  

The Permitted Inter-Entity Mergers

[8.12.1] Merger of a General Partnership into an LLC

A general partnership organized under the Kentucky Uniform Partnership Act, may not 
merge with a LLC in that mergers are not authorized for those partnerships. A general

203 KY. REV. STAT. ANN. §§ 275.365(1), (2), (3), (4), (5), (6), (7), (8), (10) and (11).
204 KY. REV. STAT. ANN. ch. 362.
205 See also THOMAS E. RUTLEDGE AND ALLAN W. VESTAL, RUTLEDGE & VESTAL ON KENTUCKY PARTNERSHIPS 
AND LIMITED PARTNERSHIPS at 139 (“Article 9 of RUPA, which has no counterpart in UPA, sets forth procedures by 
which a partnership organized under RUPA may either merge with or convert into another business organization.”)
partnership organized under the Kentucky Revised Uniform Partnership Act (2006),\textsuperscript{206} may merge with a LLC.\textsuperscript{207}

[8.12.2] **Merger of a Limited Partnership into an LLC**

A limited partnership organized under the Kentucky Revised Uniform Limited Partnership Act\textsuperscript{208} may merge with a LLC.\textsuperscript{209} Likewise, a limited partnership organized under the Kentucky Uniform Limited Partnership Act (2006)\textsuperscript{210} may merge with an LLC.\textsuperscript{211}

A limited partnership formed under any prior Kentucky statute prior to Kentucky’s adoption of the Revised Uniform Limited Partnership Act which has not previously elected to be governed by KRS ch. 362 (or which is not governed by KRS ch. 362 by operation of law) must first file an amended and restated Certificate of Limited Partnership under KRS ch. 362.2\textsuperscript{212} in order to avail itself of the merger provisions. This must be done whether such limited partnership is to be the disappearing or surviving entity in the merger. The filing of the amended and restated Certificate of Limited Partnership may be done simultaneously with the merger filings.

[8.12.3] **Merger of a Corporation into a Corporation**

A business corporation or a cooperative association with shares may merge with an LLC.\textsuperscript{213}

[8.12.4] **Other**

There exists no mechanism by which a domestic business trust may merge with a LLC. A domestic nonprofit LLC may merge only with another domestic nonprofit LLC.\textsuperscript{214}

**Effect of Merger on Personal Liability**

A partner in a partnership or limited partnership that merges into an LLC remains liable for pre-merger partnership obligations as provided for in the law governing the merging partnership or limited partnership.\textsuperscript{215}

\begin{footnotes}
\textsuperscript{206} KY. REV. STAT. ANN. ch. 362.1.
\textsuperscript{207} See KY. REV. STAT. ANN § 275.345(1); id. § 362.1-908.
\textsuperscript{208} KY. REV. STAT. ANN. §§ 362.401 through 362.546.
\textsuperscript{209} See KY. REV. STAT. ANN. § 275.345(1); id. § 362.531.
\textsuperscript{210} KY. REV. STAT. ANN. ch 362.2.
\textsuperscript{211} KY. REV. STAT. ANN. § 275.345(1); id. § 362.1-908.
\textsuperscript{212} See KY. REV. STAT. ANN. § 362.2-1204(2).
\textsuperscript{213} See KY. REV. STAT. ANN. § 271B.11-080; id. § 272.042; id. § 275.345(1).
\textsuperscript{214} KY. REV. STAT. ANN. § 275.345(4).
\textsuperscript{215} See KY. REV. STAT. ANN. § 275.365(9).
\end{footnotes}
Dissenter Rights in a Merger


Shareholders in a business corporation have the right to dissent from any merger with an LLC unless the corporation if the shareholder had the right to vote thereon.\(^{216}\)


Partners in a domestic general or limited partnership and members in a domestic LLC will not have dissenters rights unless they are provided for by private ordering.\(^{217}\)

[8.14.3] Mergers involving Foreign Entities

Whether the constituents of a foreign entity may in connection with a merger exercise dissenters rights is dependent upon foreign law.

Share Exchanges Involving a LLC

In 2007, the LLC Act was amended to enable LLCs to engage in share exchanges with corporations.\(^{218}\) The transaction authorized works only in one direction, namely of that of the LLC acquiring the shares. The corporation whose shares are at issue may be either domestic or foreign provided that, in the instance of a foreign corporation, the share exchange is permitted under the laws of its jurisdiction of incorporation.\(^{219}\) Whether “not forbidden” is equivalent to “permitted” is a question to be assessed under that foreign law.

There does not exist a statutory transaction pursuant to which a corporation may acquire the limited liability company interests in an LLC. This is not to say, however, that a corporation and an LLC are precluded from engaging in a share exchange in which the corporation is the acquiring party. Rather, such a transaction will be simply pursuant to private contract enforceable in accordance with the terms of that agreement. There will exist no statutory overlay as to either the requirements for the approval of the transaction, its legal effect amongst the parties thereto or its effect as to third parties. In order to effectuate a share exchange, there must be adopted a plan of share exchange setting forth:

- The name of the corporation whose shares will be acquired and name of the acquiring LLC;
- The terms and conditions of the exchange; and

\(^{216}\) See KY. REV. STAT. ANN. § 271B.13-020(1)(a).

\(^{217}\) See KY. REV. STAT. ANN. § 275.345(3); id. § 362.1-906(6); id. §362.2-1107(4).


\(^{219}\) KY. REV. STAT. ANN. § 275.500(1).
• The manner and basis of exchanging the shares for limited liability company interests, obligations or other securities of the LLC or cash or other property.\(^{220}\)

With respect to the LLC, the plan of share exchange requires the approval of the majority of the members.\(^{221}\) As to the business corporation, a plan of share exchange must be approved as is dictated by the law governing the corporation.\(^{222}\)

Subsequent to approval of the plan of share exchange, the LLC is obligated to file with the Secretary of State articles of share exchange setting forth:

• The plan of share exchange; and

• A statement that the plan of share exchange was duly authorized and approved by each the LLC and the corporation in accordance with the laws applicable to each.\(^{223}\)

The share exchange is effective upon the effective date of the articles of share exchange.\(^{224}\) Upon the share exchange taking effect, the shares of the acquired corporation are exchanged as provided for in the plan of share exchange and the former holders thereof are entitled only to the exchange rights provided for in the articles of share exchange.\(^{225}\)

**Dissenter Rights in a Share Exchange**

Unless such are provided for the articles of organization, writing operation agreement or plan of share exchange, the members in the LLC participating in a share exchange have a right to dissent from the share exchange.\(^{226}\) Whether the shareholders in the corporation subject to the right to dissent will be determined pursuant to the law governing the corporation.\(^{227}\)

**Sale of Substantially All Assets**

The sale by an LLC of substantially all of its assets is not an organic transaction as contemplated by this chapter in that the transfer will not be effected by operation of law. Rather, assets will be transferred to the purchasee by deed, bill of sale, etc. The provision of the LLC Act addressing a sale of assets only defines the default rule for the required threshold to approve

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\(^{220}\) KY. REV. STAT. ANN. § 275.500(2)(a)-(b).

\(^{221}\) KY. REV. STAT. ANN. § 275.505(1). See also id. § 275.175(1).

\(^{222}\) KY. REV. STAT. ANN. § 275.505(2).

\(^{223}\) KY. REV. STAT. ANN. § 275.510(1).

\(^{224}\) KY. REV. STAT. ANN. § 275.510(2); id. § 14A.2-070.

\(^{225}\) KY. REV. STAT. ANN. § 275.515.

\(^{226}\) KY. REV. STAT. ANN. § 275.500(5).

\(^{227}\) See, e.g., KY. REV. STAT. ANN. § 271B.13-020(1)(b).
the transaction without defining the legal affect of the transaction. That is left to the private agreement of the buyer and the seller.

12. Dissolution, Winding Up and Termination

Dissolution of a limited liability company may come about by any of six reasons, namely:

- upon having reached a definite date of dissolution set forth in the articles of organization;  

- as otherwise dictated by a written operating agreement;  

- by agreement of the members;  

- for the failure to have a member;  

- pursuant to judicial order; or  

- by administrative dissolution by the Secretary of State.

This chapter will begin by reviewing seriatum the various events that will trigger an LLC; dissolution, proceeding then to discuss the effect of dissolution on the LLC and its members/managers. Last, it will review the process of winding up.

[9.1.1] Dissolution Upon Having Reached a Definite Date of Dissolution

While such is in no manner required, an LLC may set forth in its articles of organization a definite date upon which it will dissolve. Having reached the end of its term as defined in its articles of organization, the LLC is dissolved, but with a limited opportunity for retroactive cure. That cure is accomplished by, within the 60 days after the date of dissolution, the LLC amending its articles to either delete the term provision or extend it to a future date. In either instance, that amendment will relate back and be effective as of the previously provided-for date

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228 KY. REV. STAT. ANN. § 275.247.  
229 KY. REV. STAT. ANN. § 275.285(1).  
231 KY. REV. STAT. ANN. § 275.285(3).  
233 KY. REV. STAT. ANN. § 275.285(5).  
235 KY. REV. STAT. ANN. § 275.025(2).  
236 KY. REV. STAT. ANN. § 275.285(1).
of termination, and the existence of the entity will not be interrupted.237 Conversely, after that 60 day period has run, amendment of the articles of organization is no longer permitted, and the organization must proceed to wind up and terminate.238

The Secretary of State, with respect to a business entity with a limited period of duration, may issue a certificate of dissolution during the 60 day period during which the business entity may still cure its dissolution for having reached the end of its term.239 During that 60 day cure period, the Secretary of State’s office will not be able to issue, with respect to that business entity, a certificate of existence240 unless and until the articles of organization have been amended to extend or delete the termination date.

[9.1.2] Dissolution as is Otherwise Required by the Operating Agreement

The operating agreement (or the articles of organization) may define events upon which the LLC will dissolve.241 For example, it could be provided that upon the death or resignation of a particular member or upon the sale of substantially all company assets that the LLC will dissolve.

That the LLC will be dissolved upon an event set forth in an operating agreement is entirely a matter of contract, and the LLC will need to file articles of dissolution in order to make that fact of public record.242 The operating agreement should specify both who has the authority, upon the event transpiring, to execute and deliver for filing the articles of dissolution and whether the event may be subsequently waived (prior to filing articles of dissolution) by amendment of the operating agreement.243

[9.1.3] Dissolution by the Members

An LLC may dissolve upon the consent of all members or such other threshold as is set forth in the operating agreement.244

237 KY. REV. STAT. ANN. § 14A.8-010(1); see also Rutledge, The 2007 Amendments to the Kentucky Business Entity Statutes, 97 KY. L.J. 229 at 247-48 (2008-09).
238 KY. REV. STAT. ANN. § 14A.8-010(2).
239 KY. REV. STAT. ANN. § 14A.8-010(3).
240 KY. REV. STAT. ANN. § 14A.2-130.
242 KY. REV. STAT. ANN. § 275.315.
244 KY. REV. STAT. ANN. § 275.285(3); see also Rutledge, The 2007 Amendments to the Kentucky Business Entity Statutes, 97 KY. L.J. 229, 244-45 (2008-09). The alternative threshold must be in writing.
Dissolution for Failure to Have a Member

An LLC must have at least one member. Prior to the 2007 amendments, the KyLLCA was silent as to what occurs when a LLC ceases to have a member such as upon the death or termination of the sole member. The addition of subsection (4) to KRS § 275.285 addressed this situation. Generally speaking, the LLC will not be dissolved if:

- a succession mechanism set forth in a written operating agreement is satisfied; or
- the successor-in-interest of the last remaining member determines to continue the LLC.

Prior to this amendment, the successor to the last member would be an assignee of the member, but would be unable to cause their own admission as a member. While an operating agreement may provide for the admission of a successor member, most do not. The consequences of having neither a member nor a provision allowing, sua sponte, the admission of a member, can be troubling. Consider a single member LLC, member managed, with a piece of realty. The LLC is preparing to sell the realty when the sole member dies intestate. No person now has actual agency authority on behalf of the LLC and nobody is vested with authority to execute the deed and cause the transfer of the realty. Court intervention is necessary to authorize the estate or its representative to execute and deliver the deed as the agent for the LLC. With this new provision, the successor of the last member will have the right to elect themselves to membership and continue the operation of the LLC. This election must take place within ninety (90) days of the disassociation of the last remaining member, and must be in writing.

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245 KY. REV. STAT. ANN. § 275.015(8). Contrast VA. CODE ANN. § 13.1-1038.1(A)(3) (permitting the formation of an LLC that does not have a member). The Revised Uniform Limited Liability Company Act permits the formation of an LLC without a member (a so called “shelf LLC”) with provisions to address the status of the organization until such time as a member is admitted and the mechanism by which notice is given that the LLC has a member and is no longer “on the shelf.” RULLCA § 201, 6A U.L.A. (2007 Supp.) 238. These provisions have received significant criticism (see, e.g., Larry E. Ribstein, An Analysis of the Revised Uniform Limited Liability Company Act (2006), 3 V.A. L. & BUS. REV. 35, 40-42 (Spring 2008)) and in the four states that have to date adopted RULLCA (see 2008 Idaho Session Law ch. 176, Iowa 2007 HF 2633, Nebraska 2010 LB 888 and Wyoming 2010 SF 18), the “Shelf LLC” provisions were not adopted.

246 See KY. REV. STAT. ANN. § 275.265(1).

247 KY. REV. STAT. ANN. § 275.135(1); id. § 275.245(1); id. § 275.255(1)(c).

248 It should be recognized that the successor-in-interest need not be only one person. For example, an individual may provide in her will that her membership interests in the LLC will upon her death go to her two children. The member in question dies, and the operating agreement does not address the question of what happens upon the LLC no longer having a member. Each of the children, each being a successor-in-interest of the last remaining member, may elect to continue the LLC and to their individual admission as a member, and neither requires the consent of the other to their admission as a member.

Alternatively, and controlling if existing, the operating agreement may provide for the processes to be followed, or the operating agreement could eliminate the right of the successor to the last member to continue the LLC.

[9.1.5] **Judicial Dissolution**

Upon the petition of a member, the circuit court may grant a decree dissolving the LLC if “it is established that it is not reasonably practicable to carry on the business of [LLC] in conformity with the operating agreement.”

The appropriate court for the action is that for the county in which the principal office of the LLC is located or, if the LLC has no principal office in Kentucky, for the county in which the registered agent is located. The decision dissolving the LLC is to specify the effective date of the dissolution and is to be delivered by the clerk to the Secretary of State for filing. Upon the entry of the order of dissolution the LLC will enter the winding up phase.

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251 KY. REV. STAT. ANN. § 279.290(1). See also Styssinger v. Brewster Park, LLC, 321 Conn. 312, ___ A.3d ___ (Sup.Ct. Conn. 2016) (assignee does not have right to move for judicial dissolution of LLC); Eureka VIII LLC v. Niagra Falls Holdings, LLC, 899 A.2d 95 (Del. Ch. 2006) (former member, now an assignee, may not seek LLC’s judicial dissolution); Faienza v. T-N-B Marble-N-Granite, LLC, 66 Conn. L. Rptr. 231, 2018 WL 1882686 (Conn. Super. Ct. March 26, 2018) (estate of member, being an assignee, lacked standing to move for LLC’s judicial dissolution). However, in In re Carlisle Etcetera LLC, the Delaware Court of Chancery held that the right to petition for dissolution may, “when equity demands,” be extended to a non-member assignee of an LLC membership interest. This holding was reached despite the nonmember assignee having no such right under either the LLC agreement or the LLC Act, placing considerable emphasis on the equitable principles that underlie the court of chancery’s jurisdiction over Delaware alternative entities. In re Carlisle Etcetera LLC, C.A. 10280-VCL (April 30, 2015).


This Court has held that “[j]udicial dissolution of entities created under, and granted substantial contractual freedom by, the laws of one state should be accomplished by a decree of a court of that state.” Camacho v. McCallum, 2016 NCBC LEXIS 81, at *13–14 (N.C. Super. Ct. Oct. 25, 2016). Courts in other jurisdictions have consistently reached the same conclusion. See, e.g., In re Raharney Capital, LLC v. Capital Stack LLC, 25 N.Y.S.3d 217, 217–18 (N.Y. App. Div. 2016) (holding that New York courts lack jurisdiction to dissolve Delaware LLC); Young v. JCR Petroleum, Inc., 423 S.E.2d 889, 892 (W.Va. 1992) (“The existence of a corporation cannot be terminated except by some act of the sovereign power by which it was created.”); Mills v. Anderson, 214 N.W. 221, 223 (Mich. 1927) (“It is textbook law that the courts of one State cannot dissolve a corporation created by another State.”).

253 KY. REV. STAT. ANN. § 275.290(2). The statute is silent as to the consequence of the failure to file the dissolution order with the Secretary of State.

254 KY. REV. STAT. ANN. § 275.290(3).
There are no Kentucky appellate court decisions interpreting the “is not reasonably practicable to carry on the business of the limited liability company in conformity with the operating agreement” standard. A Kentucky partnership case, *Allen v. Cummings*, referenced but did not interpret the same standard as utilized in the partnership act. A bankruptcy court in Iowa stated that the “not reasonably practicable” standard lacks a prevailing interpretation. A New York decision held the standard to apply when:

1. Management is unable or unwilling to reasonably permit or promote the stated purpose of the entity to be realized or achieved; or
2. Continuing the entity is financially unfeasible

In Delaware, which allows LLC judicial dissolution on a “not reasonably practicable” standard, it has interpreted the standard as being met when the members were deadlocked and the LLC lost its sole client. The court reasoned that the LLC’s sole purpose of servicing that client no longer existed, and therefore it was not possible to continue the business.

The South Dakota Supreme Court held that the inability to resolve the members’ differences (deadlock) frustrated the LLC’s economic purpose to the point the LLC could no longer function as it had been functioning. In contrast, a New York court denied a request for dissolution of a profitable and functioning LLC in which the members were deadlocked. In contrast, in a Delaware decision, dissolution of an LLC was granted when co-equal managers are deadlocked in deciding the future direction of the company with no mechanism to solve the dispute even as, in an earlier decision, a contentious relationship between the two parties to the venture was not sufficient to justify dissolution. A Washington court ordered dissolution based upon the “high degree of animosity” existing between the members such that “they no longer can act together to make reasonable business decisions relating to the LLC.”

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255 500 S.W.2d 795 (Ky. 1973).
262 *Vila v. BVWebTies LLC*, No. 4308-VCS (Del. Ch. 2010).
destroyed so that they cannot proceed together in prosecuting the business for which it was formed.265

It is open to debate whether the members of a particular LLC may either alter the standard for judicial dissolution or waive the right to seek judicial dissolution.266

The proper pleading of an action for judicial dissolution is the plaintiff member or members versus the LLC as the defendant. The other members of the LLC should not be named as defendants unless some relief, such as an accounting, is sought from them.267 Should non-plaintiff members seek to participate in the action, they may intervene in the action.

In 2015 the LLC Act has been amended to provide for judicial supervision of the winding up even where the dissolution itself is not judicial in nature.268 This provision has application where, for example, the company has dissolved in accordance with its operating agreement or otherwise, but the members either failed to proceed with the winding up and liquidation process or are unable to agree as to how it should be accomplished. This provision is consistent with the law governing business corporations.269 In contrast with KRS § 275.300(1)(b), which may require a showing of “wrongful conduct” in order for the court to oversee the winding up, under KRS § 275.290(5) only “good cause” is required. For example, assume an LLC with two equal members; suffice it to say they do not get along. On the basis of their inability to get along along the court orders judicial dissolution. The court may as well order judicial supervision of the winding up consequent to the fact of disagreements among the members without the need for a showing of “wrongful conduct” by one or the other of the members. In addition to being consistent with the Kentucky Business Corporation Act, judicial supervision of an LLC’s winding up is consistent with the LLC Acts of many other states.270

While an agreement to resolve disputes arising out of an LLC in arbitration is enforceable,271 there is authority supporting the position that an application for judicial dissolution is not subject to arbitration.272

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266 In a Delaware Chancery Court decision that was subsequently affirmed by the Delaware Supreme Court without an opinion, it was held that judicial dissolution could be waived in the operating agreement. Huatuco v. Satellite Healthcare, et al., C.A. No. 8465-VCG (Del. Ch. Dec. 9, 2013). In an earlier decision, the Delaware Court of Chancery enforced the waiver of a member’s right to petition for judicial dissolution and for appointment of a receiver contained in a limited liability company agreement. R&R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, CA No. 3803-CC (Del. Ch. August 19, 2008).

267 See also KY. REV. STAT. ANN. § 275.155.


269 See KY. REV. STAT. ANN. § 271B.14-300(4). Accord id. § 272A.12-060(3); id. § 386A.8-050(2).

270 See, e.g., MINN. STAT. ANN. § 322B.83; TENN. CODE § 48-245-801.


[9.1.6] Administrative Dissolution

The Secretary of State may initiate the administrative dissolution of a domestic LLC:

- that does not respond to interrogatories from the Secretary of State;\(^\text{273}\)
- that does not file its annual report by the due date;\(^\text{274}\)
- that does not have a registered office or registered agent for 60 days or more;
- that does not notify the Secretary of State within 60 days after a change in the registered office or agent, a resignation of the registered agent or the discontinuance of a registered office; or
- for such other reasons as may be provided in the Business Entity Filing Act or the LLC Act.\(^\text{275}\)

A LLC will be given notice of the grounds for administrative dissolution\(^\text{276}\) sent to the principal office address.\(^\text{277}\) If those grounds are not addressed or remedied during a 60 day cure period commencing from the date the notice was sent, the entity will be administratively dissolved.\(^\text{278}\) A LLC administratively dissolved continues to exist but is restricted to activities necessary to wind up and liquidate its affairs.\(^\text{279}\) Administrative dissolution may be cured and relates back to the date of dissolution,\(^\text{280}\) but reinstatement is not possible if the entity has taken certain steps to wind up its affairs.\(^\text{281}\) The denial of an application to reinstate may be appealed to the Franklin Circuit Court.\(^\text{282}\)

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\(^{273}\) See also KY. REV. STAT. ANN. § 14A.1-040.
\(^{274}\) See also KY. REV. STAT. ANN. § 14A.6-010.
\(^{275}\) KY. REV. STAT. ANN. §§ 14A.7-010(1)(a)-(d).
\(^{276}\) KY. REV. STAT. ANN. § 14A.7-020(1).
\(^{277}\) KY. REV. STAT. ANN. § 14A.2-010(12).
\(^{278}\) KY. REV. STAT. ANN. § 14A.7-020(2).
\(^{279}\) KY. REV. STAT. ANN. § 14A.7-020(3); see also id. § 275.300(2).
\(^{280}\) KY. REV. STAT. ANN. § 14A.7-030.
\(^{281}\) KY. REV. STAT. ANN. § 14A.7-030(4).
\(^{282}\) KY. REV. STAT. ANN. § 14A.7-040.
The Effect of Dissolution upon the LLC

A dissolved LLC, irrespective of the event precipitating its dissolution, continues to exist as an LLC. 283 A dissolved LLC may “not carry on any business except that appropriate to wind up and liquidate its business and affairs” 284 and must commence to wind up its affairs. 285 The statute is specific as to numerous consequences that do not follow from dissolution, namely:

- unless a written operating agreement provides to the contrary, dissolution does not transfer title to any of the LLC’s property; 286

- unless a contrary rule is provided either in a written operating agreement or the authorization to dissolve, a limited liability company interest may still be transferred; 287

- unless a contrary rule is provided for in a written operating agreement, dissolution does not subject the members or managers to standards of conduct different than those apply pre-dissolution; 288

- except as may be provided in a written operating agreement, dissolution does not amend the operating agreement, change quorum voting requirements or provisions applicable to the admission or removal of members, change the threshold for amending the operating agreement or terminating existing contribution obligations; 289

283 KY. REV. STAT. ANN. § 275.300(2). See also PLR 201522001 (May 29, 2015) (administrative dissolution of corporation did not terminate corporate existence; “[a] corporation is subject to Federal corporate income tax liability as long as it continues to do business in a corporate manner, despite the fact that its recognized legal status under state law is voluntarily or involuntarily terminated.”)

284 KY. REV. STAT. ANN. § 275.300(2). See also Styslinger v. Brewster Park, LLC, 321 Conn. 312, ___ A.3d ___ (2016) (“After dissolution, the purpose of the LLC is no longer to maintain its business operations, but to wind up its affairs so that the LLC’s assets may be liquidated and distributed to its members or their assignees.”).


286 KY. REV. STAT. ANN. § 275.300(3)(a). See also Potter v. Blue Flame Energy Corp., No. 2002-CA-001404-MR (Ky. App. Oct. 31, 2003) (Not to be Published) (corporate dissolution did not effect transfer of title of corporate owned real property to corporation’s shareholders); Pinkerton v. Pinkerton, 548 So.2d 449 ( Ala. 1989) (while descendants of a shareholder held the shares as tenants-in-common, those descendants were not, with other shareholders, tenants-in-common as to the property of the corporation); Mukon v. Gollnick, 151 Conn. App. 126, 92 A.3d 1052 (Conn. App. 2014) (dissolution of single-member LLC did not effect transfer of LLC’s assets to sole member).

287 KY. REV. STAT. ANN. § 275.300(3)(b).

288 KY. REV. STAT. ANN. § 275.300(3)(c).

• dissolution does not prevent the commencement of a proceeding against the LLC in its own name; 290
• dissolution does not abate or suspect any proceedings pending by or against the LLC as of the time of its dissolution;291
• dissolution does not terminate the authority of the LLC’s registered agent;292
• dissolution does not alter the LLC’s obligations and responsibilities with respect to federal and state tax returns and remission of taxes due;293 or
• dissolution does not alter the rule of limited liability otherwise applicable.294

The procedure followed in Ceres Protein, LLC v. Thompson Mechanical & Design 295 upon the administrative dissolution of the plaintiff LLC failed to respect the rule that a dissolved LLC may continue to participate, as an LLC, in litigation. Therein, Ceres Protein, LLC, a plaintiff in the action along with Shannon, one of its members, was administratively dissolved. Thereafter the defendants moved to substitute Tarullo, the other of Ceres Protein, LLC’s members, for the LLC. When, ultimately, the LLC was reinstated, it was substituted back in for Tarullo, in effect returning the parties to the place they were at the initiation of the suit.

The issue is that the LLC need never have been removed as a party to the suit. The dissolution of an LLC does not limit its capacity to participate in litigation.296 Furthermore, dissolution does not vest in the members the property, including the legal rights, of the LLC.297

290 KY. REV. STAT. ANN. § 275.300(4)(a).
291 KY. REV. STAT. ANN. § 275.300(4)(b).
293 KY. REV. STAT. ANN. § 275.300(4)(d).
296 See KY. REV. STAT. ANN. § 275.300(4)(a).
297 See KY. REV. STAT. ANN. § 275.300(3)(a); see also Potter v. Blue Flame Energy Corp., No. 2002-CA-001404-MR (Ky. App. Oct. 31, 2003) (Not to be Published) (corporate dissolution did not effect transfer of title of corporate owned real property to corporation’s shareholders); Pinkerton v. Pinkerton, 548 So.2d 449 (Ala. 1989) (while descendants of a shareholder held the shares as tenants-in-common, those descendants were not, with other shareholders, tenants-in-common as to the property of the corporation); Makan v. Gollnick, 151 Conn. App. 126, 92 A.3d 1052 (Conn. App. 2014) (dissolution of single-member LLC did not effect transfer of LLC’s assets to sole member).
But that is what the substitution of Tarullo purported to do. The error of treating the members of Ceres Protein LLC as the owners, upon dissolution, of the LLC’s assets was ultimately corrected, but it should not have needed to be remedied.

While it is clear that the limited liability enjoyed by members and managers survives dissolution, under agency law and absent reinstatement, those acting on behalf of the dissolved LLC on matters outside those appropriate for winding up and termination may be personally liable on claims arising therefrom.

**Articles of Dissolution**

A LLC dissolved upon an event defined in the operating agreement or by the consent of the members files articles of dissolution with the Secretary of State. Conversely, no articles of dissolution are filed where the dissolution is consequent to reaching a date of termination set forth in the articles of organization, for judicial or for administrative dissolution. The articles of dissolution must set forth:

- The LLC’s name;
- The subsection of KRS § 275.285 pursuant to which the LLC dissolved; and
- The date certain of the dissolution.

The articles of dissolution may contain such information as may be desired. There is no separate filing made to indicate that the winding up has been completed.

**Winding Up**

The winding up of the affairs of an LLC is carried out by the body with management authority or, in certain cases of wrongful conduct by a member or otherwise for good cause, by the circuit court. The circuit court is that for the county in which the LLC maintains its principal office or, if that office is not maintained in Kentucky, the county in which the registered agent is maintained.

During the winding up phase, an LLC is limited to actions related to collecting its assets, providing for the satisfaction of its liabilities and distributing to its members of those assets that

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298 See KY. REV. STAT. ANN. § 275.300(3)(i).
299 KY. REV. STAT. ANN. § 275.300(2); id. § 275.095; RESTATEMENT (3RD) OF AGENCY § 6.04; see also Rutledge, The 2007 Amendments to the Kentucky Business Entity Statutes, 97 Ky. L.J. 229, 243, n. 95 (2008-09).
300 KY. REV. STAT. ANN. §§ 275.315(1)-(3).
301 KY. REV. STAT. ANN. § 275.315(4).
302 KY. REV. STAT. ANN. § 275.290(5); id. § 275.300(1).
303 KY. REV. STAT. ANN. § 275.300(1)(b).
are not necessary to satisfy its liabilities. A non-exhaustive list of the actions appropriate to an LLC’s winding up include:

- collecting the LLC’s assets;
- disposing of assets that were not ultimately distributed in-kind to the members;
- discharging or making provision for discharging the LLC’s liabilities; and
- distributing the remaining property among the members according to their interests in the company.  

At least one local title insurance company has taken the position that a dissolved LLC (in this instance the LLC had been judicially dissolved) lacked the capacity to receive a conveyance of title from a member by means of a quit-claim deed. The LLC’s operating agreement recited that the member was contributing the property to the LLC, but no deed to that effect had been filed prior to dissolution.

In fact a dissolved LLC continues to exist as an LLC, and is empowered to engage in business “appropriate to wind up and liquidate its business and affairs.” In the course of winding up and liquidating its business and affairs, a dissolved LLC may “collect its assets.” If one of its assets is real property, in order to collect that asset, the LLC must be able to accept title by means of a deed. In addition, a dissolved LLC, in the course of its winding up and liquidation, may “[Do] every other act necessary to wind up and liquidate its business and affairs.” Accepting deeds and other conveyances in order to clarify title falls with “every other act” that is “necessary to … liquidate its business.”

Simply put, there is no authority for the proposition that an LLC, after dissolution, cannot take title to property.

[9.4.1] Agency Power of Members or Managers After Dissolution

During the winding up phase, a member or manager of the LLC may bind the LLC in the course of transactions appropriate to the winding up of its affairs and for such other purposes as
are authorized by the members or managers.\textsuperscript{311} With respect to third parties without knowledge of the dissolution, a member or manager may bind the LLC with respect to matters outside those appropriate to winding up.\textsuperscript{312} At the same time, the filing of articles of dissolution, the entry of decree of dissolution or the filing of a certificate of dissolution shall be presumed to constitute notice of the LLC’s dissolution.\textsuperscript{313} Consequent to that deemed notice it is open to debate whether there can be a third-party without notice. At the same time it is open to question whether the General Assembly intended that every party doing business with an LLC is obligated to investigate its status as to dissolution. The agent on behalf of a dissolved LLC bears the risk of personal liability on contracts entered into after dissolution.\textsuperscript{314}

\textbf{[9.4.2] Distribution of Assets During Winding Up}

During the winding up phase, the assets of the LLC are to be applied first to the payment or making adequate provision for the claims of creditors, which class includes members for claims not involving declared but unpaid distributions.\textsuperscript{315} Thereafter, assuming a balance remains in the assets, they are distributed in satisfaction of declared but unpaid distributions.\textsuperscript{316} Third, again assuming a balance remains, LLC assets are distributed to the members and any assignees of members in return of their respective contributions to the company.\textsuperscript{317} Fourth, any balance thereafter is distributed amongst the members in proportion to their respective sharing ratios.\textsuperscript{318} It bears noting the KRS § 275.310 is silent as to its modification in an operating agreement, written or otherwise. While no Kentucky court has directly addressed the point, guidance from the courts of other jurisdictions as well as appreciation that this provision serves to protect the interest of third parties indicate that its requirements as to the order of distribution should not be subject to modification except and then only to the extent different rules are agreed to amongst the members as to their respective rights.\textsuperscript{319}

\textbf{[9.4.3] Known and Unknown Claims Against a Dissolved LLC}

The LLC Act provides mechanisms by which an LLC may notify known or unknown creditors of the dissolution and further providing that certain claims not brought within the

\begin{flushleft}
\begin{footnotesize}\textsuperscript{311} KY. REV. STAT. ANN. § 275.305(1)(a); id. § 275.305(3).  
\textsuperscript{312} KY. REV. STAT. ANN. § 275.305(1)(b).  
\textsuperscript{313} KY. REV. STAT. ANN. § 275.305(2).  
\textsuperscript{314} But see section [9.5.1] infra.  
\textsuperscript{315} KY. REV. STAT. ANN. § 275.310(1).  
\textsuperscript{316} KY. REV. STAT. ANN. § 275.310(2).  
\textsuperscript{317} KY. REV. STAT. ANN. § 275.310(3).  
\textsuperscript{318} KY. REV. STAT. ANN. § 275.310(4).  
\textsuperscript{319} See, e.g., New Horizons Supply Cooperative v. Hack, 1999 WL 33499 (Wisc. App. 1999).\end{footnotesize}\end{flushleft}
procedural and timing requirements thereof shall be barred. It bears noting that these provisions are optional; a dissolved LLC is not obligated to utilize either or both.320

After dissolution, with respect to persons known to have claims against the LLC, the LLC may provide a written notice setting forth:

- with respect to any claim made against the LLC, the information that must be provided;321
- the mailing address to which any claim should be sent;322
- a deadline, which may be fewer than 120 days after the latter of the date the notice is transmitted or the date of the filing of articles of dissolution, by which date the claim must be made;323 and
- a statement that the claim will be barred if not received by the deadline.324

Upon receipt of the claim, the LLC may either satisfy or reject it. The statute does not require that any rejection of a claim be in writing, but obviously doing so has beneficial evidentiary effect. With respect to a rejected claim, it is barred against the LLC unless the claimant within 90 days after receiving the notice of rejection commences suit to enforce the claim.325 Likewise, there will be barred any claims not presented to the LLC within the applicable deadline.326

For purposes of determining what are the known claims against an LLC as of the time of its dissolution, they do not include claims that are either contingent or based upon events occurring after the effective date of dissolution.327

320 See Bear Inc. v. Smith, 303 S.W.3d 137 at 144-45 (Ky. App. 2010) (interpreting the equivalent provision of the Kentucky Business Corporation Act, KRS § 271B.14-060, and determining that it does not impose an obligation to give notice of dissolution).
321 KY. REV. STAT. ANN. § 275.320(2)(a).
322 KY. REV. STAT. ANN. § 275.320(2)(b).
323 KY. REV. STAT. ANN. § 275.320(2)(c). This provision is somewhat confusing in that, under KRS § 275.320(2), the written notice may be given “at any time after the effective date of dissolution,” implying that the notice may be sent not earlier than the effective date of dissolution. In contrast, KRS § 275.320(2)(c), by requiring that there be a minimum period of 120 days after the latter of the transmission of the notice or the filing of the articles of dissolution, implies that the notice of the right to bring a claim could predate the articles of dissolution.
324 KY. REV. STAT. ANN. § 275.320(2)(d).
325 KY. REV. STAT. ANN. § 275.320(3)(b).
326 KY. REV. STAT. ANN. § 275.320(3)(a).
327 KY. REV. STAT. ANN. § 275.320(4).
With respect to unknown claimants, an LLC may, by means of publication, give notice of its dissolution and thereby bar certain claims against the LLC. Publication of the notice of dissolution is to take place in a newspaper of general circulation in the county in which the LLC’s principal office is maintained or, where the principal office is outside of Kentucky, in the county in which the LLC maintains its registered office. The published notice must provide the information that must be provided by the claimant in their claim as well as the address to which it must be sent. In addition, the published notice must state that any claim will be time barred if not filed within, in most instances, two years of the notice’s publication. Where the LLC in question is a professional LLC, the two-year period is extended to five-years from the publication of the notice. Claims against the dissolved LLC not brought within the applicable two- or five-year period after the date of publication are barred if brought by:

- any claimant who did not, as a known claimant, receive notice under KRS § 275.320;
- a claimant who submitted a timely claim to the LLC that was not acted upon; or
- a claimant whose claim is contingent or based upon events occurring after the effective date of dissolution.

A claim brought by an unknown creditor receiving notice via publication may be enforced against the LLC to the extent of its undistributed assets or against the members pro rata to the extent of the claim up to an amount not exceeding the LLC assets distributed to the member in the course of the liquidation.

While the statute allowing recovery of distributed assets from members is silent as to who has standing to bring an action, under the equivalent corporate law statute it may be brought by a creditor of the LLC.

328 KY. REV. STAT. ANN. § 275.325(2)(a).
329 KY. REV. STAT. ANN. § 275.325(2)(b). Although not express in the statute, it is implicit that the notice must as well identify the LLC that has undergone dissolution.
330 KY. REV. STAT. ANN. § 275.325(2)(c).
331 Id.
332 KY. REV. STAT. ANN. § 275.325(3)(a).
333 KY. REV. STAT. ANN. § 275.325(3)(b).
334 KY. REV. STAT. ANN. § 275.325(3)(c). It remains to be seen whether this provision constitutes an unconstitutional statute of repose. See Perkins v. Northeastern Log Homes, 808 S.W.2d 809 (Ky. 1991).
335 KY. REV. STAT. ANN. § 275.325(4).
336 See Bear Inc. v. Smith, 303 S.W.3d 137, 147 (Ky. App. 2010) (“Kentucky law allows a creditor who timely files its claim to proceed directly against a shareholder of a dissolved corporation to the extent of the corporate assets received by that stockholder….”); id. at 146 (“[W]hen a shareholder receives assets of a corporation that dissolves, such assets are held in trust for the corporation’s creditors, and the shareholder remains personally liable for the
The Effect of Reinstatement After Administrative Dissolution

An LLC, having been administratively dissolved and assuming it has not acted to notify its creditors and otherwise wind up and liquidate its business and affairs, may apply for reinstatement. Assuming reinstatement is granted:

[I]t shall relate back to and take effect as of the effective date of the administrative dissolution and the entity shall resume carrying on its business as if the administrative dissolution or revocation had never occurred.

A frequently litigated point is the contractual or tort liability of those who acted on behalf of the administratively dissolved LLC during the period between the dissolution and the subsequent reinstatement. Essentially, the plaintiff argues that during the period of dissolution the LLC lacked the capacity to undertake acts not appropriate to its winding up and liquidation, and thus the persons purporting to act on the LLC’s behalf were actually acting as principals and are therefore personally liable on the contract. The defendant argues that because reinstatement relates back to the initial administrative dissolution, the dissolution is of no legal effect and the rules governing the personal liability of the agents should be applied as if the dissolution never occurred.

The position of the defendant is correct, a conclusion confirmed by a 2012 amendment to the statute and the Kentucky Supreme Court’s decision in Pannell v. Shannon.

See also Reeves v. East Cairo Ferry Co., 158 S.W.2d 937, 938 (Ky. 1942).

KY. REV. STAT. ANN. § 14A.7-030(4).

KY. REV. STAT. ANN. § 14A.7-030(3). Prior to January 1, 2011, this rule was set forth at KRS § 275.295(3)(c).

See, e.g., Forleo v. American Products of Kentucky, Inc., 2006 WL 2788429 (Ky. App. 2006); Fairbanks Arctic Blind Co. v. Prather & Associates, Inc., 198 S.W.3d 143 (Ky. App. 2005); Esselman v. Irvine, No. 1997-CA-001155-MR (Ky. App. Jan. 8, 1999); Pannell v. Shannon, 425 S.W.3d 58 (Ky. 2014). Messing v. Paul, 147 Fed. Appx. 437 (6th Cir. 2005), is not on point; it involved liability absent reinstatement. Another decision not involving reinstatement is Pelsor v. Petoria, Inc., 2011 WL 1434641 (W.D. Ky. 2011). The Pelsor case is interesting. The corporation at issue was administratively dissolved and was not reinstated, so the effect of the reinstatement statute is actually not at issue. The interesting point is that the plaintiff is a shareholder in the defendant corporation; he is, in effect, asserting that his co-shareholders are infringing on his IP. The plaintiff has used his voting position in the corporation to preclude it from reinstating.

See KY. REV. STAT. ANN. § 14A.7-020(3) (“An entity administratively dissolved continues its existence but shall not carry on any business except that necessary to wind up and liquidate its business and affairs.”); id. § 275.300(2) (“A dissolved [LLC] shall continue its existence but shall not carry on any business except that appropriate to wind up its business and affairs.”); accord id. § 271B.14-050(1) (“A dissolved corporation shall continue its corporate existence but may not carry on any business except that appropriate to wind up and liquidate its business and affairs.”); see also Stearns Coal & Lumber Co. v. Douglas, 185 S.W.2d 385 (Ky. 1944) (a dissolved corporation continues to exist for the purpose of settling its affairs and paying its creditors).

KY. REV. STAT. ANN. § 14A.7-030(3) (“as if the administrative dissolution or revocation had never occurred.”).

425 S.W.3d 58 (Ky. 2014).
Initially, it is important in analyzing questions of this nature to be exceptionally careful in relying upon court decisions. Many are dated and of no utility. For example, in Steele v. Stanley, the Court held that the shareholders of a corporation are liable for all debts and obligations undertaken after dissolution. At the time of that ruling, a corporation’s dissolution terminated its legal existence. Further, in this era there was neither administrative dissolution nor, crucially for these purposes, reinstatement after dissolution with retroactive effect. Under the modern system, a dissolved entity continues to exist and retains the power and authority to wind up and liquidate its affairs. After the filing of the articles of dissolution (or administrative dissolution) the entity is restricted to activities appropriate for its winding up and liquidation even as it continues to exist. Ergo, the Steele decision (and others of its milieu) fails to account for the statutory developments that give rise to this question. Even in more modern decisions from other jurisdictions, the outcome often hinges on the specific statutory language, and these differences between the states’ formulae may preclude reliance on the analysis employed and the conclusions reached.

[9.5.1] Irrespective of Reinstatement, an LLC Affords Its Members Limited Liability Even After Dissolution

In the case of an LLC, it must be initially recognized that the limited liability provision of the LLC Act is broader than is the limited liability provision of the Business Corporation Act. In the latter statute, it is provided that shareholders enjoy limited liability from the debts and obligations of the corporation. The statute is silent as to the limited liability that is enjoyed by both the directors and the officers. In contrast, the LLC Act, in addition to providing that the

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343 35 S.W.2d 867 (Ky. 1931).
344 See, e.g., 16A WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 8113. Of course a plaintiff relying upon this reasoning could well find themselves hoist upon their own petard. Under the law of that era, a corporation’s dissolution extinguished its debts. See, e.g., II STEWART KYD, A TREATISE ON THE LAW OF CORPORATIONS 516 (1794) (“The effect of the dissolution of a corporation is, that all its lands revert to the donor; its privileges and franchises are extinguished; and the members can neither recover debts which were due to the corporation, nor be charged with debts contrar
345 The “relates back” language came into Kentucky law with the 1988 adoption of KRS § 271B.14-220. The prior statute (KRS § 271A.615) was silent as to whether reinstatement related back or was only prospective.
346 See KY. REV. STAT. ANN. § 14A.7-020(3); see also Greene v. Stevenson, 175 S.W.2d 519, 523-24 (Ky. 1943) (the purpose of statutes for the extension of corporate existence after dissolution “is to abrogate the common law rules relative to the reversion of corporate real estate, escheat of its personal property, and extinguishment of the debts owed by and to it”).
347 See KY. REV. STAT. ANN. § 14A.7-020(3). It may be said that upon dissolution, whether voluntary, judicial or administrative, that the purpose of the LLC is to wind up and liquidate its business and affairs.
349 KY. REV. STAT. ANN. § 271B.6-220(2).
350 The limited liability enjoyed by the officers of a corporation is derived not from the law of corporations, but rather the law of agency. See, e.g., RESTATEMENT (THIRD) OF AGENCY § 6.01 (2006); RESTATEMENT (SECOND) OF
members enjoy limited liability from the LLC’s debts and obligations, goes on to extend that protection to the managers, employees and agents of the LLC.\textsuperscript{351} As such, the grant of limited liability by the LLC Act extends significantly further than does that afforded by the corporate law.

An LLC continues to exist as an LLC after dissolution.\textsuperscript{352} The dissolution of an LLC does not cause any of the members, managers, employees or agents of the LLC to cease being in those roles. If, after dissolution, an LLC remains an LLC (and the statute says that is the case) and an LLC affords each of its members, managers, employees and agents limited liability from its debts and obligations (and the statute says that is the case), it necessarily follows that even after dissolution the LLC continues to afford the members, managers, agents and employees of the LLC limited liability from its debts and obligations.

\textbf{[9.5.2] Upon Reinstatement After Administrative Dissolution, There is Limited Liability for Actions Undertaken After Dissolution and Before Reinstatement}

A dissolved LLC continues to exist as an LLC.\textsuperscript{353} From the administrative dissolution, the LLC is restricted to activities appropriate for its winding up and liquidation.\textsuperscript{354} Upon reinstatement, it is as if the administrative dissolution had never taken place;\textsuperscript{355} the existence of the LLC continues without interruption. In that an effect of reinstatement is that the LLC’s existence has not been interrupted, then the limited liability enjoyed by its agents is likewise uninterrupted.\textsuperscript{356}

This rule is consistent with the Restatement (Third) of Agency (the “Restatement”). Putting the issue in agency terms, Agent A, on behalf of Principal P, has both actual and apparent agency authority conferred at a time when P was fully competent. At some later time, P becomes incapacitated. During P’s incapacity, in the ordinary course of what would otherwise be P’s line of business and having fully disclosed P’s identity as the principal, A enters into a contract with third-party (“TP’’). At some point thereafter, P regains competency and expressly ratifies A having during the period of incapacity entered into the agreement with TP on P’s behalf. Thereafter, P defaults on the agreement with TP.


\textsuperscript{352} \textit{Ky. Rev. Stat. Ann.} § 275.300(2) (“A dissolved [LLC] shall continue its existence….”); \textit{id.} § 14A.7-020(3) (“An entity administratively dissolved continues its existence….”). Simply put, the “dissolution” of an LLC does not terminate its existence.


\textsuperscript{354} \textit{See id.}

\textsuperscript{355} \textit{Ky. Rev. Stat. Ann.} § 14A.7-030(3) (“as if the administrative dissolution or revocation had never occurred.”).

\textsuperscript{356} \textit{See also Ky. Rev. Stat. Ann.} § 275.003(1) (“Unless displaced by particular provisions of this chapter, the principals of law and equity shall supplement this chapter.”).
Initially, even if A was not aware of P’s incapacity, by entering into the contract with TP while P was incapacitated, A violated his warranty of authority and is potentially liable to TP on the obligation. Still, by ratification after the incapacity was lifted, P agreed to be bound on the contract with TP. The question is whether P’s ratification of A’s conduct during the period of incapacity cures A’s breach of the warranty of authority such that TP does not have recourse against A upon P’s default. The answer is that TP has no recourse against A.

The clearest authority for the proposition that the agent would not, on these facts, be personally liable for P’s obligations on the agreement is the Restatement (Third) of Agency section 4.02, which addresses the “Effect of Ratification.” Presuming that the LLC ratifies the agent’s actions undertaken during the period of incapacity (administrative dissolution), section 4.02(1) provides:

Subject to the exceptions stated in subsection (2), ratification retroactively creates the effects of actual authority.

It is important to consider as well section 4.01(1) of the Restatement, defining “ratification,” it providing:

Ratification is the affirmance of a prior act done by another, whereby the act is given effect as if done by an agent acting with actual authority.

Official comment (b) to section 4.02 of the Restatement provides in part:

Ratification has an immediate effect on legal relations between the principal and agent, the principal and the third party, and the agent and the third party. Ratification recasts those legal relations as they would have been had the agent acted with actual authority. Legal consequences thus “relate back” to the time the agent acted.

357 See RESTATEMENT (THIRD) OF AGENCY § 6.10 (2006); see also 3 AM.JUR.2d Agency § 295 (2008) (“Generally, one who contracts as an agent in the name of a non-existent or fictitious principal, or a principal without legal status or existence, is personally liable on a contract so made.”).

358 See RESTATEMENT (THIRD) OF AGENCY § 6.04 (2006) (“Unless the third party agrees otherwise, a person who makes a contract with a third party purportedly as an agent on behalf of a principal becomes a party to the contract if the purported agent knows or has reason to know that the purported principal does not exist or lacks capacity to be a party to a contract.”).

359 See RESTATEMENT (THIRD) OF AGENCY § 4.02 (2006).

360 See also RESTATEMENT (THIRD) OF AGENCY § 4.03 (2006) (“A person may ratify an act if the actor acted or purported to act as an agent on the person’s behalf.”).

361 This proposition is consistent with that has been Kentucky’s law on ratification. See, e.g., A & Equip. Co. v. Carroll, 377 S.W.2d 895, 897 (Ky. 1964) (citing 2 FLETCHER CYCLOPEDIA CORPS. (Permanent Ed.) § 752, pp. 1057-58):
Ergo, even if during the period of administrative dissolution the entity could not authorize an agent to undertake an act not relating to its winding up and liquidation,\textsuperscript{362} upon reinstatement the entity’s ratification of such actions causes the agent to have been vested with actual authority.\textsuperscript{363} Having actual authority to act on the principal’s behalf (and assuming identification of the principal), the agent is not personally obligated on the agreement.\textsuperscript{364}

This analysis is consistent with recent Kentucky decisions with the exception of the unsound \textit{Forleo} decision. In that unpublished decision, in partial reliance upon \textit{Steele v. Stanley},\textsuperscript{365} the Court held that the corporation’s reinstatement after administrative dissolution\textsuperscript{366} did not impact upon the personal liability of the shareholders and officers for debts incurred after dissolution and prior to reinstatement. Further, the Court relied upon the “resume” language in KRS § 271B.14-040(5) for the proposition “The ‘shall resume’ language necessarily implies that the corporation ceased doing business as required by KRS 271B.14-210(3).”\textsuperscript{367}

As will be reviewed below, the \textit{Forleo} decision conflicts with prior law and is an aberrational decision.

If the officers of the agents of a corporation assume to act for the corporation without any authority at all, or if they exceed their authority or act irregularly, and the act is one which could have been authorized in the first instance by the stockholders, board of directors or subordinate officers, as the case may be, it may be expressly or impliedly ratified by them, thus be rendered just as binding except as to intervening rights of third persons, as if it had been authorized when done, or done regularly.

\textsuperscript{362} See, e.g., \textit{KY. REV. STAT. ANN.} § 14A.7-020(4); \textit{RESTATEMENT (THIRD) OF AGENCY} § 3.04(2) (2006).

\textsuperscript{363} See \textit{RESTATEMENT (THIRD) OF AGENCY}, Ch. 4, Introductory Note (2006); \textit{id.} § 4.01, comment b (“That is, when a person ratifies another’s act, the legal consequence is that the person’s legal relations are affected as they would have been had the actor been an agent acting with actual authority at the time of the act.”).

\textsuperscript{364} See \textit{RESTATEMENT (THIRD) OF AGENCY} § 6.01 (2006). This rule as to the effect of ratification and the consequent release of the agent from personal liability on the contract is in no manner a recent innovation in the law. \textit{See, e.g., ERNEST W. HUFFCUT, THE LAW OF AGENCY INCLUDING THE LAW OF PRINCIPAL AND AGENT AND THE LAW OF MASTER AND SERVANT} at § 49 (p. 61) (Little, Brown & Co., 1901) (“An agent after ratification of his unauthorized act by his principal is in the same relation to the third party as if the acts had been previously authorized. The principal alone is generally liable on the contract he has ratified, ....”).


\textsuperscript{366} Prior to January 1, 2011 and the Kentucky Business Entity Filing Act, the language employed in the LLC Act as to the effect of reinstatement and that employed in the Business Corporation Act were essentially identical. \textit{Compare KY. REV. STAT. ANN.} § 271B.14-220(3) (prior to repeal by 2010 Ky. Acts, ch. 151, § 151) (“When the reinstatement is effective, it shall relate back to and take effect as of the effective date of the administrative dissolution or revocation and the corporation shall resume carrying on its business as if the administrative dissolution or revocation had never occurred.”) \textit{and KY. REV. STAT. ANN.} § 271B.14-040(5) (“When revocation of dissolution is effective, it shall relate back to and take effect as of the effective date of the dissolution and the corporation shall resume carrying on its business as if the dissolution never occurred.”) \textit{with KY. REV. STAT. ANN.} § 275.295(3)(c) (prior to repeal by 2010 Ky. Acts, ch. 151, § 151) (“When the reinstatement is effective, the reinstatement shall relate back to and take effect as of the effective date of the administrative dissolution, and the [LLC] shall resume carrying on business as if the administrative dissolution had never occurred.”).

Esselman v. Irvine\textsuperscript{368} should have been the definitive ruling on the matter, but unfortunately it was unpublished. Squarely addressing the effect of reinstatement upon the personal liability of an agent for an agreement entered into during the period of administrative dissolution and prior to reinstatement, the Court of Appeals affirmed the trial court’s conclusion that reinstatement “‘absolved [Irvine] of the personal liability that might have attached had his corporation remained dissolved.’”\textsuperscript{369} Further, Esselman considered and rejected the notion that “resume” limited the effect of “shall relate back.”\textsuperscript{370}

The next consideration of the issue by the Court of Appeals was \textit{Fairbanks Arctic Blind Co. v. Prather & Associates, Inc.},\textsuperscript{371} wherein it addressed an effort to dismiss a suit seeking enforcement of an agreement entered into while the corporation was administratively dissolved.\textsuperscript{372} The Court of Appeals\textsuperscript{373} held that:

> When the General Assembly stated in KRS 271B.14-220(3) that reinstatement shall relate back to and take effect as of the effective date of the administrative dissolution … and the corporation shall resume carrying on its business as if the administrative dissolution … had never occurred[.]

> We conclude, applying the rationale of \textit{J.B. Wolfe} and \textit{Joseph A. Holpuch} that it [the General Assembly] intended for reinstatement to restore a corporation to the same position it would have occupied had it not been dissolved and that reinstatement validates any action taken by a corporation between the time it was administratively dissolved and the date of its reinstatement. Simply put, the General Assembly meant what is said, that upon

\textsuperscript{368} No. 1997-CA-001155-MR (Ky. App. 1999).

\textsuperscript{369} \textit{Id.}, Slip op. at 5; see also \textit{id.} at 8 (“By allowing a corporation to be reinstated at “any time” after an administrative dissolution has taken place and by specifically stating that such a reinstatement \textit{shall} relate back to the date of the administrative dissolution and \textit{shall} operate as if the administrative dissolution has \textit{never occurred} the clear intent of the statute is unambiguous. As such the finding of the trial court in this matter – that the reinstatement of ICM absolves Irvine of personal liability – is not clearly erroneous.”) (\textit{emphasis} in original).

\textsuperscript{370} \textit{Id.} at 8.

\textsuperscript{371} 198 S.W.3d 143 (Ky. App. 2005).

\textsuperscript{372} \textit{Id.} at 144 (“On January 30, 2004, Prather, pursuant to Kentucky Rules of Civil Procedure (CR) 12, moved to dismiss Fairbanks’ claim on the ground that, according to Kentucky Revised Statutes (KRS) 271B.14-210, a corporation that has been administratively dissolved is prohibited from carrying on any business except that which is necessary to wind up and liquidate its business. Since Fairbanks had been administratively dissolved in 1991, Prather argued, it was prohibited from entering into the 1993 contract and thus the contract was null and void.”).

\textsuperscript{373} Apparently unaware of its prior decision in \textit{Esselman}, the \textit{Fairbanks} Court thought “Since this is an issue of first impression in the Commonwealth, ….” \textit{Id.} at 145.
reinstatement, it is "as if the administrative dissolution ... had never occurred."³⁷⁴

At this juncture the Esselman and Fairbanks opinions consistently state the view that upon reinstatement the agent is not liable upon agreements entered into on behalf of the entity after administrative dissolution and before reinstatement. It should be recognized that this rule is consistent with that described as being accepted by most jurisdictions:

In most jurisdictions, the reinstatement of a corporation following dissolution by administrative action of the court relates back to the effective date of dissolution, and directors or officers are not personally liable for actions taken during the period of dissolution or suspension. Such matters become the exclusive liability of the corporation.³⁷⁵

The Forleo decision was rendered in September, 2006, eleven months after the October, 2005 decision rendered in Fairbanks; how was it decided notwithstanding the Fairbanks decision? Likely we will never have a clear answer to the question. What is clear is that Fairbanks was not cited in the briefs submitted to the Court of Appeals panel considering the Forleo appeal,³⁷⁶ and it must be assumed that the Court’s own research did not reveal the prior published law on the topic.

In Eve v. Cosmo’s LLC,³⁷⁷ the Court considered an argument based upon the “resume” language of the statute; of course, this was the same argument that had been considered and rejected in Esselman v. Irvine³⁷⁸ to the effect that there should not be limited liability for actions undertaken during the period of administrative dissolution and prior to restatement. Rejecting that argument, the Court held:

By including the language that reinstatement relates back to the date of the administrative dissolution, the Court believes that the legislature meant what it said, to wit, that a § 275.295 reinstatement cures the dissolution, and that cure is effective as of the date of dissolution…. The situation herein is similar [to that in

³⁷⁴ Id. at 146 (citation omitted). The Court of Appeals rejected an effort to apply the statutory “resume” to limit the effect of the statute. “Prather urges us to focus solely on the word ‘resume’ found in KRS 271B.14-220(3) and construe the statute to disavow interim corporate activities. This would effectively redact the statute to read, ‘When the reinstatement is effective ... the corporation shall resume carrying on its business[,]’ However, as noted above, we may not subtract language from a statute nor may we render any of its language meaningless, if we can avoid doing so. Since Prater’s interpretation would do so, we decline to adopt it.” This determination was obviously consistent with that in Esselman.

³⁷⁵ 16A FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 8117.

³⁷⁶ See Brief for Appellants Dean Forleo and John Tandy dated September 6, 2005 and Brief for Appellees dated November 2, 2006.

³⁷⁷ Case No. 06-188-DLB, Memorandum Order (E.D. Ky. Mar. 27, 2008).

³⁷⁸ See supra notes 124 through 126 and accompanying text.
Fairbanks], where the alleged tortious conduct occurred while the LLC was administratively dissolved but then reinstated later. If contracts that were entered into on behalf of the dissolved corporation in Fairbanks were deemed valid by the Kentucky Court of Appeals, the Court believes Kentucky courts would similarly conclude when asked to interpret the LLC statute. As a result, Cosmo’s LLC and its members will be able to take advantage of the limited liability that K.R.S. § 275.150(1) provides.

In Pannell v. Shannon,379 the Court of Appeals rejected an effort to hold an individual liable on a lease entered into at the time her LLC was administratively dissolved.380 Relying upon Fairbanks, the Court wrote:

[R]einstatement restores a corporation to the same position it would have occupied had it not been dissolved and that reinstatement validates any action taken by a corporation between the time it was administratively dissolved and the date of its reinstatement. Simply put, the General Assembly meant what it said, that upon reinstatement, it is “as if the administrative dissolution … had never occurred.” Fairbanks Arctic Blind Co., 198 S.W.3d at 146. As reinstatement of a limited liability company relates back to the effective date of dissolution and operates as if dissolution never occurred, it naturally follows that members of such company are not individually liable for actions undertaken on behalf of the company during dissolution. See Fairbanks Arctic Blind Co., 198 S.W.3d 143. Hence, the subsequent reinstatement of Elegant Interiors as a limited liability company “related back” to date of its dissolution, and Shannon cannot be held individually liable for any actions undertaken on behalf of Elegant Interiors while it was administratively dissolved.381

Further, the Court chastised the plaintiff for citing the Forleo decision in its brief, noting that CR 76.28(4)(c) permits the citation of unpublished authority only when there is a “complete lack of published authority upon an issue.”382 Clearly, at least this panel of the Court of Appeals accepted that Fairbanks is the final authority on this point.

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380 Id. at *3 (“Alternatively, Pannell argues that Shannon is individually liable because Elegant Interiors was administratively dissolved as a limited liability company at the time of execution of the March 2006 lease.”).
381 Id. at 4.
382 Id., note 22.
Thereafter, the question was considered by Judge Coffman in *eServices, LLC v. Energy Purchasing, Inc.* When Energy Purchasing defaulted on a contract with eServices, the contract having been entered into while Energy Purchasing was administratively dissolved, it sought to hold Buchart, its agent, personally liable thereon. Energy Purchasing defended on the ground that it had been reinstated, thereby relieving Buchart of any personal liability. Judge Coffman agreed:

Because Energy Purchasing was reinstated after Buchart signed the contracts, the corporation is treated as having been in existence when the contracts were signed…

*eServices* had pinned its hopes on the *Forleo* decision. Judge Coffman dissected and discarded any application of *Forleo*, finding its reasoning unpersuasive, that it conflicted with the operation of the express statutory language and as well conflicted with the published *Fairbanks* decision.

In *Harshman Construction & Electric, Inc. v. Witte*, the plaintiffs sought to hold certain of the defendant’s representatives personally liable on their claim on the basis that the defendant corporation was administratively dissolved while performing on the subject contract; it was subsequently reinstated. Reversing the determination that the individuals were personally liable, the Court of Appeals parsed KRS § 271B.14-220(3), the predecessor to now applicable KRS § 14A.7-030, both of which provide that upon the reinstatement of a dissolved entity, the reinstatement shall “relate back to and take effect as of the effective date of the administrative dissolution or revocation” and the organization shall proceed forward as if the administrative dissolution “had never occurred.” Noting that the statute does not impose a time limitation for seeking reinstatement after administrative dissolution, and in reliance upon the 2005 ruling of the Court of Appeals in *Fairbanks*, the *Harshman* Court writing that:As reinstatement of a corporation relates back to the effective date of dissolution and operates as if dissolution never occurred, it naturally follows that the shareholders and officers of such corporation are not individually liable for actions undertaken on behalf of the corporation during its dissolution.

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In an effort to reduce to statute the rules consistently set forth in *Esselman, Fairbanks, Pannell* and *eServices* (as well anticipating the holding in *Harshman*)\(^{388}\) and to reject the aberrational *Forleo* decision, the 2012 General Assembly enacted two statutory amendments to KRS § 14A.7-030. First, but of smaller importance, “resume” was deleted and “continue” was substituted in place thereof.\(^ {389}\) Second and of greater import, a new subsection (3)(c) was added to the statute, it defining one effect of reinstatement as:

> The liability of any agent shall be determined as if the administrative dissolution or revocation had never occurred.\(^ {390}\)

The Kentucky Supreme Court brought this debate to a clear conclusion in *Pannell v. Shannon*.\(^ {391}\)

The dispute arose out of a defaulted lease. Shannon’s LLC was the tenant – that LLC was during the term of the lease administratively dissolved. A replacement lease was entered into in the period between the administrative dissolution and the LLC’s reinstatement. When the LLC ultimately defaulted the landlord sought to hold Shannon liable on the obligation.

The real crux of the decision is the impact of administrative dissolution and subsequent reinstatement upon each of (i) a member’s limited liability and (ii) the liability of an agent on a contract entered into after dissolution and before reinstatement.\(^ {392}\) The Court recognized that these are distinct questions based upon distinct legal principles:

> [T]he liability of a director, officer, employee or agent of a limited liability entity during a period of administrative dissolution is technically a separate question from the liability of the owners of the entity.\(^ {393}\)

The Court could not have been more express about the continuity of a member’s limited liability after dissolution:

> This Court concludes that a member of an [LLC] enjoys statutory immunity from liability under KRS 275.150 for actions taken during a period of administrative dissolution so long as the

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\(^{388}\) See also *Moore v. Stills*, 307 S.W.3d 71, 81 (Ky. 2010) (giving retroactive effect to statutes “that clarify existing law or that codify judicial precedent.”).

\(^{389}\) See KY. REV. STAT. ANN. § 14A.7-030(3)(b) as amended by 2012 Ky. Acts, ch. 81, § 83.


\(^{391}\) 425 S.W.3d 58 (Ky. 2014).

\(^{392}\) 425 S.W.3d at 68.

\(^{393}\) 425 S.W.3d at 77.
company is reinstated before a final judgment is rendered against the member.\textsuperscript{394}

Distancing LLCs from the common law of corporations, the Court looked to the statutes addressing a member’s limited liability (KRS § 275.150) and the retroactive effect of reinstatement (KRS § 275.295(3)(c); now KRS § 14A.7-030(3)) and determined that reinstatement wiped the slate clean.

The plain meaning of the relate-back language is that the company is deemed viable on reinstatement from the point of administrative dissolution onward, which necessarily includes the time of suspension between the date of administrative dissolution and reinstatement.

Reinstatement under the statute literally undoes the dissolution. This is why the Secretary of State was required to “cancel” the certificate of dissolution and issue a certificate of existence. \textit{See} KRS 275.295(3)(a). And that certificate of existence took effect, by statute, retroactively on the date of dissolution.\textsuperscript{395}

Pannell’s argument that a member’s limited liability is suspended during the period between administrative dissolution and reinstatement was rejected.

Turning to the question of Shannon’s liability as an agent for the LLC’s obligation undertaken while the LLC was administratively dissolved, the Court noted that the question divides into a pair of inquiries, namely:

First, can Shannon under the circumstances of this case be personally liable by reason of her merely being an agent? Second, can she be personally liable because she acted as an agent without authority?

In response to the first question, the Court referred to KRS § 275.150(1) and noted that its rule of limited liability extends to the LLC’s agent. As the LLC’s existence had been reinstated and:

reinstatement is retroactive to the date of dissolution, and it is as if the dissolution never occurred, giving the company a seamless

\textsuperscript{394} 425 S.W.3d at 67. It is this aspect of the decision that is most unsettling. Essentially, the balance of the decision supports and applies the statutory rules that (i) dissolution of an LLC does not terminate its existence as an LLC and (ii) dissolution does not terminate the rule of limited liability. The “so long as the company is reinstated” language cuts against the statute by in affect conditioning continuing limited liability upon reinstatement. This language may have been intended by the Court as a means of supporting the \textit{Forleo} decision, but it is out of step with and adds ambiguity to what is otherwise a clear application of unambiguous statutory law.

\textsuperscript{395} 425 S.W.3d at 68.
existence. The limitation on the agent’s liability simply for being an agent is likewise seamless.\textsuperscript{396}

In that the LLC in question was subsequently reinstated, the Court found there to be no opportunity for imposing liability on an agent. Rather, as the LLC Act protects agents from liability on the LLC’s debts (KRS § 275.150(1)), then:

To the extent that any liability is claimed solely because Shannon was a manager or agent of the LLC, the analysis above for why she cannot be liable as a member applies. The reinstatement is retroactive to the date of dissolution, and it is as if the dissolution never occurred, giving the company a seamless existence. The limitation on the agent’s liability simply for being an agent is likewise seamless.\textsuperscript{397}

Providing an appropriate critical eye to the question before it, the Court observed:

The immunity provided by KRS 275.150 extends only to liability \textit{by reason} of her being an agent. By alleging that Shannon acted without authority, Pannell is not claiming she is liable solely because of her status as an agent, but because she had no authority to act as an agent.\textsuperscript{398}

In reliance upon the statutory statement that a dissolved LLC continues to exist after its dissolution, the Court found that when combined with reinstatement, Shannon never lost the capacity of being the LLC’s agent.

In response to the argument that giving such a broad affect to the effect of reinstatement is improper, the Court observed:

The simple fact is that Kentucky’s corporation law and other business entity laws differ from those in other states …. The existence of a majority rule can only be persuasive if the rule is based on statutes like those in Kentucky.\textsuperscript{399}

\textbf{[9.5.3] Different Statutes and Different Rules}

Be aware, however, that different statutes have different rules as to the effect of administrative dissolution. For example, a recent decision from Illinois interprets and places certain limits upon

\textsuperscript{396} 425 S.W.3d at 78.
\textsuperscript{397} 425 S.W.3d at 78.
\textsuperscript{398} 425 S.W.3d at 81.
\textsuperscript{399} 425 S.W.3d at 79, 80.
the effect of the statute providing that, upon reinstatement after administrative dissolution, it is as if it never took place. In this case, the fact that it took place had legal effect.400

Clark/School LLC was the borrower pursuant to a mortgage that included as an event of default the failure to maintain the LLC as an LLC. A default was declared under the mortgage on the basis that the LLC had been administratively dissolved as well as other defaults in the covenants. In response to a declaration of default and the appointment of a receiver, the LLC asserted that there was no default in the existence covenants in that the LLC had been reinstated by the Illinois Secretary of State pursuant to a statute that provides, *inter alia*, that the reinstatement after administrative dissolution relates back to and in effect cures the dissolution. The lender responded, *inter alia*, that the subsequent cure of the dissolution did not impact the fact that it had taken place. Rather:

In this case, Section 4.14 of the party’s mortgage security agreement plainly stated that the mortgage loan was made in reliance on defendant’s continued existence as an LLC. Defendant agreed to maintain its existence and ensure its continuous right to carry on its business. The party’s agreement defined defendant’s breach of Section 4.14 as an “Event of Default.” In its December 2013 complaint, plaintiff alleged defendant failed to maintain its existence as an LLC because it was not in good standing with the Secretary of State and dissolved in September, 2011. Defendant acknowledges that, at the time plaintiff filed its complaint, it was not in good standing and had been dissolved. Under these circumstances, we hold the LLC Act’s relation-back provision does not apply to prevent defendant’s dissolution from constituting an “Event of Default under the party’s agreement.

13. **Winding Up and Termination**

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Exhibit A
Model LLC Organizational Checklist
Model Organizational Checklist

For a Limited Liability Company
Introduction

Every limited liability company is a unique entity intended to reflect the objectives and agreement of the members (and perhaps other stakeholders) in the business. With few exceptions there is freedom of contract among those parties to reflect their agreement in the operating agreement. Counsel’s obligations are at minimum two-fold: to explain the consequences and implications of the deal points on which decisions have at least provisionally been made and to identify additional matters upon which decisions need to be made. Counsel is then obligated to reflect the agreement in the written instrument.

This checklist is an effort, in an admittedly generic document, to identify certain matters upon which agreement needs to be had and which in most, although admittedly not all, operating agreements that agreement should be set forth.

This document is not business or transaction specific. Obviously the operating agreement of a small accounting firm LLC in which allocations/distributions are based on a formula that looks to client origination, maintenance, and work credits is a substantially different document from that of a syndicated real estate venture in which several pension funds are providing funds and a developer is serving as manager and is receiving an incentive interest. The particulars of the deal in question must be addressed in the operating agreement drafted for that deal. Neither is this document state specific. As such, we do not devote significant attention to the non-economic member that is possible in Delaware and Kentucky, the board management structure that is available in Tennessee, Minnesota and North Dakota, and the series LLC available in Delaware, Iowa, Illinois, Texas and other states. Each state’s LLC act has its differences when compared to those of other states, and counsel needs to take account of them in determining choice of jurisdiction in which to organize and in drafting the operating agreement.

It is not possible to draft an operating agreement without taking into account the tax implications of the arrangement being memorialized in the operating agreement. That said, this checklist is not intended to provide a comprehensive education regarding the implications of various elections and determinations vis-à-vis either an individual member and the LLC or among the members. In many instances we have provided indications of the tax consequences of particular elections, but that no tax effect of a particular provision is identified should not be interpreted as an indication that there is no tax effect. The footnotes are intended to identify many substantive issues and to inspire the readers to investigate potential issues more closely on their own.

The Committee on LLCs, Partnerships and Unincorporated Entities has published a Model Real Estate Development Operating Agreement, 63 BUS. LAW. 385 (2008). That agreement is an exploration of how an operating agreement could be written for a particular fact situation, namely a three-party real estate development, and under the laws of a particular state, namely Delaware. In addition, this Committee has published a Model Limited Liability Company Membership Interest Redemption Agreement, 61 BUS. LAW. 1197 (2006), and the Mergers and Acquisitions Committee of the Business Law Section of the American Bar Association has published a MODEL JOINT VENTURE AGREEMENT (2006). This checklist is not intended to be a companion to any of those agreements. Rather, this checklist is intended to be
broader in scope, not limited to either a particular factual situation for the transaction in question or restricted to any individual state.

This Model Limited Liability Company Organizational Checklist is a project of the Limited Liability Company Subcommittee of the LLCs, Partnerships and Unincorporated Entities Committee, Section of Business Law, American Bar Association.

This model is the product of contributions from many individuals over several years, and the following should be recognized for their efforts: Paul M. Altman, Michael A. Bamberger, Louis T. Conti, Allan G. Donn, Curtis L. Golkow, Louis G. Hering, Peter D. Hutcheon, Leon Andrew “Andy” Immerman, W. Alan Kailer, Lewis R. Kaster, Cristin Conley Keane, Robert R. Keatinge, Professor Daniel S. Kleinberger, Scott E. Ludwig, Professor Elizabeth S. Miller, Jennifer Howard Moore, Thomas E. Rutledge, Sherwin P. Simmons, Edward L. Wender and James J. Wheaton.

Respectfully,

Your Co-Chairs,

Laura D’Angelo and Phuc H. Lu
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MEMORANDUM

TO: File

FROM:

RE: LLC Formation Checklist

DATE: July 21, 2009

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OUR CLIENT

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Client is:

☐ Member

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401 This agreement necessarily assumes that an appropriate choice of entity analysis has been undertaken and that the conclusion was that an LLC is the most appropriate form for the particular venture. For an extensive analysis of choice of entity issues, see ANN CONAWAY, BRUCE ELY & ROBERT R. KEATINGE, KEATINGE AND CONAWAY ON CHOICE OF BUSINESS ENTITY (2014) [hereinafter KEATINGE AND CONAWAY]; see also CARTER G. BISHOP & DANIEL KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶¶ 3.01-.12 (2014) [hereinafter BISHOP AND KLEINBERGER]; 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES §§ 2:01–:38 (2014) [hereinafter RIBSTEIN AND KEATINGE].

402 Clearly identify who is the client and make that determination clear not to only the client but others who may believe or assert an attorney-client relationship. The situation is complicated by the fact that if the client is the LLC, then the client does not exist before filing the articles of organization/certificate of formation. Some states apply the incorporation rule under which the organizers consult with an attorney regarding the formation of a business entity, and upon its formation the attorney-client relationship shifts to the newly formed business structure. See, e.g., Manion v. Nagim, No. C.A. 00-238 ADM/RLE, 2004 U.S. Dist. LEXIS 1776, *10-11 (D. Minn. 2004), aff’d, 394 F.3d 1062 (8th Cir. 2005); but see Pucci v. Santi, 711 F. Supp. 916, 927 n.4 (N.D. Ill. 1989) (attorney for partnership also represents each general partner); Schwartz v. Broad. Music, Inc., 16 F.R.D. 31, 32 (S.D.N.Y. 1954) (each member of unincorporated association is client of association’s attorney); New York City Bar Ass’n Comm. on Professional and Judicial Ethics, Formal Op. 1986-2 (1986); see also MODEL RULES OF PROF’L CONDUCT 1.7, 1.9, 1.13, 2.2 (2013) (now deleted by ABA but still in place in some states, see, e.g., W. VA. RULES OF PROF’L CONDUCT, R. 2.2 (2013)); Thomas E. Rutledge & Phuc H. Lu, No Good Deed Goes Unpunished: Pitfalls for Counsel to a Business Organization About to be Governed by a New Law, 45 BRANDEIS L.J. 755, 770-71 (2007). In Montgomery v. eTreppid Technologies, LLC, 548 F. Supp. 2d 1175, 1183-88 (D. Nev. 2008), the court held that counsel to an LLC were counsel to it as a distinct legal organization, that a former manager and member was not a joint client with the LLC for that time he was its manager for purposes of privilege, and that communications between the LLC and its counsel were not discoverable in a dispute between that former manager/member and the LLC.
Counsel should consider whether there are potential problems with counsel’s representing all of the LLC members during the formation or operational stages of the LLC. For example, the competing interests of the members may be so strong or antagonistic that the counsel’s representing those members may create unavoidable conflicts of interests. Indeed, there is potential for this complication to arise whenever there is multiple representation in business organizations. In that situation, it may be advisable for the LLC members to have separate representation. See MODEL RULES OF PROFESSIONAL CONDUCT R. 1.7 cmts. 8, 18, and [29]-[32] (2012).

Letters to other initial members who will be involved in the organization but who are not represented should be considered as well. See I GARY A. MUNNEKE & ANTHONY B. DAVIS, THE ESSENTIAL FORMBOOK: COMPREHENSIVE MANAGEMENT TOOLS FOR LAWYERS 273-280 (2000). Consider whether the operating agreement should recite for whom the drafting attorney was engaged, who is that attorney’s client, and who is not the attorney’s client.

A. Jurisdiction of organization:  
Choice of the jurisdiction of organization will have an impact upon the rules governing the LLC and its owners. For example, although certain states provide a default rule of unanimous approval for amendment of the operating agreement (see, e.g., ALA. CODE § 10A-5-4.03 (LEXIS through 2014 Reg. Sess.); MONT. CODE ANN. § 35-8-307(3)(a) (LEXIS through 2013 Reg. and Special Sess.); TEX. BUS. ORGS. CODE ANN. § 101.053 (LEXIS through 2013 3rd Called Sess.); VA. CODE ANN. § 13.1-1023(B)(2) (LEXIS through 2014 Regular Session and Acts 2014, Sp. Sess. I, c. 1, of the General Assembly)), other states permit the amendment of the operating agreement by less than unanimous approval. See, e.g., CONN. GEN. STAT. § 34-142(b) (LEXIS through P.A. 14-211 (except 14-175, 14-187 and 14-205)) (2/3rd of the members); KY. REV. STAT. ANN. § 275.175(2)(a) (LEXIS through 2013 First Extra. Sess.) (a majority in interest of the members); OKLA. STAT. tit. 18 § 2020(B)(3) (LEXIS Current through Chapter 23(End) of the First Extraordinary Session of the 54th Legislature (2013)) (a majority of the members). For another example, the Delaware LLC act provides that unless the operating agreement provides otherwise, a resigning member is entitled to receive the fair value of its limited liability company interest. DEL. CODE ANN. tit. 6, § 18-604 (LEXIS through 2014 Fiscal Sess.). Other acts provide that a member, upon withdrawing, becomes simply an assignee of its membership interest in the company and has no right to liquidate that interest. See, e.g., KY. REV. STAT. ANN. § 275.280(4) (LEXIS through 2013 First Extra. Sess.).

RPLLCA § 603(a), 67 BUS. LAW. at 171; RULLCA § 603(a)(3), 6B U.L.A. 504 (2008). See also Thomas E. Rutledge, You Just Resigned – Now What? Different Paradigms for Withdrawing from a Venture. J. PAST THROUGH ENTITIES, Nov./Dec. 2009, at 43; Rutledge, Chapman v. Regional Radiology Associates, PLLC: A Case Study in the Consequences of Resignation, 100 KY. L.J. ONLINE 15 (2011). While those and other default rules may be in the operating agreement, not appreciating the underlying default rule can materially affect the agreement. For an overview of the basic approach of LLC statutes including a discussion of selection criteria, see Bishop & Kleinberger, supra note 1, ¶ 5.01-.04.

B. Name of LLC:  
Each state has a requirement regarding mandatory designators for a limited liability company such as “limited liability company” or “L.L.C.” See, e.g., DEL. CODE ANN. tit. 6, § 18-102 (LEXIS through 2014 Fiscal Sess.); FLA. STAT. ANN. § 608.406 (LEXIS through the 2013 Reg. Sess.); KY. REV. STAT. ANN. § 14A.3-010(3) (LEXIS through 2013 First Extra. Sess.); N.Y. LTD. LIAB. CO. LAW § 204 (Consol. 2014); TEX. BUS. ORGS. CODE ANN. § 5.056 (LEXIS through 2013 3rd Called Sess.); VA. CODE ANN. § 13.1-1012 (LEXIS through the 2014 Regular Session and Acts 2014, Sp. Sess. I, c. 1, of the General Assembly); see also Ribstein & Keating, supra note 1, § 4:11. See infra note 14 for particular issues involving the name of a professional LLC. Consider also the requirements for “distinguishability” imposed by the laws of the jurisdiction of organization and of states in which it is anticipated the LLC will need to qualify to transact business. State and federal trademark and service mark protections and infringements should also be considered.

C. LLC will be:  
Some, but not all, LLC acts require a designation in the articles of organization of the LLC as “member-managed” or “manager-managed.” See, e.g., KY. REV. STAT. ANN. § 275.025(1)(d) (LEXIS through 2013 First Extra. Sess.); MONT. CODE ANN. § 35-8-202(1)(2) (LEXIS through 2013 Reg. and Special Sess.); TEX. BUS. ORGS. CODE ANN. § 101.251 (LEXIS through 2013 3rd Called Sess.). States without this requirement include Delaware (DEL. CODE ANN. tit. 6, § 18-402 (LEXIS through 2014 Fiscal Sess.)) (Delaware defaults to member-managed if no designation is made in the operating agreement), Georgia (GA. CODE ANN. § 14-11-301 (LEXIS through 2014 Reg. Sess.)); Georgia defaults to member-managed if no designation) and Virginia, although Virginia does expressly allow this designation. VA. CODE ANN. § 13.1-1021.1(B)(1) (LEXIS through the 2014 Regular Session and Acts 2014, Sp. Sess. I, c. 1, of the General Assembly). Similarly, no such election is required under the Revised Prototype LLC Act (see RPLLCA § 201, 67 BUS. LAW. at 142) or under RULLCA. See RULLCA § 201, cmt. to subsection b, 6B U.L.A. 458 (2008). This election has implications for both the external apparent authority on behalf of the LLC and the internal decision-making mechanism of the LLC. See, e.g., KY. REV. STAT. ANN. § 275.135 (LEXIS through 2013 First Extra. Sess.); id. § 275.165; VA. CODE ANN. § 13.1-1021.1 B.1 (LEXIS.
D. Name of Registered Agent: 410


The statutory provisions for either a “member-managed” or a “manager-managed” LLC, as they relate to the inter-se decision making function, are optional and non-exclusive models. Minnesota, North Dakota and Tennessee, by statute, each provides an alternative management structure, namely a board-managed LLC. See MINN. STAT. § 322B.606 (LEXIS through 2014 Reg. Sess.); N.D. CENT. CODE § 10-32-69 (LEXIS through 2013 Reg. Sess.); TENN. CODE ANN. § 48-239-101 (LEXIS through 2013 Reg. Sess.). In each of those states, if the board-managed option is utilized, it may be customized in the operating agreement. In the other states, even though there is no statutory mechanism for board management, it may be provided for in the operating agreement. Even then, there is a nearly inexhaustible number of options that might be provided. For example, it could be provided that there will be any number of individuals who will bear the title of manager, and that while any individual manager has authority to bind the LLC up to a particular dollar threshold, any obligation in excess of that limit must be sanctioned by some threshold of the entire number of managers before the company is to be bound. Alternatively, it could be provided that there will be a board of directors, elected or appointed from time to time by the members, that has a general oversight responsibility for the LLC but whose individual constituent members do not, as members of the board of directors, have any agency authority to bind the LLC. Rather, the LLC will act through those persons who are granted specific authority with respect to a particular transaction or through persons who have been afforded apparent agency authority to bind the LLC, such as through a title such as president, that indicates apparent agency to bind a business organization.

409 Tennessee, North Dakota and Minnesota fall outside of the general “member-managed” or “manager-managed” structures. Minnesota does not specifically authorize management of the LLC by its members, and it requires that each LLC have at least two managers, a chief executive manager and a treasurer. Minnesota LLCs have a board of governors that appoints the managers. MINN. STAT. ANN § 322B.676 (LEXIS through 2014 Reg. Sess.). It should be noted, however, that the power to directly manage some or all aspects of the LLC may be reserved to the members pursuant to a control agreement (MINN. STAT. ANN. § 322B.37), and that any decisions that could be made by the managers may as well be taken by unanimous vote of the members (MINN. STAT. ANN. § 322B.606, subd. 2). Tennessee utilizes a structure under which LLCs are either member-managed or board-managed. TENN. CODE ANN. § 48-239-101 (LEXIS through 2013 Reg. Sess.). Where the LLC is board-managed, the members may override the decisions of the board by a two-thirds vote. TENN. CODE ANN. § 48-239-101(a)(3) (LEXIS through 2013 Reg. Sess.). North Dakota provides a board-managed structure where the board consists of one or more governors (N.D. CENT. CODE § 10-32-70 (LEXIS through 2013 Reg. Sess.),) and may be elected by the organizers or named in the articles of organization or member-control agreement. N.D. CENT. CODE § 10-32-69(1) (LEXIS through 2013 Reg. Sess. 2013). Members may, by unanimous vote, take any action that is permissible or required by the board. N.D. CENT. CODE § 10-32-69(2) (LEXIS through 2013 Reg. Sess. 2013). Members may, subject to exceptions, remove any one or all governors with or without cause by majority vote. N.D. CENT. CODE § 10-32-78(3) (LEXIS through 2013 Reg. Sess.).

410 Every LLC act requires the designation by the company of a registered agent. See, e.g., DEL. CODE ANN. tit. 6, § 18-201(a)(2) (LEXIS through 2014 Fiscal Sess.); IND. CODE § 23-18-2-4(b)(2) (LEXIS through 2013 Reg.
are no incumbent members. While the

LEXIS through 201-

rd-
LEXIS

Virginia permits the formation of an LLC that lacks, at the time of formation, a

3.001(c)(d) (allowing a filed document to have a delayed effective date not to exceed 60 days after the filing date); RULLCA § 201(d)(1), 6B U.L.A. 456 (2008). Most, if not all, states allow the filing of documents, including articles of

organization, with a delayed effective date.


Depending upon the specifics of state law, the principal office address may be a post office box or, in the alternative, it may be required that it be a street address. If, at the time this checklist is being completed, a
determination as to the state of organization has not yet been finalized, the best practice may be to get both the street and, if different, the mailing address that will be the principal address of the LLC.

Most states provide that the organizer/authorized person need not be a member, but most states require that there be, at the time the LLC is formed, at least one member. See, e.g., KY. REV. STAT. ANN. § 275.020(1) (LEXIS through 2013 First Extra. Sess.); id. § 275.020(2); MD. CODE ANN., CORPS & ASS’NS 4A-202(b) (LEXIS Emergency Legis. Through 2013 Second Reg. Sess.); TEX. BUS. ORGS. CODE ANN. § 3.001(c)(d) (LEXIS through 2013 3 rd Called Sess.); RPLLCA § 201(b)(1), 67 BUS. LAW. at 142; RULLCA § 201(d)(1), 6B U.L.A. 456 (2008). Most, if not all, states allow the filing of documents, including articles of organization, with a delayed effective date. See, e.g., FLA. STAT. § 608.409(2) (LEXIS through the 2013 Reg. Sess.) (delayed effective date for a document may not be later than the 90th day after the filing date); KY. REV. STAT. ANN. § 14A.2-070(2) (LEXIS through 2013 First Extra Sess.) (allowing a filed document to have a delayed effective date not later than the 90th day after the filing); N.Y. LTD. LIA. CO. LAW § 203(d) (Consol. 2014) (allowing a filed document to have a delayed effective date not to exceed 60 days after the filing date); TEX. BUS. ORGS. CODE ANN. §§ 4.052-4.053 (LEXIS through 2013 3 rd Called Sess.); RPLLCA § 205(d)(3)(B), 67 BUS. LAW. at 145. In Virginia, a company is deemed organized upon the issuance of a certificate of organization by the Virginia State Corporation Commission. VA. CODE ANN. § 13.1-1004.B (LEXIS through the 2014 Regular Session and Acts 2014, Sp. Sess. I,
I. Professional LLC.\textsuperscript{414} \textbf{☐} Yes \textbf{☐} No

Formed by conversion or merger.\textsuperscript{415} \textbf{☐} Yes \textbf{☐} No

c. 1, of the General Assembly.). The Delaware act requires there to be a limited liability company agreement to complete the formation process but allows a limited liability company agreement to be entered into after the filing of a certificate of formation and to be made effective as of the formation or at some other time or date as provided in the limited liability company agreement. \textsc{Del. Code Ann. tit. 6, \textsection{} 18-201(d) (LEXIS through 2014 Fiscal Sess.).}

\textit{Federal tax principles, rather than state LLC law, determine the time at which a “partnership” comes into existence for federal tax purposes. One influential decision notes, “A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses.” Comm’r v. Tower, 327 U.S. 280, 286 (1946); see also Torres v. Comm’r, 88 T.C. 702, 736 (T.C. 1987); Sparks v. Comm’r, 87 T.C. 1279, 1282 (T.C. 1986) (“A partnership is formed when the parties to a venture join together capital or services with the intent of conducting presently an enterprise or business”). Accordingly, other than the confusion of having the date of the operating agreement differ from the date of the LLC’s formation, there should be no substantive difference between dating the agreement as of the date it is signed or as of the date of its formation when the LLC does not conduct any business or engage in any activities during the period between those two dates. An argument exists, however, during the interim period that the state’s default rules govern and may result in unintended consequences for that time period.}

\textsuperscript{414} California allows the use of the LLC for structuring a professional practice except for the professions of law and medicine. \textsc{Cal. Corp. Code \textsection{} 17375 (LEXIS (with urgency legislation) through Ch. 31 of the 2014 Session and Propositions 41 & 42 approved June 2014). All other states allow the use of the LLC for legal and medical practices and other professions. For the state or states at issue, check the LLC act for a “profession.” See, e.g., \textsc{Fla. Stat. \textsection{} 621.03(3) (LEXIS through the 2013 Reg. Sess.); Ky. Rev. Stat. Ann. \textsection{} 275.015(25) (LEXIS through 2013 First Extra. Sess.); Tex. Bus. Orgs. Code Ann. \textsection{} 301.003(8) (LEXIS through 2013 3\textsuperscript{rd} Called Sess.). Some states require additional information in the articles of organization of a professional LLC. See, e.g., \textsc{Ky. Rev. Stat. \textsection{} 275.025(3) (LEXIS through 2013 First Extra. Sess.) (profession or professions to be practiced through LLC); Tenn. Code Ann. \textsection{} 48-249-1103(a)(2)-(3) (LEXIS through 2013 Reg. Sess.) (that LLC is a professional LLC and that it has one or more professional owners and no non-professional members); Tex. Bus. Orgs. Code Ann. \textsection{} 3.014 (LEXIS through 2013 3\textsuperscript{rd} Called Sess.) (that the entity is a professional LLC and the type of professional service to be provided). In forming a professional LLC, care must be taken to address compliance with professional regulatory rules that affect structure and ownership. See, e.g., \textsc{Ky. Rev. Stat. Ann. \textsection{} 325.301(1)(a), (c) (LEXIS through 2013 First Extra. Sess.); 201 KAR 1:081 (LexisNexis 2014) (rules applicable to accounting firms). In some states, the name of a professional LLC must include the word “professional” or an appropriate abbreviation in its name. See \textsc{Fla. Stat. \textsection{} 621.12(2)(b)(2) (LEXIS through the 2013 Reg. Sess.); Ky. Rev. Stat. Ann. \textsection{} 14A.3-010(3) (LEXIS through 2013 First Extra. Sess.); N.C. Gen. Stat. \textsection{} 48-248-301(a)(1) (LEXIS through 2013 Reg. Sess.); Tex. Bus. Orgs. Code Ann. \textsection{} 5.059 (LEXIS through 2013 3\textsuperscript{rd} Called Sess.). \textit{Contrast N.Y. Ltd. Liab. Co. Law \textsection{} 1212 (Consol. 2014) (“Professional” not required to be in the name of a professional service limited liability company).}}

Other mandatory provisions:  

Other non-mandatory provisions:  

Waivers of limited liability:  

Operating Agreement to be signed by LLC:  

there exists only one business entity, (ii) there having been no merger, “due on merger” clauses are not triggered, and (iii) the converted entity is the same entity as that which existed before the conversion. See, e.g., DEL. CODE ANN. tit. 6, § 18-214 (LEXIS through 2014 Fiscal Sess.); FLA. STAT. § 608.4404 (LEXIS through the 2013 Reg. Sess.); KY. REV. STAT. ANN. § 275.375 (LEXIS through 2013 First Extra. Sess.); RPLLCA § 1008, 67 BUS. LAW. at 208; VA. CODE § 13.1-1010.2 (LEXIS through the 2014 Regular Session and Acts 2014, Sp. Sess. I, c. 1, of the General Assembly.).

The requirements for the articles/certificate are state specific and need to be satisfied. For example, a state may require that they list the initial members or initial managers. See, e.g., NEV. REV. STAT. § 86.161(1)(d) (LEXIS through 2013 Reg. and Special Sess.).

Many LLC acts permit the articles of organization to contain provisions that are not required to be included. See, e.g., DEL. CODE ANN. tit 6, § 18-201(a)(3) (LEXIS through 2014 Fiscal Sess.); KY. REV. STAT. ANN. § 275.025(4) (LEXIS through 2013 First Extra. Sess.); RPLLCA, § 201(a)(5), 67 BUS. LAW. at 142; TEX. BUS. ORGS. CODE ANN. § 3.005(b) (LEXIS through 2013 3rd Called Sess.). However, although the states may permit additional information in the articles, they have different rules for whether those provisions, simply by filing with the Secretary of State, constitute notice to third parties who are not otherwise aware. See, e.g., DEL. CODE ANN. tit. 6, § 18-207 (LEXIS through 2014 Fiscal Sess.) (only those provisions of the certificate of formation setting forth the name, the registered agent/office, and whether the LLC is a series LLC constitute notice by filing with the Secretary of State’s office); KY. REV. STAT. ANN. § 275.025(7) (LEXIS through 2013 First Extra. Sess.) (articles of organization on file with the Secretary of State are notice that an LLC is organized under Kentucky law and of all other facts set forth therein that are required to be set forth in the articles); N.H. REV. STAT. ANN. § 304-C:16 (LEXIS through 2013 Reg. Sess.) (certificate of formation on file with the Secretary of State is notice that the entity has been formed as an LLC “and is notice of all other facts set forth in the certificate which are required to be set forth by RSA 304-C:12II(a), (b), and (c).”). See also Zions Gate R.V. Resort, LLC v. Oliphant, 326 P.3d 118 (Utah Ct. App. 2014). For a discussion of optional contents in the articles of organization, see BISHOP AND KLEINBERGER, supra note 1, ¶ 5.05[3]; RIBSTEIN AND KEATINGE, supra note 1, § 4:08. New York has an additional requirement that the articles of organization be published in two newspapers for six weeks and that the LLC file proof of that publication with the department of state. N.Y. LTD. LIAB. CO. LAW § 206 (Consol. 2014).

Several of the LLC acts expressly permit the members, by a provision in the articles of organization, to waive their limited liability either in total or with respect to certain obligations. Other LLC acts allow that election to be set forth in either the articles of organization or in another written agreement. See, e.g., KAN. STAT. ANN. § 17-7688(b) (LEXIS through 2013 Reg. Sess.); KY. REV. STAT. ANN. § 275.150(2) (LEXIS through 2013 First Extra. Sess.); TEX. BUS. ORGS. CODE ANN. § 101.114 (LEXIS through 2013 3rd Called Sess.); id. § 101.051. It is unusual for LLC members to waive limited liability completely. It is more common, however, for LLC members to guarantee some or all of the LLC debt or to agree to a limited obligation to restore a deficit capital account. Besides the obvious economic consequences, a guarantee of debt or deficit restoration obligation can have important tax consequences, including consequences under Code § 465 (“at risk” rules) and Code § 752 (LLC debt included in member’s basis).

There is some question regarding whether the LLC is bound by the operating agreement if the LLC fails to execute the operating agreement. Contrast Tover v. 419 OCR, Inc., 921 N.E.2d 1249, 1254-45 (Ill. App. 2010) (LLCs not bound by arbitration clauses in operating agreement because LLC is not a party to operating agreement);
Operating Agreement to be signed by Managers: 420

☐ Yes  ☐ No  ☐ N/A

O. Company Communication Agent: 421

Bubbles & Bleach, LLC v. Becker, No. 97 C 1320, 1997 U.S. Dist. LEXIS 7471, at *6 (N.D. Ill. May 16, 1997) (LLC not bound by arbitration clause in operating agreement); In re Am. Media Distrib., LLC, 216 B.R. 486, 487 (Bankr. S.D.N.Y. 1998) (LLC is not a party to operating agreement and therefore bankrupt LLC cannot assume operating agreement); Mission Residential, LLC v. Triple Net Props., LLC, 654 S.E.2d 888, 891 (Va. 2008) (arbitration clause in operating agreement did not require arbitration of a member’s derivative claim because the claim belonged to the LLC, and as the LLC was itself not a party to the operating agreement, it did not mandate the arbitration of a derivative claim subsequently overruled by amendment (VA. CODE ANN. § 13.1-1023.A.1. (LEXIS through the 2014 Regular Session and Acts 2014, Sp. Sess. I, c 1, of the General Assembly.)); with Elf Atochem North Am., Inc. v. Jaffari, 727 A.2d 286, 293 (Del. 1999) (though not a party, LLC bound by choice of forum and arbitration clauses in operating agreement). The Delaware LLC act now specifically provides that a LLC need not sign the limited liability company agreement to be “bound by it.” DEL. CODE ANN. tit. 6, § 18-101(7) (LEXIS through 2014 Fiscal Sess.). See also KY. REV. STAT. ANN. § 275.003(4) (LEXIS through 2013 First Extra. Sess.); OHIO REV. CODE ANN. § 705.081(A) (Anderson 2001 and 2013 supp.); RULLCA § 111(a), 6B U.L.A. 449 (2008) (“A limited liability company is bound by and may enforce the operating agreement, whether or not the company has itself manifested assent to the operating agreement.”); RPLCAA § 111(a), 67 BUS. LAW. at 138. For an analysis suggesting that a Delaware LLC, before the statutory amendment described supra, had standing to enforce its LLC agreement without being a party, see BISHOP AND KLEINBERGER, supra note 1, ¶ 14.02[8][a][ii]. Most LLC acts are silent on the issue. By the act’s providing that a Delaware LLC that does not sign the operating agreement is “bound” by it, if reference is made in the operating agreement or in another agreement to the “parties” of the operating agreement, should that include the LLC itself? The drafter should be cognizant of this question and provide appropriate clarification. Perhaps the easiest way to deal with this question is to have the LLC sign the operating agreement, thereby clearly making it a “party” to the operating agreement; then if a reference to the parties of the operating agreement is not intended to include the LLC itself, a statement or carve out to that effect may be provided.

420 Under most statutory formulations, the operating agreement is entered into by and among the members. See, e.g., IND. CODE § 23-18-1-16 (LEXIS through 2013 Reg. Sess. And 2013 First Reg. Tech. Sess.); KY. REV. STAT. ANN. § 275.015(20) (LEXIS through 2013 first Extra. Sess.); VA. CODE ANN. § 13.1-1002 (LEXIS through the 2014 Regular Session and Acts 2014, Sp. Sess. I, c. 1, of the General Assembly.). At the same time, third parties to the operating agreement may be made beneficiaries of the agreement (see, e.g., KY. REV. STAT. ANN. § 275.003(3) (LEXIS through 2013 First Extra. Sess.); RPLCAA § 112(b), 67 BUS. LAW. at 139), and by necessary implication a manager is obligated to discharge its authority in accordance with the operating agreement. To that end, it may be appropriate to require the managers, if not already members, to agree to be bound in the discharge of their services by the operating agreement. Care should be taken to insure, unless it is the desired outcome, that the consent of the managers to subsequent amendments to the operating agreement do not require their consent. A manager may want protection against a retroactive modification of the operating agreement impacting upon his rights and obligations.

421 Certain acts require the LLC to identify to its registered agent a “communications contact” authorized to receive communications on behalf of the LLC from the registered agent. See, e.g., DEL. CODE ANN. tit. 6, § 18-104(g) (LEXIS through 2014 Fiscal Sess.); KY. REV. STAT. ANN. § 14A.4-010(3) (LEXIS through 2013 First Extra. Sess.). Even when not required by statute, most commercial registered agent companies will ask the LLC to identify a person filling the role of the communications contact.
Identification of Members

A. Members:

Generally, limited liability companies are governed by contract (see, e.g., DEL. CODE ANN. tit. 6, § 18-1101 (LEXIS through 2014 Fiscal Sess.); KY. REV. STAT. ANN. § 275.003(1) (LEXIS through 2013 First Extra. Sess.)), and that contract is typically denominated the “operating agreement,” although in certain states it is referred to as the “company agreement” (TEX. BUS. ORGS. CODE ANN. § 101.001(1) (LEXIS through 2013 3\textsuperscript{rd} Called Sess.)), the “member control agreement” (see MINN. STAT. § 32B.37 (LEXIS through 2014 Reg. Sess.); N.D. CENT. CODE § 10-32-50 (LEXIS through 2013 Reg. Sess.)) or the “limited liability company agreement.” DEL. CODE ANN. tit. 6, § 18-101(7) (LEXIS through 2014 Fiscal Sess.); RPLLCA § 102(14), 67 BUS. LAW. at 129. As LLC acts typically serve as gap fillers where there exists no written operating agreement, with respect to any critical point at issue, it is crucial that an operating agreement be drafted that reflects the agreement of the parties. As observed by the Delaware Chancery Court, “LLC members’ rights begin with and typically end with the Operating Agreement.” Walker v. Res. Dev. Co., LLC, 791 A.2d 799, 813 (Del. Ch. 2000). When drafting an operating agreement, one should be mindful of the observation made by Vice Chancellor Strine in Kronenberg v. Katz, 872 A.2d 568, 593 (Del. Ch. 2004), that “murkiness” of the language of an operating agreement, particularly with respect to modifying traditional fiduciary duties, often “is fatal.” Vice Chancellor Strine also has warned investors in alternative entities that they will be held to the terms of the contract into which they enter:

This Court has made clear that it will not [be] tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties. The DRULPA [(as does the DLLCA)] puts investors on notice that fiduciary duties may be altered by partnership agreements, and therefore that investors should be careful to read partnership agreements before buying units. In large measure, the DRULPA reflects the doctrine of 	extit{caveat emptor}, as is fitting given that investors in limited partnerships have countless other investment opportunities available to them that involve less risk and/or more legal protection. For example, any investor who wishes to retain the protection of traditional fiduciary duties can always invest in corporate stock. Miller v. Am. Real Estate Partners, L.P., No. 16788, 2001 Del. Ch. LEXIS 116, *26-27 (Del. Ch. 2001 Sept. 6, 2001) (footnotes omitted).

Part III of this Checklist (“Identification of Members”) is the place to list the owners of the LLC, but do not read too much into the term “member.” “Membership” can mean almost anything the parties want it to mean. LLC membership usually entails some combination of financial (equity ownership) and nonfinancial (governance) rights, but there are exceptions. In some states it is possible for the LLC to have a “member” lacking any financial rights. See, e.g., DEL. CODE ANN. tit. 6, § 18-301(d) (LEXIS through 2014 Fiscal Sess.); KY. REV. STAT. ANN. § 275.195(3) (LEXIS through 2013 First Extra. Sess.). Typically those provisions are utilized to create protective provisions. For example, a lender could insist upon its appointment of a non-economic member and that the operating agreement require the approval of all members for its amendment. See also RULLCA § 112(a), 6B U.L.A. 449 (2008).

In most instances, each “member” of the LLC will be treated as a “partner” (or owner or member) for tax purposes. Even if the LLC is classified as a partnership for tax purposes, however, the “members” of the LLC under applicable state law may not be the same as the “partners” for tax purposes. While an assignee of a member’s entire economic

The LLC and its advisors are charged with reviewing the list of the Office of Foreign Assets Control (“OFAC list”) (money laundering and terrorist rules) to insure that business is not conducted with a prohibited person. The OFAC within the United States Department of the Treasury enforces various economic and trade sanctions and maintains the Specially Designated Nationals List (“SDN List”); it is available at OFAC’s website. United States citizens and companies, subject to certain exclusions typically conditioned upon the issuance of a special license, are precluded from engaging in business with any person or entity listed on the SDN List. For more information and OFAC guidance, see the OFAC website at www.treasury.gov/about/organizational-structure/officers/pages/office-of-foreign-assets-control.aspx. See also ABA Comm. On Ethics & Prof’l Responsibility, ABA Formal Op. 463, Client Due Diligence, Money Laundering and Terrorist Financing (May 23, 2013); Resolution and Report 116, Voluntary Good Practice Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing, AMERICAN BAR ASSOCIATION (2010).

The LLC may have special withholding tax obligations with respect to members who are not U.S. persons unless those members are otherwise subject to U.S. tax on income allocated to them from the LLC. A U.S. person, as defined in 26 U.S.C.A. § 7701(a)(30) (LexisNexis 2014), means: (i) a citizen or resident of the United States; (ii) a partnership or corporation created or organized in the United States or under the laws of the United States or any state; (iii) an estate the income of which is subject to U.S. federal income taxation regardless of source; or (iv) a trust (for example, interest, dividends, rent, or royalties) allocable to foreign partners regardless of whether the LLC makes distributions to the foreign partners. See Treas. Reg. § 1.1446-5(b)(2)(i)(A) (2001). Non-U.S. persons may be entitled to reduction or elimination of withholding on certain kinds of income under the extensive tax treaty network that the U.S. has with other countries. See generally IRS PUBLICATION 515, CAT. NO. 15019L.

Withholding of tax with respect to foreign partners can be burdensome for the LLC, and some LLCs try to avoid having foreign partners. Code § 1446 generally requires quarterly withholding on a foreign partner’s allocated share of income “effectively connected” with a U.S. trade or business, even if distributions are not made to the foreign partner. 26 U.S.C.A. § 1446 (LexisNexis 2014). This requirement can create cash flow problems, particularly if the LLC engages in a transaction that generates “effectively connected” income but no cash. Id. Code § 1445 (which gives teeth to the “Foreign Investment in Real Property Tax Act” or “FIRPTA”) may require the LLC to withhold tax on gain allocable to foreign partners when the LLC disposes of an interest in U.S. real property (including an interest in a “U.S. real property holding corporation”). 26 U.S.C.A. § 1445 (LexisNexis 2014). An LLC may also be required to withhold on “fixed or determinable annual or periodical” (“FDAP”) income (for example, interest, dividends, rent, or royalties) allocable to foreign partners regardless of whether the LLC makes distributions to the foreign partners. See Treas. Reg. § 1.1441-5(b)(2)(i)(A) (2001). Non-U.S. persons may be entitled to reduction or elimination of withholding on certain kinds of income under the extensive tax treaty network that the U.S. has with other countries. See generally IRS PUBLICATION 515, CAT. NO. 15019L.

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Most states assert the right to tax nonresident members of the LLC by reason of the LLC’s business or property in the state. The states have taken different approaches to the enforcement of this taxing jurisdiction. Approaches include having the LLC: (i) obtain a signed consent from nonresident members to pay income tax to that state on their share of the LLC’s income, relieving the LLC of an obligation to make tax payments in respect of a nonresident member; (ii) withhold (and pay over to the state) income tax on the nonresident members’ share; (withholding is the term used even if there are no distributions from which to withhold); or (iii) file a composite return and remit tax on the members’ share. A single state may combine different approaches. In California, the LLC’s obligation to pay tax on behalf of a nonresident member is triggered only if the member fails to provide a consent to file individually in California. CAL. REV. & TAX. CODE § 18633.5(e) (LEXIS (with urgency legislation) through Ch. 31 of the 2014 Session and Propositions 41 & 42 approved June 2014). In Georgia, the LLC must withhold at the rate of 4% on Georgia income distributed or “credited” to a nonresident, or, in the alternative, must file a composite return and remit the tax shown on the composite return. GA. CODE ANN. § 48-7-129 (LEXIS through 2014 Reg. Sess.). A member of a multistate LLC may face a severe compliance burden if the member must file a tax return in every state in which the LLC does business. Almost all states that impose income tax on partners now permit (or, in some instances, require) “composite returns,” in which the LLC files a return and remits the taxes on behalf of the nonresident members. Amounts that the LLC withholds, or remits with the composite return, are credited against the member’s tax liability in that state. In some instances, but not all, the member may be entitled to file for a refund of overpayments. States have different methods for determining how much of an LLC’s income is allocated or apportioned to that state. Although the LLC member’s home state usually subjects the member to tax on his or her entire share of the LLC’s income – without regard to how much of that income is allocated or apportioned to that state – the problem of double taxation tends to be greatly reduced, but not necessarily eliminated, by credits that the member’s home state gives for taxes paid to other states. See, e.g., Patrick H. Smith & Michael W. McLoughlin, State Non-Resident Composite Income Tax Returns Can Provide Simplicity but at a Cost, BUS. ENTITIES, Nov./Dec. 2004, 26; BISHOP AND KLEINBERGER, supra note 1, ¶ 1.07[41]; RIBSTEIN AND KEATINGE, supra note 1, § 16:10. Certain states have adopted, for state law purposes, provisions patterned on the federal “FIRPTA” withholding requirements. See, e.g., CAL. REV. & TAX. CODE § 18662 (LEXIS (with urgency legislation) through Ch. 31 of the 2014 Session and Propositions 41 & 42 approved June 2014). State withholding can raise the same issues – cash flow problems and the treatment of amounts paid on behalf of a member – noted above in connection with federal withholding.

The LLC may need or want to know whether the member is itself a pass-through entity, or whether it is a tax-exempt entity (and if so what tax-exempt status it has). For example, if the member is a tax-exempt entity, the LLC may be required to report “unrelated business taxable income” (“UBTI”) to the member. See 26 U.S.C.A. §§ 511–514 (LexisNexis 2014). Some tax-exempt organizations (primarily educational institutions and pension plans) enjoy a special exemption from certain UBTI where the LLC invests in debt-financed real property but are subject to some of the most complicated requirements in all of tax law. See 26 U.S.C.A § 514(c)(9)(2014). The presence of tax-exempt members sometimes affects tax consequences to other LLC members. See 26 U.S.C.A. §§ 168(h)(6), 470 (LexisNexis 2014). See BISHOP AND KLEINBERGER, supra note 1, ¶ 1.09 for an analysis of joint ventures between exempt and for-profit organizations.
[Use attached list rather than space for 6 members]

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- If a member is a trust, provide name of trustee and date of document creating trust, and whether revocable or irrevocable.  

- If a member is an estate, provide name of legal representative, date of death if applicable, and certified copy of appointing court order.

- If agent, provide name of principal, copy of appointing document, and affidavit of effect.

- Is any Member an Affiliate of any other Member or Manager?

- Identify other relationships between the Members and/or Manager (personal, family, other business relationships).

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427 The trust document must be reviewed in order to establish that membership in an LLC, and the anticipated business activities, are permitted under the trust document and the trustee’s scope of authority. The trust document will also provide who has authority to bind the trust.
Tax Classification:

Is this a single member LLC?428 □ Yes □ No

LLC to be taxed under:429

□ Subchapter K430
□ Subchapter C431
□ Subchapter S432

428 All states now permit the formation of a single member LLC. See, e.g., RIBSTEIN AND KEATINGE, supra note 1, § 4:3. A single member LLC is generally simple to organize and many of the items on this Checklist will be unnecessary, including, for example, requirements for given levels of member approval of decisions, or items presupposing that the LLC is a partnership for tax purposes, e.g., capital account maintenance.

429 Note that this question addresses only federal tax classification. Some states impose an entity-level tax on business structures that, for federal tax purposes, are pass-through entities. See generally Bruce P. Ely, State Taxation of Subchapter S and Subchapter K Entities and Their Owners – An Overview, CHOICE OF ENTITY-2007 Update, A.L.A.-A.B.A. (Feb. 8, 2007), in SM069 A.L.A.-A.B.A. 215, app. B-C; KEATINGE AND CONAWAY, supra note 1, §§ 5.1–26; BISHOP AND KLEINBERGER, supra note 1, ¶¶ 3.01–12; RIBSTEIN AND KEATINGE, supra note 1, § 16:10. Many states that follow the federal classification for income tax purposes diverge from the federal classification for purposes of other taxes, such as sales and use tax. The Georgia LLC act, for example, follows the federal classification rules only for “income” tax purposes. GA. CODE ANN. § 14-11-1104 (LEXIS through 2014 Reg. Sess.) (2001 amendment inserted the word “income” in four places, see Kimberly A. Childs, Revenue and Taxation, 18 GA. ST. U.L. REV. 294 (2001)).

430 For purposes of federal income tax classification, a limited liability company is an “eligible entity” as defined in the so-called “Check-the-Box” classification regulations, meaning that it is eligible to choose either corporation or non-corporation classification. LLCs are not specifically mentioned in the Check-the-Box Regulation. The reason LLCs are generally eligible to choose their own tax classification is simply because they are not formed under a statute that “describes or refers to [them] as incorporated or as a corporation, body corporate, or body politic.” Treas. Reg. § 301.7701-2(b)(1) (2014). An LLC or other business entity that is taxable as a corporation under some provision of the Code other than Code § 7701(a)(3), however, is not eligible to select another classification. Treas. Reg. § 301.7701-2(b)(7). Most importantly, any entity – LLC, partnership or otherwise – will be ineligible if it is a “publicly traded” entity that is required to be treated as a corporation under Code § 7704. 26 U.S.C.A. § 7704 (LexisNexis 2014). In addition to many publicly traded entities, some of the other categories of businesses that are ineligible – and will always be classified as corporations – include insurance companies, state-chartered banks holding federally insured deposits, certain government-owned entities, certain foreign entities and entities claiming federal tax-exempt status. Assuming that an LLC is an “eligible entity” and it has two or more members, it will have a default classification as a “partnership” and will be governed by Subchapter K of the Internal Revenue Code. Where the LLC is an eligible entity and has only a single member it will have a default classification as a “disregarded entity.” Treas. Reg. § 301.7701-2. As noted above, a member or “partner” for tax purposes is not necessarily the same as a “member” under applicable LLC law. Most (not all) multi-member LLCs will be classified as partnerships for tax purposes. Unless otherwise noted, comments in this Checklist relating to the tax treatment of the LLC and its members assume that the LLC will be treated as a partnership and that the members will be treated as partners.

431 In almost every case, a limited liability company not otherwise required to be taxed as a corporation may elect to be taxed as a corporation. The election is made by filing a Form 8832 with the IRS. Essentially, the only limitation on an LLC’s eligibility to be classified as a corporation is that an LLC (or other entity) generally may change its election once every sixty months (although an election by a new entity effective on the date of formation does not count as a change). Treas. Reg. § 301.7701-3(c)(1)(iv) (2006). The LLC’s election must be signed by all the members or “any officer, manager, or member of the electing entity who is authorized (under local law or the entity’s organizational documents) to make the election . . . .” Treas. Reg. § 301.7701-3(c)(2)(i).
OFAC Compliance:

Confirmation that no initial manager or beneficial owner is on Office of Foreign Asset Control (OFAC) Specially Designated Nationals (SDN) List. □ Yes □ No

Date of List: ____________________________
Responsibility for checking SDN upon admission of additional member(s):

□ Manager
□ All Members
□ Legal Counsel
□ Other: ____________________________

General Provisions

A. General Provisions:

Effective date of operating agreement: _____, 20__. 434

Statement of LLC’s purpose: 435

432 If the LLC seeks to be an S corporation under Code § 1361, it will file a Form 2553. When S corporation status is desired, the Form 2553 will accomplish both the election to be classified as an association taxable as a corporation and the election under Code § 1361, and the Form 8832 need not be filed. Treas. Reg. § 301.7701-3(c)(1)(v)(C) (2006). Many LLCs will be ineligible for S corporation status. For example, if even one of the members of the LLC is a corporation or another LLC that is classified as a partnership, eligibility is lost. 26 U.S.C.A. § 1361(b)(1)(B) (LexisNexis 2014). Furthermore, an LLC that seeks S corporation status will be subject to the one class of stock rule of Code § 1361(b)(1)(D). See also Robert R. Keatinge, LLCs and Limited Partnerships as S-Corporations, Limited Liability Entities: New Developments in Limited Liability Companies and Limited Liability Partnerships, A.L.I.-A.B.A. (Mar. 17, 2005), in VMF0317 A.L.I.-A.B.A.; Thomas E. Rutledge, S Corp LLCs – Planning Opportunity or Solution in Search of a Problem?, J. PASSTHROUGH ENTITIES, July/Aug. 2012, 37.

433 There are many “other” possibilities, although they do not commonly arise. For example, in some cases an LLC may be able to elect classification as a cooperative and taxation under Subchapter T. While it does not appear the issue has been directly addressed by the IRS, the consensus answer appears to be that an LLC, otherwise taxed under Subchapter K, in most circumstances may not make an election out of Subchapter K under Code § 761. See generally RIBSTEIN AND KEATINGE, supra note 1, § 17:20; BISHOP AND KLEINBERGER, supra note 1, ¶ 2.10. Certain LLCs owned by a husband and wife will not be treated as partnerships. See 26 U.S.C.A. § 761(f) (LexisNexis 2014).

434 Assuming this is the initial operating agreement, the effective date is usually the effective date of the filing of articles of organization, unless a different date is desired. Care should be taken in determining when the operating agreement is effective to avoid a gap in the understanding and agreement of the parties. Some state statutes deem an operating agreement to exist as of the date of organization of the LLC and other statutes do not.

435 It is all too easy to take comfort in statutory provisions to the effect that the business at issue may be used for “any lawful business” (see, e.g., RULLCA § 104(b), 6B U.L.A. 437 (2008); RPLLCA § 105(a), 67 BUS. LAW. at 132; KY. REV. STAT. ANN. § 275.005 (LEXIS through 2013 First Extra. Sess.)) and assume that purpose
limitations are no longer a concern for modern business organizations. That comfort is unjustified. In fact, an array of proper purpose limitations exist, and there are a number of statutes that expressly remind practitioners that these other limitations on proper purpose must be considered. For example, Kentucky law provides that: “if the purpose for which a limited liability company is organized or its activities make it subject to special provisions of law, the limited liability company shall also comply with those provisions.” KY. REV. STAT. ANN. § 275.005 (LEXIS through 2013 First Extra. Sess.); see also S.D. CODIFIED LAWS § 47-34A-112(a) (LEXIS through all 2013 legislation passed at the 88th Regular Session, including Supreme Court Rule 14-10 and November 2012 ballot measures.); VT. STAT. ANN., tit. 11, § 3012(b) (LEXIS through the 2014 Regular Session and Acts 2014, Sp. Sess. I, c. 1. of the General Assembly.). This issue can also arise where a foreign business organization, engaged in a permissible activity in its jurisdiction of organization, engages in an activity in a foreign jurisdiction in which it is not permitted to so act. See, e.g., RULLCA § 801(c), 6B U.L.A. 515 (2008) (“A certificate of authority does not authorize a foreign limited liability company to engage in any business or exercise any power that a limited liability company may not engage in or exercise in this State.); RPLLC A. supra note 5, §§ 801 (c), (d); KY. REV. STAT. ANN. § 275.380(2) (LEXIS through 2013 First Extra. Sess.) (“A certificate of authority obtained pursuant to this chapter shall not authorize a foreign limited liability company to exercise any powers or engage in any business that a domestic limited liability company is forbidden to exercise or engage in by the laws of this Commonwealth”); S.D. CODIFIED LAWS § 47-34A-1001(c) (LEXIS through all 2013 legislation passed at the 88th Regular Session, including Supreme Court Rule 14-10 and November 2012 ballot measures. ) (“A certificate of authority does not authorize a foreign limited liability company to engage in any business or exercise any power that a limited liability company may not engage in or exercise in this state.”); TEX. BUS. ORGS. CODE ANN. § 9.201 (LEXIS through 2013 3rd Called Sess.) (“A foreign entity may not conduct in this state a business or activity that is not permitted by this code to be transacted by the domestic entity to which it most closely corresponds….”). For example, a railroad organized as an LLC may not transact business in Vermont. See VT. STAT. ANN., tit. 11, § 3012(b)(3) (LEXIS through the 2014 Regular Session and Acts 2014, Sp. Sess. I, c. 1. of the General Assembly. See generally Allan G. Donn, Is the Liability of Limited Liability Entities Really Limited, BUSINESS ENTITIES: 2014 UPDATE, A.L.I.-A.B.A. (Feb. 18, 2014), in VCVA0218 ALI-ABA 191; Thomas E. Rutledge, Limited Liability (Or Not): Reflections on the Holy Grail, 51 S.D. L. REV. 417, 439-42 (2006). For analysis of business purpose requirements including statutory restrictions on types of business, see BISHOP AND KLEINBERGER, supra note 1, ¶ 5.03; RIBSTEIN AND KEATINGE, supra note 1, § 4:10. In addition to legal limitations, defining the purpose more narrowly will affect the manager’s authority and whether a dissolution is appropriate because it is no longer reasonably practicable to carry on the business. See, e.g., In re Seneca Invs., LLC, 970 A.2d 259, 266 n. 29 (Del. Ch. 2008).


437 If the LLC intends to conduct business using a name different from its “real name,” it may be necessary to file a certificate of assumed name or similar document with the appropriate secretary of state. See, e.g., Fla. STAT. § 865.09 (LEXIS through the 2013 Reg. Sess.); KY. REV. STAT. ANN. § 365.015 (LEXIS through 2013 First Extra. Sess.) (regulating assumed names in general); id. § 14A.3-040 (regulating use of fictitious name by foreign LLC); TEX. BUS. & COM. CODE § 71.101 (LEXIS through 2013 3rd Called Sess.).
Disputes are further avoided by specifying that \( \text{any capital accounts in accordance with the applicable Treasury Regulations to prepare its} \) (members of a limited liability company have the right to demand \( \text{ULLCA} \)) (e.g. if the LLC is classified as a partnership for tax purposes, the IRS must allow “any person who was a member of such partnership during any part of a reasonable restricted.

\( \text{but is not limited to, financial records of the company. Under certain statutes, the right to information may not be more of the foregoing provided to member, but only upon members’ request (items).} \)

438 This begs two questions – what is “regular,” and what are the “financial reports”? The answer to each will depend upon the deal in question. Disputes can be avoided by specifying that reports will be delivered within \( X \) days of identifiable dates such as the end of various fiscal periods. Disputes are further avoided by specifying whether certain documents (e.g., balance sheet, periodic profit and loss statement, profit and loss statement compared against budget, etc.) are incorporated into the definition of the financial statements that will be delivered. It may be appropriate as well to specify whether those financial statements will be prepared in accordance with U.S. generally accepted accounting principles (“GAAP”), or in accordance with other accounting standards such as International Financial Reporting Standards (“IFRS”). Audited financial statements are typically available only on an annual basis. Where it is anticipated that an audited report will be delivered on an annual basis, it may be appropriate to specify that other periodic reports will not be audited. Unless the LLC is a disregarded entity, the LLC is required to have a set of tax books. If the LLC is classified as a partnership for tax purposes, the LLC generally should maintain capital accounts in accordance with the applicable Treasury Regulations to prepare its federal income tax returns. In many situations, the financial information prepared for tax purposes is sufficient. If, however, the parties believe that financial information prepared in accordance with tax accounting methods is insufficient, they may require that a separate set of books and records be maintained under U.S. GAAP or some other set of standards. A middle approach is to require that only tax books must be maintained but allow the manager or the members to cause the LLC to prepare financial statements in accordance with one or more other methods of accounting. Consider state-specific requirements with respect to the delivery of information and whether the operating agreement may modify those delivery obligations. See, e.g., DEL. CODE ANN. tit. 6, § 18-305(a) (LEXIS through 2014 Fiscal Sess.) (members of a limited liability company have the right to demand information, subject to reasonable standards “as may be set forth in a limited liability company agreement … for any purpose reasonably related to the member’s interest as a member of the limited liability company,” and subject to additional restrictions on obtaining information that may be imposed in accordance with section 18-305(g) of the Delaware LLC Act); KY. REV. STAT. ANN. § 275.185(3) (LEXIS through 2013 First Extra. Sess.) (requiring the affirmative delivery of information to members “to the extent the circumstances render it just and reasonable, true and full information of all matters affecting the members to any member”…).

439 Depending upon the LLC act under which the LLC is formed and the LLC’s operating agreement, members may have a right to access records and information, including the right to inspect and copy, during ordinary business hours to the extent the information is material to the member’s rights and duties under the operating agreement. See, e.g., FLA. STAT. § 608.4101(2) (LEXIS through the 2013 Reg. Sess.); RPLLCA § 408, 67 BUS. LAW. at 160; RULLCA § 410, 6B U.L.A. 492 (2008); TEX. BUS. ORGS. CODE ANN. § 101.502 (LEXIS through 2013 3rd Called Sess.). In other instances there is no requirement of a proper purpose but only that the request be “reasonable.” See, e.g., KY. REV. STAT. ANN. § 275.185(2) (LEXIS through 2013 First Extra. Sess.). This right presumably includes, but is not limited to, financial records of the company. Under certain statutes, the right to information may not be unreasonably restricted. See, e.g., RULLCA § 110(c)(6), 6B U.L.A. 442 (2008). If the LLC is classified as a partnership for tax purposes, the IRS must allow “any person who was a member of such partnership during any part
of the period covered by the return” to see the partnership return. 26 § U.S.C.A. § 6103(e)(1)(C) (LexisNexis 2014). See generally BISHOP AND KLEINBERGER, supra note 1, ¶ 5.07; RIBSTEIN AND KEATINGE, supra note 1, § 9.5.
Accounting Method:  

☐ Cash  

☐ Accrual  

Audit or Review:  

<table>
<thead>
<tr>
<th>Audit</th>
<th>Review</th>
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<tbody>
<tr>
<td>☐ Required</td>
<td>☐ Required</td>
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<tr>
<td>☐ At option of Managers</td>
<td>☐ At option of Managers</td>
</tr>
<tr>
<td>☐ At option of Members</td>
<td>☐ At option of Members</td>
</tr>
<tr>
<td>☐ Who shall bear cost</td>
<td>☐ Who shall bear cost</td>
</tr>
</tbody>
</table>

Certification of Membership Interests:  

☐ Yes  

☐ No

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440 An LLC should discuss accounting methods with its accountant and tax advisor. In general, an LLC will have the same overall method for tax and financial accounting purposes (see the “conformity rule” of 26 U.S.C.A. § 446(a) (LexisNexis 2014)), but there are exceptions. The two most common tax accounting methods are the “cash receipts and disbursements method” and the “accrual method.” The cash method tends to be simpler, but the accrual method is considered more accurate and is more consistent with generally accepted accounting principles (“GAAP”). Taxpayers sometimes have a choice in selecting their overall tax accounting method. See 26 U.S.C.A. § 446(c). However, the taxing authorities tend to disfavor cash method reporting, and there are rules mandating the accrual method for many taxpayers, including certain C corporations, certain partnerships that have a C corporation as a partner, “tax shelters” and businesses required to maintain inventories. See 26 U.S.C.A. § 448(a) (LexisNexis 2014). Other accounting methods may be required or permitted depending on the nature of the LLC’s activities. See, e.g., 26 U.S.C.A. § 460 (LexisNexis 2014) (percentage of completion method required for many long-term manufacturing or construction contracts); 26 U.S.C.A. § 475 (LexisNexis 2014) (mark to market accounting required for dealers in securities).

441 Most if not all LLC acts expressly permit membership interests to be represented by a physical certificate. See, e.g., GA. CODE ANN. § 14-11-501(b) (LEXIS through 2014 Reg. Sess.); KY. REV. STAT. ANN. § 275.255(2) (LEXIS through 2013 First Extra. Sess.). However, depending upon applicable state law and modifications to those definitions contained in the operating agreement, a certificate might evidence only a member’s economic rights (see, e.g., GA. CODE ANN. § 14-11-101(13) (LEXIS through 2014 Reg. Sess.); VA. CODE ANN. § 13.1-1002) (LEXIS through the 2014 Regular Session and Acts 2014, Sp. Sess. I, c. 1, of the General Assembly.) and not the entirety of the management rights that might be commonly perceived as being component to a “membership interest.” Note that, if it is desired that physical certificates be governed by and have the effect of a certificated security under Article 8 of the Uniform Commercial Code, it is necessary that a specific election to that effect be made in the operating agreement. Absent that election, interests in a limited liability company are general intangibles governed by Article 9 of the Uniform Commercial Code. See LYNN A. SOUKUP, “Opting In” to Article 8 – LLC, GP & LP Interests as Collateral, COMMERCIAL LAW NEWSLETTER (newsletter of the ABA Uniform Commercial Code Committee), July, 2002, reprinted in PUBOGRAM (newsletter of the ABA Committee on Partnerships and Unincorporated Business Organizations), November, 2002; see also Robert R. Keatinge, Taking and Enforcing Security Interests in Interests in Unincorporated Businesses, LIMITED LIABILITY ENTITIES IN TIME OF CHANGE, A.L.I.-ABA (Mar. 12, 2003), in VPC0312 ALI-ABA 245; Robert R. Keatinge, Interests in Unincorporated Associations as Securities Under Article 8 of the UCC, LIMITED LIABILITY ENTITIES IN TIME OF CHANGE, A.L.I.-ABA. (Mar. 12,
Capital contributions:

Initial Contributions:

<table>
<thead>
<tr>
<th>Member</th>
<th>Form of Contribution (if debt, how secured)?</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
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<td>2</td>
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</table>

Representations and warranties regarding debt and title related to contributions (Title Insurance required by LLC?) (Consider preparation of separate contribution


442 Most LLC acts permit members’ contributions to be made in any of a variety of forms including cash, property, services rendered, promissory notes, agreements to contribute cash or property, or contracts for services to be performed. See, e.g., FLA. STAT. § 608.4211 (LEXIS through the 2013 Reg. Sess.); RPLLCA, supra note 5, § 403(a); RULLCA § 401, 6B U.L.A. 478 (2008); VA. CODE ANN. § 13.1-1027(A) (LEXIS through the 2014 Regular Session and Acts 2014, Sp. Sess. I, c. 1, of the General Assembly.). In some jurisdictions, if a member fails to make a required contribution of property or services, the member is obligated to contribute cash equal to the value of the stated contribution that was not made. See, e.g., KY. REV. STAT. ANN. § 275.200(3) (LEXIS through 2013 First Extra. Sess.); R.I. GEN. LAWS § 7-16-25(c) (LEXIS through 2013 Reg. Sess.); RPLLCA § 403(b), 67 BUS. LAW. at 155; RULLCA §§ 402 and 403, 6B U.L.A. 479 (2008); VA. CODE ANN. § 13.1-1027.B (LEXIS through the 2014 Regular Session and Acts 2014, Sp. Sess. I, c. 1, of the General Assembly.). While the general rule under Code § 721(a) is that neither gain nor loss is recognized upon the contribution of property to a partnership in exchange for an interest in the partnership, attention needs to be paid to Code § 721(b) and Treas. Reg. § 1.351-1(c)(1) to avoid the unintentional recognition of gain upon the contribution of appreciated property to an LLC that is treated as an “investment company.” Although LLC acts permit the contribution of services, and the contribution of services is essential for many LLCs, Code § 721(a) does not apply to contributions of services. The tax treatment of service contributions has been very controversial. 26 U.S.C.A. § 721(a) (LexisNexis 2014). However, if the LLC member does not receive any capital account credit for services, the member often can receive an LLC interest for services without triggering immediate income. In this checklist, service contributions are treated separately from capital contributions. For analysis of member contributions including contribution of services, see BISHOP AND KLEINBERGER, supra note 1, ¶¶ 5.04[3][b], 5.04[4]; RIBSTEIN AND KEATINGE, supra note 1, § 5:4.

443 If the LLC is maintaining capital accounts under the Code § 704(b) regulations, an LLC member generally will not get immediate capital account credit for contributing the member’s own promissory note. See Treas. Reg. § 1.704-1(b)(2)(iv)(d)(2) (2013)

444 The stated value of contributed property will generally be whatever amount the parties agree is fair market value, although the parties may adopt other procedures (such as an appraisal or a formula) for setting value. The capital accounting rules of Treas. Reg. § 1.704-1(b)(2)(iv)(b) require capital accounts to be increased by (among other things) the fair market value of contributed property, net of liabilities that the partnership is considered to assume or take subject to.
A contribution agreement is a separate agreement that details the assets (and liabilities) that each member contributes to the LLC and should set forth the value of those contributions for purposes of establishing each member’s capital account.

The responsibility and liability for contributing the equity capital needed by the enterprise are subjects that should receive considerable attention when negotiating and drafting an operating agreement. Members want to limit the amount of capital that they may be required to contribute to a venture. A business, however, likely will fail if it is chronically undercapitalized and is unable to acquire equity capital or other financing when it is needed. The tension between a venture’s need for equity capital and the reluctance by some or all of its members either to obligate themselves to contribute capital when it is needed or accept dilution of their economic interests is often difficult to reconcile.

Additional issues arise if members are not required to participate in contributions. Members who choose to contribute will probably want their shares of LLC profits to increase relative to the shares of members who fail to contribute. Thus, as in the case of defaults in required capital contributions, drafters should consider including a provision to reduce the interest of non-contributing members in LLC profits. See Bradley R. Coppedge, LLC Operating Agreements Drafting Tips and Traps for the Unwary, PROB. & PROP., Jan./Feb. 2005, 44, 50. However, members who may be less able to come up with additional capital should consider the potential for unfair dilution of their interests in profits.
Specific event or circumstance or process?
Manager makes call; members must contribute pro rata
within _____ days/weeks/months, or
within the time period specified in call notice
Manager makes call; if _____% of members consent, members must contribute pro rata
within _____ days/weeks/months, or
within the time period specified in call notice

Voluntary Contribution (changes sharing ratio/operating agreement may have pro-rata rights?)

Consequences of failure to fund: 448

448 See Terence Floyd Cuff, Drafting Partnership and LLC Agreements: Part I, BUS. ENTITIES, May/June 2001, 22, for a discussion of various remedies for dealing with defaults in capital contributions and potential tax consequences of provisions that result in capital shifts among venturers. Cuff further notes that the enforceability of default provisions may vary considerably among the states. See also Coppedge, supra note 47, at 50. Dealing with consequences of a failure to meet a required capital call is a complicated issue. As noted by one commentator, it is sometimes suggested that the non-defaulting participants “want to be able to castrate the defaulting venture, coat him in honey, and bury him in an ant hill in the hot summer sun.” See Cuff, supra at 22 n. 8. That same commentator goes on to note “[t]his particular remedy normally is not permitted under state laws concerning LLCs or partnerships.” Id. at 22 n. 14. For further analysis of remedies for default, see BISHOP & KLEINBERGER, supra note 1, § 6.05[1][c]; RIBSTEIN AND KEATINGE, supra note 1, §§ 5.7, 5.8.

The starkest division between provisions addressing a defaulted capital contribution obligation are between those that mandate a buyout or forfeiture of the interests of the defaulting participant versus those provisions that simply provide for the dilution of that participant’s interest. One question to keep in mind in deciding which avenue to take is whether a default will so taint the relationship between the defaulting participants as to make proceeding after dilution appropriate and effective. Note, however, that providing for a buyout of the interests of the defaulting member will require a disposition of company capital and to that extent perhaps constitutes a further negative impact upon the non-defaulting members. If neither a default nor forfeiture is provided for, but rather dilution applies, operating agreements may provide for some or all of (i) a reduction/dilution in the interest of the defaulting venturer; (ii) permitting the other venturers to make deemed loans to the venture on behalf of the defaulting venturer in the amount of the default giving rise to an obligation of the defaulting venturer to satisfy those loans by the substitution of capital; (iii) the loss of management or voting rights during the pendency of the default; and (iv) a suit for specific performance of the obligation to contribute. While it is not uncommon to see provisions calling for the forfeiture of the interest of the defaulting participant, “one common error is to assume that a court will enforce whatever you draft. The capital contribution default remedy provisions are similar to liquidated damages provisions. A remedy provision will not do you much good if you cannot enforce it. The enforceability of default provisions may vary considerably from state to state or be undermined by a partner in bankruptcy.” See Cuff, supra at 8. Some LLC acts expressly state that forfeiture is permitted. See DEL. CODE ANN. tit. 6, § 18-502(c) (LEXIS through 2014 Fiscal Sess.); GA. CODE ANN. §
Reduction in share of profits
Reduction in share of profits and reallocation of capital
Preferential distributions to other members
Loan from company at _____%
Loan from non-defaulting member (and interest rate)
Personal liability on the part of member
Opportunities for other members to make up and defaulting member is diluted
Suspension of management authority or voting rights
Right to purchase defaulting member’s interest in the LLC
Forfeiture of defaulting member’s interest in the LLC
Automatic diversion of distributions to make up deficit (lien like)

Adjustment of Capital Accounts. 449

Issuance of Equity Interests to Service Provider: 450

14-11-402(b) (LEXIS through 2014 Reg. Sess.); KY. REV. STAT. ANN. § 275.003(2) (LEXIS through 2013 First Extra. Sess.).

Dilution provisions may have unintended tax consequences in the nature of a capital shift or may alter interests in the LLC in such a manner as to transfer unrealized appreciation, either of which may result in a taxable consequence. See generally Terence Floyd Cuff, Tax Aspects of Partnership Dilution Provisions, BUS. ENTITIES, March/April 1999, 16; BISHOP AND KLEINBERGER, supra note 1, ¶ 8.07.

449 The operating agreement may permit or require the capital accounts to be adjusted in some circumstances to reflect a “revaluation” of the LLC’s property (including goodwill). Although the provisions for those adjustments may be buried in the definition of a term such as “Gross Asset Value,” or in a “Tax Appendix” to the agreement, they may be crucial to the economic deal. Be careful who is given the authority to decide on the time and amount of those adjustments. For capital accounts that comply with Treas. Reg. § 1.704-1(b)(2)(iv), adjustments generally may be made: (i) in connection with a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership; (ii) in connection with the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership; (iii) in connection with the grant of an interest in the partnership (other than a de minimis interest) as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner; or (iv) under generally accepted industry accounting practices, if substantially all of the partnership’s property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

450 Assuming that the LLC member is treated as a partner for tax purposes, he or she cannot be treated as an LLC employee for tax purposes. Rev. Rul. 69-184, 1969-1 C.B. 256; I.R.S. Gen. Couns. Mem. 34001 (Dec. 23, 1969); I.R.S. Gen. Couns. Mem. 34173 (July 25, 1969). The LLC member who receives compensation for services from the LLC is self-employed and may be subject to self-employment tax. Many LLC members react with shock or disbelief on learning that the IRS refuses to consider them employees of the business for which they render services. LLCs that consider the tax treatment of member/service providers to be a problem have adopted various approaches for avoiding that treatment. One approach has been to structure the service provider’s compensation so that it is a “phantom interest,” based in some way on equity but not constituting equity.

Even if an LLC is a “disregarded entity” for income tax purposes, it is required to be treated as a separate entity for employment tax (and excise tax) purposes. For wages paid by a disregarded entity before January 1, 2009,
Will the LLC issue equity interests as compensation for services?\textsuperscript{451}

- Yes
- No

- Vested
- Unvested

- Profits Interest
- Capital Interest

For services by members?

- Yes
- No

For services by non-member employees? (If so, consider phantom interests.\textsuperscript{452})

- Yes
- No

Member guarantees of LLC obligations:\textsuperscript{453}


\textsuperscript{451} If the conditions of a “safe harbor” are met, the IRS will not impose an immediate tax on a member who receives an interest in LLC profits in exchange for services. \textit{See} Rev. Proc. 93-27, 1993-27 C.B. 343; \textit{see also} Rev. Proc. 2001-43, 2001-2 C.B. 191 (unvested interests). If the safe harbor is not satisfied, the treatment of the service provider may be less clear. If the member receives an interest in the capital of the LLC for past or future services, the member is deemed to have received taxable compensation income. The amount of the compensation income may be difficult to determine but might be deemed equal to the capital account credit given to the service provider. The company generally will have an equal deduction for compensation paid. \textit{See}, \textit{e.g.}, O’Connor and Wilhelm, \textit{Partnership and LLC Equity Compensation: What Do We Do Now?}, J. TAX’N AND REG. FIN. INST’S, Sept/Oct. 2011, 28; Steven C. Alberty, \textit{Adding a New Member to an LLC (with Form)}, 48 PRAC. LAW. 25, 30 (2002). Proposed regulations and an accompanying notice would, if adopted, revoke Rev. Proc. 93-27 and Rev. Proc. 2001-43, and would cause large changes in current practices. Reg-105346-03, May 24, 2005; Notice 2005-43, 2005-24 I.R.B. 1221. The proposed regulations take the position, however, that the company would not have gain recognition in connection with issuing a capital interest to a service provider. Some advisors are concerned, however, that, in the absence of final regulations, there is some risk that the company granting a capital interest to a service provider might be deemed to have “sold” a portion of its assets to the service provider, possibly triggering a taxable gain to the company.

LLCs issuing, and service providers receiving, LLC equity in connection with the performance of services should consider the advisability of a “Section 83(b)” election. The election is made by the service provider, but because it may affect all members of the LLC, the service provider and LLC will sometimes agree in advance whether the election is to be made. If the service provider is going to make the section 83(b) election, he or she needs to do so within the required 30-day window.

\textsuperscript{452} \textit{See infra} note 63.
Absent an extraordinary waiver of limited liability (see, e.g., KY. REV. STAT. ANN. § 275.150(2) (LEXIS through 2013 First Extra. Sess.); RULLCA § 110(g), 6B U.L.A. 442 (2008); TEX. BUS. ORGS. CODE ANN. § 101.114 (LEXIS through 2013 3rd Called Sess.)), members, as members, are not personally liable for the debts and obligations of the LLC. As a condition to extending credit, certain creditors will insist upon personal guarantees from some or all of the members. Circumstances may justify providing in the operating agreement some combination of (a) a commitment by each member to guarantee some or all obligations of the LLC, (b) an undertaking, in particular circumstances, to execute and deliver a personal guaranty and/or (c) a power of attorney authorizing an agent to bind the member to guarantee a LLC obligation. See generally BISHOP AND KLEINBERGER, supra note 1, ¶ 6.04[1] (discussing personal guaranties of members as well as practice pointers for the unwary).

When personal guaranties are given, the operating agreement should address contribution obligations among the members when less than all guarantors satisfy the obligation and the determination of each member’s contribution amount. In addition, members should consider the interaction of any buy-sell provisions with personal guaranties, to-wit, in the event a member’s interest is being purchased by another member or redeemed by the LLC, the release of the departing member’s personal guaranty or an agreement of the purchasing member to indemnify the departing member should be considered. Guaranties and contribution obligations can have important tax consequences. See supra note 18.

454 There are many reasons why distributions may not be in proportion to capital contributed, but perhaps the most common reason is that some distributions reflect the provision of services by some of the members.

455 For example, in an LLC in which one member (“Capital Partner”) contributes $1,000, and the other member (“Service Partner”) contributes only services, Capital Partner may be entitled to a distribution equal to 10% simple interest annually, cumulatively on unreturned capital, before Service Partner receives any distribution.
Are preferences intended to be temporary or permanent? Will operating distributions and capital distributions be treated differently?

Guaranteed Payments: __________

Distributions of Proceeds from Operations:

Define Operations.

Sharing Ratios and Economic Units

<table>
<thead>
<tr>
<th>Member</th>
<th>Sharing Ratio</th>
<th>Economic Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
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<td>4</td>
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456 A preferential return of capital to the Capital Partner is one sign that the Service Partner is likely to be allocated “phantom income” and may want to demand a “tax distribution” in order to have enough cash to pay its tax liability. See infra note 66.

457 For example, if Capital Partners get a 10% interest-like preference and the residual profits are split 80% Capital Partners/20% Service Partners, will the Service Partners get to “catch up” so that they receive 20% of all profits, including the 10% that went to the Capital Partners (which would mean that the 10% was a temporary preference for the Capital Partners)? Or instead will the Service Partners share in whatever profits are left over after the Capital Partners receive their 10% (which would make the 10% a permanent preference for the Capital Partners)?

458 A “guaranteed payment” under Code § 707(c) is not “guaranteed” in any normal sense. 26 U.S.C.A. § 707(c) (LexisNexis 2014). Rather, it is a payment to a partner for services or the use of capital, determined without regard to the income of the partnership. There may be important tax differences between an allocation and distribution, on the one hand, and a guaranteed payment on the other. For some purposes, but not all, a guaranteed payment is treated as paid to a third party. Fixed salary-type payments to a Service Partner are normally treated as guaranteed payments, regardless of whether they are provided for in a separate “employment agreement” apart from the LLC’s operating agreement. Preferences to Capital Partners sometimes constitute guaranteed payments. Guaranteed payments for capital often resemble interest payments, but the tax consequences may be different. A payment made to a partner “other than in his capacity as a member of such partnership” – such as a loan – is not a “guaranteed payment” but is treated as occurring between the partnership and a third party. See generally WILLIAM S. MCKEE, ET AL., FEDERAL TAXATION OF PARTNERSHIPS, ¶¶ 14.02-.03 (4th Ed. 2007) [hereinafter MCKEE]. Many operating agreements are careful to observe a distinction between distributions and payments.

459 The general rule in corporate law is that all shares of stock of the same class “must have preferences, limitations, and relative rights identical with those of other shares of the same class . . . .” GA. CODE ANN. § 14-2-601 (LEXIS through 2014 Reg. Sess.). There is no such rule in LLC law, even if the operating agreement uses corporate jargon by designating interests in the LLC as “shares,” “classes,” or the like. An LLC “unit” is essentially whatever the operating agreement says it is. Do not be fooled by terminology such as “unit” into assuming that all the “units,” or all the “units” of a given “class,” are fungible, or that all important aspects of the members’ rights and obligations are captured in the terms of the “units.” Instead, LLC interests “may, and frequently do, on a per-unit or per-share basis, have different interests in the management, capital, profits, losses, and tax attributes of the LLC. A common mistake is to forget to take those differences into account when drafting the buy-sell, preemptive rights, co-sale rights, drag-along rights, put and call options, liquidating distribution, etc. provisions of the operating agreement.” Warren P. Kean, Common Mistakes and Oversights When Drafting and Reviewing LLC Operating Agreements XXV-2 PUBOGRAM 6 (March 2008), reprinted, TAX NEWS FOR BUS. LAW. (Summer 2008); Andy Immerman, Is There Any Such Thing as an LLC Unit?, BUS. ENTITIES, July/Aug. 2009, 20.
In accordance with Capital Accounts
☐ Any preferred return on Capital Contributions (temporary or permanent)?
☐ Any preferred return of Capital Contributions?
☐ Draws or advances
☐ Other: 

Distribution of Proceeds from Capital Transactions.

Define Capital Transactions:
☐ Sales of capital assets
☐ Refinance
☐ Other
☐ In accordance with Capital Accounts
☐ As preferred return on Capital Contributions
☐ In accordance with Sharing Ratios
☐ In accordance with Economic Units
☐ Other: 

460 Strictly speaking, an advance or draw is somewhat different from a distribution, and the difference may have important tax consequences. An advance or draw against a partner’s distributive share of income is treated as a current distribution made on the last day of the partnership taxable year. Treas. Reg. § 1.731-1(a)(1)(ii) (1960); see generally McKee, supra note 58, ¶ 19.03[2].

461 Many LLCs provide for distributing liquidation proceeds in accordance with positive capital accounts because that provision may help ensure that the LLC’s allocations are respected for tax purposes. However, many LLCs, especially those formed in recent years, do not provide for liquidating distributions in accordance with capital accounts. In particular, LLCs using “targeted allocations” (also known as “forced allocations”) do not provide for liquidating distributions in accordance with capital accounts. See Terence Lloyd Cuff, Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements, 65 N.Y.U. TAX LAW INST. § 18.07[5] (2009).

462 Most LLC acts are similar to each other in their provisions for disposing of assets upon liquidation. Assets must first be applied to discharge obligations to creditors; ULLCA § 806 expressly includes members who are creditors. Whether or not payments to creditors on liquidation technically should be called “distributions,” many operating agreements treat them as distributions. The default rule of RULLCA directs that surplus be used to return all contributions not previously returned and that the remainder be distributed to the members in equal shares. RULLCA § 708(b), 68 U.L.A. 514 (2008). See also RPLLCA § 711(b), 67 BUS. LAW. at 181. The default rule under the Kentucky LLC Act provides for distribution of LLC assets upon liquidation as follows: (1) to creditors; (2) to members or former members in satisfaction of liabilities for declared but unpaid distributions; and (3) “to
In accordance with Capital Accounts  
☐ As preferred return on Capital Contributions  
☐ In accordance with Sharing Ratios  
☐ In accordance with Economic Units  
☐ As preferred return on capital contributions  
☐ Other: (Should it mirror distribution provisions? Not see problem if mirrors economic relationships.)  

Distributions in kind:\(^{462}\)  
☐ Prohibited (all distributions must be in cash)  
☐ Permitted if pro-rata among the members  
☐ Other:  

Tax Distributions:\(^{463}\)  

members and former members first for the return of their contributions and second in proportion to the members’ respective rights to share in distributions from the LLC prior to dissolution.” KY. REV. STAT. ANN. § 275.310 (LEXIS through 2013 First Extra. Sess.). The operating agreement generally will not affect the rights of third-party creditors, but it can establish how distributions to members will be dealt with upon liquidation, and will generally supersede the LLC act’s provisions regarding distributions to members.

\(^{462}\) Certain LLC acts, absent a contrary provision in the operating agreement, preclude distributions in kind (e.g., MD. CODE ANN., CORPS & ASS’NS § 4A-504 (LEXIS Emergency Legis. through 2013 Second Reg. Sess.); NEV. REV. STAT. § 86.346 (LEXIS through 2013 Reg. and Special Sess.)) or permit distributions in kind only to the extent the assets are distributed pro-rata among the members (e.g., KY. REV. STAT. ANN. § 275.220(2) (LEXIS through 2013 first Extra. Sess.); TEX. BUS. ORGS. CODE ANN. § 101.203 (LEXIS through 2013 3\(^{rd}\) Called Sess.)). Prohibiting distributions in kind limits flexibility and may compel the sale of an asset in a falling or illiquid market or otherwise in a “fire sale.” Conversely, distributing an asset in common tenancy among the members following a dissolution may compel former members who did not want to be in business with one another to continue in that role, although now outside of an LLC. In addition, holding property as tenants in common may sometimes give rise to a deemed partnership for tax or non-tax purposes. In recent years, the borderline between tenants in common and deemed partners has been explored intensively in connection with tax-free exchanges. See generally Richard M. Lipton, The ‘State of the Art’ in Like-Kind Exchanges, 2009, J. TAX’N, Jan. 2009, 27; Rev. Proc. 2002-22, 2002-1 C.B. 733. Some situations may justify permitting non-pro-rata in kind distributions subject to appropriate oversight of valuation.

\(^{463}\) Operating agreements may provide for so-called “tax distributions.” Income of a partnership is taxed to the partners when it is earned by the partnership, whether or not it is distributed. Income that is allocated, without any corresponding distribution, is sometimes called “phantom income.” The point of a tax distribution is to minimize the risk that partners will have to pay tax on allocated income when they have not received enough cash to pay the tax. Tax distributions should not be looked on as a special kind of distribution. It is more accurate to think of them as advance distributions of amounts that, at least at the time the distributions are made, the partner appears to be entitled to receive eventually. Because it is usually impractical to determine the actual amount of cash that a member needs to pay taxes, tax distributions are usually made under certain general assumptions about tax rates. Members who receive an interest in LLC profits in connection with performing services tend to have a particularly acute need for tax distributions. Some advisors mistakenly attempt to eliminate the need for tax distributions by providing that income will be allocated away from the members who are not otherwise receiving distributions.
These attempts may result in invalid allocations or distortions in the economic deal. A sample tax distribution provision is set out in Coppedge, supra note 47, at 48. Terence Cuff, Drafting Tax Distribution Provisions, REAL EST. TAX’N, Fourth Quarter 2010, 10 discusses tax distribution provisions in some detail and describes factors that can make them complex to draft. U.S. corporate and individual taxpayers must pay estimated taxes under Code §§ 6654 and 6655. An operating agreement often provides that tax distributions are to be made by the LLC in time for the equity owners to use the distributed funds to pay, or help to pay, their estimated tax liabilities. Although those payments are frequently referred to as having to be made on a quarterly basis, the payment dates do not fall precisely three months apart from each other.

The general rule is that 25% of the “required annual payment” (which, with certain exceptions, is between 90% and 100% of the total tax actually due by the taxpayer for the taxable year) must be paid with each installment. Both corporations and individuals, however, may determine the amount of estimated taxes to pay with each installment on an annualized basis. The definition of “Net Taxable Income” used in determining the LLC’s “Net Taxable Profits” applies such an annualized approach to determine the LLC’s quarterly taxable income.

The federal government is only one of the taxing authorities to which an equity owner may be required to pay income taxes on the equity owner’s share of the LLC’s income. Moreover, in addition to regular federal income taxes, an equity owner may be subject to other federal taxes, such as excise taxes, withholding taxes, alternative minimum taxes, and self-employment taxes. The non-managing members may want to include language in the operating agreement to help bolster their position that they should be treated as “limited partners,” who under Code § 1402(a)(13) are not subject to self-employment taxes (i.e., SECA taxes) on their distributive share of a partnership’s net trade or business income. See Ribstein and Keatinge, supra note 1, §§ 21.01-21 for additional discussion on the federal tax treatment of employees and other service providers of LLCs. See also Bishop and Kleinberger, supra note 1, ¶¶ 4.10, 4.13[3][c].

In addition, different types of income may be subject to different rates of tax (most notably, long-term capital gains are taxed to individuals at preferential rates). Furthermore, federal and state tax credits may flow through the LLC. Accordingly, the parties can, at best, approximate what they believe to be a fair rate for computing the tax distributions to be made, while attempting to minimize both the amount of cash an equity owner will have to use from other sources to pay taxes owed on undistributed earnings and the amount of cash flow redirected for tax distributions. For that reason, an agreement may impute a rate of tax that can be adjusted from time to time as the manager/members deem appropriate (such as, by factoring in the capital gains rate if the LLC has a significant amount of long-term capital gains for a taxable year or quarter or having those equity owners taxed at higher rates agree to a lower imputed rate).

Another formulation is to provide that the rate shall be “the highest combined federal, state and local and, in some cases, foreign marginal income tax rate (adjusted for any deductions or credits allowed by one taxing authority for taxes paid to another taxing authority) applicable with respect to the Interest of any Equity Owner as reasonably determined by the Manager and/or Members at the time that the income in respect of which those distributions are to be made was earned by the Company.” As pointed out above, this formulation is really no more precise than using a fixed, stipulated rate but will require the LLC to spend significantly more time and effort to derive it year after year - an exercise that many conclude is unnecessary and
☐ Yes
☐ No

☐ automatically at ____% of taxable income
☐ automatically at % redetermined periodically by members or managers
☐ automatically at highest combined marginal state and federal rate for an individual in specified state, taking into account the federal deduction of state taxes
☐ take into account different rates on different types of income
☐ take into account different rates paid by different members
☐ tax distributions to all members, pro rata by profit share
☐ tax distributions only to members who would otherwise have phantom income
☐ member applies to manager; manager approves
☐ member applies to manager, manager approves; members approval required at ____%
☐ member applies to manager, manager approves; if manager declines, special meeting of members is called (or consent required) who have to approve at ____%

Maintenance of Capital Accounts. Capital accounts will be maintained in accordance with Treas. Reg. § 1.704-1(b)(2)(iv): ☐ Yes ☐ No

“Tax Basis”;
“Tax Book Rules”;
GAAP;
Optional/Additional method: __________________________________________________________________________

Allocations of Profits and Losses:  


464 See Schneider & O’Connor, Partnership and LLC Agreements: Learning to Read and Write Again, TAX NOTES 1323, 1332 (Dec. 24, 2009). These four alternatives are the ones listed on IRS Schedule K-1. It is usually advisable, and sometimes essential, for an LLC to maintain capital accounts in accordance with the principles of Treas. Reg. § 1.704-1(b)(2)(iv) (2013) (known as “Section 704(b) book) capital accounts), whether or not the LLC also needs to maintain additional capital accounts under other principles. Under Treas. Reg. § 1.704-1(b)(2)(iv), each partner has one and only one capital account; capital accounts are kept for each partner, and not for each “unit” (or “share”). For purposes of the capital account rules, the division of LLC interests into “units” (or “shares”) is generally ignored by the IRS. Although the tax rules tend to have an enormous influence on capital account maintenance, capital accounts can be – and often are – fundamental to the economics of the deal. Do not assume that everyone except the tax advisors can safely ignore capital accounts.

465 Allocations are among the most confusing topics in partnership tax. A tax expert may be required, even for many apparently simple transactions. One problem is that allocations, unlike most aspects of the LLC, leave very limited room for negotiation and agreement among the parties. Valid allocations are less flexible than parties
sometimes assume. In a typical business deal, allocations will be dictated by the flow of contributions in and distributions out of the LLC. The existence of alternative drafting techniques should not disguise the very limited nature of the parties’ freedom to allocate. Over the entire life of the LLC, contributions plus allocations of income (minus allocations of deductions) ought to equal distributions. If you know how you want contributions to be made, and how you want distributions (importantly including liquidating distributions) to be made, then the allocations tend to follow. An important exception exists for allocations attributable to nonrecourse debt. For distinction between allocations and distributions, see ROBERT L. WHITMIRE, ET AL., STRUCTURING AND DRAFTING PARTNERSHIP AGREEMENT, ¶ 4.01[3] (3rd Ed. 2003) [hereinafter WHITMIRE DRAFTING].

LLC acts may have default provisions on the allocation of profits and losses. See, e.g., KY. REV. STAT. ANN. § 275.205 (LEXIS through 2013 First Extra. Sess.) (profits and losses of an LLC “shall be allocated on the basis of the agreed value, as stated in the records of the [LLC] as required by KRS 275.285, of the contributions made by each member to the extent they have been received by the [LLC] and have not been returned.”). See also TEX. BUS. ORGS. CODE ANN. § 101.201 (LEXIS through 2013 3rd Called Sess.). The Revised Prototype provides for per capita (i.e., equal among the members) distributions. See RPLLCA § 404(a)(1), 67 BUS. LAW. at 156. However, allocation provisions for operating agreements are normally drafted primarily with tax considerations in mind and with little regard for the LLC act defaults. If special allocations are desired, provisions authorizing specialized allocations should be added. See generally McKee, supra note 58, ¶¶ 11.01-08; BISHOP AND KLEINBERGER, supra note 1, ¶ 4.12.

466 See generally McKee, supra note 58, ¶ 11.02. It is virtually unheard of for LLC members to agree to an unlimited deficit restoration obligation. If the LLC wants to comply with the “safe harbor,” it will rely on the “alternate test.”

467 On “targeted capital accounts” (or “forced allocations”), see Terence Floyd Cuff, Working with Target Allocation – Drafting in Wonderland, REAL EST. TAX’N, Third Quarter 2008, 162; Terence Floyd Cuff, Working with Target Allocations – Idiot-Proof or Drafting for Idiots?, REAL EST. TAX’N, Second Quarter 2008, 116. Regarding forms of targeted allocation provisions, see, e.g., WHITMIRE DRAFTING, supra note 65, ¶ 5.05[2] (forced allocation technique); Cavanaugh, Targeted Allocations Hit the Spot, TAX NOTES, Oct. 4, 2010, at 89; Golub, How to Hit Your Mark Using Target Allocations in a Real Estate Partnership, 50 BNA TAX MGMT. MEMO No. 20, at 403 (2009).

468 Debt incurred by the LLC, both recourse debt and nonrecourse debt, is included in the tax bases that the members have in their LLC interests. The rules for allocating debt among the partners are quite elaborate and vary depending on whether the debt is recourse or nonrecourse. See 26 U.S.C.A. § 752; Treas. Reg. §§ 1.752-1 through -
Code § 704(c) methodology and reverse 704(c) methodology:  

☐ Traditional  
☐ Traditional With Curative  
☐ Remedial  
☐ Other: ________________________________

Loans from Members:

May members make loans to the LLC?

☐ Yes. If Yes, who makes that determination?________________

☐ No

Are members obligated to make loans to the LLC?

☐ Yes  
☐ No

If mandatory:

Amount: ____________________________  
Interest Rate: ________________________

7 (2006). See generally McKee, supra note 58, ¶¶ 8.02-.03. The definition of “nonrecourse” debt for those purposes may surprise business lawyers. A liability is nonrecourse “to the extent that no partner or related person bears the economic risk of loss for that liability . . . .” Treas. Reg. § 1.752-1(a)(2). Thus, debt that is fully recourse to all the assets of the LLC may be “nonrecourse” under the tax rules.

Code § 704(c) deals with the tax consequences of contributed property that, at the time of contribution, has a value either higher or lower than its tax basis and is mandatory. 26 U.S.C.A. § 704(c) (LexisNexis 2014). The choice of Code § 704(c) method(s) set forth in the checklist can make a big difference. For example, if the contributed property is sold at its tax basis, but at a loss from book value, the owner would have no taxable gain under the traditional method(s) but could have substantial taxable gain under the remedial method. If the property is depreciable or amortizable, the selection of Code § 704(c) method becomes more significant because it may affect the amount of taxable income or loss for each equity owner during the applicable recovery period. Members often will negotiate which Code § 704(c) allocation method to use with respect to particular property contributed to the LLC. The members usually will have adverse interests on this issue, and any method likely will benefit some members at the expense of other members. Because of the adverse interests of the members, the LLC should not leave the choice of Code § 704(c) to the manager unless it is intended that the manager have the authority to favor some members at the expense of others. The choice of Code § 704(c) method(s) can have significant tax and, therefore, economic consequences to the parties. Thus, those provisions relating to the selection of the Code § 704(c) method(s) to be adopted by the LLC should not be treated as insignificant or neutral boilerplate. Different methods may be used for different assets. “Reverse 704(c)” allocations deal with the situation in which a partnership revalues its assets in connection with a distribution or contribution, and the new value of an asset differs from the tax basis of the asset. See Cuff, supra note 67, § 18.83.

The mechanism for approving a member loan is addressed below in Part V.
Term:
☐ Collateral: __________
☐ Not collateralized

Remedies upon default: ____________________________________________________________________________
________________________________________________________________________________________________
________________________________________________________________________________________________

If permitted:

Amount: $_________
Interest Rate: _________
Term: ___________
Description of collateral: __________________________________________________________________________
________________________________________________________________________________________________
________________________________________________________________________________________________
Remedies upon default: ____________________________________________________________________________
________________________________________________________________________________________________
________________________________________________________________________________________________

Recourse or Nonrecourse:
☐ Recourse ☐ Nonrecourse

Transfers of membership interests: 471

Voluntary transfers:
☐ Absolutely prohibited 472
☐ Permitted, but assignee is not admitted as a member without consent of ______% of the other members 473

471 Membership in an LLC typically carries with it financial rights (especially the right to distributions) and non-financial rights (such as the right to vote, participate in management, or receive information). In Delaware and Georgia, LLC “interest” essentially means “economic interest,” so in some states it could be confusing to refer to “full membership interest.” Generally, the operating agreement restricts transfer of LLC interests to reflect the intent of the parties to be able to veto new members. There is no uniform anti-transfer provision, and thus any such provision must be specifically tailored to the transaction. Transfer of only the financial interest in an LLC is permitted by each LLC act since it does not affect the management of the LLC. See generally RIBSTEIN AND KEATINGE, supra note 1, § 7.3; BISHOP AND KLEINBERGER, supra note 1, ¶ 8.06. Under most state LLC acts, the transfer of an interest merely transfers the member’s right to receive distributions (the economic interest), and the assignee does not have an automatic right to become a member or to participate in the management of the LLC. See, e.g., KY. REV. STAT. ANN. §§ 275.255(b)-(c) (LEXIS through 2013 First Extra. Sess.); RPLLCA §§ 502(a)(4)(A)-(B), 67 BUS. LAW. at 163; RULLCA § 502(a)(3), 6B U.L.A. 496 (2008); TEX. BUS. ORGS. CODE ANN. § 101.109 (LEXIS through 2013 3rd Called Sess.).

472 Consider whether applicable state law will enforce an absolute prohibition on transfer. See generally HOWARD M. ZARITSKY, ET AL., STRUCTURING BUY-SELL AGREEMENTS: ANALYSIS WITH FORMS ¶ 7.03 (2014); see also EGON GUTTMAN, MODERN SECURITIES TRANSFERS § 7:7 (4th Ed. 2013).

473 This approach is often adopted by states as the default rule. See, e.g., KY. REV. STAT. ANN. § 275.265(1) (LEXIS through 2013 First Extra. Sess.) (“[A]n assignee of a limited liability company interest shall become a member only if a majority-in-interest of the members consent”); MD. CODE ANN., CORPS & ASS’NS § 4A-604
Permitted only with consent of ____% of the other members

- Spouse
- Children
- Other relatives: __________________________

- Trusts for any of the above
- Controlled business entities but only under these conditions:
  - Assignee automatically becomes member
  - Assignee is not admitted without consent
  - Permitted only with consent of ____% of the other members

Involuntary transfers.

- Assignee is not admitted without consent of all other members
- Assignee not admitted without consent of ____% of the other members

(LEXIS Emergency Legis. through 2013 Second Reg. Sess.) (all members must consent to an assignee’s being admitted, unless the operating agreement provides otherwise); TEX. BUS. ORGS. CODE ANN. § 101.109(b) (LEXIS through 2013 3rd Called Sess.) (“An assignee of a membership interest in a limited liability company is entitled to become a member of the company on the approval of all of the company’s members.”).

474 It may be desirable to provide an absolute right to transfer to or for the benefit of (i.e., trust) permitted transferees (such as the member, a spouse or children), which would permit transfer to those persons without triggering right of first refusal provisions. Coppedge, supra note 47, at 47. This sort of provision could also be made applicable only in the event of death or other involuntary transfer. Consider whether the provision for permissible transfers should (or should not) provide that the transferee will be admitted automatically as a substitute member. “The primary drawback to this option is that the other members may end up with partners not of their choosing.” Id. For tax discussion relating to sales and transfers of economic rights to the LLC and to persons other than the LLC, see BISHOP AND KLEINBERGER, supra note 1, ¶ 8.07[1], 8.07[2]; RIBSTEIN AND KEATINGE, supra note 1, §§ 20.01-.39.

475 Some operating agreements allow the transfer of membership interests to an entity controlled by the transferring member. Those provisions create the potential for abuse if inadequately drafted, allowing the member to transfer her interest to a single member LLC that she controls, then selling that interest to an unrelated third party. To prevent this type of situation, provisions should dictate the buy-out of the indirectly transferred member interest if the agreement provides that a change of control is deemed a transfer. See generally Terence F. Cuff, Drafting Partnership and LLC Agreements: Part II, BUS. ENTITIES, July/August 2001, 26; Cuff, supra note 67, § 18.40.

476 Under Section 541(c) of the Bankruptcy Code, a debtor’s bankruptcy estate automatically succeeds to the debtor’s property, which includes a member’s financial rights and may include some governance rights. Be aware that the trustee in bankruptcy of a member may assert the right to become a substitute member authorized to exercise all rights, including the right to participate in management, of a member, notwithstanding the absence of the consent of the remaining members to the admission of the trustee as a member. See, e.g., In re Ehmann, 319 B.R. 200, 206 (Bankr. D. Ariz. 2005); 334 B.R. 437, withdrawn 337 B.R. 228 (Bankr. D. Ariz. 2006); see also Thomas E. Rutledge & Thomas Earl Geu, In re Ehmann II - Now You See It, Now You Don’t, BUS. ENTITIES, May/June 2006, 44. An Ohio court afforded to the estate of a former member the right to participate in the management of the LLC. See Holdeman v. Epperson, 857 N.E.2d 583 (Ohio 2006); see also BISHOP AND KLEINBERGER, supra note 1, ¶ 1.04[3][c]; RIBSTEIN AND KEATINGE, supra note 1, § 7:9.
Right of first refusal: Right of first offer:

Voluntary transfers:
- Exercisable by LLC
- Exercisable by members but not economic interest holders
- Exercisable by members and economic interest holders
- Exercisable by LLC first and members second
- Exercisable by LLC first and members and economic interest holders second

Involuntary transfers:
- Exercisable by LLC
- Exercisable by members but not economic interest holders
- Exercisable by members and economic interest holders
- Exercisable by LLC first and members second
- Exercisable by LLC first and members and economic interest holders second

Disengagement Arrangements:

Type of arrangement:
- Put
- Call
- Buy-Sell (also called a Russian Roulette, High-Noon, or Shotgun Provision)

---

477 If the operating agreement provides for a right of first refusal, a member who intends to sell his membership interest in the LLC and has negotiated a sale agreement must first offer the LLC or the remaining members an option to purchase that member’s LLC interest generally on the same terms and conditions as offered by the potential purchaser. See Coppedge, supra note 47, at 46. The operating agreement must set forth every step of procedure, with clear time periods from notice through closing. The operating agreement should also spell out exactly what happens if the members fail to exercise the right of first refusal. See Terence F. Cuff, Drafting Partnership and LLC Agreements: Part II, BUS. ENTITIES, July/Aug. 2001, 26. Upon the bankruptcy of a member, a right of first refusal that is triggered by bankruptcy or the appointment of a receiver may be treated differently from rights triggered upon any transfer by the member. See, e.g., In re Capital Acquisitions & Mgmt. Corp., 341 B.R. 632, 638 (Bankr. N.D. Ill. 2006).

478 One means of avoiding deadlock is for the operating agreement to provide an economically acceptable exit provisions for members. Any exit provision should require the departing member’s interest to be completely separated from the LLC. See RIBSTEIN AND KEATINGE, supra note 1, § 11:9; see also BISHOP AND KLEINBERGER, supra note 1, ¶¶ 8.02, 8.06.

479 “The put provision provides that a member may, at any time, ‘put’ his interest to the other members. In this instance, the selling member would notify the remaining members that he or she wishes to buy or sell at a given price.” Coppedge, supra note 47, at 46. The remaining members have two options: (1) they may sell their interests to the selling member at his stated price, or (2) they may purchase the selling member’s interest. Id.

480 One common form of buy-sell provision generally provides that either member may offer to buy out the other member’s LLC interest during a deadlock. Once a member receives such an offer, that member can sell his or her membership interest for the offered price, or buy the offering member’s interest for such price (or for a price determined on the same basis if the ownership of the members is not equal).
Circumstances for exercise of disengagement:

- Any time
- Any time after ________________________
- In the event of deadlock
- In the event of certain deadlocks ________________________
- Upon the dissociation of a member
- If non-reciprocal rights among members or classes of members, describe rights of each here: ________________________

Price:

- Set by agreement by the members or managers on a regular basis
- “Book” value

Examples of other exit strategies include a “drag-along” right, which permits a member selling his interest to a third party to force the other members to sell their interests to the same party on similar terms, as well as the “tag-along” right, which permits the other members to require a selling member to require the purchaser of his interest to buy the interest of the other members on similar terms. The possibilities for these types of provisions are limited only by the creativity of the drafter. See Terence F. Cuff, Drafting Partnership and LLC Agreements: Part II, BUS. ENTITIES, July/August 2001, 26.

It is important to specify how the LLC will be valued upon disengagement of a member. The enterprise may be valued according to a price established by the selling member, determined through an appraisal, or decided by an arbitrator. The mechanism for setting the price on disengagement may tie into the mechanism for booking up capital accounts. See generally BISHOP AND KLEINBERGER, supra note 1, ¶ 8.05; RIBSTEIN AND KEEINGE, supra note 1, § 11:3.

One approach is to specify that each year the members will determine an agreed value for a 1% interest. See Coppedge, supra note 47, at 46, 47. When the agreement calls for a periodic revaluation by the members, consideration should be given to whether the last agreed value, should apply regardless of how “stale,” or whether the last agreed value will be non-binding after some period of time and an alternative valuation procedure will instead be employed.

As is addressed in the various options identified below with respect to “book value,” exactly what in any particular instance will be “book value” both is and properly should be a matter of discussion. For example, in a business which holds property, such as real estate, that is expected to significantly appreciate in value, determining “book value” based upon historical acquisition costs may yield a windfall to those persons who are not being bought out. Similarly, companies in which capital is not a material income-producing item, such as in professional practices, which do generate significant good will, and especially in the case of good will that may be traceable to the efforts of one particular owner, there is again the risk that a buyout based upon historical balance sheet values may generate an inappropriate windfall. See Estate of Cohen v. Booth Computers, 22 A.3d 991, 1005-06, (N.J. Super. Ct. App.Div. 2011) (disparity in price between book value and fair market value does not make a buyout provision unconscionable if the provisions clearly specifies book value).
As kept for tax purposes (prepared by the Company’s regularly employed accountant)

“Booked up” to fair market value of Company assets

“Fair Market” determined by appraisal periodically or at time of call, etc.

As kept for tax purposes

“Booked up” to fair market value of Company assets.

Formula

Dissociation:

Voluntary withdrawal of a member

A member may not unilaterally withdraw

485 Consider and select between “fair value” and “fair market value,” appreciating that courts at times improperly construe the terms as equivalent (see, e.g., Ford v. Courier-Journal Printing Co., 639 S.W.2d 553, 556 (Ky. Ct. App. 1982), overruled Shawnee Telecom v. Brown, 360 S.W.3d 152 (Ky. 2011)) and as necessary specify whether and how discounts for marketability and/or control should be applied. See also Denike v. Cupo, 926 A.2d 869, 883-884 (884 N.J. Super. Ct. App.Div. 2007) (discussing distinction between “fair value” and “fair market value.”)

486 If the appraisal option is selected, the operating agreement should address how an appraiser is to be selected. There are many options for selecting an appraiser — providing a time period for the parties to agree on an appraiser, naming an arbitration service or judge to select an appraiser, or selecting multiple appraisers and averaging the appraisals. Appraisals can be expensive.

487 Formulas may be based on a capitalization of the income stream of the LLC in an effort to obtain an estimate of fair market value or, in the case of a repurchase from a terminated employee, be based on a formula that is not intended to estimate fair market value. The formula could be a percentage of fair market value or be tied to a percentage of the capital account for the interest, but there is an endless variety of possible formulas. If the purchase price is less than the withdrawing member’s capital account, the excess capital account will be allocated to the other members, likely triggering taxable income.

488 Of particular importance in those situations is how to handle the removal of the managing member of the LLC. The operating agreement should specify who may remove the manager and under what circumstances. A detailed list of events of default is typical. Also, the operating agreement should set forth provisions for selecting a new managing member. Certain states provide a statutory default rule for the removal of the manager. See, e.g., VA CODE ANN. 13.1-1024(F) (LEXIS through the 2014 Regular Session and Acts 2014, Sp. Sess. I, c. 1, of the General Assembly).

489 State LLC acts vary with regard to a member’s power to withdraw voluntarily from an LLC and receive the financial value of his/her interest. This disparity results from the competing interests between providing some liquidity for LLC members while still protecting the LLC and the remaining members from the disruption caused by dissociation. See generally RIBSTEIN AND KEATINGE, supra note 1, § 11:2; BISHOP AND KLEINBERGER, supra note 1, ¶ 8.03[1]. Some LLC statutes provide for some type of payment to a withdrawing member under various state-specific formulations. See RIBSTEIN AND KEATINGE, supra note 1, § 11:3; BISHOP AND KLEINBERGER, supra note 1, ¶ 8.05. See also Thomas E. Rutledge, You Just Resigned – Now What? Different Paradigms for Withdrawing From a Venture, J. PASSTHROUGH ENTITIES, Nov./Dec. 2009, 43.

490 It is important to identify a specific dispute resolution mechanism in the operating agreement. In some cases litigation may be appropriate, but other situations may lend themselves best to resolution through arbitration. A mediation requirement may be used as a first step before either binding arbitration or litigation is entered into. Any specific dispute resolution provisions must take into account local law. When drafting an agreement to arbitrate, it is important to define the parties bound by the arbitration, whether the LLC is bound by the obligation to
A member may withdraw upon the consent of
☐ Managers
☐ All
☐ Supermajority
☐ Majority
☐ Members
☐ All
☐ Supermajority
☐ Majority

Upon an approved withdrawal:

Member’s interest is repurchased
Member becomes an assignee

Death, disability, dissolution or bankruptcy of a member:

☐ Member’s legal representative or heir becomes a member without further action
☐ Member’s legal representative or heir continues as an assignee
☐ Member’s interest is repurchased from the legal representative or heir
☐ Member’s legal representative or heir becomes a member only with consent

Definition of disability:
Guardian/conservator appointed by court
Primary care physician or designee determines inability to manage business affairs
Member has not performed business functions for _______ days
Agent pursuant to power of attorney notifies Company

Dissolution/termination of a member’s existence as a member:

Arbitrate, whether it is the exclusive remedy available and whether it is binding, how the arbitrator is selected, and the extent of the arbitrator’s authority.

491 Upon the death of a member, only the member’s interest in the LLC, and not specific LLC property, passes to the member’s estate. The transfer represents the member’s financial interest in the LLC and does not include any interest in management. See RIBSTEIN AND KEATINGE, supra note 1, § 7:9; see also BISHOP AND KLEINBERGER, supra note 1, ¶ 8.03[3]. But see Holdeman v. Epperson, 857 N.E.2d 583, 588 (Ohio 2006) (executor of estate of deceased member of LLC has all rights that member had prior to death but only for limited purpose of settling estate and administering property).

492 Almost every state allows members to identify specific events in the operating agreement that will result in dissolution of the LLC. See generally RIBSTEIN AND KEATINGE, supra note 1, § 11:5 and apps. 11-5. See also BISHOP AND KLEINBERGER, supra note 1, ¶ 9.02. A few states, however, allow the continuation of an LLC following an event of dissolution only with the consent of all remaining members. See, e.g., ARK. CODE ANN. § 4-32-901(3) (LEXIS through the 2014 Fiscal Sess.); ARIZ. REV. STAT. § 29-781 (LEXIS through Fifty-first Legislature, 2nd Regular Session Emergency Legislation); WASH. REV. CODE § 25.15.270(4) (LEXIS through 2013 3rd Special Sess.). See also Bruce P. Ély & Christopher R. Grissom, “Choice of Entity: An Overview of Tax and Non-Tax Considerations,” 1500 Tax Mgmt. (BNA), 1550:0220 (2002); RIBSTEIN AND KEATINGE, supra note 1, § 11:7; BISHOP
<table>
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<th>Purpose</th>
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<tbody>
<tr>
<td>Authority of members or managers</td>
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<tr>
<td>Dissolution</td>
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<tr>
<td>Amendment procedure</td>
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<tr>
<td>Other:</td>
</tr>
</tbody>
</table>
Will the LLC be offering interests to the public?\textsuperscript{495}

\begin{itemize}
  \item [\square] Yes
  \item [\square] No
\end{itemize}

Dissenters’ rights in the event of merger:\textsuperscript{496}

\begin{itemize}
  \item [\square] Yes
  \item [\square] No
\end{itemize}

Derivative actions:\textsuperscript{497}

approval of the person who is not a party to the limited liability company agreement or the satisfaction of conditions, it may amended only in that manner or as otherwise permitted by law (except that the approval of any person may be waived by that person and any conditions may be waived by all persons for whose benefit those conditions were intended”); RULLCA § 112(a), 6B U.L.A. 449 (2008) (“An operating agreement may specify that its amendment requires the approval of a person that is not a party to the operating agreement or the satisfaction of a condition. An amendment is ineffective if its adoption does not include the required approval or satisfy the specified condition.”).

\textsuperscript{495} If offered to public, consider securities matters, entity structure and publicly traded partnership tax issues.

\textsuperscript{496} A minority of the LLC acts provide statutory dissenters’ rights to the members in the event of certain transactions, although it may be possible to eliminate this right in the operating agreement. See, e.g., Calif. (CAL. CORP. CODE §§ 17600 -17613 (LEXIS (with urgency legislation) through Ch. 31 of the 2014 Session and Propositions 41 & 42 approved June 2014)); Georgia (GA. CODE ANN. § 14-11-1001 et seq. (LEXIS through 2014 Reg. Sess.)); Maryland (MD. CODE ANN., CORPS. & ASS’NS § 4A-705 (LEXIS Emergency Legis. through 2013 Second Reg. Sess.)); Michigan (MICH. COMP. LAWS § 450.4702(2) (West 2011)); Minnesota (MINN. STAT. § 322B.383-.386 (LEXIS through 2014 Reg. Sess.)); Mississippi (MISS. CODE ANN. § 79-29-214 (West 2009 and 2013 supp.)); New Hampshire (N.H. REV. STAT. ANN. § 304-C:161 (LEXIS through 2013 Reg. Sess.)); New York (N.Y. LTD. LIAB. CO. LAW §§ 1005, 1002 (Consol. 2014)); North Dakota (N.D. CENT. CODE § 10-32-54(1)(c) (LEXIS through 2013 Reg. Sess.)); Ohio (OHIO REV. CODE ANN. § 1705.40 et seq. (Anderson 2001 and 2013 supp.)); Tennessee (TENN. CODE ANN. § 48-231-101 et seq. (LEXIS through 2013 Reg. Sess.)); Washington (WASH. REV. CODE § 25.15-425 et seq. (LEXIS through 2013 3rd Special Session.)); Wisconsin (WIS. STAT. § 183.1206 (West 2002 and 2013 supp.)). Under Kentucky law, they exist if provided for in the articles of organization or the operating agreement or in a plan of merger or of conversion (KY. REV. STAT. ANN. § 275.175(4) (LEXIS through 2013 First Extra. Sess.)); id. § 275.345(3); id. § 275.350(4); id. § 275.247), but otherwise are not available. See also DEL. CODE ANN. tit. 6, §18-210 (LEXIS through 2014 Fiscal Sess.); TEX. BUS. ORGS. CODE ANN. § 10.351(b)(c)(2) (LEXIS through 2013 3rd Called Sess.). If the organizational law provides dissenters’ rights, but those are not desired, consider whether the LLC act in question provides the flexibility to modify or entirely waive those rights. Where dissenters’ rights are sought and they are not provided for in the statute, they must be included in the operating agreement. Consider as well the statutory language providing for dissenters’ rights in the case of, for example, a merger, and whether that language needs to be expanded to address, for example, a conversion that was subsequently added to the LLC act or is now available by reason of the adoption of the Model Entity Transactions Act (6A U.L.A 1 (2008)) or a similar junction box statute. For a discussion of dissenters’ rights, see BISHOP AND KLEINBERGER, supra note 1, ¶ 12.11; RIBSTEIN AND KEATINGE, supra note 1, § 11:13.

\textsuperscript{497} While some LLC acts expressly provide for derivative actions (see, e.g., FLA. STAT. § 608.601 (LEXIS through the 2013 Reg. Sess.); TEX. BUS. ORGS. CODE ANN. §§ 101.451-101.463 (LEXIS through 2013 3rd Called Sess.), others are silent on the issue. New York’s highest court held that there was a common law right to bring a derivative action that was not abolished by the passage of the LLC act. Tzolis v. Wolff, 884 N.E.2d 1005, 1016 (N.Y. 2008). If the LLC act in question does not expressly permit derivative actions and they are desired, they should be addressed in the operating agreement. Delaware permits a member or an assignee of an LLC interest to
A. Classes of members:

☐ One class


498 Under Code § 6221, many partnerships are subject to unified federal tax audit proceedings, which are designed to facilitate partnership tax audits by determining adjustments, to the extent possible, at the partnership level rather than requiring that the Service audit each individual partner. 26 U.S.C.A. § 6221 (LexisNexis 2014). As noted above, most multi-member LLCs are considered partnerships for tax purposes. A “small partnership” is exempt from the unified audit rules. A partnership is considered a “small partnership” if it has ten or fewer partners, each of whom is an individual (other than a nonresident alien), a C Corporation or the estate of a deceased partner. 26 U.S.C.A. § 6231(a)(1)(B)(i) (LexisNexis 2014). Therefore, an LLC having an S corporation or partnership as a member is not a “small partnership” regardless of size. Where an interest in an LLC is itself held by a disregarded entity, the partnership no longer qualifies as a small partnership and must have a tax matters partner. I.R.S. Gen. Couns. Mem. 200250012 (Aug. 30, 2002). A husband and wife are treated as one partner for this purpose. Even if a partnership is otherwise exempt from these rules, the partnership may elect to be subject to them. 26 U.S.C.A. § 6231(a)(1)(B)(ii) (LexisNexis 2014). See generally WILLIS, PENNELL & POSTLEWAITE, PARTNERSHIP TAXATION §§ 20.02-20.09 (6TH Ed. 1997).

Any partnership subject to the unified audit proceedings is required to have a tax matters partner. 26 U.S.C.A. § 6231(a)(7) (LexisNexis 2014). The tax matters partner must be a “general partner,” and it is either the general partner so designated by the partnership or the partner with the largest profits interest where no designation has been made. See Treas. Reg. § 301.6231(a)(7)-2 (2001) (for the determination of who is a “general partner” of an LLC and the designation of the tax matters partner of an LLC). See Rev. Rul. 2004-88, 2004-32 I.R.B. 65, regarding a “disregarded entity” as the tax matters partner. For a discussion of the small partnership exception, see BISHOP AND KLEINBERGER, supra note 1, ¶ 2.07[2][c]. For a discussion of tax matters partner, see id. ¶ 2.07[2][c][i]; RIBSTEIN AND KEATINGE, supra note 1, § 17:19.

499 Some states expressly permit LLCs to have different classes of members with different rights and powers. See, e.g., DEL. CODE ANN. tit. 6, § 18-302 (LEXIS through 2014 Fiscal Sess.); TEX. BUS. ORGS. CODE ANN. § 101.104 (LEXIS through 2013 3rd Called Sess.). In Drafting Partnership and LLC Agreements, Terence Cuff discusses potential uses for different classes of interests, such as creating common and preferred interests. See Cuff, supra note 77.

42
☐ Multiple classes of members

☐ Differing voting rights
☐ Differing economic rights
☐ Other: ____________________________

Initial voting rights:500

<table>
<thead>
<tr>
<th>Member</th>
<th>Class of Voting Rights</th>
<th>________ of Voting Rights</th>
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<tbody>
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<td>1</td>
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Manner of consenting:

Meetings with formal rules

Voting by Proxy

Consent501

☐ Unanimous of the members502
☐ Vote of members otherwise sufficient to act
☐ Other: ____________________________

500 State law may provide a default rule that voting is per capita (members have equal vote even when ownership is not equal), pro rata based on ownership interests or otherwise. Consideration should also be given to an appropriate quorum provision. See id. at 45-46. For a state-by-state analysis of voting right default rules, see RIBSTEIN AND KEATINGE, supra note 1, § 8:3, app. 8-4.

501 Alternatives include permitting consent by a unanimous written consent, by the vote of the members sufficient to pass on the matter in question at a convened meeting of the members, or by a threshold higher than that required at a convened meeting but below unanimous. The last option has the benefit of encouraging careful scrutiny when acting absent the discussion that would take place in a convened meeting.

502 Under this option, even if the members may at a meeting act by a mere majority, when acting by written consent the approval of all the members is required. Accord MODEL BUS. CORP. ACT § 7.04(a) (2012) [hereinafter MBCA]. Delaware requires only the vote that would be necessary to authorize an action at a meeting. DEL. CODE ANN. tit. 6, § 18-404(d) (LEXIS through 2014 Fiscal Sess.).
A. Methods of measuring level of authorization or consent:

- Per capita
- By sharing ratios/units
- By capital contributions
- By current capital account balances
- Other: 

Items requiring different levels of authorization or consent:

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503 The benefit of per capita voting (see, e.g., Tex. Bus. Orgs. Code Ann. § 101.354 (Lexis through 2013 3rd Called Sess.); Rullca §§ 407(b)(2), (3), (4), 6B U.L.A. 483 (2008); RPLLCA § 406(b)(1), 67 Bus. Law. at 159; see also RUPA § 401(f), § 401(j), 6 (pt. I) U.L.A. 133 (2001) is that, assuming there is at least agreement regarding who are the members, it is easy to determine relative voting rights. Per capita voting rights avoid, in many unsophisticated LLCs, problems of valuation of different types of capital contributions (e.g., working capital versus intellectual property versus an agreement to provide services).

504 Allocating voting rights relative to capital contributions has the benefit of certainty assuming there is compliance with the requirement of a written record of contributions. However, to the extent that capital is other than paid in (e.g., an agreement to pay in capital that has not yet been called), differentiations in actual versus prospective exposure need to be addressed, as do the consequences of a failure to contribute vis-à-vis future voting rights.

505 If voting rights are based on capital accounts, to the extent distributions are not pro-rata but rather weighted toward a particular class of members, their voting rights will be disproportionately reduced as distributions are made. Reliance, however, on capital account balances will necessitate continuous attention to their maintenance. A “record date” as to their calculation for an upcoming vote may be appropriate. In an LLC utilizing special allocations, especially if losses are anticipated, utilization of capital accounts to determine voting rights can create uncertainty.
<table>
<thead>
<tr>
<th>Action</th>
<th>Member(s)</th>
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<tbody>
<tr>
<td></td>
<td>Managing</td>
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<td>Majority of</td>
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<td>Supermajority of</td>
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<td>Unanimous Consent of</td>
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<tr>
<td></td>
<td>Other</td>
</tr>
<tr>
<td>1. Acquire property</td>
<td></td>
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<tr>
<td>2. Maintain insurance</td>
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<tr>
<td>3. Borrow funds</td>
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<tr>
<td>4. Approve or initiate a Loan from a Member</td>
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<tr>
<td>5. Call a Loan</td>
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<tr>
<td>6. Investment of LLC funds in excess of $__________________________</td>
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<tr>
<td>7. Execute documents</td>
<td></td>
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<tr>
<td>8. Decisions with respect to investment of funds</td>
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<tr>
<td>9. Maintain records</td>
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<tr>
<td>10. Do other acts to carry on business in the usual way</td>
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<tr>
<td>11. Cause the LLC to participate in a reorganization, merger,</td>
<td></td>
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<tr>
<td>conversion</td>
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<tr>
<td>12. Dissolve the LLC</td>
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<tr>
<td>13. Sell all or substantially all of the property of the LLC outside</td>
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<tr>
<td>of the ordinary course of the LLC’s business</td>
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<tr>
<td>14. Incur indebtedness not in excess of $___________________________</td>
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<tr>
<td>15. Incur indebtedness in excess of $_______________________________</td>
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<tr>
<td>16. Expend funds of the LLC not in excess of $_______________________</td>
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<tr>
<td>17. Expend funds of the LLC in excess of $__________________________</td>
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<tr>
<td>18. Construct capital improvements not in excess of $________________</td>
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<tr>
<td>19. Construct capital improvements in excess of $___________________</td>
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<tr>
<td>20. Cause the LLC to guarantee the obligation of any person or to</td>
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<tr>
<td>pledge its property to secure the obligation of any person</td>
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<tr>
<td>21. Lend money of the LLC to any person</td>
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<tr>
<td>22. File on behalf of the LLC under the reorganization, insolvency</td>
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<tr>
<td>or bankruptcy laws</td>
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<tr>
<td>23. Cause the LLC to require a capital contribution from its Members</td>
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<tr>
<td>24. Determine the time and amounts of distributions to the Members</td>
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<tr>
<td>Action</td>
<td>Member(s)</td>
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### Information for Operating Agreement if Manager-Managed

**A. Initial Managers:**

Number of Managers: _____

Board of Managers?^{507}

---

^{506} There is often a special provision for an election under Code § 754; also closing of books vs. pro rata allocation. 26 U.S.C.A. § 754 (LexisNexis 2014).
If the LLC is to have a board of managers or other management committee, the Agreement should provide for “appointment of successors, terms of office, resignation and removal procedures, and the like.” Coppedge, supra note 47, at 49. Voting procedures for managers should also be specified in the agreement. Id.

Certain statutes expressly provide for differentiation in the authority and duties of various managers (see, e.g., VA. CODE ANN. § 13.1-1024(J) (LEXIS through the 2014 Regular Session and Acts 2014, Sp. Sess. I, c. 1, of the General Assembly.)), while other statutes do so in a less direct manner. See, e.g., KY. REV. STAT. ANN. § 275.165(2) (LEXIS through 2013 first Extra. Sess.); TEX. BUS. ORGS. CODE ANN. § 101.252 (LEXIS through 2013 3rd Called Sess.).

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<table>
<thead>
<tr>
<th>Classes of Managers</th>
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<tbody>
<tr>
<td>Yes</td>
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<tr>
<td>No</td>
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</table>

Names, addresses and titles (if any) of Managers:

<table>
<thead>
<tr>
<th>Manager #1</th>
<th></th>
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<tbody>
<tr>
<td>Name:</td>
<td>Taxpayer Identification</td>
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<tr>
<td>Address:</td>
<td>Number:</td>
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<tr>
<td>Telephone Number:</td>
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<tr>
<td>Fax Number:</td>
<td></td>
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<tr>
<td>E-mail Address:</td>
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<tr>
<th>Manager #2</th>
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<tbody>
<tr>
<td>Name:</td>
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<tr>
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<td>Number:</td>
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<tr>
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<td>E-mail Address:</td>
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Manager #3

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<tbody>
<tr>
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<tr>
<td></td>
<td>Fax Number:</td>
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<td></td>
<td>E-mail Address:</td>
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Manager #4

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<tr>
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<th>Taxpayer Identification Number:</th>
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<tbody>
<tr>
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<td>Telephone Number:</td>
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<tr>
<td></td>
<td>Fax Number:</td>
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<td>E-mail Address:</td>
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Manager #5

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<tr>
<td></td>
<td>Fax Number:</td>
</tr>
<tr>
<td></td>
<td>E-mail Address:</td>
</tr>
</tbody>
</table>
Qualification of Managers:

Must be members?\(^{509}\)
- [ ] Yes
- [ ] No

Must be individuals?\(^{510}\)
- [ ] Yes
- [ ] No

Selection of Managers:

- [ ] Unanimously selected by members
- [ ] Selected by a majority of members consisting of ________%
- [ ] Managers selected by particular members or classes of membership interests:

<table>
<thead>
<tr>
<th>Member / Class</th>
<th>Number of Managers that Member can appoint</th>
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- [ ] Managers selected by cumulative voting\(^{511}\)

---

\(^{509}\) See, e.g., KY. REV. STAT. ANN. § 275.165(2)(b) (LEXIS through 2013 First Extra. Sess.) (except as required by the articles of organization or the operating agreement, managers “shall not be required to be members of the limited liability company or natural persons”); TEX. BUS. ORGS. CODE ANN. § 101.302 (LEXIS through the 2014 Regular Session and Acts 2014, Sp. Sess. I, c. 1, of the General Assembly.) (“manager” may consist of one or more “persons,” which are defined to include artificial persons, and specifying managers need not be members or resident of state); VA. CODE § 13.1-1024.B (LEXIS through 2014 Regular Session and Acts 2014, Sp. Sess. I, c. 1, of the General Assembly.) (“Managers need not be residents of this Commonwealth or members of the limited liability company unless the articles of organization or an operating agreement so require.”); VT. STAT. ANN. tit. 11, § 3001(12) (LEXIS through the 2013 Regular Session and Acts 2014, Sp. Sess. I, c. 1 of the General Assembly.) (“‘Manager’ means a person, whether or not a member, of a manager-managed [LLC]…”).

\(^{510}\) If an entity is appointed as the manager, either the operating agreement itself or a management agreement between the LLC and the manager should address change of control of the manager as well as its bankruptcy, dissolution, and similar events. Compare MBCA § 8.03(a) (director must be an individual).

\(^{511}\) If cumulative voting is desired, the operating agreement should spell out exactly what is meant by cumulative voting. It should not be assumed in the contractual environment of the LLC that the corporate law of cumulative voting will be applied unless it is expressly incorporated into the operating agreement. For a discussion
<table>
<thead>
<tr>
<th></th>
<th>Special rule where manager removed for cause</th>
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<tbody>
<tr>
<td>☐</td>
<td>All of the members other than member who appointed the manager</td>
</tr>
<tr>
<td>☐</td>
<td>The member appointed the manager</td>
</tr>
<tr>
<td>☐</td>
<td>Same rule as for other elections or appointment</td>
</tr>
<tr>
<td>☐</td>
<td>Majority of the members other than the member who appointed the manager</td>
</tr>
<tr>
<td>☐</td>
<td>Majority of the members</td>
</tr>
<tr>
<td>☐</td>
<td>Other:</td>
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</tbody>
</table>

Election or appointment of Managers:

<table>
<thead>
<tr>
<th>☐</th>
<th>Periodic election of managers</th>
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<tbody>
<tr>
<td>☐</td>
<td>Annual</td>
</tr>
<tr>
<td>☐</td>
<td>Other:</td>
</tr>
</tbody>
</table>

|☐ | Election or appointment only on the removal or departure of a manager |
|☐ | Specific succession provided in operating agreement: |  |

Removal of Managers:

Who determines removal of manager?

|☐ | All of the members |
|☐ | All of the members who appointed the manager |
|☐ | _____% of the members who appointed the manager |
|☐ | All of the members other than the member who appointed the manager |
|☐ | _____% of the members |
|☐ | _____% of the members other than the member who appointed the manager |
|☐ | All of the managers other than the manager being removed |
|☐ | _____% of the managers other than the manager being removed |
|☐ | Other: |

Removal only for cause?

---

of manager management structure including manner of selection, see generally BISHOP AND KLEINBERGER, supra note 1, ¶ 7.04.

50
☐ Yes
☐ No

If yes, definition of “cause:”
☐ Fraud
☐ Gross negligence
☐ Bankruptcy
☐ Disability; if so, definition of disability: _______________________

☐ Guardian/conservator appointed by court
☐ Primary care physician or designee determines inability to manage business affairs
☐ Member has not performed business functions for __ days
☐ No performance of duties for Company in __ days
☐ Agent pursuant to power of attorney notices Company of disability
☐ Willful misconduct
☐ Conviction of a crime
☐ Conviction of a crime against the Company
☐ Violation of the operating agreement:
☐ Any violation
☐ Material violation
☐ Repeated violation
☐ Violation of particular provisions: _______________________

☐ Other: _______________________

If yes, who determines whether “for cause” factors have been met?
☐ Same as determines removal of manager, above
☐ Adjudication
☐ Arbitration

Manner of consenting:512

__________________________

512 Generally, LLC acts do not include default provisions for meetings of the members and other formal governance procedures. Rather, those procedures will be determined by the agreement of the members. The absence of standard provisions dealing with member meetings and similar issues is in striking contrast to business corporation laws. However, there are exceptions to this rule, notably Minnesota and North Dakota which, by statute, contain detailed provisions dealing with those procedural matters. See MINN. STAT. §§ 322B.33-.37 (LEXIS through 2014 Reg. Sess.); N.D. CENT. CODE §§ 10-32-44 through -50 (LEXIS through 2013 Reg. Sess.). See also N.Y. LTD. LIAB. CO. LAW §§ 403-407 (Consol. 2014); TENN. CODE ANN. § 48-222-101(a) (LEXIS through 2013 Reg. Sess.); id. § 48-224-104; TEX. BUS. ORGS. CODE ANN. § 101.351-101.359 (LEXIS through 2013 3rd Called Sess.); id. § 6.001-6.053.
Meetings with formal rules

Informal consent

Vote by Proxy?513

Methods of measuring level of consent:514

Per capita

Other: ____________________________________________

Managers to sign Operating Agreement:

Yes

No

Items requiring different levels of consent:515

513 There are state specific limitations on the use of proxies in LLCs. Proxies are expressly permitted by the Revised Prototype LLC Act. See RPLLCA § 406(d), 67 BUS. LAW. at 159. Issues regarding restricting the right to participate in management to those admitted as members may arise as well under a state enactment of the Uniform Power of Attorney Act. For example, the Tennessee LLC act provides that an operating agreement may not authorize a “director” of an LLC to vote by proxy. See TENN. CODE ANN. § 48-249-205(b)(11) (LEXIS through 2013 Reg. Sess.). See also Thomas E. Rutledge, In Delectus Personae and Proxies, J. PASSTHROUGH ENTITIES, July/Aug. 2011, 43.

514 In LLCs, there generally exists significant flexibility with respect to the allocation of voting rights. While certain early acts provided that all members, irrespective of their economic position in the company, would have equal voting rights (e.g., RPLLCA § 406(b), 67 BUS. LAW. at 159), most acts today allocate, as a default matter, voting rights in proportion to contributions. See, e.g., KY. REV. STAT. ANN. § 275.175(3) (LEXIS through 2013 First Extra. Sess.); id. § 275.015(3). Other states do not provide a default rule, leaving the issue of allocation of voting rights entirely to the operating agreement. See, e.g., OHIO REV. CODE ANN. § 1705.26 (Anderson 2001 and 2013 supp.) (the operating agreement “may grant to all or a specified group of its members the right to vote on a per capita or other basis upon any matter.”) If voting rights are determined relative to capital contributions, the operating agreement should specify under what circumstances a distribution is a return of a capital contribution (e.g., that the first dollars distributed are a return of capital).

515 It is important to prevent third parties from relying on the apparent authority of managers, members, and/or officers when those persons are not actually authorized to bind the LLC. For a discussion of the power to bind the LLC in contractual undertakings, see BISHOP AND KLEINBERGER, supra note 1, ¶ 7.06; RIBSTEIN AND KEATINGE, supra note 1, §§ 8.5–9. See also Rutledge, supra note 8; Rutledge & Frost, supra note 8.
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<tbody>
<tr>
<td></td>
<td>Single</td>
<td>Majority of Members</td>
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<td>Majority of Supermajority of Members</td>
<td>Unanimous Consent of Members</td>
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<td>Single “Super”</td>
<td>Majority of Members</td>
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1. Acquire property
2. Maintain insurance
3. Borrow funds
4. Approve Loan from a Member
5. Call a Loan
6. Invest LLC funds in excess of $____
7. Execute documents
8. Employ professionals and other agents
9. Decisions with respect to investment of funds
10. Maintain records
11. Do other acts to carry on business in the usual way
12. Cause the LLC to participate in a merger/conversion/domestication/________
13. Dissolve the LLC
14. Sell all or substantially all of the property of the LLC outside of the ordinary course of the LLC’s business
15. Incur indebtedness not in excess of $_____ 
16. Incur indebtedness in excess of $________
17. Expend funds of the LLC not in excess of $____
In addition to the crucial issue of determining the appropriate threshold for amendment of the operating agreement, there is as well the issue of defining exactly what constitutes the operating agreement. Generally, the “operating agreement” constitutes the agreement among the members as to the operation of the company. See, e.g., KY. REV. STAT. ANN. § 275.015(20) (LEXIS through 2013 First Extra. Sess.); RPLLCA § 102(14), 67 BUS. LAW. at 129; TEX. BUS. ORGS. CODE ANN. § 101.001(1) (LEXIS through 2013 3rd Called Sess.). Consequently, any decision made by all of the members (or any decision made by that threshold of the members necessary to adopt an amendment to the operating agreement) arguably constitutes part of the “operating agreement.” It follows that any later action to alter that previous decision is itself arguably an amendment to the operating agreement and will require that threshold of the members required for an amendment. For example, assume that an operating agreement requires an 80% vote of the members for its amendment, but allows a majority of the members to determine a matter in the ordinary course. A decision is made with respect to the carpeting in the reception area of the LLC’s offices, and that decision is made by at least that threshold of the members required for
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<td>26. Determine the time and amounts of distributions to the members</td>
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Individual LLC acts may have specific requirements for distributions. For example, Rhode Island (R.I. GEN. LAWS § 7-16-28 (LEXIS through 2013 Reg. Sess.)) and Hawaii (HAW. REV. STAT. § 428-404(c)(6) (Thomson West 2008)) provide a default rule for unanimous approval of the members for an interim distribution. In contrast, under the Revised Prototype LLC Act, the declaration of a distribution is an ordinary course activity requiring the approval of only a majority of the members. See RPLLCA § 404(a)(2), 67 BUS. LAW. at 156; id. § 406(b)(1), 67 BUS. LAW. at 159.

A member of an LLC may unilaterally transfer the right to receive the economic fruits of the LLC (i.e., allocation of the tax items of income, loss, deduction and credit and interim and liquidating distributions) but may not unilaterally transfer the right to participate in the management and direction of the LLC. See, e.g., ME. REV. STAT. ANN. tit. § 685 (West 2011). Rather, the right to participate in the management of the LLC is restricted to those who have been admitted as a member. The states have adopted a variety of default voting thresholds required for the admission of a “mere transferee” as a member. See, e.g., CONN. GEN. STAT. § 34-172 (LEXIS through P.A. 14-211 (except 14-175, 14-187 and 14-205) (majority in interest of the members); HAW. REV. STAT. § 428-404(c)(7) (LEXIS through 2013 Second Special Sess.) (all of the incumbent members); KY. REV. STAT. ANN. § 275.275(1) (LEXIS through 2013 First Extra. Sess.) (all of the incumbent members); RPLLCA § 401(b)(3), 67 BUS. LAW. at 154 (all of the incumbent members); RULLCA § 502(a)(3), 6B U.L.A. 496 (2008). For a discussion of the limitations on member’s power and right to transfer, see BISHOP AND KLEINBERGER, supra note 1, ¶ 8.06; RIBSTEIN AND KEATINGE, supra note 1, § 7:5.
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Duties of managers:

Duty of care\(^{519}\)

Gross negligence
Ordinary prudence
Other: __________________________________________

Duty of Loyalty:

Right to compete:  
☐ Yes
☐ No
☐ Yes, but limited to __________________________________________.
☐ No, but may invest in entities competing with the Company if no management rights and investment in other entity does not exceed a ______% interest in the competing venture.

Duty to offer opportunities to the LLC:  
☐ Yes, as to ________________________________.
☐ No

Expectation that manager will have other activities:
☐ Yes

537692 (Del. Ch. 2002)); Guttman v. Huang, 823 A.2d 492, 507 n. 39 (Del. Ch. 2003) (the "litmus test" in Delaware for imposing liability for breach of the fiduciary duty of care, absent a more exculpatory provision in the entity’s governing documents, is gross negligence). To establish the gross negligence of the manager, a member must plead and prove that the manager was “recklessly uninformed or acted outside the bounds of reason.” Cincinnati Bell Cellular Sys. Co. v. Ameritech Mobile Phone Serv. of Cincinnati, Inc., No 13389, 1996 WL 506906, at *4 (Del. Ch. 1996) (quoting Tomczak v. Morton Thiokol Inc., No. 7861, 1990 Del. Ch. Lexis 47, 35 (Apr. 5, 1990), aff’d 692 A.2d 411 (Del. 1997). LLC acts have addressed the standard of care owed by managers and managing members in a variety of ways. See J. William Callison & Allan W. Vestal, “They’ve Created a Lamb with Mandibles of Death:” Secrecy, Disclosure, and Fiduciary Duties in Limited Liability Firms, 76 IND. L.J. 271, 281-91 (2001). Several LLC acts adopt a standard of care akin to gross negligence. See, e.g., FLA. STAT. § 608.4225(b) (LEXIS through the 2013 Reg. Sess.) (“The duty of care is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.”); KY. REV. STAT. ANN. § 275.170(1) (LEXIS through 2013 First Extra. Sess.) (“[A] member or manager shall not be liable, responsible, or accountable in damages or otherwise to the [LLC] or the members of the [LLC] for any action taken or failure to act on behalf of the [LLC] unless the act or omission constitutes wanton or reckless misconduct.”); RULLCA § 409(c), 6B U.L.A. 488 (2008) (applying, subject to the business judgment rule, a standard of ordinary negligence). Other states adopt various standards including good faith, ordinary negligence, and acting “In a manner believed to be in the best interests of the company.”). See Callison & Vestal, supra at 283. Statutes based upon ULLCA or RULLCA provide that the operating agreement may not “unreasonably reduce” the standard of care and leave the operating agreement free to impose more strict standards. See RULLCA § 110(d)(3), 6B U.L.A. 442 (2008). For discussions of the duty of care, see BISHOP AND KLEINBERGER, supra note 1, ¶ 10.02; RIBSTEIN AND KEATINGE, supra note 1, § 9:2.

520 The enforceability of covenants not to compete is largely dependent on state law. Terence Floyd Cuff, Drafting Partnership and LLC Agreements: Part 4, BUS. ENTITIES, Nov./Dec. 2001, 12.

521 The extent to which, if at all, members and managers of an LLC must present opportunities germane to the LLC’s business or may engage in other business activities is a subject that usually requires particular attention and negotiation when organizing a venture. Care needs to be taken to reconcile the provision with the purpose of the LLC (Item IV(a)(2) and note 35 above).
No Other Duty of Loyalty Issues:

Good Faith/Fair Dealing:

Member Approval of Conflict of Interest Transaction:

☐ Unanimous

☐ Standard for Judicial Approval of Conflict of Interest Transactions between LLC and Managers:

☐ Entire Fairness

☐ Arm’s Length

☐ No

522 An operating agreement is a contract, and as such incorporates an implied duty of good faith and fair dealing. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) (“every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”). Under the RULLCA § 110(c)(5), an operating agreement may not eliminate the obligation of good faith and fair dealing, set forth expressly in that act in § 409(d), but the operating agreement may prescribe the standard by which the performance of the obligation of good faith and fair dealing will be measured. RULLCA § 110(d)(5), 6B U.L.A. 442 (2008). See also DEL. CODE ANN. tit. 6, § 110(b)(1) (LEXIS through 2014 Fiscal Sess.); KY. REV. STAT. ANN. § 275.003(7) (LEXIS through 2013 First Extra. Sess.); RPLLCA, supra note 5, § 110(b)(1); id. § 110(c)(5). There is, however, significant disagreement as to the meaning of “good faith.” For example, in Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006), the Delaware Supreme Court determined that good faith is a “subsidiary element” of the duty of loyalty. The scope of what constitutes good faith or the absence of bad faith is recognized as being murky at best. In the Disney decision the Delaware Chancery court acknowledged that it likely is impossible to articulate a broad enough definition to capture the “universe of acts that would constitute bad faith.” In re Walt Disney Co. Derivative Liti., 907 A.2d 693, 755 (Del. Ch. 2005). See also The Committee on Corporate Laws, Changes in the Revised Model Business Corporation Act --- Amendment Pertaining to the Liability of Directors, 45 BUS. LAW. 695, 697 (1990). The phrase “acts or omissions not in good faith” is “easily susceptible to widely differing interpretations, especially retroactively” and was determined to be too imprecise a standard or duty to be barred from being waived in a corporation’s certificate of incorporation. Instead, the breadth of what might constitute nonwaivable bad faith has been narrowed under the Model Business Corporation Act to include acts or omissions (i) with respect to which the director derives a financial benefit to which he or she is not entitled or (ii) that are either intentionally criminal or intentionally designed to harm the corporation.

The Disney decision refers to the case law in this area as a “fog of . . . hazy jurisprudence,” but “[t]o act in good faith, a director must act at all times with an honesty of purpose and in the best interests and welfare of the corporation,” which includes not intentionally disregarding his or her duties as a fiduciary. Be aware that “good faith” may be a fiduciary obligation while “good faith and fair dealing” is a rule of contract law.

523 For a case interpreting and applying a similar “arms-length” provision in an operating agreement, see Flight Options International, Inc. v. Flight Options, LLC, C.A. No. 1459-N, 2005 WL 679924 (Del. Ch. 2005), concluding that the basis for evaluating a transaction under that standard is whether the price and other terms of the transaction “would have been the outcome of an arms-length negotiation.” In that case, absent a process for ratifying the manager’s determination that the terms of a self-interested transaction were equivalent to what would have been negotiated in an arms-length transaction, the court concluded that the manager had the burden of demonstrating that its determination met that standard. The court, in footnote 34, recognized that this standard was
Management fee and arrangement: 524

________________________________________________________________________
________________________________________________________________________

Titles of certain managers, if any:

________________________________________________________________________
________________________________________________________________________

Compensation of managers, if any: 525

________________________________________________________________________
________________________________________________________________________

Manager Information: 526

☐ All books and records
☐ Same rights as members
☐ All books and records pertinent to discharge of responsibilities as a manager

Other (describe):

Exculpation and Indemnification of Managers.

Other Matters

less onerous than the “entire fairness” standard but required proof that the price was equivalent to what would have been achieved after “real negotiations - the process of give and take.” Id. at n. 32.

524 Holding equity in an LLC, including a “carried interest,” typically makes the manager a partner for tax purposes. See Rev. Rul. 69-184, 1969-1 C.B. 256.

525 Compensation of the managers needs to be addressed either in the operating agreement or in a separate management agreement between the LLC and the manager. Note that, if the manager is not a member, under most LLC acts the manager will have no voice with respect to amendment of the operating agreement, including those provisions addressing the manager’s responsibilities and compensation. For that reason, some managers may prefer that all compensation issues be set forth in a separate management agreement so that it constitutes a bilateral agreement between the LLC and the manager that is enforced separately from the operating agreement. In contrast, where the manager is also a member, care must be taken to correctly describe the compensatory relationship as distinct from the economic rights of membership.

526 While some LLC acts expressly afford managers rights to inspect the books and records of the LLC (see, e.g., DEL. CODE ANN. tit. 6, § 18-305(b) (LEXIS through 2014 Fiscal Sess.)), many LLC acts are silent as to a manager’s right to access books and records. To the extent the state’s statute is silent or to the extent it contains a provision that is modifiable and modification is desired, the topic should be addressed in the operating agreement.
A. Foreign qualifications:\(^{527}\)

- [ ] Yes
- [ ] No

If yes, specify where and registered agent/office. Keep in mind that each state has its own requirements as to when state registration is required.

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Capital contribution/subscription agreement needed:\(^{528}\)

- [ ] Yes
- [ ] No

If yes, then provide for:

- Disclosure that membership interests are not registered securities
- Acquisition of membership / economic interests
- Acceptance of contribution; consideration
  - Cash
  - Letter of Credit

\(^{527}\) Care needs to be taken at the time of organization to investigate the laws of the foreign states in which the LLC will do business or own assets in order to determine whether qualification to transact business will be required, consequences for failure to do so, and, more importantly, whether the LLC and its members may be subject to tax in the state. Thereafter, the issue needs to be continuously reviewed to account for actual business activities. See generally BISHOP AND KLEINBERGER, supra note 1, ¶ 5.09; RIBSTEIN AND KEATINGE, supra note 1, § 13:3.

\(^{528}\) A subscription agreement usually will include standard securities law (including applicable state Blue Sky laws) representations and warranties and a questionnaire establishing the prospective member to be an accredited investor under Regulation D promulgated under the 1933 Act. Robert R. Keatinge & Thomas E. Rutledge, LLC and LLP Interest as Securities, CHOICE OF ENTITY: 2008 UPDATE, A.L.I.-A.B.A. (Feb. 13, 2008), in VCN0213 A.L.I.-A.B.A. 177. For a discussion of the relationship of federal and state securities laws to LLC membership interests, see BISHOP AND KLEINBERGER, supra note 1, ¶¶ 11.01-03; RIBSTEIN AND KEATINGE, supra note 1, § 14:2.
Secured promissory note
Personal guaranty of company debt (if permitted by state law)
Representations as to investor suitability standards; other standards
Representations as to non-foreign person status; residence
Representations that all requested information was made available
Representations that investment intent only
Indemnification as to representations; security therefor
Transferability
Consider legal review of other offering documents
Other: __________________________________________________________
_______________________________________________________________
Business already in operation as a general or limited partnership or sole proprietorship:
☐ Yes
☐ No
Transfer of documents of assets in exchange of capital contribution
Bill of sale for assets (request listing from client)
Assignment for intangible assets and other assets
Tax considerations for initial contribution (book-up; taxable event, etc.)
Tradename registrations with Secretary of State:
________________________________________________________________________
Advice given that name registration of company and of tradename does not give trademark protection:
☐ Yes
☐ No
Intellectual Property Work Referred to: ________________________________
Name of accountants; other legal advisors:

**Tax Advisor**

<table>
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<tr>
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**Estate planning attorney**

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**Financial advisor**

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**Other Advisor**

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<td>Address:</td>
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Dissolution, Winding up & Termination

A. Voluntary Dissolution:

Consent of members

☐ Unanimous consent of the members or classes of members
☐ Consent of _______ Number or _______% of the members
☐ Will of any one member
☐ Other: ________________________________________________.

Specific event

☐ Upon Sale of substantially all assets of the LLC
☐ Event making it unlawful to carry on business
☐ Dissociation of key person
☐ Date or Event Certain
☐ Other: ________________________________________________.

Involuntary Dissolution:

Judicial Dissolution

529 See generally BISHOP AND KLEINBERGER, supra note 1, ¶¶ 9.01-.06; RIBSTEIN AND KEATINGE, supra note 1, § 11:5, app. 11-5.

530 The states set a variety of default thresholds for voluntary dissolution. See, e.g., ALA. CODE § 10-12-37(2) (LEXIS through 2014 Reg. Sess.) (“written consent of all members”); ARK. CODE ANN. § 4-32-901(2) (LEXIS through the 2014 Fiscal Sess.) (“written consent of all members”); CONN. GEN. STAT. § 34-206(2) (LEXIS through P.A. 14-211 (except 14-175, 14-187 and 14-205) (“at least a majority in interest of the members”); MD. CODE ANN., Corps & Ass’ns § 4A-902(a)(2) (LEXIS Emergency Legis. through 2013 Second Reg. Sess.) (“the unanimous consent of the members”); R.I. GEN. LAWS § 7-16-39(3) (LEXIS through 2013 Reg. Sess.) (“majority of the capital values of all membership interests which have not been assigned”); TEX. BUS. ORGS. CODE ANN. §101.552 (LEXIS through 2013 3rd Called Sess.) (“a majority vote of all the members”). Often the statute expressly permits modification of this threshold. See, e.g., CONN. GEN. STAT. § 34-206 (LEXIS through P.A. 14-211 (except 14-175, 14-187 and 14-205) (“unless otherwise provided in writing in the articles of organization or operating agreement”); R.I. GEN. LAWS § 7-61-21(b) (LEXIS through 2013 Reg. Sess.) (“Unless otherwise provided in the articles of organization or operating agreement”); TEX. BUS. ORGS. CODE ANN. § 101.052 (LEXIS through 2013 3rd Called Sess.) (company agreement controls except as to specified non-waivable matters). For a discussion of voluntary dissolution by the consent of members, see BISHOP AND KLEINBERGER, supra note 1, ¶ 9.02[3]; RIBSTEIN AND KEATINGE, supra note 1, § 11:5.

531 This is a difficult definition, and consideration should be given to defining it in the operating agreement.
Administrative dissolution\textsuperscript{533}

Authority to reverse administrative dissolution?
Agreement to allow a court ordered dissolution\textsuperscript{534}

Oppression\textsuperscript{535}
Inability to operate except at a loss\textsuperscript{536}
Deadlock
Not reasonably practical standard
Winding Up\textsuperscript{537}

Who has authority to wind up?

\textsuperscript{532} State LLC acts provide for judicial dissolution under specified circumstances. They typically include, at minimum, circumstances where it is not reasonably practicable to carry on the business in conformity with the operating agreement. See, e.g., DEL. CODE ANN. tit. 6, § 18-802 (LEXIS through 2014 Fiscal Sess.); KY. REV. STAT. ANN. § 275.290 (LEXIS through 2013 First Extra. Sess.); N.Y. LTD. LIAB. CO. LAW § 702 (Consol. 2014); TEX. BUS. ORGS. CODE ANN. § 11.314 (LEXIS through 2013 \textsuperscript{3rd} Called Sess.). Some states also provide for judicial dissolution in the event of a deadlock. See FLA. STAT. § 608.449(2)(a) (LEXIS through the 2013 Reg. Sess.). Certain states may permit the operating agreement to provide for additional bases for judicial dissolution. Despite state statutes providing for judicial dissolution, it can be very difficult to obtain. See Allan G. Donn, \textit{Freedom of Contract and Boilerplate Provisions of Business Entity Agreements}, J. PASSTHROUGH ENTITIES, March/April 2005, 11 at 16-18. For discussions on judicial dissolution, see \textsc{bishop and kleinberger}, \textit{supra} note 1, ¶ 9.02[7]; \textsc{ribstein and keatinge}, \textit{supra} note 1, § 11.5. Under Delaware law, it is possible for the operating agreement to waive the right to judicial dissolution. See R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, No. 3803-CC, 2008 Del. Ch. LEXIS 115 (Aug. 19, 2008). Conversely, under RULLCA, judicial dissolution of an LLC is justified on the bases set forth in subsections (4) and (5) of Section 701(a). See RULLCA § 701(a), 6B U.L.A. 506 (2008). RULLCA provides that the operating agreement may not "vary the power of a court to decree dissolution in the circumstances specified in Sections 701(a)(4) and (5)." RULLCA, \textit{supra} note 5, § 110(c)(7). Consequently, in a jurisdiction in which RULLCA has been adopted (and presuming no modification of those provisions in the state enactment), it would not be possible to eliminate the right of a member to move, on the statutorily defined basis, for judicial dissolution of an LLC.

\textsuperscript{533} For example, administrative dissolution for failure to pay taxes or file an annual report. KY. REV. STAT. ANN. § 14A.7-010 (LEXIS through 2013 First Extra. Sess.) (administrative dissolution for failure to file annual report, maintain a registered agent and office, or for failure to respond to interrogatories from the Secretary of State); TEX. BUS. ORGS. CODE ANN. § 11.251 (LEXIS through 2013 \textsuperscript{3rd} Called Sess.) (involuntary termination by Secretary of State on various grounds); TEX. TAX CODE ANN. § 171.251; id. §171.301 (administrative forfeiture for failure to file report or return). For a discussion on administrative dissolution, see \textsc{bishop and kleinberger}, \textit{supra} note 1, ¶ 9.02[6].

\textsuperscript{534} Consider whether an operating agreement can bestow subject matter jurisdiction of this nature on a court. For example, "if X occurs, dissolve under supervision of court."

\textsuperscript{535} Another vague concept that is subject to different interpretations. Consider defining in operating agreement.

\textsuperscript{536} Entities often operate at a tax loss and guaranteed payments may be structured to generate a loss for tax purposes, so this limitation may not be appropriate.

\textsuperscript{537} Process of settling accounts and liquidating assets for the purpose of final distributions to the members. See generally \textsc{bishop and kleinberger}, \textit{supra} note 1, ¶ 9.03; \textsc{ribstein and keatinge}, \textit{supra} note 1, § 11.8. Consider providing for who shall be responsible for filing documents, paying creditors, marshaling assets. Coordinate with tax advisor regarding timing and characterization of payments, state and federal filings.
Articles or Certificate of Dissolution
Publication requirement (Notice to known and unknown creditors)
Change in fiduciary duties?
Termination

<table>
<thead>
<tr>
<th>Dispute Resolution</th>
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<tbody>
<tr>
<td>A. Mediation required:</td>
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<tr>
<td>☐ Yes</td>
</tr>
<tr>
<td>☐ No</td>
</tr>
</tbody>
</table>

Arbitration:

| ☐ Yes |
| ☐ No |

Initiation of arbitration:

Who? .
How? .

☐ Single arbitrator
or
☐ Panel

538 It is important to appreciate that the “termination” of an LLC is separate and distinct from its dissolution. The statutes generally provide that the dissolution of an LLC is simply the description of a stage of its existence, typically one during which the LLC is restricted to activities appropriate to its winding up and liquidation. See, e.g., ALA. CODE § 10A-5-7.04(a) (LEXIS through 2014 Reg. Sess.); KY. REV. STAT. ANN. § 275.300(2) (LEXIS through 2013 First Extra. Sess.); RPLLC § 707(a), 67 BUS. LAW. at 176; RULLCA § 702(b)(2)(F), 6B U.L.A. 507 (2008); see also BISHOP AND KLEINBERGER, supra note 1, ¶¶ 9.03[1] and 9.06 (federal tax consequences). Typically, except as otherwise provided therein, the operating agreement, along with its various obligations and responsibilities, will continue to be in place and enforceable during the winding up and liquidation phase. The operating agreement should address when in the winding up and liquidation phase the obligations existing under the operating agreement will come to an end. For example, a provision in the operating agreement precluding any members from competition with the company should not remain in place indefinitely after dissolution. At the same time, however, it may be inappropriate to provide that it ends upon the filing of the articles of dissolution because doing so may diminish the value of company assets in liquidation. Likewise, obligations to pay compensation to a manager need to be addressed so those do not continue as indefinite obligations.

539 Generally, this is a non-binding procedure before a single neutral third party mediator who does not judge the case but helps facilitate a discussion and eventual resolution of the dispute. Details that should be included in a mediation provision include: (1) notice to other parties; (2) timing issues; (3) appointing a mediator; (4) obligation to mediate in good faith; and (5) obligation to provide funds to satisfy costs of mediation.

540 If arbitration is selected over litigation as the form for dispute resolution, the operating agreement needs to address the provider, forum and venue, and cost shifting (if any) that would be applicable in the case of litigation.
A. Is LLC being organized in a jurisdiction with series:⑤

---

⑤ For example, each party will select an arbitrator and the two selected arbitrators will select a third arbitrator.

⑤ Waiver of jury trial clauses are generally enforceable everywhere except Georgia and California. See Bank S., N.A. v. Howard, 444 S.E.2d 799, 800 (Ga. 1994) (pre-dispute contractual waivers of jury trials unenforceable in cases tried under Georgia law); Grafton Partners L.P. v. Superior Court, 36 Cal. 4th 944, 967 (Cal. 2005).
□ Yes
□ No
Are series desired: 544

□ Yes
□ No
Authority to organize an individual series: 545

□ Managers
□ Members

Membership of series:

□ LLC
□ All Members
□ Other

Management of series: 546


544 The series concept arose in the context of statutory trusts utilized for asset securitization and the organization of investment companies/mutual funds. See Thomas E. Rutledge, Again, For the Want of a Theory: The Challenge of the “Series” to Business Organization Law, 46 Am. Bus. L.J. 311, 313-14 (2009). In recent years the concept has spread to LLCs, and the utilization of the series concept has expanded beyond its original applications. Still, there remain significant issues with respect to the utilization of the series, including with respect to (i) the treatment of the series under bankruptcy law; (ii) whether the “internal shields” will be respected in jurisdictions in which the series is not incorporated into the domestic LLC act; (iii) federal tax classification, including whether an individual series is an “eligible entity” able to independently elect its classification; (iv) issues of state tax classification; (v) issues of nexus for purposes of state tax treatment; (vi) issues of apportionment, for purposes of state taxation, between individual series and between a series and the parent LLC; (vii) issues with respect to the granting of a security interest in assets that are associated with but not titled in the names of a particular series; (viii) issues, in the states that do not expressly provide a rule, as to whether an individual series may contract in its own name, sue and be sued in its own name, or hold title to property in its own name. See also Prefatory Note to RULLCA, 6B U.L.A. 408 (2008); Rutledge, supra at 321-26; Allan G. Donn, et al., Series LLCs, Business Entities: 2014 Update, A.L.I.-A.B.A. (Feb. 1, 2014), in VCVA0218 A.L.I.-A.B.A. 57.

545 Determine whether the authority to organize an individual series of the LLC and associate LLC property therewith will be a determination of the managers or the members and the appropriate threshold thereof.

546 The LLC acts providing for series universally provide that the individual series may have management different from that of the “parent” LLC. In an operating agreement for a series LLC, a provision needs to be made for how each series will be managed.
Manager employment agreement(s)

A. For any member that is an entity, due formation and valid existence.

Member has read the agreement.

Member not named on OFAC SDN List.

Representation of accredited investor status and other disclosures required pursuant to applicable federal and state securities laws.

Schedule of responsibilities

<table>
<thead>
<tr>
<th>Task</th>
<th>Party Responsible</th>
<th>Promised to Client by</th>
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<tbody>
<tr>
<td>Articles/Certificate of Organization</td>
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<tr>
<td>Operating Agreement</td>
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<tr>
<td>Capital contribution agreement^548</td>
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<tr>
<td>Manager employment agreement(s)</td>
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^547 A form series agreement has been published. See WHITMIRE DRAFTING, supra note 65, app. A.28.

^548 In many instances the LLC and the contributing member will enter into a separate contribution agreement or will add more detailed information concerning the contributed property in schedules or exhibits to the operating agreement. It often is good practice to have some or all of the members execute subscription agreements, purchase agreements or contribution agreements that contain representations, warranties, and covenants for transactions of this nature. A contribution agreement between the LLC and the contributing member often is appropriate when property other than money is contributed. That agreement will be similar to a purchase and sale agreement for the property involved. It usually will include customary representations, warranties, and covenants in respect of the property being conveyed to the LLC. For analysis of capital-related obligations imposed by LLC statutes, see BISHOP AND KLEINBERGER, supra note 1, ¶ 6.05; RIBSTEIN AND KEOATINGE, supra note 1, §§ 5:1-.8.

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TEXTS CITED

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UNIFORM AND MODEL ACTS CITED

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REVISED UNIFORM LIMITED LIABILITY COMPANY ACT, 6B U.L.A. 407 (2008) (‘‘RULLCA’’)

70
UNIFORM LIMITED LIABILITY COMPANY ACT, 6B U.L.A. 545 (2008) (“ULLCA”)
Exhibit B
Outline of Fiduciary Duties
But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?[^549]

The bare assertion that someone is a fiduciary may be grammatically correct, but seldom if ever does it actually convey any information. “Mr. X is a fiduciary” is a conclusory statement based upon an assessment (correct or otherwise) as to a particular relationship in which we must assume Mr. X is a participant. “Mr. X is a fiduciary” is only the subject; it requires a predicate in order to convey information. Actual information, subject and predicate, exists in: “Mr. X is a fiduciary to Y such that he must/must not ….”

The last element, “such that he must/must not,” is crucial to the fiduciary analysis. Different fiduciary duties impose different obligations to either act or not act in particular circumstances. Put another way, there are different duties of care and there are different duties of loyalty.

Ultimately, the following issues must be addressed:[^550]


[^550]: This discussion is almost exclusively focused upon Kentucky law. It may not be assumed that the principles here reviewed and the rules recited are equally applicable in other jurisdictions. For example, while in a Kentucky member-managed LLC it is clear, absent contrary private ordering, that a member owes fiduciary obligations, whether a member in a Delaware organized LLC owes fiduciary obligations is open to dispute. Contrast Myron T. Steele, Freedom of Contract and Default Contractual Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies, 46 AM. BUS. L.J. 221 (Summer 2009) (positing that there are no default fiduciary duties in limited partnership or LLCs organized under Delaware law) with Auriga Capital Corp. v. Gatz Properties, LLC, 40 A.3d 389, 2012 WL 361677 (Del. Ch. 2012) (holding that here exist default fiduciary duties in Delaware LLCs) and Auriga Capital Corp. v. Gatz Properties, LLC, 40 A.3d 839 (Del. 2012) (holding LLC manager had violated contractually defined standards and chastising Chancellor Steele for reviewing hypothetical of what are the standards absent a contractually agreed standard and declaring those portions of his opinion dicta.). Then, in Feeley v. NHAOCG, LLC, 2012 WL 5949209, *8-10 (Del. Ch. Nov. 28, 2012), Vice Chancellor Laster adopted the reasoning and path of analysis employed by Chancellor Strine in Auriga Capital, writing “Until the Delaware
Who is a Fiduciary?

To Whom are They a Fiduciary?

When Does the Fiduciary Relationship Begin?

When Does the Burden of the Fiduciary Relationship End?

What Affirmative and Negative Obligations Burden the Fiduciary?

By What Means Are the Fiduciary Obligations Enforced?

A. Who is a Fiduciary?

A fiduciary relationship begins with a relationship of unequal position, knowledge or skill.

The [fiduciary] relation[ship] may exist under a variety of circumstances; it exists in all cases where there has been a special confidence reposed in one who in equity and good conscience is bound to act in good faith and with due regard to the interests of the one reposing confidence. 551

On the other hand, a fiduciary relationship does not exist between the parties to an arms-length contractual relationship. For example, in Gonzalez v. Imaging Advantage, LLC, the court observed:

Gonzalez’s claim for breach of fiduciary duty fails outright. Basic contractual relationship (such as the contract between Gonzalez and IA [Imaging Associates]) do not give rise to fiduciary duties. 552

Particular relationships are defined by statute as being fiduciary in nature, a conclusion drawn not so much from the use of the word fiduciary (although that does happen), but rather the definition of duties owed; if the duties are fiduciary in nature then the person owing them is a fiduciary:

Directors of a Corporation 553

General Partners 554

Supreme Court speaks, the long line of Court of Chancery precedents and the Chancellor’s dictum provide persuasive reasons to apply fiduciary duties by default to the manager of a Delaware LLC.” Amendments to the Delaware LLC Act adopted in 2013 (Del. Code Ann. tit. 6, § 19-1104) expressly incorporate “the rule of law and equity relating to fiduciary duties” into the LLC Act, thereby adopting the view that there exist fiduciary duties in the absence of a contractual elimination or modification. But even as amended, the Delaware LLC Act is silent as to who owes those duties and to whom they are owed.


553 Ky. Rev. Stat. Ann. § 271B.8-300(1); id. § 273.215(1). Under prior law, the relationship between a corporate director and the corporation was expressly labeled as being “fiduciary” in nature. See Ky. Rev. Stat. Ann. § 271.365 (enacted 1946 Ky. Acts, ch. 141, § 1) (“Officers and directors shall be deemed to stand in a fiduciary relation to the corporation, and shall discharge the duties of their respective positions in good faith, and with that diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions.”).
Members in a Member-Managed LLC\textsuperscript{555}  
Real Estate Agents\textsuperscript{556}  
Common Law Agents\textsuperscript{557}  
Common Law Employees\textsuperscript{558}  
Trustees of a Statutory Trust\textsuperscript{559}  

Other relationships are defined as not being fiduciary in nature:

Limited Partners\textsuperscript{560}  
Members in a Manager-Managed LLC\textsuperscript{561}  

\textsuperscript{554}KY. REV. STAT. ANN. § 362.1-404(1) ("The fiduciary duties a partner owes include…."). The "include" is non-uniform.  
\textsuperscript{555}KY. REV. STAT. ANN. §§ 275.170(1), (2).  
\textsuperscript{556}201 KAR 11:121(1)(4)(e) ("the following fiduciary duties owed to the licensee’s client").  
\textsuperscript{557}"Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act." CSX Transp., Inc. v. First Nat'l Bank, 14 S.W.3d 563, quoting McAlistier v. Whitford, 36 S.W.2d 317, 319 (Ky. 1962). See also RESTATEMENT (3\textsuperscript{rd}) OF AGENCY § 1.01 ("Agency is the fiduciary relationship…."); id. § 8.05; id. § 8.08.  
\textsuperscript{558}RESTATEMENT (3\textsuperscript{rd}) OF EMPLOYMENT LAW § 8.01(a) (Tentative Draft No. 3 (Apr. 8, 2010)) ("Employees owe a duty of loyalty…."); Stewart v. Kentucky Paving Co., Inc., 557 S.W.2d 438 (Ky. App. 1977).  
\textsuperscript{559}KY. REV. STAT. ANN. § 386A.5-050(1) ("Subject to KRS 386A.5-010(2), in exercising the powers of trusteeship, a trustee shall act in good faith, on an informed basis, and in a manner the trustee reasonably believes to be in the best interests of the statutory trust."); id. § 386A.5-050(2) ("A trustee shall discharge his or her duties with the care that an ordinarily prudent person in a similar position would reasonably believe appropriate under similar circumstances."). See also Conlon v. Haise, No. 2014-CA-001581-MR, 2016 WL 5485531, n. 3 (Ky. App. Sept. 30, 2016) (cataloguing certain relationships as being or not as being fiduciary in nature).  
\textsuperscript{560}KY. REV. STAT. ANN. § 362.2-305(1) ("A limited partner does not have any fiduciary duty to the limited partnership or to any other partner solely by reason of being a limited partner.").  

"Under Kentucky law, fiduciary duties are generally concomitant with the responsibility for management of the LLC." Xcell Energy & Coal Co., LLC v. Energy Inv. Grp., LLC, 2014 WL 2964076, at *6 (Del. Ch. June 30, 2014); see also Patmon v. Hobbs, 280 S.W.3d 589, 591 (Ky. Ct. App. 2009) ("one entrusted with active corporate management, such as officer or director or manager-member, occupies fiduciary relationship"). A Kentucky LLC can be managed either by its members or by a manager. KRS § 275.025(1)(d). If an LLC is member-managed, then the members have fiduciary duties. Conversely, if the LLC is manager-managed, then the manager owes fiduciary duties, but the members do not. Xcell, 2014 WL 2964076, at *6 ("Unless provided otherwise in the LLC’s operating agreement, if a Kentucky LLC is managed by its managers, then, by Kentucky statute, its members do not manage the LLC and thus do not owe fiduciary duties to the LLC"); Thomas E. Rutledge, Shareholders Are Not Fiduciaries: A Positive and Normative Analysis of Kentucky Law, 51 U. Louisville L. Rev. 535, 547 (2013) ("By statute, the members in
Corporate Shareholders

In other instances it is necessary to ascertain the aspects of the particular relationship to determine whether or not it is fiduciary in nature. As addressed by the Sixth Circuit in Sallee v. Fort Knox National Bank:

To make out a claim that a fiduciary relationship existed, the party claiming the fiduciary relationship must first show the relationship

a manager-managed limited liability company do not govern the LLC and do not owe fiduciary duties”.

Griffin is a member of Blackrock, a manager-managed LLC. Jones is the manager of Blackrock. Therefore, as a matter of Kentucky law, Griffin does not owe a fiduciary duty to Jones as a member of Blackrock.

The existence (actually the lack of existence) of fiduciary duties inter se the shareholders of a Kentucky corporation is reviewed in depth in Rutledge, Shareholders Are Not Fiduciaries – A Positive and Normative Analysis of Kentucky Law, 51 LOUISVILLE LAW REVIEW 535 (2012-13). A shorter treatment of the same issue is set forth at Rutledge, Minority Shareholder Oppression? - The Problem is Not With the Answer But Rather With The Question, 17 J. PASSTHROUGH ENTITIES 55 (July/Aug. 2014). As long ago as 1917, Kentucky courts recognized that shareholders are not as to one another in a fiduciary relationship. See Haldeman v. Haldeman, 197 S.W. 376, 381 (Ky. 1917) (“A stockholder occupies a position and owes a duty radically different from a director. A stockholder may in a stockholders’ meeting vote with a view to his own benefit: he represents himself only.”). When Kentucky adopted a uniform/model corporate act, it did not adopt a provision addressing fiduciary duties between the shareholders. See Rutledge, More Evidence that Kentucky Law Does Not Recognize Fiduciary Duties Among Shareholders, http://kentuckybusinesseentitylaw.blogspot.com/2013/03/more-evidence-that-kentucky-law-does.html (March 20, 2013). This analytic paradigm was adopted in Griffin v. Jones, 170 F. Supp. 3d 956, 964 (W.D. Ky. 2016), wherein the court held that shareholders of a Kentucky corporation are not as to one another fiduciaries. Therein the court wrote:

In Kentucky, a stockholder does not owe a fiduciary duty. Compare KRS § 271B.7 with KRS § 271B.8-300 and KRS § 271B.8-420. Other states have held that a stockholder may owe a fiduciary duty in the special case of closely-held corporations. See e.g. Crosby v. Beam, 548 N.E.2d 217, 220 (1989) (explaining circumstances in which a stockholder can owe a fiduciary duty to another stockholder under Ohio law). Kentucky has not adopted this rule. Estep v. Werner, 780 S.W.2d 604 (Ky. 1989); Thomas E. Rutledge, Shareholders Are Not Fiduciaries: A Positive and Normative Analysis of Kentucky Law, 51 U. Louisville L. Rev. 535, 535 (2013) (explaining the history of cases and legislation on this issue and advocating that Kentucky not adopt such a rule).


This case requires us to squarely confront an issue that to date no appellate court in this Commonwealth has explicitly ruled upon: whether shareholders in a privately owned corporation owe one another common-law fiduciary duties. Having reviewed the nature of fiduciary relationships in conjunction with the applicable business statutes and our prior case law, we have concluded that our common law does not support imposing fiduciary duties on shareholders. Slip op. at 7.

It would do violence to normal corporate practice and our corporation law to impose a duty on the majority to vote their shares in the minority’s interests as opposed to their interests. Slip op. at 13.


286 F.3d 878, 892 (6th Cir. 2002).
existed before the transaction that is the subject of the action. Second, the party claiming a fiduciary relationship must show that reliance was not merely subjective. Third, the party claiming a fiduciary relationship must show that the nature of the relationship imposed a duty upon the fiduciary to act in the principal’s interest, even if such action were to the detriment of the fiduciary.  

As to the second requirement, the party seeking to have a fiduciary relationship recognized must show more than mere subjective trust. An aggrieved party must also show that he trusted the other party to act as a fiduciary and that such trust was reasonable under the circumstances. Only in rare commercial cases is it reasonable to believe the other party will put your interests ahead of their own.

The Kentucky Supreme Court has observed:

A fiduciary, moreover, is one who has expressly undertaken to act for the plaintiff’s primary benefit. Although fiduciary relationships can be informal, a fiduciary duty does not arise from the universal business duty to deal fairly nor is it created by a unilateral decision to repose trust and confidence; it derives from the conduct or undertaking of the purported fiduciary.  

This is obviously a fact intensive determination, but the burden is high – most business relationships are not fiduciary in nature. As set forth in Crestwood Farm Bloodstock v. Everest Stables, Inc.:  

That the two were friends, even close friends, may well explain why they did business together. But that does not establish a fiduciary relationship – that Crestwood was charged with putting Everest’s interest above its own. Many friends do business together. But not all friends are fiduciaries, and in the world of arms-length commercial negotiations few are. See, e.g., Sallee, 286 F.3d at 891-92 (“[T]he fact that the relationship has been a cordial one, of long duration, [is not] evidence of a [fiduciary] relationship.”) (internal quotation marks omitted); 90 C.J.S. Trusts § 197 (“The mere existence of mutual respect and confidence does not make a business relationship fiduciary.”).  

564 See also CNH Capital America LLC v. Hunt Tractor, Inc., 2013 WL 1310878, *12 (W.D. Ky. March 26, 2013) (after discussing the Sallee standard, the court observed that there was no reason to hold a corporate officer as fiduciary to a corporate creditor, which would have “obligated [the officer] to put [the creditor’s] interests ahead of this own.”).  


Setting forth a tour-de-force recitation of the elements of a fiduciary relationship, the James T. Scatuorchio Racing Stable, LLC v. Walmac Stud Management, LLC, the court wrote:

Under Kentucky law, to establish the existence of a fiduciary duty, a party must demonstrate that: (i) the parties’ relationship existed prior to the transaction that is subject of the claim; (ii) the reliance was not merely subjective but reasonable; and (iii) the nature of the relationship imposed a duty upon the fiduciary to act in the principal’s interest, even if such action were to the detriment of the fiduciary. In re Salle, 286 F.3d at 892; Ballard v. 1400 Willow Council of Co-Owners, Inc., No. 2010-SC-533-DG, 2013 Ky. LEXIS 579, at *33-35 (Ky. Nov. 21, 2013). A fiduciary duty requires more than the generalized business obligation of good faith and fair dealing. See In re Salle, 286 F.3d at 891; see also Gresh v. Waste Servs. Of Am., 311 F. App’x 766, 771 (6th Cir. 2009); Quadrille Bus. Sys. V. Ky. Cattlemen’s Ass’n, 242 S.W.3d 359, 365 (Ky. Ct. App. 2007) (“An ordinary business relationship or an agreement reached through arm’s length transactions cannot be turned into a fiduciary one absent factors of mutual knowledge of confidentiality or the undue exercise of power or influence.” (quotation marks and citation omitted)). “Only in rare commercial cases is it reasonable to believe the other party will put your interest ahead of their own.” In re Salle, 286 F.3d at 892. Rather, “extraordinary facts are necessary” to support such a belief. Id.; see also Crestwood Farm Bloodstock v. Everest Stables, Nos. 13-5688/13-5689, 2014 U.S. App. LEXIS 8751, at *14-15 (6th Cir. May 9, 2014).567

Whether there is a fiduciary duty and what is that duty are questions of law to be resolved by the court.568

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At the onset, it appears Griffin is arguing the circuit court was required to believe Sarah owed him direct fiduciary duties in the contexts he describes above because his complaint alleged that she did, and because factual allegations in a complaint must be taken as true whenever a court considers the propriety of granting a CR 12.02 motion to dismiss. However, a statement to the effect that some form of legal duty exists under a given set of circumstances is not a factual allegation; it is a legal conclusion. Bartley v. Commonwealth, 400 S.W.3d 714, 726 (Ky. 2013) (“[W]hether a legal duty exists is purely a question of law[].”) Accordingly, any statements in Griffin’s complaint regarding legal duties Sarah may have owed him under the facts of this case are entitled to no deference whatsoever. See Rosser v. City of Russellville, 306 Ky. 462, 208 S.W.2d 322, 324 (1948) (“It is the duty of courts to declare conclusions, and of the parties to state the facts from which legal conclusions may be drawn.”).
B. To Whom are They a Fiduciary?

A fiduciary duty arises out of a fiduciary relationship; the duty is owed to the counter-party in the relationship. In certain instances the statute will define who is the counterparty. For example:

<table>
<thead>
<tr>
<th>Fiduciary</th>
<th>Beneficiary</th>
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<tbody>
<tr>
<td>Corporate Directors</td>
<td>KRS § 271B.8-300(1) Duty is owed “to the corporation”</td>
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<td>KRS § 273.215(1) Duty is owed “to the corporation”</td>
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<td></td>
<td>1400 Willow Council of Co-Owners v. Ballard69 Director’s fiduciary duties are owed to the corporation</td>
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<td></td>
<td>Griffin v. Jones570 “to the corporation”</td>
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<td></td>
<td>Patmon v. Hobbs571 “to the corporation”</td>
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<td>Gross v. Adcomm, Inc.572 “to the corporation”</td>
</tr>
<tr>
<td>General Partners</td>
<td>KRS § 362.1-404(1) “The fiduciary duties a partner owes the partnership and the other partners”</td>
</tr>
<tr>
<td>Members in a Member-Managed LLC</td>
<td>KRS § 275.170(1) Fiduciary duty of care owed to the LLC and the other members</td>
</tr>
<tr>
<td></td>
<td>KRS § 275.170(2) Fiduciary duty of loyalty owed to the LLC573</td>
</tr>
</tbody>
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569 430 S.W.3d 229 (Ky. 2013).

[I]t is generally understood that the common law fiduciary duty owed by members of the board of directors or officers of a corporation runs directly to the corporation and the shareholders/members as a whole. Hence, a board member or officer owes no common-law fiduciary duty directly to an individual shareholder/member. Likewise, the statutory duties respectively imposed upon a board member, corporate officer, or even a managing member of a limited liability company … run directly to the corporation or limited liability company, not the members or shareholders.

572 478 S.W.3d 396, 400 (Ky. App. 2015) (“Officers and directors owe fiduciary duties to the corporation, not the shareholders.”).
If the fiduciary duty is not owed to a particular person, then a third-party, as to that fiduciary, cannot assert there has been a breach of duty except through some type of authorized representational capacity such as where a:

parent, as next friend of a minor, may sue the trustee of a trust for child’s benefit to enforce the terms of the trust; or

shareholder of corporation may on the corporation’s behalf initiate a derivative action.574

It is important to focus upon the words of the statute both as to who owes the duty and to whom the duty is owed. If those parameters have been determined by the General Assembly then there will seldom if ever be additional obligors or beneficiaries save and except as created by private ordering. As observed by the Kentucky Supreme Court in *Pannell v. Shannon*:575

[The] common law of business entities has largely been abrogated by the adoption of the various statutes like the Kentucky Business Corporation Act and the Kentucky Limited Liability Company Act. In fact, “limited liability companies are creatures of statute,” controlled by Kentucky

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574 KY. REV. STAT. ANN. § 271B.7-400. Kentucky rigorously applies the direct versus derivative distinction, and has no exception from its requirements for closely-held corporations. The decision rendered in *Smith v. Tarten*, 305 F. Supp. 3d 733 (E.D. Ky. 2018) illustrates this principle. See also Opinion and Order dated April 25, 2011, *Fenley v. Fencroft Company*, No. 10-CI-0998 (Jeff. Circuit Ct, Div. 2, Shake, J.) (discussing ALI PRINCIPLES OF CORPORATE GOVERNANCE § 7.01, “While the ALI materials are certainly reasonable and make interesting reading, they are not the law of Kentucky and there exists at this time no exception [from the derivative action rules] for closely held corporations.”); Order dated April 15, 2010 (Jeff. Circuit Court, Div. 4, Cunningham, J.), *Snyder v. Baumgardner*, No. 09-CI-04445 (rejecting the suggestion that pursuant to Section 7.01(d) of the PRINCIPLES OF CORPORATE GOVERNANCE the plaintiffs be permitted to proceed on an individual, rather than a derivative basis, writing that the Principles had not been adopted by Kentucky courts).

Revised Statutes (KRS) Chapter 275,” *Turner v. Andrew*, 413 S.W.3d 272, 275 (Ky. 2013) (quoting *Spurlock v. Begley*, 308 S.W.3d 657, 659 (Ky.2010)), not primarily by the common law. To the extent that common law doctrines could arguably govern limited liability companies, the Kentucky Limited Liability Company Act “is in derogation of common law,” KRS 275.003(1), and the traditional rule of statutory construction that “require[s] strict construction of statutes which are in derogation of common law shall not apply to its provisions.” *Id.* Thus, to the extent the statutes conflict with common law, the common law is displaced.

This Court must therefore first look at the controlling statutory law.576

An example of this problem is the decision rendered in *Mason v. Underhill*577 where, notwithstanding that as of the time of the drafting of the limited partnership agreement at issue Kentucky had adopted both the Uniform Partnership Act (1914) and the Revised Uniform Limited Partnership Act (1985), neither of which was actually mentioned, the Court quoted *Meinhard v. Salmon* at length in describing what are the fiduciary duties of the general partner of a limited partnership. Of course the statutorily defined fiduciary standards578 are materially different from the language of *Meinhard v. Salmon*.

This is an area as to which reference to the law of Delaware can be particularly troubling. While Kentucky courts oft look to those of Delaware for guidance as to points of particularly corporate law when the issue is not squarely addressed by Kentucky law (whether statutory or common),579 care needs to be taken to assure that the rules and principles of Kentucky law, especially positive law, are not set aside. To provide an example from outside the fiduciary context, under the Delaware General Corporation Law the shareholders may act outside of a meeting by majority action.580 In contrast, in Kentucky the shareholders of a business corporation may act outside of a meeting by unanimous consent581 or, if so authorized by the articles of incorporation, by a threshold not lower than 80% of the shareholders.582 Obviously the simple majority threshold of Delaware law is both different and more relaxed than in Kentucky law. That differential is, however, of no import. The two rules are simply different; neither is better or worse than the other.583

576 425 S.W.3d at 68: 2014 WL 1101472, *7. *See also Roethke v. Sanger*, 68 S.W.3d 352, 358 (Ky. 2001) (“[R]egardless of any common law theories, the existence or nonexistence of a partnership in 1992 … was governed by the Uniform Partnership Act … adopted as the law of Kentucky in 1954. Thus the facts of the case are governed, not by pre-existing common law cases, but by the following statutory provisions.”).


578 *See KY. REV. STAT. ANN.* § 362.250(1); *id.* § 362.447; *see also id.* §§ 362.1-404(2), (3); *id.* §§ 362.2-408(1), (2), (3).

579 *See, e.g.*, *Bacigalupo v. Kohlhepp*, 240 S.W.3d 155, 157 (Ky. App. 2007) (“Delaware has long been a bastion for corporate law and its development” and this Court “has previously adopted Delaware case law when examining corporate statutes…”).

580 *See DEL. CODE ANN.* tit. 8, § 228(a).

581 *See KY. REV. STAT. ANN.* § 271B.7-040.

582 *See KY. REV. STAT. ANN.* § 271B.7-040(2).

583 *See also Rutledge, Going to Delaware (?)*, J. PASSTHROUGH ENTITIES, July/Aug. 2013, 45.
The caution is especially applicable as to the existence and scope of fiduciary duties. In Delaware the law of fiduciary duties has been left to the courts, most particularly the Chancery Court. The DGCL does not contain provisions setting forth the fiduciary duty of those who are directors or officers of a Delaware corporation. The Delaware LLC Act only references the existence of fiduciary duties in LLC, without providing any further detail thereon, a provision added only to resolve, to the extent of the language, whether or not fiduciary duties as a default exist in Delaware LLCs. While Delaware has adopted the Revised Uniform Partnership Act (1997), including § 404 thereof, it defining the fiduciary duties of partners, it did not adopt RUPA §§ 103(b)(3) and (4), they limiting the modification of those duties.

Delaware’s exclusion of statutory fiduciary duties is in marked contrast to the proactive positive law approach utilized in Kentucky. The Kentucky Business Corporation and Nonprofit Corporation Acts provide detailed formulae of the fiduciary duties and by directors and officers. Those same acts go on to detail the standard of culpability for monetary damages and allocate the burden of proof to the plaintiffs. The Kentucky adoption of RUPA while modifying the formulae of RUPA § 404 defines the fiduciary duty of partners. The LLC Act has since its adoption in 1994 defined the fiduciary duties found in LLCs, defined who owes those duties (as well as who does not) and to whom the duties are owed. Kentucky, in contrast with Delaware, has by statute defined numerous (sometimes all) aspects of the fiduciary duties of participants in various organizational forms. For that reason, reference to Delaware law will be oft inappropriate. Rather, reference to Delaware law will be appropriate if and only if Delaware is integrating a statute or a contractual provision employing the same formulae as that employed in Kentucky.

C. When Does the Fiduciary Relationship Begin?

The fiduciary burdens imposed upon the fiduciary come into being upon the initiation of the fiduciary relationship. But when does that take place? Is the presentation of the relationship sufficient to initiate the obligations, or does that consequence await the initiation of the formal relationship?

584 Amendments to the Delaware LLC Act adopted in 2013 (Del. Code Ann. tit. 6, § 19-1104) expressly incorporate “the rule of law and equity relating to fiduciary duties” into the LLC Act, thereby adopting the view that there exist fiduciary duties in the absence of a contractual elimination or modification.
591 See KRS ch. 362.1.
Under the 1914 Uniform Partnership Act, the fiduciary relationship among the partners arose upon the negotiation of the terms of the partnership. In contrast, under the 1997 Revised Uniform Partnership Act the fiduciary duties did not arise until the partnership’s actual formation.\footnote{596}{See Thomas E. Rutledge and Allan W. Vestal, Rutledge & Vestal on Partnerships and Limited Partnerships in Kentucky § 2.5.4 (2010).}

Recently the New York Court of Appeals wrestled with, but did not answer, the question of whether, upon solicitation of investments in to-be-formed LLCs, did the fiduciary relationship attach even prior to the investment in the LLC.\footnote{597}{Roni LLC v. Rachel L. Arfa, 2011 WL 6338906 (NY 2012).} Working from the proposition that there does not exist a partnership among the anticipated participants in an LLC prior to its formation,\footnote{598}{See, e.g., Ramone v. Lange, 2006 Del. Ch. LEXIS 71 at fn. 62 (April, 2006) (In anticipation of formation of LLC there was not a partnership amongst the members); Longview Aluminum, L.L.C. v. Indus. General, L.L.C., 2003 WL 21518585 (N.D. Ill. July 2, 2003) (same).} that the fiduciary obligations arise from member status\footnote{599}{Ky. Rev. Stat. Ann. §§ 275.170(1), (2).} and that prior to the LLC’s organization there are no members, we need to consider the nature (if any) of the limits on opportunistic behavior among to be members. Be aware that “from the perspective of fiduciary law there are none” may be the correct determination.

\section*{D. When Does the Burden of the Fiduciary Relationship End?}

The question of “when do the burdens of the fiduciary relationship end?” yields the classic lawyer answer – “It depends.” The answer is dependent upon the nature of the difference fiduciary obligations.

Consider first a corporate director’s or a partner’s duty of care. Upon the resignation as a director or resignation as a partner, there is no further involvement in the venture’s management and affairs. From there, there is no further duty of care.\footnote{600}{See, e.g., Ky. Rev. Stat. Ann. §§ 362.1-603(2)(b), (c).}

In contrast, consider a fiduciary’s duty of loyalty. While the resigned director or partner may have no further involvement in prospective management, he or she is going to know the venture’s confidential information; the “neuraliser”\footnote{601}{See Men in Black.} has not yet been invented. Even after the termination, as an active relationship, of the circumstances creating the fiduciary burden, the fiduciary is bound by ongoing obligations. The fiduciary may not utilize information derived from the relationship or against the others cannot be used in competition with the beneficiary of the fiduciary relationship and must otherwise protect the confidentiality of the information. Ergo:

\begin{quote}
After the termination of his fiduciary relationship [the fiduciary] is allowed the freedom to compete, and he may carry with him his personal experience, enterprise, and knowledge, but he may not use prior financial confidences to profit at the expense of his former employer.\footnote{602}{Stewart v. Kentucky Paving Co., Inc., 557 S.W.2d 435, 439 (Ky. App. 1977), quoting Aero Drapery of Kentucky, Inc. v. Engdahl, 507 S.W.2d 166, 169-70 (Ky. 1974).}
\end{quote}

Engdahl also breached his duty to the corporation by exposing the confidential stock-bonus plan, both before and after the termination of
his employment with Aero. Fiduciary duty is not renounced at will at the termination of employment. “It is as sacred and inviolable after as before the expiration of it term.”

E. A Fiduciary is Not Always a Fiduciary

It is an all too oft-overlooked point that a fiduciary is not always bound to act in accordance with fiduciary principles, primarily that to look solely to the interests of the principal without divided loyalty for the benefit of the fiduciary or a third-party.

Consider an employee; an employee has a fiduciary duty of loyalty to the employer. Assume that this employee has skills that are difficult to replace and which were learned and developed at the employer’s expense. When the employee, without notice, announces that she is immediately terminating her employment relationship with the employer, we do not charge her with breach of fiduciary duty. The abrupt departure, highly disruptive to the beneficiary of the fiduciary obligation, is not itself a breach of fiduciary duty even though it cannot be suggested that the action was in the employer’s best interest. Rather, under Kentucky’s law on employment-at-will, while a resignation without notice may be bad form, it is not of itself actionable.

The partner is the prototypical fiduciary, owing duties to both the partnership and the other partners. We do not, however, charge a partner with disloyalty and breach of duty in insisting that, based upon her production and client orientation, that in this next year her sharing ratio needs to be increased, a demand which if accepted will result in fewer firm revenues being available to be split among the other partners. Admittedly the alteration in the sharing ratios likely will require the consent of the other partners. Do they have a fiduciary obligation to agree to the sharing ratio alteration? – surely not. Does a partner violate a fiduciary duty by requesting an increased share of the firm’s revenues? – surely not.

To provide another example, assume a member-managed LLC; each member owes a fiduciary duty of loyalty to the LLC and a fiduciary duty of care to the LLC and each of the other members. The written operating agreement obligates Scott, a member of the LLC, to sell to it Blackacre for $1,000. Notwithstanding having undertaken this obligation in the operating agreement, Scott refuses to close on

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603 Aero Drapery, 507 S.W.2d at 169, quoting Trice v. Comstock, 121 F. 620, 625 (8th Cir. 1903). See also Rutledge, Care and Loyalty After the Dissociation From or Dissolution of an Unincorporated Entity, in RESEARCH HANDBOOK ON PARTNERSHIPS, LLCs AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS (Robert W. Hillman and Mark J. Loewenstein eds.) (Edward Elgar Publishing, 2015).

604 See also II ALAN R. BROMBERG AND LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP § 6.07(a) (“The partners owe fiduciary duties to each other and to the partnership, although they do not have such duties in all circumstances.”) (citations omitted); id. footnote 16 (collecting cases); Ribstein, Are Partners Fiduciaries?, 2005 U. ILL. L. REV. 209, 238 (2005) (“The partners of a default partnership, when exercising their governance rights, inherently lack the openended delegation of power that would make them fiduciaries.”); id. 243-44; id. 245 (“Moreover, partners have a duty of care only when they act as agents or managers, and not when they are acting solely as co-owners.”).

605 RESTATMENT (THIRD) OF EMPLOYMENT LAW § 8.01(a) (Tentative Draft No. 3 (Apr. 8, 2010)) ("Employees owe a duty of loyalty…."); Stewart v. Kentucky Paving Co., Inc., 557 S.W.2d 438 (Ky. App. 1977).

606 See, e.g., KY. REV. STAT. ANN. §§ 362.1-404(1)-(3).

607 See KY. REV. STAT. ANN. §§ 275.170(1), (2), (4).
the sale. Clearly the LLC has a claim against Scott for breach of the operating agreement.

But there is no claim for breach of Scott’s fiduciary obligations to either the LLC or the other members. The breach of contract is not morphed into a breach of fiduciary duty by reason of the fact that one of the parties to the agreement, in this instance the party causing the breach, owed fiduciary duties. Simply put, in this circumstance the member is acting not as a member subject to fiduciary obligations, but rather as a vendor. The law of contract has long addressed how breach, either monetary damages or specific performance (the latter likely being the outcome in this hypothesis), should be handled.

F. The Obligation of Good Faith and Fair Dealing is Not a Fiduciary Obligation

Before turning to the substance of the fiduciary obligations, it is important to distinguish the contractual obligation of good faith and fair dealing. In Kentucky, every contract incorporates and imposes upon the parties thereto an obligation of good faith and fair dealing. The implied covenant of the good faith and fair dealing obligates a party to a contract to do “everything necessary” to carry out the contract. There is as well a negative burden to not act to “prevent [] the creation of the condition under which payment would be due.” The implied covenant informs the interpretation of the agreed upon terms of the contract; it does not provide extra-contractual terms. The covenant of good faith and fair dealing will not preclude a party from exercising their contractual rights. Another important point is that the implied covenant does not serve to preclude self-dealing conduct, but rather only police it at the margins by protecting the express contractual terms.

As to allegations that “constitute self dealing,” a party may act in its own interest and not breach the covenant of good faith and fair dealing, as

608 See KY. REV. STAT. ANN. § 275.003(4) (the LLC is a party to and bound by the operating agreement).

609 See Farmers Bank and Trust Co. of Georgetown, Kentucky v. Willmott Hardwoods, Inc., 171 S.W.3d 4, 11 (Ky. 2005) (“Within every contract there is an implied covenant of good faith and fair dealing, and contracts impose on the parties thereto a duty to do everything necessary to carry them out.”); see also KY. REV. STAT. ANN. § 275.003(7); id. § 362.1-404(4); id. § 362.2-408(4); id. § 386A.1-060(6). Accord RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).


613 See, e.g., Scheib v. Commonwealth Anesthesia, P.S.C., 2011 WL 5008089, *5 (Ky. App. 2011); Farmers Bank and Trust Co. of Georgetown, Kentucky v. Willmott Hardwoods, Inc., 171 S.W.3d 4, 11 (Ky. 2005). See also United Propane Gas, Inc. v. Federated Mut. Ins. Co., 2007 WL 779443, *3 (Ky. App. Mar. 16, 2007) (“Since Federated had a right to settle under the contract and therefore was merely exercising a contractual right, and UPG has otherwise cited us to no specific policy provision alleged to have been breached, we affirm the circuit court’s award of summary judgment on the breach of contract claim.”); Hunt Enters. v. John Deere Indus. Equip. Co., 18 F. Supp.2d 697, 700 (W.D. Ky. 1997) (the covenant of good faith and fair dealing, “does not preclude a party from enforcing the terms of the contract... It is not ‘inequitable’ or a breach of good faith and fair dealing in a commercial setting for one party to act according to the express terms of a contract for which it bargained.”).
long as its discretion is not used in a way that is contrary to the spirit of the agreement.⁶¹⁴

This is not to suggest that good faith and fair dealing are inapplicable in a fiduciary relationship; rather the reverse is the typical rule. The fiduciary must discharge the obligations undertaken by contract consistent with good faith and fair dealing.

G. What Affirmative and Negative Obligations Burden the Fiduciary?

After these other steps are completed, it is necessary to determine what are the fiduciary obligations that bind the fiduciary. In order to assess whether a violation of a limitation has taken place it is necessary to know the parameters of that limitation. What is crucial to appreciate is that there are different fiduciary limitations even within the same category.⁶¹⁵ Speed limits provide an analogous situation; speed limits bind each driver. There are, however, different speed limits. Some roads permit 55 mph, some 70 mph, and within a school zone the speed limit is 25 mph. Knowing that a particular driver was going 60 mph does not tell you whether they were speeding unless you also know the speed limit along the stretch of road in question.

Speaking in the broadest terms, a fiduciary is held to duties of care and loyalty.⁶¹⁶ Care requires that the fiduciary exercise responsibilities and discharge obligations undertaken in accordance with a performance standard. Loyalty requires that the fiduciary act in a self-abrogating manner; the fiduciary may not, absent informed consent, benefit (beyond agreed to compensation) from or transact business with the beneficiary or the subject matter of the fiduciary relationship.⁶¹⁷ The crucial point bears emphasis – there are different standards of care and there are different standards of loyalty. The correct determination that X is a fiduciary in favor of Y and that X engaged in conduct that violates fiduciary standard Z is entirely irrelevant unless it is demonstrated that standard Z is that at issue in their fiduciary relationship. If X is guilty of negligence but not gross negligence, and the fiduciary standard for X’s conduct on Y’s behalf is gross negligence, there is no fiduciary breach and no fiduciary liability.

⁶¹⁵ See also UNIFORM POWER OF ATTORNEY ACT (2006) § 114, cmL:

Although well settled that an agent under a power of attorney is a fiduciary, there is little clarity in state power of attorney statutes about what that means. Among states that address agent duties, the standard of care varies widely and ranges from a due care standard (see, e.g., 755 ILL. COMP. STAT. ANN. 45/2-7 (West 1992); IND. CODE ANN. § 30-5-6-2 (West 1994)) to a trustee-type standard (see, e.g., FLA. STAT. ANN. § 709.08(8) (West 2000 & Supp. 2006); MO. ANN STAT. § 494,714 (West 2001)).

⁶¹⁶ Other obligations at times identified as being fiduciary in nature include that to act lawfully, the duty of candor, and a duty of good faith. In accordance with the holding of the Delaware Supreme Court in Stone v. Ritter, 911 A.2d 362 (De. 2006), it is here assumed that the duty of good faith is a component of the duty of loyalty. A duty of candor may be treated as a component of the duty of loyalty, which an obligation to operate the venture in accordance with applicable law goes to ultra vires limitations upon the venture. See, e.g., KY. REV. STAT. ANN. § 275.005 (“any lawful purpose”).

⁶¹⁷ See RESTATEMENT (3rd) OF AGENCY § ; RESTATEMENT (2nd) OF AGENCY § 387; UNIF. TRUST CODE § 802(a); see also Rutheford B. Campbell, Jr., Corporate Fiduciary Duties in Kentucky, 93 KY. L.J. 551, 555 note 16 (2004-05) (differentiating “care” as being implicated in decisions that (could) increase corporate wealth from “loyalty,” it being implicated in decisions that allocate corporate wealth among constituencies).
1. Care

Care is generally a positive duty; it requires that in the discharge of particular acts by the fiduciary that the fiduciary discharge those well. What is “well” in a particular form of organization is typically defined by the statute. Certain fiduciaries, such as simple agents, are held to a standard of simple negligence. None have doubted that partners in partnerships organized under the 1914 Uniform Partnership Act are subject to a duty of care even as the statute is silent as to the point, the standard having been ascertained by means of the common law. At other times a statutory duty is defined or there is specified, without defining the underlying standard, the level of culpability required in order to be held responsible. Sometimes the requirement is subjective while at other times it is objective.

Some assert that a fiduciary is protected from criticism for breach of the duty of care by the Business Judgment Rule (the “BJR”). This is a gross overstatement. First, the BJR, in order to trigger its benefits, requires a number of distinct showings such as an informed decision and a demonstration that the transaction being challenged did not involve a breach of the duty of loyalty. Second, the BJR is a unique construct of the law governing a particular class of fiduciaries, namely the directors of a corporation. To suggest that the BJR protects the actions of trustees, simple agents, partners or the members or managers of an LLC is at minimum unsupported or more likely simply incorrect.

It is important to here understand that the “duty of care” describes a range of obligations as contrasted with a single monolithic standard. Certain fiduciaries subject to a duty of care, an example being a simple agent, imposing a standard of simple negligence. Absent an agreement by the principal to hold the fiduciary to a less exacting standard, the agent will be responsible to the principal for the discharge of their obligations where that discharge did not meet the standard of a reasonable person. A

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619 While courts have applied a “reasonable care” standard to partner conduct, a “good faith” standard has of late been more broadly accepted. See J. William Callison and Maureen A. Sullivan, Partnership Law and Practice § 12.2 (2015 ed.).
620 See, e.g., Ky. Rev. Stat. Ann. § 271B.8-300(1) (a director of a corporation is to discharge his or her obligations “(a) in good faith; (b) on an informed basis; and (c) in the manner he honestly believes to be in the best interests of the corporation.”).
624 See, e.g., Kaplan v. Centrix Corp., 284 A.2d 119, 124 (Del. Ch. 1971) (protection of the business judgment rule not available where the directors made no decision); Smith v. Van Gorkom, 488 A.2d 858, 870-71 (Del. 1985) (“benefit of Business Judgment Rule not available where directors acted on an uninformed basis”); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (same); FDIC v. Castetter, 184 F.3d 1040, 1046 (9th Cir. 1999) (benefits of business judgment rule not available where directors were either not disinterested or not independent).
626 See, e.g., Restatement (Third) of Agency § 8.08 (2006) (“Subject to any agreement with the principal, an agent has a duty to the principal to act the care, confidence, and diligence normally exercised by agents in similar circumstances.”).
similar (and non-uniform) provision is utilized in Kentucky Revised Uniform Partnership Act (2006).\textsuperscript{627} As such, the bare assertion that a particular fiduciary is subject to a “duty of care” begs the most crucial question, namely which standard of care.

Even then, the violation of the standard of care imposed by the statute, an example being the requirement that a director act “in good faith,”\textsuperscript{628} does not compel a conclusion that the director or other fiduciary is subject to liability. Numerous of the statutes, sometimes while defining a standard of care, define a different and heightened standard for imposing liability. By way of example, the Business Corporation Act defines an aspirational standard of care applicable to directors.\textsuperscript{629} Violation of those standards does not alone result in liability; rather, liability for monetary damages attaches only if the breach constituted either willful misconduct or a wanton or reckless disregard for the best interests of the corporation and its shareholders.\textsuperscript{630} If and only if there is pled\textsuperscript{631} and proved\textsuperscript{632} will the director be answerable in damages for violation of the duty of care.

A point oft missed is that the standard of care is itself relational to a duty – absent a duty it is inapplicable. The duty of care does not of itself require that a fiduciary do or not do anything. Rather, the duty of care defines a standard of performance as to a duty otherwise undertaken. A naked allegation of a breach of the duty of care is not actionable. Rather, there must be:

(1) a duty undertaken by the fiduciary as a fiduciary;

(2) either performance or non-performance of that duty, such that;

(3) the performance or non-performance met or went beyond the fiduciaries’ standard of care.

Put another way, a standard of, for example, wanton and reckless misconduct informs the discharge of a duty undertaken; it is not of itself an obligation to do or not do anything.

2. Loyalty

It is the duty of loyalty that presents the most problems and the most opportunities for breach.\textit{Meinhard v. Salmon},\textsuperscript{633} the prototypical case on the fiduciary obligations among partners, is a duty of loyalty case, it yielding the following oft-cited prose:

Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of

\textsuperscript{627} See KY. REV. STAT. ANN. § 362.1-404(3); see also id. § 362.2-408(4).

\textsuperscript{628} See KY. REV. STAT. ANN. § 271B.8-300(1)(a); id. § 273.215(1)(a).

\textsuperscript{629} See KY. REV. STAT. ANN. §§ 271B.8-300(1)(a)-(c).

\textsuperscript{630} See KY. REV. STAT. ANN. § 271B.8-300(5)(b).

\textsuperscript{631} See Sahn v. Hock, 369 S.W.3d 39, 47 (Ky. App. 2010) (Plaintiff minority shareholder who did not allege that director “committed willful misconduct or that he acted with wanton or reckless disregard for the best interest of the corporation or its shareholders … did not sufficiently allege a cause of action under KRS 271B.8-300.”).

\textsuperscript{632} See also KY. REV. STAT. ANN. § 271B.8-300(6).

\textsuperscript{633} 164 N.Y.S.2d 545 (N.Y. 1928).
conduct permissable in a workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.634

In another formulation it is stated:

“‘Fiduciary duty’ is defined as ‘a duty of utmost faith, trust, confidence and candor owed by a fiduciary (such as a lawyer or corporate officer) to the beneficiary ... ; a duty to act with the highest degree of honesty and loyalty toward the other person and in the best interest of the other person (such as the duty that one partner owes to another).”635

And in still another:

A fiduciary relationship creates the highest order of duty imposed by law. If a fiduciary relationship exists, the fiduciary cannot profit from the relationship without the knowledge and permission of the principal. In a fiduciary relationship, the fiduciary must make every effort to avoid having his own interest conflict with those of the principal. When conflict is unavoidable, the fiduciary must place the interests of the principal above his own. A fiduciary duty requires more than the generalized business obligation of good faith and fair dealing.636

It bears highlighting that the obligations of the fiduciary under all of these standards relate to the duty of loyalty, the requirement that the fiduciary subordinate personal interests to those of the beneficiary of the fiduciary relationship. None of these formulae go the duty of care, the obligation of the fiduciary to, in a sense, “do a good job.”637

Ultimately, a fiduciary bound by a duty of loyalty is precluded from:

(1) self-dealing (the fiduciary reaping a profit or benefit in or from a transaction in which the focus of the fiduciary relationship is a party);

(2) appropriation (utilizing an asset of the fiduciary relationship for personal benefit or gain),638 and

634 Id. at 439.
637 It has been asserted by some that only loyalty, and not care, is a fiduciary obligation. See, e.g., Larry E. Ribstein, Are Partners Fiduciaries?, 2005 U. Ill. L. Rev. 209, 221; Pegram v. Herdrich, 530 U.S. 211, 235 (2000). That is not a point that need be here resolved.
(3) making differential judgments among equally situated beneficiaries (i.e., within a class giving certain benefits to only certain members of the class or within a class subjecting only certain beneficiaries to certain burdens).

In different contexts the fiduciary’s conduct as to appropriation may be subject to different standards. Under almost all systems an appropriation may be permitted upon full disclosure by the fiduciary and approval by the beneficiaries. In the corporate context it is also possible, ex ante, to show that the terms of the transaction were “fair to the corporation.”639 It is important to recognize that KRS § 271B.8-310 is simply a safe harbor provision addressing when the corporation may not void a transaction by reason of the conflict of interest taint;640 it sets forth alternative mechanisms by which a conflicted transaction may be sanctioned and thereby rendered, as between the corporation and the third-party, non-voidable. It is possible only to satisfy the statute’s terms and requirements and so gain the benefit of the safe harbor; it is not possible to violate the statute. To that end it does not set forth a substantive standard of loyalty. Rather, a conflict of interest transaction may constitute a violation of the director’s duty to discharge the obligations imposed by KRS § 271B.8-300(1) and with particularity the obligation to act “in the best interests of the corporation.”

In approving a conflict transaction the disinterested directors641 are required to discharge their fiduciary standards.642 The shareholders are not restrained by fiduciary obligations in granting or denying approval of the proposed conflict transaction. The question of a director’s discharge of fiduciary obligations needs to focus upon KRS § 271B.8-300(1), it setting forth the substantive fiduciary obligations of directors; a conflict of interest transaction, if a breach of duty, is not a violation of KRS § 271B.8-310, but rather a breach of KRS § 271B.8-300(1). The statute provides that, in order to prevail on a claim for a breach of duty to be remedied by monetary damages, it is the plaintiff’s burden to prove the breach and as well causation.643 It goes on to provide that the burden is on the plaintiff to demonstrate, in
effect, the failure to discharge fiduciary obligations.\textsuperscript{644} This allocation of burden is admittedly in contrast to that under the law of Delaware,\textsuperscript{645} but it is the Kentucky General Assembly, and not the Delaware courts, that has the first order responsibility for determining the rules applicable in Kentucky business organizations generally and in corporations in particular.\textsuperscript{646}

Retaining the traditional rule of trust law, namely the rule of “no further inquiry.”, a “fairness” defense is not available under Kentucky’s partnership, LLC or statutory trust laws;\textsuperscript{647} it matters not that the source of the gain or benefit was zero sum vis-à-vis the fiduciary relationship. Rather, in those contexts there is strict liability absent complete disclosure and disinterested consent. In the case of the statutory trust, the disinterested consent must precede the conduct and there is no capacity for the ex post sanction.\textsuperscript{648} In other forms the approval may be ex post.

Consider then actor X, both a director of a Kentucky corporation and the manager of a Kentucky LLC. It is clear that he owes fiduciary obligations to each entity.\textsuperscript{649} With respect to each of the corporation and the LLC he causes the organization to enter into a clearly conflicted transaction with a third-party that is under his control; X never discloses his interests in and never solicits (much less receives) disinterested approval for the transactions. X realizes $1,000 on each transaction.

Under corporate law, first, the corporation may void the transaction unless there is a demonstration, presumably by X, that the transaction was “fair to the corporation.”\textsuperscript{650} Second, even if the transaction is not avoided, X may be liable to the corporation for breach of his obligations to the


\textsuperscript{645} See, e.g., Alcott v. Hyman, 208 A.2d 501, 506 (Del 1965); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983). See also Giannotti v. Hamway, 239 Va. 14, 24 (1990) (in the context of a conflict transaction between the corporation and a fiduciary, “the burden of proof lies upon the persons who fill the position of trust and confidence to show that the transaction has been fair.”).

\textsuperscript{646} KY. CONST. § 190. See also BRAM STOKER, DRACULA (“We are in Transylvania, and Transylvania is not England. Our ways are not your ways, and there shall be to you many strange things. Nay, from what you have told me of your experiences already, you know something of what strange things there may be.”)

\textsuperscript{647} See KY. REV. STAT. ANN. § 275.170(3); id. § 362.250(3); id. § 362.1-404(5); id. § 362.2-408(5); id. § 386A.5-070(3); see also Rutledge, The 2012 Amendments to Kentucky’s Business Entity Statutes, 101 KY. L.J. ONLINE 1, 13-14 (2012); Rutledge, The Kentucky Uniform Statutory Trust Act (2012): A Review, 51 N. KY. L. REV. 93, 137 (2012-13).

\textsuperscript{648} See KY. REV. STAT. ANN. § 386A.1-040(2)(k).

\textsuperscript{649} See KY. REV. STAT. ANN. § 271B.8-300(1); id. §§ 275.170(1), (2).

\textsuperscript{650} See KY. REV. STAT. ANN. § 271B.8-310. Alternatively, the counter-party to the agreement may have the obligation to demonstrate fairness.
absent a showing that the threshold of culpability has not been met, assuming of course that it is determined that X was not acting as a director in initiating the transaction at issue. On the other hand, X must surrender to the LLC the $1,000 gain realized from the conflicted transaction; fairness is not a defense.

For these and other reasons, it is not possible to say that any particular conduct (and here we assume that the conduct does not involve a knowing or willful violation of either law or applicable standards) violates a duty of care or a duty of loyalty. Rather, it is necessary to first ascertain what is the duty of care or the duty of loyalty applicable to that particular fiduciary, and it is as well necessary to determine whether any particular exculpatory procedure was employed to sanction conduct that would otherwise be impermissible.

H. Assuming, Of Course, That the Default Fiduciary Standards Have Not Been By Private Agreement Altered

The law of corporations is rather straightforward as to fiduciary obligations in that they are not subject to modification in the articles of incorporation or otherwise. The law of the various unincorporated business organizations is far less restrictive. In that realm it is possible to modify the fiduciary duties that are, as a default rule, provided for statute. In the context of a partnership or limited partnership governed by, respectively, the Kentucky Revised Uniform Partnership Act (2006) or the Kentucky Uniform Limited Partnership Act (2006), the statutes impose maximum limits to the degree to which the default duties may be altered, and neither permits a duty to be eliminated. Conversely, in the Kentucky LLC Act, it is possible to not only modify but as well eliminate the default statutory duties.

Focusing for these purposes upon the LLC as the now prototypical unincorporated organization, it needs to be recognized that LLCs are creatures of contract and statute. As a general rule, the LLC

651 See KY. REV. STAT. ANN. § 271B.8-300(1).
652 See KY. REV. STAT. ANN. § 271B.8-300(5).
653 See KY. REV. STAT. ANN. § 275.170(2). Those desiring to use the LLC form but being unhappy with this rule may modify it in a written operating agreement. Conversely, it does not appear that the shareholders, by private ordering in the articles or bylaws, can deprive a director of the fairness defense.
654 A Delaware 102(b)(7) or Kentucky 271B.2-020(2)(d) provision do not alter a director’s fiduciary obligations, but rather alter only the standard of culpability for monetary damages. Further, those provisions are themselves limited to certain conduct and cannot alter the standard of culpability with respect to other conduct.
655 See, e.g., KY. REV. STAT. ANN. § 362.1-103(2)(c); KY. REV. STAT. ANN. § 362.2-110(2)(e); REV. UNIF. P’SHP ACT § 103(b)(3), 6 U.L.A. 73 (2001); UNIF. LTD. P’SHP ACT § 110(b)(5), 6A U.L.A. 378 (2008). Neither the Uniform Partnership Act nor the various uniform limited partnership acts prior to the 2001 act addressed whether the statutory or common law duties could be, much less the degree to which they could be, modified.
656 See KY. REV. STAT. ANN. § 275.170 (“Unless otherwise provided in a written operating agreement: ….”); see also id. § 275.180(1) (providing that a written operating agreement may eliminate personal liability for a breach of a duty provided for in KRS § 275.170).
657 See KY. REV. STAT. ANN. § 275.003(1) (“It shall be the policy of the General Assembly through this chapter to give maximum effect to the principles of freedom of contract and the enforceability of operating agreements.”) (emphasis added); see also Fisk Ventures, LLC v. Segal, No. 3017-CC, 2008 WL 1961156 at *1 (Del. Ch. May 7,
Act set forth default rules that may be modified inter se by the members by private ordering in the operating agreement.661 Prototype section 402 is expressly a default rule applicable, “[u]nless otherwise provided in an operating agreement . . .”662 Thus, private ordering can, for example, subject a broader or narrower class of persons to fiduciary duties than provided by the default statutory rule.663 Additionally, a 2008) (stating the operating agreement “defines the scope, structure, and personality of limited liability companies”); TravelCenters of Am., LLC v. Brog, No. 3516-CC, 2008 WL 1746987, at *1 (Del. Ch. April 3, 2008) ("[LLCs] are creatures of contract, ‘designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved.’") (quoting In re Grupo Dos Chiles, LLC, C.A. No. 1447-N, 2006 WL 668443 at *2 (Del. Ch. March 10, 2006)); Walker v. Res. Dev. Co., 791 A.2d 799, 813 (Del. Ch. 2000) ("LLC members’ rights begin with and typically end with the Operating Agreement."). The language employed in the Delaware LLC Act at section 18-1101(b) is for all intents and purposes identical to the language employed in the Kentucky LLC Act at section 275.003(1) of the Kentucky Revised Statutes.

660 See, e.g., KY. REV. STAT. ANN. § 275.020(2) (stating the existence of an LLC begins upon filing by the secretary of state of the articles of organization). The statement that “LLCs are creatures of contract and of statute” is surprisingly controversial in some contractarian corners even though it is a truism because an LLC must comply with statutory filing requirements in order to be recognized by either the state or third parties with whom it might interact. Moreover, contract really does not seem to apply where there exists a single-member LLC. The comments to RULLCA state that an LLC is a creature of both contract and statute. See REV. UNIF. LTD. LIAB. CO. ACT § 110 cmt., 6B U.L.A. 445 (2008); REV. UNIF. LTD. LIAB. CO. ACT § 112 cmt. to subsection (d), 6B U.L.A. 451 (2008).

661 See, e.g., General Considerations Underlying the ULLCA Project, ULLCA Prefatory Note, UNIF. LTD. LIAB. CO. ACT, 6B U.L.A. prefatory cmt. at 547-48 (2008) (“The Committee believes that flexibility is an important hallmark of the LLC form. Accordingly, the Act gives the members maximum freedom to adopt customized rules including rules concerning voting rights and fiduciary duties.”); KY. REV. STAT. ANN. § 275.003(1) (“It shall be the policy of the General Assembly through this chapter to give maximum effect to the principles of freedom of contract and the enforceability of operating agreements.”). Accord RESTATEMENT (SECOND) OF TRUSTS § 222 (1957) (stating an express provision to the trust instrument governs over the trustee’s generally applicable duty of loyalty); RESTATEMENT (THIRD) OF TRUSTS § 78. cmt. c(2) (“A trustee may be authorized by the terms of the trust, expressly or by implication, to engage in transactions that would otherwise be prohibited by the rules of undivided loyalty stated in [S]ubsections (1) and (2).”); Rutheford B. Campbell, Jr., Bumping Along the Bottom: Abandoned Principles and Failed Fiduciary Standards in Uniform Partnership and LLC Statutes, 96 KY. L.J. 163, 168-69 (2007-08):

Perhaps most fundamental is the principle that managers and investors in unincorporated entities, if they are able, ought to be permitted to shape the terms of their arrangements between or among themselves, provided that their arrangements do not generate material adverse third-party effects. The moral and economic right of parties, in the absence of third-party effects, to pursue their own preferences is supported by their own consent and thus can be traced to both Kantian moral theory and utilitarianism. Allowing parties to set their own terms is respectful of the autonomy of rational beings (broadly, a Kantian notion) and promotes the maximization of overall utility or happiness (a utilitarian goal).

(citations omitted); Monumental Life Ins. Co. v. Nationwide Retirement Solutions, Inc., 242 F.Supp.2d 438, 449 (W.D. Ky.2003) (applying Kentucky law) (“Where a contract exists defining the scope of the principal-agent relationship… the existence and extent of the agent’s duties are determined by the agreement between the parties.”); RESTATEMENT (SECOND) OF AGENCY § 376. See also Martindale v. Hartman Harlow Bassi Robinson and McDaniel PLLC, 119 So.3d 338 (Miss. Ct. App. 2012) (even if expulsion of member and determination of redemption price is subject to “intrinsic fairness,” that obligation is not violated by applying the terms of the written agreement.).

662 PROTOTYPE LLC ACT § 402 (1992). While the Prototype LLC Act did not impose a statute of frauds mandating that any modification be in writing, the Kentucky adoption does so require. See KY. REV. STAT. ANN. § 275.170.

663 For example, it could be applied to all “affiliates” of the managers or applied to the members, as well as the managers, in a manager-managed LLC.
written operating agreement can alter the scope of the duties to be broader or narrower than the statutory formula.\textsuperscript{664} It could provide an alternative mechanism for approval of a particular transaction that violates or may violate the applicable standard, or it could even eliminate the duty entirely.\textsuperscript{665} In light of the capacity to modify or even eliminate the duty of loyalty, the unconditional statement, “members in a

\textsuperscript{664} In other instances the “opportunity” may be waived. See, e.g., ABA Section of Bus. Law, Joint Task Force of Comm. on LLCs, Partnerships and Unincorporated Entities and the Comm. on Taxation, Model Real Estate Development Operating Agreement with Commentary, 63 BUS. LAW. 385, 413 (Feb. 2008); Stoker v. Bellemeade LLC, 615 S.E.2d 1, 10 (Ga. Ct. App. 2005), rev’d on other grounds, 631 S.E.2d 693, 695-96 (Ga. 2006); see also II ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP (2010) § 6.07(d) (noting that partnership opportunity doctrine is often waived in certain categories of partnerships).

\textsuperscript{665} The possibility of eliminating fiduciary duties by agreement is determined on a state-by-state basis, and various LLC acts vary to the extent of fiduciary duties and whether they may be eliminated. No Kentucky court has addressed the question of how far parties may go in the operating agreement in modifying or even entirely eliminating a fiduciary obligation. The Delaware Supreme Court held that the then existing language in the Delaware Limited Partnership Act providing that fiduciary duties could, in a limited partnership agreement, be expanded or restricted was not sufficient to permit the elimination of fiduciary duties. Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160, 167 (Del. 2002); DEL. CODE ANN. tit. 6, § 17-1101(d)(2) (prior to 2004 amendment). In 2004, the Delaware General Assembly amended the Delaware limited partnership, general partnership, and LLC acts to provide expressly that the organic agreement between the participants may “eliminate” fiduciary obligations. See, e.g., DEL. CODE ANN. tit. 6, § 18-1101(c):

To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to [an LLC] or to another member or manager or to another person that is a party to or is otherwise bound by [an LLC] agreement, the member’s or manager’s or other person’s duties may be expanded or restricted or eliminated by provisions in the [LLC] agreement; provided that the [LLC] agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

See also DEL. CODE ANN. tit. 6, § 18-1101(e) (“[An LLC] agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager, or other person to [an LLC] . . . .”). It has been argued that the formulae employed in the Prototype (and by implication as adopted in Kentucky) do not permit the elimination of fiduciary obligations. See Frances S. Fendler, A License to Lie, Cheat and Steal? Restriction or Elimination of Fiduciary Duties in Arkansas Limited Liability Companies, 60 Ark. L. Rev. 643, 680-86 (2007). The Delaware common law requires that any waivers of fiduciary duties must be carefully crafted. See Willie Gary LLC v. James & Jackson LLC, 2006 WL 75309, *2 (Del. Ch. Jan. 10, 2006), aff’d, 906 A.2d 76, 82 (Del. 2006). If the modification is sufficiently specific, parties thereto should not thereafter seek to undo the deal to which they have entered. Miller v. Am. Real Estate Partners, L.P., Civ. No. 16788, 2001 WL 1045643, at *8 (Del. Ch. 2001) (“This court has made clear that it will not [be] tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties.”) (citation omitted). Under RUPA and ULPA, the duty of loyalty may not be eliminated, but it may be qualified. See KY. REV. STAT. ANN. § 362.1-103(2)(e); id. § 362.2-110(2)(e); REV. UNIF. P’SHP ACT § 103(b)(3)(i), 6 U.L.A. 73 (2001); UNIF. LTD. P’SHP ACT. § 110(b)(5)(A), 6A U.L.A. 378 (2009); see also RESTATEMENT (THIRD) OF AGENCY § 8.06 cmt b. (2006):

Moreover, although a person may empower another to take action without regard to the interests of the person who grants the power, the law applicable to relationships of agency as defined in § 1.01 imposes mandatory limits on the circumstances under which an agent may be empowered to take disloyal action. These limits serve protective and cautionary purposes. Thus, an agreement that contains general or broad language purporting to release an agent in advance from the agent’s general fiduciary obligation to the principal is not likely to be enforceable. This is because a broadly sweeping release of an agent’s fiduciary duty may not reflect an adequately informed judgment on the part of the principal; if effective, the release would expose the principal to the risk that the agent will exploit the agent’s position in ways not foreseeable by the principal at the time the principal agreed to the release.
member-managed LLC have a fiduciary duty of loyalty” is at best an overbroad generalization and at least misstates the operative legal rule. It is easy to correct, however, by adding the simple preface, “assuming the operating agreement does not provide to the contrary.”

In any partnership, limited partnership or LLC, in assessing any question involving fiduciary duties, it is crucial to first examine the controlling private agreement. If it alters the fiduciary stands and does so within permissible limits, those privately structured rules control.

It bears noting that simply because something can be done, it does not follow that it should be done. Departing from the default fiduciary duties is a complicated undertaking that requires that the drafter consider and address at least:

(i) What is the duty?
(ii) When is it owed?
(iii) Who owes it?
(iv) To whom is it owed?
(v) At what point does the duty terminate?
(vi) By what means is it enforced?
(viii) What is the standard of culpability?
(ix) Who bears the burden of showing breach?
(x) Who bears the burden of showing that the standard of culpability has or has not been met?

Fail to address any of these points and there will exist an ambiguity in the agreement.

I. Contractual Duties Typically Are Not “Fiduciary”?

Kentucky law expressly permits a written operating agreement to modify the standard of care and the duty of loyalty set forth in KRS § 275.170. Assume a written operating agreement, in complete

Some have argued that there should be an irreducible minimum to reducing, in advance, the duty of loyalty. See, e.g., Sandra K. Miller, What Fiduciary Duties Should Apply to the LLC Manager After More Than a Decade of Experimentation, 32 J. CORP. L. 565, 600-06 (2007). Some argue that the absence of limitations upon the permissible modification demonstrates a failure of the act, see, e.g., Allan W. Vestal, Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992, 73 B.U. L. REV. 523, 549 (1993), while others have hailed the absence of such limitations as confirming the primacy of the agreement entered into between the parties. See, e.g., Larry E. Ribstein, An Analysis of the Revised Uniform Limited Liability Company Act, 3 VA. L. & BUS. REV. 35, 66-71 (2008).

See KY. REV. STAT. ANN. § 275.120 (“except as otherwise provided in a written operating agreement”); see also id. § 275.180 (written operating agreement may eliminate liability for breach of KRS § 275.170 standards).
opposition to both the statute and the common law, that comprehensively addresses both all elements of the duty of care and all elements of the duty of loyalty. With those standards now in place, assume conduct that arguably violates the contractually defined duty of loyalty.

The essential question is whether the matter will proceed as a claim for breach of contract or rather as a claim in tort for breach of fiduciary duty. The outcome of that determination will have a number of implications including but not limited to the appropriate remedy and whether punitive damages will be available for breach.

Typically the breach of an expressly contracted obligation, even if undertaken by a fiduciary, gives rise to an action for breach of contract and not a claim in tort for breach of fiduciary duty.

J. In What Context is a Breach of Fiduciary Duty Equivalent to Fraud?

In the iconic decision Steelvest v. Scansteel Service, Inc., the Kentucky Supreme Court stated “Accordingly, we determine, as a matter of law, that a breach of fiduciary duty is equivalent to fraud.”

This same statement was repeated in Lach v. Man O’War, LLC.

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668 Under the 2010 amendments to KRS § 275.170(2), it is now manifest the common law does not provide the applicable duty of loyalty in an LLC; rather, the statute is the exclusive source of duties of LLC members and managers. See also Pannell v. Shannon, 425 S.W.3d 58, 67-68 (Ky. 2014).

669 See, e.g., Thornton V. Western & Southern Financial Group Beneflex Plan, 797 F. Supp.2d 796, 812 (W.D. Ky. 2011) (“Under Kentucky law, “[a] breach of a duty which arises under the provisions of a contract between the parties must be redressed under contract, and a tort action will not lie. A breach of a duty arising independently of any contract duties between the parties, however, may support a tort action.”, quoting Presnell Construction Mers., Inc. v. EH Const., LLC, 134 S.W.3d 575, 589 (Ky. 2004) (Keller, J., concurring) (emphasis in original)); Quadrille Business Systems v. Kentucky Cattlemen’s Association, Inc., 242 S.W.3d 359, 365 (Ky. App. 2007) (a plaintiff cannot sustain an action for breach of a fiduciary duty where the plaintiff alleges that the fiduciary duty arose solely from the alleged agreement); Battista v. Lebanon Trotting Ass’n, 538 F.2d 111, 117 (6th Cir.1976) (Under Ohio law, a tort exists only if a party breaches a duty which he owes to another independent of the contract, that is, a duty which would exist even if no contract existed). See also Glorvigen v. Cirrus Design Corp., 816 N.W.2d 572, 584 (Minn. 2012) (“Tort actions and contract actions protect different interests. Through a tort action, the duty of certain conduct is imposed by law and not necessarily by the will or intention of the parties…. On the other hand, contract actions protect the interests in having promises performed. Contract obligations are imposed because of conduct of the parties manifesting consent, and are owed only to the specific parties named in the contract.”, quoting 80 South Eighth Street Ltd. Partnership v. Carey-Canada, Inc., 486 N.W.2d 393, 395-96 (Minn. 1992)); In re Kitchin, 445 B.R. 472, 480 (Bankr. E.D. Pa. 2010) (“As stated by the Third Circuit, a claimant is barred from tort recovery “when the parties’ obligations are defined by the terms of the contracts, and not by the larger social policies embodied by the law of torts.” Bohler-Uddeholm Am., Inc. v. Ellwood Group, Inc., 247 F.3d 79, 104 (3rd Cir.2001); see also Wewinski v. Ford Motor Co., 286 F.3d 661, 671 (3d Cir.2002) (recognizing that plaintiffs are prohibited “from recovering in tort economic losses to which their entitlement flows only from a contract.”) (citations omitted)); JPMCC 2006-CIBC14 Eads Parkway, LLC v. DBL Axel, LLC, 977 N.E.2d 354, (Ind. App. 2012) (“But a party may not restyle a breach-of-contract claim as a tort claim simply to obtain additional damages. French-Tex Cleaners, Inc. v. Cefaro Co., 893 N.E.2d 1156, 1167 (Ind. Ct. App. 2008). Where the source of a party’s duty to another arises from a contract, “tort law should not interfere.” Greg Allen Const. Co. v. Estelle, 798 N.E.2d 171, 175 (Ind. 2003). “T]he question is not whether [the plaintiffs] have, as we assume, adequately pleaded their tort claims, but, rather, whether [the defendant] is alleged to have done anything that constituted an independent tort if there were no contract.” Koehlinger v. State Lottery Comm’n of Ind., 933 N.E.2d 534, 542 (Ind. Ct. App. 2010) (quotation omitted), trans. denied. Further, “the Indiana legislature did not intend to criminalize bona fide contract disputes.” French-Tex Cleaners, 893 N.E.2d at 1168.”).

670 807 S.W.2d 476 (Ky. 1991).
The question is whether this statement is categorically true. A careful review of both of those opinions and others makes clear that the statement of the equivalency of breach of fiduciary duty with fraud is made in connection with determining whether certain attorney-client privileged communications are exempt from discovery or, conversely, the fraud exception applied, thereby eliminating the privilege. Furthermore, (i) it does not appear that this principle of equivalency has been utilized outside of the question of the privilege, and (ii) it appears the courts that have considered doing so have rejected the opportunity.

In *Pixler v. Huff*, the Court considered and rejected the assertion that the complaint in a derivative action brought with respect to an LLC alleging breach of fiduciary duty should be held to the standards of F.R.C.P. 9(b). Responding specifically to the statement in *Steelvest* that breach of fiduciary duty is “equivalent to fraud,” the court observed:

> [S]everal courts have found that this statement is limited by the facts of *Steelvest* to cases involving attorney-client privilege.

Having reviewed these authorities, the *Pixler* court determined:

> The Court agrees and finds that *Steelvest* is limited to its facts, and does not apply to the determination of the pleading standard in the present case.

Turning to those authorities, in *Bariteau* the Sixth Circuit wrote:

> A “breach of fiduciary duty is equivalent to fraud,” the [Steelvest] court stated, in addressing whether the attorney-client privilege applies to certain communications. But the case says nothing about whether a breach of fiduciary duty is equivalent to fraud for discovery-rule purposes.

The *Bariteau* court went on to note the inconsistency of treating a breach of fiduciary as subject to the limitations period of KRS § 413.120(7), the general catchall, rather than KRS § 413.120(12), it relating to claims in fraud, citing *Ingram v. Cotes*.

> The *Gundaker/Jordan* decision only cited *Bariteau* and *Ingram* without otherwise expanding upon the issue, but on the basis of those rulings would not equate breach of fiduciary duty with fraud for purposes of awarding punitive damages.

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671 807 S.W.2d at 487.
672 256 S.W.3d 563, 572 (Ky. 2008).
676 74 S.W.3d 783, 787 (Ky. App. 2002).
In *Ingram v. Cotes*, the decision relied upon by *Bariteau*, the Court was called upon the address the applicable statute of limitations for a claim against the holder of a power of attorney, a species of agent subject to a fiduciary duty. Without any discussion of the *Steelvest* equivalency, the court found that for a “breach of fiduciary duties” “[T]here is no specific statutory provision providing a statute of limitations” and therefore applied KRS § 413.120(7). Citing *Ingram*, the Court of Appeals in *McCormick v. Becker*, wrote “In *Ingram v. Cates* this Court applied KRS 413.120(7) to actions alleging a breach of a fiduciary duty.”

Ergo, the equivalency between a breach of fiduciary duty and fraud as set forth in both *Steelvest* and *Lach* extends only to the fraud exception to the attorney-client privilege.

An action subject to KRS § 413.120(7) are not subject to a discovery rule, but the doctrine of adverse domination may on particular facts apply to the same effect.

**Conclusion**

Fiduciary obligations are by their very nature slippery; they exist to impose limitations upon conduct that is difficult to limit by contract. At the same time, fiduciary obligations are not all encompassing -- not every relationship involves fiduciary obligations, a fiduciary is not at all times acting in a fiduciary capacity, and not all conduct that might be complained of by the beneficiary of the fiduciary obligation is a breach of duty. Ultimately different fiduciary duties exist in different circumstances, and careful attention to the particulars of the particular relationship is crucial.