LIMITED LIABILITY COMPANIES IN KENTUCKY
(UK/CLE 2011)

2016-1 Cumulative Supplement to Chapters 5, 6, 7, 8, 9 & 9A
each fully restated

Basics of LLC Formation
Foreign LLCs
Limited Liability Company Operations
Statutory Transactions: Conversion, Mergers and Share Exchange
Dissolution of a Limited Liability Company
Developments in the Law of Kentucky LLCs

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Preface

The treatise Limited Liability Companies in Kentucky was originally published by the UK CLE office in 2011 and contained the original versions of what are Chapters 5, 6, 7, 8 and 9. Thereafter, annual supplements to those chapters were prepared and made available on SSRN. Consequent to the magnitude of the revisions made to date, in 2014 Chapter 7, *Limited Liability Company Operations*, was entirely amended and restated. That same year, new Chapter 9A, *Developments in the Law of Kentucky LLCs* was added.

For 2016, all of the chapters have been amended and entirely restated. In consequence, as set forth in the supplement, all of Chapters 5, 6, 7, 8 and 9 of the original treatise as published in 2011 have been superseded.

LIMITED LIABILITY COMPANIES IN KENTUCKY
(UKCLE 2011)

2016-1 Amendment & Restatement of Chapter 5

Basics of LLC Formation

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Chapter 5
Basics of LLC Formation

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[5.1] Introduction

This chapter will examine issues incident to the formation of LLCs in Kentucky. The immediately following chapter will consider those provisions of the LLC Act dealing with ongoing cooperation of a domestic LLC, while subsequent chapters will consider issues incident to statutory transactions and dissolution.

[5.2] Articles of Organization

Organization of a Kentucky LLC is based upon the filing of Articles of Organization; it is the filing of the Articles of Organization by the Secretary of State, as contrasted with the delivery of that document for filing, that causes the LLC's existence to begin.[1] The Articles of Organization may have a delayed effective date,[2] in which case the legal existence will not begin until that date (and time) is reached. It is not possible, however, to have the existence of the LLC commence at a time prior to the filing of the Articles of Organization. While the filing of the Articles of Organization by the Secretary of State constitutes "conclusive proof" that all conditions precedent to the organization have been satisfied,[3] an LLC must at all times have at least one member.[4] Subsequent to filing with the Secretary of State, the Articles of Organization must also be filed with the county clerk in which the LLC maintains its registered office.[5]

The Articles of Organization must include:

- The name of the LLC, the requirements of which are set forth in KRS § 14A.3-010;[6]
- The registered office and initial registered agent, each satisfying the requirements of KRS § 14A.4-010;[7]
- The mailing address of the LLC's principal office;[8] and
- A statement as to whether the LLC will be managed by managers or its members.[9]

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[1] KY. REV. STAT. ANN. § 275.020(2).

[2] KY. REV. STAT. ANN. § 275.020(2); *id*. § 14A.2-070 (defining a permissible delayed effective date).

[3] KY. REV. STAT. ANN. § 275.020(3).

[4] *See* KY. REV. STAT. ANN. § 275.015(11). *See also* DONALD W. GLAZER, SCOTT FITZGIBBON AND STEVEN O. WIESE, FITZGIBBON AND GLAZER ON LEGAL OPINIONS § 19.2 at n. 15 (3rd ed. 2008).

[5] KY. REV. STAT. ANN. § 275.045(11). *See also id.* § 14A.2-040(1)(b); *id*. § 64.012(2). The failure to file the Articles of Organization with the county clerk does not impact on the validity of the LLC's organization. *See id*. § 275.060(3).

[6] *See* KY. REV. STAT. ANN. § 275.025(1)(a); *id.* § 275.100.

[7] *See* KY. REV. STAT. ANN. § 275.025(1)(b); *see also id*. § 275.115.

[8] KY. REV. STAT. ANN. § 275.025(1)(c).

Additional requirements at times exist with respect to the Articles of Organization of certain special purpose LLCs. A limited liability company organized to render professional services[10] is required to cite the professional service or services that will be practiced through the professional LLC.[11] A nonprofit LLC must recite that it is a nonprofit and its nonprofit purpose.[12] Discussed below are additional requirements in the Articles of Organization of an LLC formed by the conversion of a general or limited partnership or corporation.

The Articles of Organization may contain additional information, not inconsistent with otherwise applicable law,[13] but the recitation of the non-required information does not constitute, simply by making it of record of the Secretary of State, notice to third parties.[14]

Unless the Articles of Organization are otherwise executed by the registered agent, they must be accompanied by a statement from the registered agent consenting to serve in that capacity.[15]

The Articles of Organization may be amended to add or modify a provision required or permitted therein or to delete a provision that is not otherwise required.[16] Absent private ordering to the contrary, the Articles of Organization may be amended by a majority-in-interest of the members.[17] Any manager in a manager-managed LLC or any member in a member-managed LLC may cause the amendment to the Articles of Organization to delete the name and address of the initial registered agent or office if the change thereof is otherwise of record with the Secretary of State or to delete the mailing address of the initial principal office if the current principal office is otherwise of record with the Secretary of State.[18] A nonprofit limited liability company may not amend its Articles of Organization to delete either the statement that it is a nonprofit limited liability company or its nonprofit purpose unless it shall have given written notice to the Kentucky Attorney General not less than ten (10) business days prior to the filing of that amendment.[19] Articles of Organization may be restated.[20]

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[9] KY. REV. STAT. ANN. § 275.025(1)(d).

[10] "Professional services" is defined at KRS § 275.015(25). Note that this definition is different from the corresponding definition as utilized in the Professional Services Corporation Act. *See* KY. REV. STAT. ANN. § 274.005(2).

[11] KY. REV. STAT. ANN. § 275.025(3).

[12] KY. REV. STAT. ANN. § 275.025(6).

[13] *See* KY. REV. STAT. ANN. § 275.025(4).

[14] *See* KY. REV. STAT. ANN. § 275.025(7).

[15] KY. REV. STAT. ANN. § 14A.4-010(2).

[16] KY. REV. STAT. ANN. § 275.030(1).

[17] KY. REV. STAT. ANN. § 275.030(2). *See also id.* § 275.175(2)(c).

[18] KY. REV. STAT. ANN. § 275.030(3).

[19] KY. REV. STAT. ANN. § 275.025(6).

[20] KY. REV. STAT. ANN. § 275.035.

A change in the registered office, the registered agent or the principal place of business of an LLC is recorded not by amending the Articles of Organization, but rather by means of independent filings with the Secretary of State's office.[21]

From the initial adoption of the LLC Act in 1994 through its amendment in 1998, it was required that the Articles of Organization recite the LLC had at least two members.[22] This requirement was deleted in 1998. Still, while this presentation is no longer required, attention should be given to LLCs that continue to contain this statement in the Articles of Organization as it is unclear what would be the consequences should an LLC with that provision be reduced to having a single member. Likewise, between 1994 and the Act's amendment in 1998, the statute expressly permitted the Articles to recite a date by which the LLC would dissolve. With the 1998 amendment of the Act and the express adoption of a default rule that LLCs have perpetual existence,[23] there was removed the suggestion that a definite date of dissolution be employed. Still, to the extent that such limitations are set forth in the Articles of Organization, they remain binding upon the LLC.

[5.2.1] LLCs Formed by the Conversion of a Partnership, a Limited Partnership or a Business Corporation

A general partnership, a limited partnerships or a business corporation may convert into the form of a LLC. The statutory requirements for action by any of these business organizations in order approve the conversion transaction and the legal effect of a conversion are elsewhere reviewed. All conversions culminate in the filing of Articles of Organization that effect the conversion. In addition to the otherwise applicable requirements for the Articles of Organization, those effecting a conversion must include as well:

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[21] *See* KY. REV. STAT. ANN. § 275.040; *id.* § 14A.5-010 (change of principal office address); *id.* § 14A.4-020 (change of registered office or registered agent).

[22] *See* Thomas E. Rutledge and Lady E. Booth, *The Limited Liability Company Act: Understanding Kentucky's New Organizational Option*, 83 KY. L.J. 1 at 10, n. 29 (1994-95).

[23] *See* KY. REV. STAT. ANN. § 275.025(2).

Converting Entity is a General Partnership[24]	Converting Entity is a Limited Partnership[25]	Converting Entity is a Business Corporation[26]
• A statement that the partnership was converted to an LLC from a partnership; • The name of the former partnership; and • Information with respect to the vote of the partners approving the conversion	• A statement that the limited partnership was converted to an LLC from a limited partnership; • The name of the former limited partnership; and • Information with respect to the vote of the partners approving the conversion	• A statement that the corporation was converted to an LLC; • The name of the former corporation; and • Information with respect to the vote in favor of the conversion

The conversion is effective upon the effective date of the Articles of Organization.[27]

[5.2.2] The Registered Office and Agent

From January 1, 2011, the requirements for the registered office and agent of a LLC are set forth in the Business Entity Filing Act[28] and specifically KRS § 14A.4-010. The BEFA sets forth the rules applicable to changing and the resignation of the registered office/agent.[29] Changes in the registered office/agent are recorded by a distinct filing and not by directly amending the Articles of Organization.

The registered agent serves as the LLC's agent for service of process of any "process, notice, or demand required or permitted to be served on the" LLC,[30] and as such extends beyond only receipt of a legal summons initiating a lawsuit. Where the registered agent cannot with reasonable diligence be served then the LLC may be served at its principal office address.[31] The

[24] KY. REV. STAT. ANN. § 275.370(3).

[25] KY. REV. STAT. ANN. § 275.370(3).

[26] KY. REV. STAT. ANN. § 275.376(11).

[27] KY. REV. STAT. ANN. § 275.370(4); *id*. § 275.376(12).

[28] Hereinafter the "BEFA." *See generally* Thomas E. Rutledge and Laura K. Tzanetos, *The Kentucky Business Entity Filing Act: The Next Step Forward in the Rationalization of Business Entity Law*, 38 N. KY. L. REV. 423 (2011).

[29] KY. REV. STAT. ANN. § 14A.4-020.

[30] KY. REV. STAT. ANN. § 14A.4-020(1). This rule is equally applicable for foreign LLCs qualified to transact business.

[31] KY. REV. STAT. ANN. § 14A.4-040(2).

registered office address must be a physical address – it may not be a P.O. box or similar facility. Other means of service remain valid and are not preempted by these provisions.[32]

Each LLC is obligated to provide to its registered agent and from time to time update the business address and phone number of a natural person authorized to receive communications from the registered agent.[33] Pursuant to otherwise legitimate interrogatories from the Secretary of State, the registered agent may be required to divulge the name and contact information with respect to the communications contact.[34]

The role of the registered agent has been defined as the forwarding of process and notices received and of maintaining the information on the communications contact.[35]

While it is quite common to do so, there is no benefit to reciting in the operating agreement what is the registered office and who is the registered agent of the LLC. The registered office and the registered agent of the LLC are as reflected in the public record maintained by the Secretary of State, and they cannot be changed by amending the operating agreement. If, however, the appropriate filings are made with the Secretary of State to change the registered office and agent, it becomes necessary, if the old information is recited in that document, to then amend the operating agreement. In the event of a failure to do so, the question will arise, at least amongst the members, as to whether service made upon the former registered office/agent is legitimate as a contractual designation of an agent separate and apart from the designation under state law. By relying entirely upon the public record (i.e., a provision in the operating agreement that goes no further than "The registered office and agent of the Company shall be as set forth in the records of the Kentucky Secretary of State."), there is avoided the possibility of conflict.

[5.2.3] Principal Place of Business Address

The principal place of business address, unlike registered office, need not be a physical address and may be a P.O. Box or similar facility.[36] Still, it is at the principal office address that the LLC is required to maintain its records unless an alternative location is set forth in a written operating agreement.[37] In addition, it is at the principal place of business address that service

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[32] KY. REV. STAT. ANN. § 14A.4-040(3). Service on an LLC may be accomplished pursuant to Kentucky Rule of Civil Procedure 4.04(4) relating to service on an "unincorporated association subject to suit under a common name." Service is accomplished against the registered agent of the LLC, it being "an agent authorized by appointment or by law to receive service on [the LLC's] behalf" (KRCP 4.04(4)) or upon an officer or managing agent of the LLC. *See also* KY. REV. STAT. ANN. § 275.135.

[33] KY. REV. STAT. ANN. § 14A.4-010(3).

[34] KY. REV. STAT. ANN. § 14A.1-040; *id.* § 14A.4-010(3); *id.* § 14A.4-050(2).

[35] KY. REV. STAT. ANN. § 14A. 4-050.

[36] There is a disconnect in the LLC Act as to the principal office address. On the one hand it needs not be a physical address. On the other hand, it is provided that the LLC must maintain certain records at the principal office address unless another address is provided for in a written operating agreement. *See* KY. REV. STAT. ANN. § 275.135. It is a fair but that most LLCs listing a P.O. Box as the principal office address do not in the written operating agreement provide for an alternative location at which those requested records will be maintained.

[37] KY. REV. STAT. ANN. § 275.185(1).

may be made on the LLC where service cannot, with reasonable diligence, be accomplished with the registered agent[38] and at which the Secretary of State may otherwise contact the LLC.[39] A change in the principal office address is accomplished by a distinct filing and not by a direct amendment of the Articles of Organization.[40]

While it is quite common to do so, there is no benefit to reciting in the operating agreement what is the principal office address of the LLC. The principal office address of the LLC is as reflected in the public record maintained by the Secretary of State, and it cannot be changed by amending the operating agreement. If, however, the appropriate filings are made with the Secretary of State to change the principal office address, it becomes necessary, if the old information is recited in that document, to then amend the operating agreement. In the event of a failure to do so, the question will arise, at least amongst the members, as to whether a communication sent to the LLC at the (now outdated) address set forth in the operating agreement is legitimate as a contractual designation of a valid address separate and apart from the designation under state law. By relying entirely upon the public record (*i.e.*, a provision in the operating agreement that goes no further than "The principal office address of the Company shall be as set forth in the records of the Kentucky Secretary of State."), there is avoided the possibility of conflict.

[5.2.4] Purposes and Powers

LLCs may, under the Kentucky LLC Act, be formed for any lawful purpose, including the provisional professional services, and are granted broad and all inclusive powers in order to accomplish those purposes.[41] By means of amendment made to the Act in 2007, it was specified that an LLC is legal entity distinct from its members.[42] Irrespective of the broad range of powers granted an LLC, those organized to render professional services are in no manner exempted from oversight from the regulatory authorities charged to oversee the profession,[43] and likewise companies formed for other activities subject to particular provisions of the law are obligated as well to satisfy those requirements.[44] Notwithstanding this recognition of continuing regulatory authority, it is expressly provided that a regulatory board may not restrict or limit the provision of the LLC Act providing limited liability for member, managers, employees and agents.

[5.2.5] Liability for Pre-organization Liabilities

The legal existence of an LLC does not begin until the latter of the filing by the Secretary of State of the Articles of Organization and there having been reached any delayed effective date

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[38] KY. REV. STAT. ANN. § 14A.4-040(2).

[39] KY. REV. STAT. ANN. § 14A.2-010(12).

[40] KY. REV. STAT. ANN. § 14A.5-010(1).

[41] *See* KY. REV. STAT. ANN. § 275.005; *id*. § 275.010.

[42] KY. REV. STAT. ANN. § 275.010(2). *See also* Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, 97 KY. L.J. 229, 257 (2008).

[43] KY. REV. STAT. ANN. § 275.010(3).

[44] *See* KY. REV. STAT. ANN. § 275.005.

specified date in the Articles of Organization.[45] Persons who purport to act by or on behalf of the LLC prior to its organization, if they have knowledge that the organization has not yet been accomplished, are jointly and severally liable for all liabilities thereby created.[46] This liability remains in place irrespective of whether the LLC, subsequent to its actual organization, adopts the debts created prior to that time.[47] Still, the LLC, subsequent to its formation, may be assigned a contract entered into pre-formation and enforce its rights thereunder.[48]

[5.2.6] LLC Names

The name of every LLC is set forth in its Articles of Organization[49] and, if a change in the name is desired, it is accomplished by filing an amendment to the Articles of Organization.[50] Assuming the LLC has not been organized for purposes of rendering a professional service, the name of every LLC must include one of:

- limited liability company; or
- limited company; or
- LLC; or
- LC,

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[45] *See* KY. REV. STAT. ANN. § 275.020(2); *id*. § 14A.2-070.

[46] *See* KY. REV. STAT. ANN. § 275.095.

[47] *See also River City Rentals, LLC v. Bays*, 2009 WL 2753304, at *4 (W.D. Ky. 2009) ("Nothing in the Kentucky limited liability company statute including KRS § 275.145 allows an individual to act as an agent of a limited liability company before the limited liability company is formed."). This rule is consistent with that set forth in the RESTATEMENT OF (THIRD) AGENCY. *See* RESTATEMENT OF (THIRD) OF AGENCY § 4.04(1)(a); *see also id.*, comment c. *Accord Pierson v. Coffey*, 706 S.W.2d 409, 413-14 (Ky. App. 1985) ("The general rule is that one who enters into a contract, (sic) for the benefit of a corporation which has yet to be incorporated remains personally liable on the contract subsequent to incorporation absent an agreement otherwise."); *Trustees of Dartmouth College v. Woodward*, 17 U.S. (Wheat.) 518, ("From the nature of things, the artificial person called a corporation, must be created, before it can be capable of taking anything."); I STEWART KYD, A TREATISE ON THE LAW OF CORPORATIONS 52 (1793; Law Book Exchange 2006) ("The incorporation ought, in fact, to precede the dotation because before the incorporation, there is no capacity to take as a corporation, …."); II WILLIAM W. COOK, A TREATISE ON THE LAW OF CORPORATIONS HAVING A CAPITAL STOCK § 705 (5th Ed. 1903) ("There has been great difficulty in determining who is to be considered a promoter and who is not. As regards the liability to strangers, however, it seem that everyone is liable herein as a promoter who induces such stranger to act in expectation of payment from the prospective corporation. Having induced the party to act, the promoter must see that he is paid."). *See also Pharmacogemetics Diagnostic Laboratory, LLC v. Essential Molecular Testing Corp., LLC – PGXL Partners, LLC*, Civ. Act. No. 3:13-CV-867-H, __ F.Supp.2nd __, 2014 WL 4163859 (W.D. Ky. Aug. 20, 2014) (KRS § 275.095 does not extend to invalidate agreement entered into with non-existent entity).

[48] *See, e.g., Geographic Network Affiliates-Inter., Inc. v. Enterprise for Empowerment Foundation at Norfolk State University*, 68 Va. Cir. 185, 2005 WL 1514432 (2005) (*de facto* LLC not recognized, but *de jure* LLC could assume contract entered into before formation).

[49] KY. REV. STAT. ANN. § 275.025(1)(a).

[50] KY. REV. STAT. ANN. § 275.030(1)(a).

with it being permitted that "limited" be abbreviated as "ltd." and "company" may be abbreviated as "co."[51] Where the LLC has been formed to render professional services, its name must include one of:

- professional limited liability company; or
- professional limited company; or
- PLLC; or
- PLC,

with the same opportunities for the abbreviation of "limited" and "company."[52] The name of every limited liability company must be distinguishable from any "name of record with the Secretary of State."[53]

Certain terminology, when used in an LLC's name, may implicate other statutes. For example, any use of "Bank," "Banker," "Banking" or "Trust" implicate review by the Department of Financial Institutions,[54] while "Engineer," "Engineering," "Surveyor," "Surveying" or "Land Surveying" implicate review by the State Board of Licensure of Professional Engineers and Land Surveyors.[55] The phrase "home medical equipment and services provider" may not be used in a business name unless the LLC is licensed by the Board of Pharmacy.[56]

In anticipation of the organization of a domestic entity, the desired name may be reserved.[57]

An LLC that is transacting business other than under its real name (*i.e.*, that name set forth in its Articles of Organization)[58] is obligated to file a certificate of assumed name.[59]

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[51] KY. REV. STAT. ANN. § 14A.3-010(3).

[52] KY. REV. STAT. ANN. § 14A.3-010(3).

[53] KY. REV. STAT. ANN. § 14A.3-010(1); "Name of record with the Secretary of State" is a defined term. *See id.* § 14A.3-070(17).

[54] *See* KY. REV. STAT. ANN. § 286.2-685.

[55] *See* KY. REV. STAT. ANN. § 322.060.

[56] *See* KY. REV. STAT. ANN. § 315.514(1).

[57] KY. REV. STAT. ANN. § 14A.3-020.

[58] *See* KY. REV. STAT. ANN. § 365.015(1)(b)7.

[59] *See* KY. REV. STAT. ANN. § 14A.3-050; *see also* Maryellen B. Allen and Thomas E. Rutledge, *The 2006 Amendments to the Assumed Name Statute: The Ongoing Task of Modernization and Clarification*, 70 BENCH AND BAR 62 (May, 2006).

[5.3] Annual Report

Every LLC, commencing in the calendar year subsequent to its formation, is obligated to file with the Secretary of State an annual report.[60] The annual report must recite:

- Name of the LLC;
- The address of its registered office and name of its registered agent;
- The address of its principal office; and
- If the LLC manager-managed, the name and business address of each manager.[61]

Effective January 1, 2011, there was eliminated the prior requirement that, where the LLC is member-managed, the annual report recite the name and address of at least one (1) member.[62] An LLC that is member-managed is not required to name any of the members in the annual report. The information as last set forth in an annual report, at the option of the LLC, may be amended over the course of the year.[63] Failing to file its annual report, an LLC will be administratively dissolved.[64]

Information in the annual report may be corrected if erroneous at the time of filing, in which case, other than as to third-parties who have relied thereon to their detriment, the corrected filing will be deemed effective as of the filing of the original (and erroneous) annual report.[65]

Not addressed by the statute is the effect of the information set forth in the annual report.[66] Subject to correction, presumably the LLC will be bound by one identified as a "manager" in the annual report even if that designation has been subsequently terminated.[67] For

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[60] *See* KY. REV. STAT. ANN. § 275.190; *id*. § 14A.6-010.

[61] KY. REV. STAT. ANN. § 14A.6-010(1). The name, the principal office address and the registered office/agent of the LLC may not be updated by amending the annual report. *See* KY. REV. STAT. ANN. § 14A.4-020 (distinct filing for change of registered office or agent); *id*. § 14A.5-010 (distinct filing for change of principal office address); *id*. § 275.030(1)(a) (name of LLC is changed by amending articles of organization).

[62] *See* Rutledge and Tzanetos, *The Kentucky Business Entity Filing Act*, *supra* note 28 at 443; *see also* Rutledge and Booth, *The Limited Liability Company Act*, *supra* note 20 at 25, n. 106.

[63] KY. REV. STAT. ANN. § 14A.6-010(6).

[64] *See* KY. REV. STAT. ANN. § 14A.7-010(1)(a).

[65] KY. REV. STAT. ANN. § 14A.2-090. *See also Cass JV, LLC v. Host International, Inc*., 2012 WL 6569318 (W.D. Ky. Dec. 17, 2012) (Where a particular LLC was incorrectly listed as a member of an LLC, thereby precluding in the context of that suit diversity jurisdiction, an amendment to the annual report deleting the incorrectly-named member was given retroactive effect, resulting in denial of the plaintiff's motion to remand).

[66] *Contrast* KY. REV. STAT. ANN. § 275.025(7) (addressing what information in the articles of organization does and does not constitute notice merely by its filing).

[67] It bears noting that while the LLC would be bound to the third-party, the LLC would have a claim against the former manager. *See* KY. REV. STAT. ANN. § 275.095; RESTATEMENT (THIRD) OF AGENCY § 8.10.

that reason, LLCs should be diligent in amending annual reports to list only current managers (or members if so identified). Conversely, a former manager (or member if the members are listed in the annual report) does not have the capacity to either amend the annual report or to compel the company to do so.[68]

[5.4] The Mythical Limited Liability Corporation

Notwithstanding their occasional appearance in both statutes and cases, there is not, under the laws of Kentucky or any other state, a legal entity properly labeled a "limited liability corporation." While the "limited liability corporation" has made several appearances in Kentucky statutes, they have since been eliminated.[69] In the slip opinion of *Arthur Andersen LLP v. Carlisle*,[70] Justice Scalia, writing for the Court, referred to a certain LLC as "limited liability corporations." This reference was subsequently corrected to "limited liability company." Still, there are decisions such as *Liberty Assignment Corporation v. Bluegrass Capital Group, LLC*,[71] it stating "Bluegrass Capital Group, LLC is a corporation …." and *Lang v. Mattison*,[72] it stating "Sunrise is a limited liability company, incorporated and formed pursuant to Kentucky law"[73], that will continue to plague us.

[5.5] What is a Limited Liability Company?

In *Patmon v. Hobbs*, the Kentucky Court of Appeals wrote that "A limited liability company is a hybrid business entity having attributes of both a corporation and a partnership."[74] Similar descriptions can be found in decisions of other courts.[75] This description is impoverished and misleading in that it indicates that partnership and corporate law are in some manner melded in the LLC and that the question is whether to apply one or the other to a particular question. While a description of an LLC as "a hybrid business entity having attributes of both a corporation and a partnership" may have been substantially correct in the early days of the LLC,[76] today this formula is misleading.[77]

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[68] Neither the LLC Act nor the Business Entity Filing Act has the equivalent of a partnership Statement of Denial. *See* KY. REV. STAT. ANN. § 362.1-304.

[69] *See, e.g.*, 2013 Ky. Acts, ch. 106, § 2 (amending KY. REV. STAT. ANN. § 11A.201(13)); 2013 Ky. Acts, ch. 106, § 12 (amending KY. REV. STAT. ANN. § 433.900); 2013 Ky. Acts, ch. 106, § 13 (amending KY. REV. STAT. ANN. § 433.902(1)(d)).

[70] 556 U.S. 624 (2009).

[71] No. 2011-CA-000852-MR, 2013 WL 1352095 (Ky. App. April 5, 2013).

[72] Civ. Act. No. 6:13-038-DCR, 2013 WL 2103145, *1 (E.D. Ky. May 14, 2013).

[73] *See also id*. ("… a Michigan corporation, PHS Muscle Cars, LLC").

[74] 280 S.W.3d 589, 593 (Ky. App. 2009).

[75] *See, e.g.*, *Purcell v. S. Hills Invs., LLC*, 847 N.E.2d 991 (Ind. App. 2006).

[76] *See, e.g.*, Thomas E. Rutledge & Lady E. Booth, *The Limited Liability Company Act: Understanding Kentucky's New Organization Option*, 83 KY. L.J. 1, 6-8 (1994-95).

[77] *See* Rutledge, *Let's Stop Describing LLCs as "Hybrids,"* J. PASSTHROUGH ENTITIES, Sept./Oct. 2014, 29.

In a realm in which limited liability is available in not only the LLC but also in general and limited partnerships[78] as well as other unincorporated forms such as the limited cooperative association[79] and the statutory trust,[80] citing the corporation as the archetype for limited liability is misleading, especially as that characteristic is not intrinsic to the corporate form.[81] As to tax classification, many LLCs are not taxed as partnerships, but rather as either associations taxable as corporations or as disregarded entities.[82] Furthermore, many LLCs, even though classified as disregarded entities, are required to be treated as corporations for certain employment tax purposes.[83] In today's environment, the LLC, like each other form of business organization, must be understood as a unique construct of formulae and characteristics that may or may not be shared with other organizational forms.[84]

First and foremost an LLC is an organizational form that is based on a contract identified as the "operating agreement."[85] Where the LLC does not adopt a particular agreement as its operating agreement the LLC Act will itself constitute the operating agreement.[86] An LLC may supplement the Act with oral agreements as to particular points, but those agreements will not be effective when the LLC Act requires that any departure from its terms be in writing.[87] Assuming the operating agreement is in writing, there is almost complete flexibility to structure the internal affairs of the LLC. It is the express public policy of Kentucky to give maximum effect to the freedom of contract in operating agreements.[88] This organizational flexibility sets the LLC off from the corporation, a form in which there is limited opportunity in the articles of incorporation or the by-laws for modification of the standard form as set forth in the business corporation act.[89]

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[78] *See* KY. REV. STAT. ANN. § 362.1-306(3) (eliminating partners' liability when partnership elects to be a limited liability partnership); *id.* § 362.2-303 (eliminating liability for limited partners in a KyULPA limited partnership); *id.* § 362.2-404(3) (eliminating general partner's liability in a KyULPA LLLP).

[79] *See* KY. REV. STAT. ANN. § 272A.5-030(1).

[80] *See* KY. REV. STAT. ANN. § 386A.3-040.

[81] *See, e.g.*, WILLIAM L. CLARK, JR., HANDBOOK OF THE LAW OF PRIVATE CORPORATIONS 16 (Francis B. Tiffany ed., 2d ed. 1907) (stating that limited liability is "not an essential attribute" of the private corporation).

[82] *See* TREAS. REG. § 301.7701-3.

[83] *See* TREAS. REG. § 301.7701-2(c)(2)(iv)(A).

[84] *See also* Rutledge, *Vampires and the Law of Business Organizations: The Fruitless Search for Authenticity*, J. PASSTHROUGH ENTITIES, Nov./Dec. 2011, 51; Rutledge, *Putting the Shepherds and the Magi in the Manger – The Problem of False Isomorphism*, J. PASSTHROUGH ENTITIES, Nov./Dec. 2012, 49.

[85] *See* KY. REV. STAT. ANN. § 275.015(20) (definition of "operating agreement").

[86] *See* KY. REV. STAT. ANN. § 275.003(8) ("To the extent the articles of organization and the operating agreement do not otherwise provide, the Kentucky Limited Liability Company Act shall govern relations among the limited liability company, the members, the managers, and the assignees.").

[87] *See, e.g.*, KY. REV. STAT. ANN. § 275.170; *id.* § 275.180; *id.* § 275.220 (each requiring that departure from statutory rule be in a "written operating agreement").

[88] *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.").

[89] By way of example, a corporation must have an officer charged with control of the corporation's records, and that officer must be identified as the "secretary." *See* KY. REV. STAT. ANN. § 271B.8-400(3); *id.* §

Likewise, while partnership and limited partnership law (at least the most modern iteration of each) generally apply principles of freedom of contract,[90] there are express statutory limits upon the degree to which the private agreement may modify certain default rules of the act.[91]

Second, the LLC is entirely a construct. All of the partnership, the limited partnership and the corporation predate the law governing each being reduced to statute.[92] LLCs are entire strangers to the common law; there was no LLC before there was an LLC Act. The Kentucky Supreme Court, in *Pannell v. Shannon*,[93] observed:

> In fact, '"limited liability companies are creatures of statute,"' controlled by Kentucky 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 that are in derogation of common law shall not apply to its provision." *Id.* Thus, to the extent the statutes conflict with common law, the common law is displaced.
>
> This Court must therefore look first to the controlling of statutory law.[94]

While aspects of the laws of other business organizations were utilized as models in drafting certain aspects of the LLC Act, they were simply models. LLCs have certain

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271B.1-400(23). The relative rights of the classes of shares in the corporation must be set forth in the publicly filed articles of incorporation, and the shareholders have cumulative voting only if that right is recited in the articles of incorporation. *See* KY. REV. STAT. ANN. § 271B.6-010; *id.* § 271B.7-280(1). The fiduciary standards of a director are not subject to modification by statute, and a committee of directors charged to review and pass upon conflict transactions must have at least two directors. *See* KY. REV. STAT. ANN. § 271B.8-300(1); *id.* § 271B.8-310(3).

[90] *See* KY. REV. STAT. ANN. § 362.1-103(1); *id.* § 362.2-110(1).

[91] *See* KY. REV. STAT. ANN. §§ 362.1-103(2)(a) – (j); *id.* §§ 362.2-110(2)(a) – (l).

[92] *See, e.g.*, KARL MOORE AND DAVID LEWIS, FOUNDATIONS OF CORPORATE EMPIRE 32-33 (Prentice Hall 2000) (discussing the terms of an investment partnership dated to 1900 b.c.).

[93] 425 S.W.3d 58, 79, 80, 2014 WL 1101472, *7 (Ky. 2014).

[94] *Accord 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."). *Contrast Mason v. Underhill*, No. 2006-CA-002144-MR, 2008 WL 1917179 (Ky. App. May 2, 2008) (notwithstanding that 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).

characteristics because those characteristics are embodied in the governing statute. The point is subtle but important; by way of example:

- LLCs are not similar to partnerships because both embody the rule of *in personam delectus*, but rather LLCs and partnerships are similar to one another because they both embody the rule of *in personam delectus*; and

- LLCs are not similar to corporations because both afford limited liability to the owners (members and shareholders), but rather LLCs and corporations are similar to one another because they both provide limited liability to the equity owners.

Third, an LLC is not a species of partnership, and it is not a species of corporation. LLCs are formed under and governed by the LLC Act.[95] LLCs are not as a default governed by the law of corporations.[96] LLCs are not as a default governed by the law of partnerships.[97] Rather, an

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[95] *See* KY. REV. STAT. ANN. § 275.015(11); *id*. § 275.003(8); *see also Pannell v. Shannon*, 425 S.W.3d 58, 67-68, 2014 WL 1101472, *7 (Ky. 2014).

[96] The law of corporations is not a general "gap filler" for the law of other business organizations. The law of corporations governs corporations, and that is all it governs. *See*, *e.g.*, *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."); *People v. Zinke*, 76 N.Y.2d 8 at 14-15, 555 N.E.2d 263 (N.Y.1990) ("Most significantly, limited partnerships and corporations are distinctly different organizational forms in the law of New York. Limited partnerships are governed by the Partnership Law—as they have been since the inception of the Partnership Law—and corporations are governed by the Business Corporation Law, a fact that has pervasive legal and financial significance."); *In re 1545 Ocean Ave., LLC*, 72 A.D.3d 121, 893 N.Y.S.2d 590 (N.Y.A.D. 2 Dept. 2010) ("The Business Corporation Law applies to "every domestic corporation and to every foreign corporation which is authorized to do business in this state" and also to "a corporation of any type or kind, formed for profit under any other chapter of the laws of this state except a chapter of the consolidated laws " (BUSINESS CORPORATION LAW § 103[a]; emphasis added). The grounds for judicial dissolution of a corporation are set forth in article 11 of the Business Corporation Law. PARTNERSHIP LAW § 10(2) states that "any association formed under any other statute of this state ... is not a partnership under this chapter." The bases for dissolution of a partnership are clearly enumerated in PARTNERSHIP LAW §§ 62, 63. Limited liability companies thus fall within the ambit of neither the Business Corporation Law nor the Partnership Law."); *Weinstein v. Colborne Foodbiotics, LLC*, 302 P.3d 263 (Colo. 2013) (stating that "corporation common law" does not extend to LLCs in the absence of a statutory mandate to that effect).

[97] Partnership law expressly provides that it does not apply in business organizations formed under other organizational statutes. *See* KY. REV. STAT. ANN. § 362.1-202(2); *id*. § 362.175(2). *See also Ginsberg v. Bistricer*, 2007 WL 987162 (N.J. Super. A.D. Apr. 4, 2007) (state adoption of UPA does not govern LLC). The "formed under other law" language precludes an argument that the members of an LLC should be as well governed in their inter-se relationship by substantive partnership law. *See also Grubb v. Galloway*, 2000-CA-0682-MR (Ky. App. Oct. 26, 2001) (having participated in the formation of a corporation in which he was intentionally not a shareholder, plaintiff could not seek to have its existence set aside and claim there to be a partnership between himself and the sole shareholder); *Dahlenburg v. Young et al*., No. 96-CA-0443-MR (Ky. App. March 20, 1998) ("Dahlenburg argues that shareholders in a closely-held corporation are analogous to partners. He reasons that because partners have fiduciary duties to each other - shareholders in a closely-held corporation should likewise have the same fiduciary duties. We disagree."); *Accolades Apartments, L.P. v. Fulton County*, 612 S.E.2d 284 (Ga. 2005) (public filing of partnership documents conclusively establishes that relationship is a partnership); *Ramone v. Lang*, 2006 Del. Ch. LEXIS 71 (April 2006) at fn. 62 (in anticipation of formation of LLC there was not a partnership among the members); *Longview Aluminum, L.L.C. v. Indus. General, L.L.C*., 2003 WL 21518585 (N.D. Ill. July 2, 2003)

individual LLC is governed by its operating agreement (incorporating as it does the LLC Act) and then by law and equity.[98]

In the end, an LLC is simply that – it is an LLC in the same way that a corporation is a corporation, a partnership is a partnership, a statutory trust is a statutory trust, etc. Each of those labels is simply the identifier of a unique combination of characteristics. Addressing only some of those characteristics:

	Corporation	Partnership	LLC
Created By:	Filing of articles of incorporation by the Secretary of State[99]	Private agreement or conduct falling within the definition of a partnership[100]	Filing of articles of organization by the Secretary of State[101]

(same); TEX. CORPS. & ASS'NS CODE ANN. § 21.730 (informality in operation of close corporation and treatment of corporation by shareholders as a partnership is not a basis for imposing on shareholders personal liability for corporation's obligations); *Beatty v. Melody Lake Ranch Club, Inc.*, No. 2003-CA-001652-MR (Ky. App. April 15, 2005) (corporation organized under business corporation act not as well or alternatively governed by nonprofit corporation act); *Glowblox Sciences, Inc. v. GCMT Administrative Services, LLC*, No. 14-CV-2280, 2015 WL 3504208 (S.D.N.Y. June 2, 2015) (if a partnership existed among the participants in the venture. "Counterclaimants do not address what impact, if any, the creation of Tumbleweed had on the existence of the alleged partnership. In the absence of any facts that show that the alleged partners retained their right, vis-à-vis one another, the Court cannot assume that the partnership – to the extent one existed – did not merge into the corporation.") (citing *Sagamore Corp. v. Diamond W. Energy Corp.*, 806 F.2d 373, 378-79 (2nd Cir. 1986)). *But see Boyd, Payne Gates & Farthing, P.C. v. Boyd, Gates, Farthing & Rudd, P.C.*, 422 S.E.2d 784 (Va. 1992) (rights of shareholders in professional corporation determined by reference to partnership law where partnership incorporated but continued to operate and refer to itself as a partnership.); *Wright v. Herman*, 230 F.R.D. 1 (D. D.C. 2005) (plaintiff met pleading requirement to maintain that there existed a partnership between plaintiff and defendant even though business activities carried on through defendant's pre-existing LLC); *Bartomeli v. Bartomeli*, 783 A.2d 1010 (Conn. App. 2001) (while business was incorporated, two brothers treated their *inter-se* relationship as that of a partnership).

[98] *See* KY. REV. STAT. ANN. § 275.003(8) ("To the extent the articles of organization and the operating agreement do not otherwise provide, the Kentucky Limited Liability Company Act shall govern relations among the limited liability company, the members, the managers, and the assignees."); *id*. § 275.003(1) ("Unless displaced by particular provisions of this chapter, the principles of law and equity shall supplement this chapter.").

[99] KY. REV. STAT. ANN. § 271B.2-030(1).

[100] KY. REV. STAT. ANN. § 362.175(1); *id*. § 362.1-202(1).

[101] KY. REV. STAT. ANN. § 275.020(1).

	Corporation	Partnership	LLC
Continuity of Life:	A corporation's existence may be perpetual; its existence is not tied to that of the shareholder body[102]	Traditionally a partnership's existence ceased upon the dissociation of any partner[103]	• Under the LLC Act as adopted in 1994, an LLC lacked continuity of life, dissolving upon the death or resignation of a member[104] • Under the LLC Act after 1998, an LLC has continuity of life unless it makes a contrary election in articles of organization[105]
Limited Liability:	Shareholders enjoy limited liability from the corporation's debts and obligations[106] (statute is silent as to the limited liability of directors, officers, employees and agents)	Partners are personally liable for all of the partnership's debts and obligations[107]	Not only does the LLC Act provide that each member enjoys limited liability from the LLC's debts and obligations, but that same rule applies to its managers, employees and agents[108]

[102] KY. REV. STAT. ANN. § 271B.3-020(1).

[103] KY. REV. STAT. ANN. § 362.290 ("The dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business.").

[104] KY. REV. STAT. ANN. § 275.285(3), as enacted in 1994 Ky. Acts, ch. 389, § 57 and prior to amendment by 1998 Ky. Acts, ch. 341, § 38.

[105] KY. REV. STAT. ANN. § 275.025(2).

[106] KY. REV. STAT. ANN. § 271B.6-220(2). This provision is silent as to the limited liability of corporate directors and of corporate agents.

[107] KY. REV. STAT. ANN. § 362.220(1); *id.* § 362.1-306(1).

[108] KY. REV. STAT. ANN. § 275.150(1).

	Corporation	Partnership	LLC
Free Transferability of Interests:	Corporate shares are freely and unilaterally transferable[109]	Right to participate in management not freely transferable[110]	Right to participate in management not freely transferable[111]
Centralized Management:	Control of the corporation is vested in the board of directors; directors need not be shareholders[112]	Control of the partnership is vested in the partners[113]	LLC elects whether to be manager-managed or member-managed,[114] but there is no obligation that a manager be appointed
Capital Lock-In:	Shareholder may not withdraw from and thereby liquidate the investment in the corporation[115]	Partner may unilaterally withdraw from the partnership and liquidate interest in the partnership[116]	A member has no right to withdraw and liquidate the investment in the LLC[117]

[109] *See, e.g.*, 12 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 5452 (2012) ("The owner of the shares, as in the case of other personal property, has an absolute and inherent right, as an incident of his or her ownership, to sell or transfer the shares at will, except insofar as the right may be restricted by the articles of incorporation, bylaws, an agreement among shareholders, or between shareholders and the corporation. In the absence of such restrictions, a transfer of shares does not require the consent of the corporation and cannot be prohibited.") (citations omitted); CHARLES B. ELLIOTT, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS § 427 (3d ed. 1900) ("A transferee of shares acquires the rights of the transferrer [sic] ….").

[110] KY. REV. STAT. ANN. § 362.280(1); *id.* § 362.1-503(1)(c).

[111] KY. REV. STAT. ANN. § 275.255(1)(c).

[112] KY. REV. STAT. ANN. § 271B.8-010(2); *id.* § 271B.8-020. *See also Allied Ready Mix Co., Inc. v. Mattingly*, 994 S.W.2d 4, 8 (Ky. 1998).

[113] KY. REV. STAT. ANN. § 362.235(5); *id.* § 362.1-401(6).

[114] *See* KY. REV. STAT. ANN. § 275.025(1)(d); *id.* § 275.165.

[115] *Contrast* KY. REV. STAT. ANN. § 274.095.

[116] KY. REV. STAT. ANN. § 362.335(1); *id.* § 362.1-701(1).

[117] KY. REV. STAT. ANN. § 275.280(4).

	Corporation	Partnership	LLC
Agency:	A shareholder is not an agent for the corporation[118] A director is not an agent for the corporation[119]	A partner is an agent for the partnership[120]	• If the LLC elects to be member-managed, then each member is an apparent agent of the LLC[121] • If the LLC elects to be manager-managed, then each manager is an apparent agent of the LLC and each member, qua a member, is not an agent[122]

[118] 1 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 30 (2012) ("The mere fact that one is a shareholder or a majority or principal shareholder gives the individual no authority to represent the corporation as its agent in dealing with third persons.") (citations omitted); WILLIAM L. CLARK, HANDBOOK OF THE LAW OF PRIVATE CORPORATIONS 38 (2nd ed. 1907) ("The mere fact that he is a stockholder does not make him an agent to contract for it or bind it by his acts.") (citation omitted); II WILLIAM W. COOK, A TREATISE ON THE LAW OF CORPORATIONS HAVING A CAPITAL STOCK § 709 (5th ed. 1903) ("The stockholders cannot enter into contracts with third persons. Contracts between the corporation and third persons must be entered into by the directors and not by the stockholders. The corporation, in such matters, is represented by the former and not by the latter. Such is one of the man objects of corporate existence. To the directors are given the management and formation of corporate contracts. The shareholders cannot, in a meeting assembled, bind the corporation by their contracts in its behalf." (citation omitted)); *Charron v. Coachmen Industries, Inc.*, 417 So.2d 1145 (Fla. 5th DCA 1982) ("Generally the board of directors represents the corporation and conducts its business while stockholders are without power to represent the corporation unless power is delegated to them or their acts are ratified by the corporation.", citing *Mease v. Warm Mineral Springs, Inc.*, 128 So.2d 174 (Fla. 2d DCA 1961)).

[119] *See, e.g., New York Dock Co., Inc. v. McCollum*, 173 Misc. 106, 16 N.Y.S.2d 844 (N.Y. Sup. 1939) ("In spite of casual language in many opinions, a director of a corporation is not an agent either of the corporation or of its stockholders, ... He derives his powers and authority neither from the stockholders nor from the corporation. His status is *sui generis.* His office is a creature of the law."); HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATIONS § 50 (Rev. Ed. 1946) ("The directors of the corporation are not individually agents of the corporation....").

[120] KY. REV. STAT. ANN. § 362.190(1); *id.* § 362.1-301(1) (each partner is an agent of the partnership); *id.* § 362.220(1); *id.* § 362.1-306(1) (partner liability for partnership debts). Under the Kentucky Revised Uniform Partnership Act (2006), while each partner is an agent of the partnership, a partner is not an agent of any other partner. *See* KY. REV. STAT. ANN. § 362.1-301(1).

[121] KY. REV. STAT. ANN. § 275.135(1).

[122] KY. REV. STAT. ANN. § 275.135(2).

	Corporation	Partnership	LLC
Major Decisions:	Major decisions require approval of the board of directors and a majority of the shareholders[123]	Major decisions require unanimous approval of the partners[124]	Major decisions require the approval of a majority-in-interest of the members[125]
Voting Rights:	Shareholders vote in proportion to share ownership[126]	Partners vote on a per capita basis[127]	Members vote in proportion to capital contributed to the LLC[128]
Dissolution:	Voluntary dissolution requires the approval of the board of directors and a majority of the shareholders[129]	Voluntary dissolution upon the resignation of any partner[130]	Voluntary dissolution requires the approval of all of the members[131]

[5.6] The Absence of Grandfather Clauses

It should be recognized that even as the LLC Act has been repeatedly amended since its initial adoption,[132] none of those amendments have incorporated a "grandfather" clause to the effect that the revised provision is applicable only to LLCs formed after that date.[133] This

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[123] *See, e.g.*, KY. REV. STAT. ANN. § 271B.10-030 (amendment of articles of incorporation requires approval of both majority of the board of directors and majority of the shareholders); *id*. § 271B.11-030 (approval of merger requires approval of both majority of the board of directors and majority of the shareholders); *id*. § 271B.12-020(2) (approval of sale of substantially all assets outside the ordinary course of business requires approval of majority of the board of directors and majority of the shareholders).

[124] KY. REV. STAT. ANN. § 362.235(8); *id*. § 362.1-401(10) ("An act outside the ordinary course of business of a partnership and an amendment to the partnership agreement may be undertaken only with the consent of all of the partners.").

[125] *See, e.g.*, KY. REV. STAT. ANN. § 275.175(2)(c) (amendment of articles of organization approved by majority-in-interest of the members); *id*. § 275.350(1) (merger approved by majority-in-interest of the members).

[126] KY. REV. STAT. ANN. § 271B.7-210(1).

[127] KY. REV. STAT. ANN. § 362.235(5); *id*. § 362.1-401(6).

[128] KY. REV. STAT. ANN. § 275.175(1); *id*. § 275.015(14); *id*. § 275.175(3).

[129] KY. REV. STAT. ANN. §§ 271B.14-020(2), (5).

[130] KY. REV. STAT. ANN. § 362.300(1)(b).

[131] KY. REV. STAT. ANN. § 275.285(3).

[132] *See infra* section [9A.2].

[133] *Contrast* DEL. CODE ANN. tit. 6, § 18-302(f) (setting forth a default rule for the amendment of the operating agreement of a Delaware LLC organized on or after January 1, 2012); IND. CODE §§ 23-18-3-1 and 23-18-3-1.1 (setting forth rules for, respectively, LLCs existing on or prior to June 30, 1999 and LLCs formed after June 30, 1999).

absence of grandfathering the prior law will no doubt lead to disputes that, in future years, will be resolved by litigation.

A trio of statutory provisions may have implications. First, it is provided that a member has no property right in any provision of an operating agreement that cannot be modified by the amendment of the operating agreement.[134] Second, it is provided that amendments to the act shall not impair the obligations of contracts existing when the amendment become effective.[135] Third, as a general rule statutes do not have retroactive effect.[136] There are also § 3 of the Kentucky Constitution, it being a *Dartmouth College* provision reserving to the legislature the right to modify laws,[137] the rule of contract law that an agreement incorporates the law as it exists at the time the contract is entered into.

LLCs are creatures of contract, in this case the operating agreement. As a contract, the operating agreement incorporates the laws as it exists at the time the contract is entered into.[138]

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[134] *See* KY. REV. STAT. ANN. § 275.003(6).

[135] *See* KY. REV. STAT. ANN. § 275.003(1).

[136] *See* KY. REV. STAT. ANN. § 446.080(3).

[137] *See* KY. CONST. § 3.

[138] *See, e.g., LJM Corp. v. Maysville Hotel Group, LLC*, No. 2004-CA-000120-MR (Ky. App. April 8, 2005) ("[A]ll existing laws, statutes and ordinances that are applicable are presumed to become part of the contract at the time and place of its making." *citing* 17A AM.JUR.2d *Contracts* § 371); *BJM, Inc. v. Melpaort Corp*. 18 F. Supp.2d 704, 705 (W.D. Ky. 1998) ("Kentucky has embraced the general proposition that 'constitutional and statutory provisions in effect at the time a contract is made become a part of the contract.'") (citation omitted); *City of Florence v. Owen Electric Corporation, Inc.*, 832 S.W.2d 876, 882 (Ky. 1992); *Whitaker v. Louisville Transit Company*, 274 S.W.2d 391, 394 (Ky. 1954, 1955); *City of Henderson v. Henderson Traction Co*., 254 S.W. 332, 323 (Ky. 1923); *Deposit Bank of Owensboro v. Daviess County*, 102 Ky. 174 (1899). *See also* 11 RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS BY SAMUEL WILLISTON § 30:19 (1999):

> When a contract expressly incorporates a statutory enactment by reference, that enactment becomes part of a contract for the indicated purposes just as though the words of that enactment were set out in full in the contract. Furthermore, parties to a contract who are not otherwise subject to a statute may choose to incorporate parts of the statute to define their relationship without bringing the full force of the statute to bear. However, the incorporation of applicable existing law into a contract does not require a deliberate expression by the parties. Except where a contrary intention is evident, the parties to a contract – including the Government, in a contract between the Government and a private party – are presumed or deemed to have contracted with reference to existing principles of law. An intention not to adopt existing law may be manifested by a contractual provision to such effect, and in most jurisdictions, the intent to modify applicable law by contract is effective only where it is expressly exercised by valid contractual stipulation.
>
> Under this presumption of incorporation, valid applicable laws existing at the time of the making of a contract enter into and form a part of the contract as fully as if expressly incorporated in the contract. Thus, contractual language must be interpreted in light of existing law, the provisions of which are regarded as implied terms of the contract, regardless of whether the agreement refers to the governing law. This principle applies to the common law in effect in the jurisdiction, as well as to constitutional provisions, statutes, ordinances and

Under the Kentucky LLC Act, to the extent that the operating agreement does not set forth a contrary rule, the terms of the LLC Act apply;[139] in effect the LLC Act is the initial operating agreement of every LLC that may then be subject to modification by private ordering, subject, in certain instances, to a statute of frauds requirement.

There is reserved to the Kentucky General Assembly the ability to amend the LLC Act,[140] thereby avoiding the rule of *Dartmouth College*. Statutes are not applied retroactively absent the General Assembly's express intent to do so.[141] While the General Assembly retains the power to amend the LLC Act, the act itself limits the degree to which existing contracts may be altered by those amendments.[142] With respect to those subsequent changes, as stated by a leading authority:

> Thus, as a rule of construction, changes in the law subsequent to the execution of a contract are not deemed to become a part of *([the] – sic)* unless its language clearly indicates such to have been *([the] – sic)* intention of *([the] – sic)* parties.[143]

And there arises the question; if an operating agreement is entered into on Monday that is silent as to Issue A, and on Wednesday the General Assembly alters (even reverses) the statutory default rule as to Issue A, and the factual situation dealing with Issue A arises on Friday, is it the law of Monday or Wednesday that will control? Put in perhaps more concrete terms, assume that an LLC was organized in 1996; its written operating is silent as to a member's right to withdraw from the company and receive a liquidating distribution. Under the statutory default rule in effect in 1996, any member could withdraw on thirty days' prior written notice and receive a liquidating distribution of the "fair value" of their interest in the company.[144] Now, in 2014, a member decides to withdraw from the company and expects a distribution in the amount of the fair value of his interest therein. Of course, beginning in 1998, the statute as to the right to withdraw has been repeatedly amended, but under none of those amendments was there preserved the right to a liquidating distribution upon dissociation.

> regulations, including provisions which affect the validity, construction, operation, effect, obligations, performance, termination, discharge and enforcement of the contract (citations omitted).

But see Grubbs v. Harris, 4 Ky. Rep. (1 Bibb) 567, 569 (1809) (law in effect at time enforcement of contract is sought, as contrasted with law in effect at time of contract's making, controls form of action for enforcement.)

[139] KY. REV. STAT. ANN. § 275.003(8).

[140] KY. CONST. § 3 ("and every grant of a franchise, privilege or exemption, shall remain subject to revocation, alteration or amended.").

[141] KY. REV. STAT. ANN. § 446.080(3).

[142] *See* KY. REV. STAT. ANN. § 275.003(1) (an amendment of the LLC Act "shall not be construed to impair the obligations of any contract existing" when the amendment becomes effective).

[143] WILLISTON ON CONTRACTS § 30:23.

[144] *See* Rutledge, *Chapman v. Regional Radiology Associates, PLLC: A Case Study in the Consequences of Resignation*, 100 KY. L.J. ONLINE 15 (2011).

On the position that no liquidating distribution is appropriate, it may be argued that in consequence of the General Assembly's ability, on an ongoing basis, to amend the act, the rights of a member from time to time are as dictated by the General Assembly, and that no contractual right to a liquidating distribution arose until the resignation, so no vested rights under a contract had been infringed. From the opposing position, it will be argued that the LLC Act, as it existed at the time of the operating agreement was adopted, was incorporated into the agreement, and on that basis the resigning member's right to a liquidating distribution upon dissociation continues to exist and is enforceable.[145]

To provide another example, assume the LLC in question was organized in 1996. At that time the members entered into a written operating agreement that was silent as to its amendment; the LLC Act then required the unanimous approval of the members to amend an operating agreement.[146] In 1998 the LLC Act was amended to provide a new default rule, that being a majority-in-interest of the members, to amend the operating agreement.[147] Now, in 2014, it has been proposed that the operating agreement be amended. As to the proposed amendment, 40% of the members are opposed and 60% are in favor. If the rule in effect in 1996 governs, it having been incorporated into the operating agreement, then the proposed amendment fails as it has far from unanimous approval. Alternatively, if the operating agreement incorporates the law as amended from time to time, then the proposed amendment passes.[148]

No Kentucky court has yet addressed this class of problems.

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[145] *See also Sage v. Radiology and Diagnostic Services, L.L.C.*, 831 So.2d 1053 (La. App. 2002) (notwithstanding subsequent amendment of governing LLC Act, member of LLC entitled to redemption upon withdrawal as provided for in LLC Act at time of the LLC's formation).

[146] *See* KY. REV. STAT. ANN. § 275.175(2)(c) as enacted by 1994 Ky. Acts, ch. 389 § 35 and prior to amendment by 1998 Ky. Acts, ch. 341, § 29.

[147] *See* 1998 Ky. Acts, ch. 341, § 29.

[148] *See also* Rutledge, *As Amended From Time to Time*, J. PASSTHROUGH ENTITIES, ____ (*forthcoming* March/April 2016).

LIMITED LIABILITY COMPANIES IN KENTUCKY
(UKCLE 2011)

2016-1 Amendment & Restatement of Chapter 6

Foreign LLCs

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Chapter 6
Foreign LLCs

by Thomas E. Rutledge

CONTENTS

[6.1] Introduction

The 2010 Kentucky General Assembly approved the Kentucky Business Entity Filing Act.[1] Codified in KRS ch. 14A and effective as of January 1, 2011,[2] the Business Entity Filing Act superseded and replaced the foreign qualification procedures distributed previously throughout the various entity acts, including those formerly set forth in the LLC Act.[3]

[6.2] Grandfathering of Prior Qualifications

Qualifications to transact business effective as of January 1, 2011, those having been filed under predecessor laws repealed in connecting with the adoption of the filing act, remain in effect and are grandfathered into the new law.[4] The amendment, withdrawal and revocation of those prior filings are subject the BEFA.

[6.3] What Constitutes Doing Business in Kentucky

A foreign LLC[5] may not "transact business" in Kentucky unless it shall have first applied for and received a certificate of authority.[6] What constitutes "transacting business" is not defined. Rather, there is a list of activities that in and of themselves do not constitute transacting business. This non-exclusive list references:

- Maintaining, defending or settling any proceeding;
- Holding a meeting of a board of directors, the shareholders, partners, members, managers, beneficial owners or trustees or carrying on other activities related to the internal affairs of the foreign LLC;
- Maintaining bank accounts;
- Maintaining an office for the transfer, exchange and registration of the foreign LLC's securities or maintaining trustees or depositories with respect thereto;
- Selling through independent contractors;

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[1] 2010 Ky. Acts, ch. 151 (hereinafter the "BEFA"). *See generally* Thomas E. Rutledge and Laura K. Tzanetos, *The Kentucky Business Entity Filing Act: The Next Step Forward in the Rationalization of Business Entity Law*, 38 N. KY. L. REV. 423 (2011).

[2] *See* 2010 Ky. Acts, ch. 151, § 152.

[3] This chapter is based upon Thomas E. Rutledge, *Kentucky*, DOING BUSINESS IN STATES OTHER THAN THE STATE OF INCORPORATION (BNA Corporate Practice Series Portfolio 84).

[4] KY. REV. STAT. ANN. § 14A.9-030(4).

[5] Defined at KY. REV. STAT. ANN.. § 275.005(9). *See also id.* § 14A.1-070(10).

[6] KY. REV. STAT. ANN. § 14A.9-010(1).

- Soliciting or obtaining orders, whether by mail or through employees, agents or otherwise where such orders require acceptance outside the Commonwealth of Kentucky in order to create a binding agreement;

- Creating or requiring indebtedness, mortgages and security interest in real, personal or intangible property;

- Securing or collecting debts or enforcing mortgages and security interest in property securing those debts;

- Owning, without more, real or personal property;

- Conducting an isolated transaction completed within 30 days that is not in the course of repeated transactions of like nature; and

- Transacting business in interstate commerce.

Whether a foreign LLC is transacting business in Kentucky is largely a question of fact to be determined by the circumstances of each particular case.[7] In the only modern (*i.e.*, within the last 25 years) published case decided on the issue, the Kentucky Court of Appeals held that a foreign corporation was not transacting business in Kentucky where it: (i) sanctioned a steeplechase race; (ii) collected in New York race entry materials and prepared booklets and identification badges and (iii) rented and delivered, but did not set up, race related equipment.[8]

The statute expressly provides that the list of activities not constituting transacting business will not apply in determining the contacts and activities that may subject the foreign LLC to service of process or taxation or regulation under other Kentucky law.[9]

[6.4] Consequences of Doing Business Without Authority

A foreign LLC transacting business without a required certificate of authority is subject to a fine of $2 per day and is barred from bringing an action in Kentucky courts until it has qualified to transact business.[10] Still, the acts of the foreign LLC transacting business without a

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[7] *See, e.g., Etheridge v. Grove Mfg. Co.*, 287 F. Supp 437 (W.D. Ky. 1968), *aff'd* 415 F.2d 1338 (6th Cir. 1969). The phrase "doing business" is not a technical term but should be read as ordinary words having their ordinary meaning. *WSAZ, Inc. v. Lyons*, 254 F.2d 242 (6th Cir. 1958).

[8] *Commonwealth v. Nat'l Steeplechase and Hunt Ass'n. Inc.*, 612 S.W.2d 347 (Ky. App. 1981) (decided under predecessor statute). The *Nat'l Steeplechase* decision was cited in the subsequent unpublished decision rendered in *Reliable Mech., Inc. v. Naylor Indus. Services, Inc.*, No. 2000-CA-001064-MR (Ky. App. Sept. 14, 2001), which discusses the isolated transaction language of KRS § 271B.15-010(j) (since superseded by KRS §14A.9-010(2)(j)). In *Roberts v. St. George Bank Ltd.*, No. 96-CA-0624-MR (Ky. App. June 26, 1998, modified July 17, 1998), a foreign banking corporation that had made four fund transfers into Kentucky in a six-month period was held not to need a certificate of authority under either the isolated transaction or the interstate transaction exceptions.

[9] KY. REV. STAT. ANN. § 14A.9-010(5).

[10] KY. REV. STAT. ANN. §§ 14A.9-020(4), (1).

certificate of authority are not otherwise impaired and it may defend an action initiated against it.[11] While a certificate of authority is required to "maintain" an action, [12] it is not required to initiate an action. The statute grants the court the ability to stay the proceeding to determine if the foreign corporation requires a certificate of authority.[13] If it is concluded that one is required, the court may stay the suit until the foreign LLC obtains a certificate of authority.

Having been sued in Kentucky, a foreign entity is not required to have and maintain a certificate of authority in order to file a compulsory counter-claim or a cross-claim.[14] No certificate of authority is required to defend an action.[15]

The inability of a foreign LLC to maintain an action consequent to not holding a required certificate of authority is in the nature of an affirmative defense that is waived if not promptly raised.[16] Although it does not appear that a Kentucky court has squarely addressed the point, there is authority for the proposition that where a defendant argues that the plaintiff lacks standing to being the suit on the basis that it is transacting business without a necessary qualification, it is the defendant's obligation to demonstrate all of: (i) that the foreign entity is "transacting business;" (ii) that qualification to transact business is required; and (iii) that the foreign entity has not qualified.[17]

There is no separate cause of action for failure to qualify to transact business. While failure to qualify may be an affirmative defense to the need to defend a suit, a parties' failure to qualify does not of itself give rise to a claim for damages or other monetary relief. The failure to qualify does not impact upon the validity of the foreign entity's organization in its jurisdiction of organization.[18]

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[11] KY. REV. STAT. ANN. § 14A.9-020(5).

[12] KY. REV. STAT. ANN. § 14A.9-020(1).

[13] KY. REV. STAT. ANN. § 14A.9-020(3).

[14] *See Kattula v. Stout*, 2007 WL 2155690 (W.D. Ky. 2007); *see also Reliable Mechanical, Inc. v. Naylor Indus. Sent, Inc.*, No. 2000-CA-001064-MR (Sept. 14, 2001), citing *Clayton Carpet Mills, Inc. v. Martin Processing. Inc.*, 563 F. Supp. 288 (N.D. Georgia 1983); *Modern Motors, LLC v. Yelder*, No. 2009-CA-000648-MR (Ky. Ct. App. Jan. 29, 2010) (holding that CR 13.01 controls, and that the requirement to qualify to transact business in order to maintain an action does not require qualification in order to file a mandatory counterclaim.).

[15] KY. REV. STAT. ANN. § 14A.9-020(5).

[16] *See Abbot v. Southern Subaru Star, Inc.*, 574 S.W.2d 684, 687-88 (Ky. App. 1978); *Williams v. American Express Bank, FSB*, No. 2012-CA-000855-MR, slip op. at 12-13 (Ky. App. June 14, 2013) (Not to be Published) (a claim that the plaintiff lacks capacity to bring an action for its failure to qualify to transact business is in the nature of an affirmative defense that must be raised in a responsive pleading or it is lost).

[17] *See Construction Management & Development, LLC v. Carnegie Hill Properties, LLC*, 2013 NY Slip Op 30404(U) (Supreme Court, New York County Feb. 20, 2013); *see also* CR 43.01(1) ("The party holding the affirmative of an issue must produce the evidence to prove it."); *Raymer v. Raymer*, 752 S.W.2d 313, 314-315 (Ky. App. 1988) ("CR 43.01 provides '(1) The party holding the affirmative of an issue must produce the evidence to prove it.' The latter rule would embrace those defenses designated as 'affirmative defenses' under CR 8.03.").

[18] *See* KY. REV. STAT. ANN. § 14A.9-050(3); RESTATEMENT (2ND) OF CONFLICTS OF LAWS § 297; *id.* § 299.

A foreign LLC, including one qualified to transact business and with a registered agent in Kentucky, may still be served through the Secretary of State through the long-arm statute;[19] both means of effecting service are equally valid.[20]

There is no Kentucky decision discussing the question of whether qualification to transact business in Kentucky is of itself consent to general jurisdiction by Kentucky courts.[21]

[6.5] The Certificate of Authority

All foreign LLCs will apply for a certificate of authority on the Secretary of State's form.[22] The application for certificate of authority requires a representation that the LLC validly exists under the laws of its jurisdiction of organization.[23] The registered agent must sign or otherwise give written consent to the appointment.[24] The application for the certificate of authority must set forth:

- The real name of the foreign LLC and, if that name is not available for use in the Commonwealth, a name that satisfies the otherwise applicable requirements;[25]
- The name of the jurisdiction under with the foreign LLC was organized;
- Its form of organization (*i.e.*, LLC);
- Its period of duration or a statement that its duration is perpetual;
- The street address of its principal office;
- The address of its registered office and the name of its registered agent in Kentucky; and

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[19] *See* KY. REV. STAT. ANN. § 454.210 (long-arm statute).

[20] *See* KY. REV. STAT. ANN. § 14A.4-040(3) ("This section does not prescribe the only means, or necessarily the required means, of serving an entity of a foreign entity."); *Haven Point Enterprise, Inc. v. United Kentucky Bank, Inc.*, 690 S.W.2d 393 (Ky. 1985) ("This Court affirms the decision of the Court of Appeals and the trial court in its refusal to set aside the default judgment on the basis of CR 60.02. KRS 454.210 and KRS 271A.565 are alternative methods of obtaining personal service and the availability of statutory agent within the state does not prevent the use of the Secretary of State as a designated agent for service of process in order to obtain personal jurisdiction.").

[21] *See, e.g.*, Tanya J. Monestier, *Registration Statutes, General Jurisdiction, and the Fallacy of Consent*, 36 CARDOZO L. REV. 1343 (2015).

[22] KY. REV. STAT. ANN. § 14A.9-030. *See also id.* § 14A.2-050(1)(b).

[23] KY. REV. STAT. ANN. § 14A.9-030(2).

[24] KY. REV. STAT. ANN. § 14A.9-030(4).

[25] *See also* KY. REV. STAT. ANN. § 14A.3-010.

- If the foreign LLC has managers, their names and business addresses.[26]

A foreign LLC, having been issued a certificate of authority, has the same but not greater rights and privileges, and is subject to the same restrictions and liabilities, imposed upon a domestic LLC.[27] With the exception of the authority of professional regulatory boards to regulate activities undertaken through a foreign LLC,[28] the Commonwealth of Kentucky is not authorized to regulate the internal affairs, including the inspection of books and records, of a foreign LLC transacting business in Kentucky.[29] What are the "internal affairs" is addressed in comment a. to section 302 of the RESTATEMENT (2ND) OF CONFLICTS and includes member/manager liability for an LLC debt and the law applicable to piercing. As enacted in 2010, and tracking the language of the prior provisions, this statute was restricted in application to those foreign entities that are qualified to transact business. This left unaddressed (a) foreign entities transacting business but exempt from the requirement to qualify to do so and (b) foreign entities in default of the obligation to qualify to transact business. By means of a 2013 amendment,[30] the provision is applicable to foreign entities irrespective of whether they have qualified to transact business.

[6.5.1] Amending the Certificate of Authority

A Certificate of Authority will need to be amended if the foreign LLC changes its real name, its period of duration, its jurisdiction of organization or its form of organization.[31] With respect to a change in form of organization, under prior law, when a foreign entity underwent a conversion, it was necessary that the Certificate of Authority issued to the predecessor be withdrawn and any successor qualify to transact business in accordance with the requirements applicable to the new form. Under this new law, it will only be required that the existing Certificate of Authority of the predecessor entity be amended to indicate the new form of organization. A change in the principal office address of a foreign LLC will be reflected not by amending the Certificate of Authority but rather by a distinct filing with the Secretary of State,[32] and likewise a change in the registered agent, registered office or both will be accomplished by means of a distinct filing.[33]

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[26] KY. REV. STAT. ANN. § 14A.9-030(1).

[27] KY. REV. STAT. ANN. § 14A.9-050(2).

[28] KY. REV. STAT. ANN. § 14A.9-050(4).

[29] KY. REV. STAT. ANN. § 14A.9-050(3). With respect to the specific reference to the inspection of records of a foreign LLC, see Rutledge, *The 2007 Amendments to the Business Entity Statutes*, 97 KY. L.J. 229, 238-39 (2008-09).

[30] *See* 2013 Ky. Acts, ch. 106, § 4.

[31] KY. REV. STAT. ANN. § 14A.9-040(1).

[32] KY. REV. STAT. ANN. § 14A.9-040(3); *see also id.* § 14A.5-010.

[33] KY. REV. STAT. ANN. § 14A.9-040(4); *see also id*. § 14A.4-020.

[6.5.2] Name of Foreign LLC

Each foreign LLC is required to qualify to transact business in Kentucky under its real name[34] unless its real name is not distinguishable upon the records of the Secretary of State, in which instance the foreign LLC will need to adopt and qualify under a fictitious name, which fictitious name will, for purposes of transacting business in Kentucky, constitute the LLC's real name.[35] To the extent that the qualified foreign LLC transacts business other than under its real name, it will need to comply with the assumed name statute.[36]

Certain terminology, when used in an LLC's name, may implicate other statutes. For example, any use of "Bank," "Banker," "Banking" or "Trust" implicate review by the Department of Financial Institutions,[37] while "Engineer," "Engineering," "Surveyor," "Surveying" or "Land Surveying" implicate review by the State Board of Licensure or Professional Engineers and Land Surveyors.[38] The phrase "home medical equipment and services provider" may not be used in a business name unless the LLC is licensed by the Board of Pharmacy.[39]

[6.5.3] Registered Office and Agent

Every foreign LLC qualified to transact business is required to appoint and maintain a registered agent and office.[40] The role of the registered agent has been defined as the forwarding of process and notices received and of maintaining the information on the communications contact.[41]

The registered office must be the business address of the registered agent.[42] The registered agent may be any of a natural person, a Kentucky entity or a foreign entity qualified to transact business in Kentucky.[43] The registered agent must expressly and in writing accept the appointment.[44] The foreign LLC may change its registered agent, the registered office, or both,[45]

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[34] *See* KY. REV. STAT. ANN. § 14A.3-040(22).

[35] KY. REV. STAT. ANN. § 365.015(1)(c)6.

[36] KY. REV. STAT. ANN. § 14A.3-050; *id.* § 365.015(2)(a).

[37] *See* KY. REV. STAT. ANN. § 286.2-685.

[38] *See* KY. REV. STAT. ANN. § 322.060.

[39] *See* KY. REV. STAT. ANN. § 315.514(1).

[40] KY. REV. STAT. ANN. § 14A.9-030(1)(g). *See also id.* § 14A.4-010(1).

[41] KY. REV. STAT. ANN. § 14A.4-050.

[42] *Id.*

[43] KY. REV. STAT. ANN. § 14A.4-010(1).

[44] KY. REV. STAT. ANN. § 14A.4-010(2); *id.* § 14A.9-030(3).

[45] KY. REV. STAT. ANN. § 14A.4-020. *See also id.* § 14A.9-040(4).

and likewise the agent may resign.[46] Failure to maintain both a registered agent and registered office are grounds for revocation of the certificate of authority.[47]

Each foreign LLC is obligated to provide to its registered agent and from time to time update the business address and phone number of a natural person authorized to receive communications from the registered agent.[48] Pursuant to otherwise legitimate interrogatories from the Secretary of State, the registered agent may be required to divulge the name and contact information with respect to the communications contact.[49]

[6.5.4] Service of Process

The registered agent appointed on behalf of a foreign LLC is its "agent for service of process, notice, or demand required or permitted by law to be served" on the foreign LLC.[50] It is through the registered agent that interrogatories from the Secretary of State may be served upon a foreign LLC.[51] The balance of this provision specifies alternative means for effecting service of process or delivering a notice or demand where either there is not registered agent or that agent cannot with "reasonable diligence" be served. In those instances, the service of process, notice or demand may be transmitted to the foreign LLC by registered or certified mail, return receipt requested, addressed to the foreign LLC at its principal office.[52] Service, whether of legal process, or of the delivery of a demand or a notice, is perfected upon actual receipt of the certified or registered mail, on the date upon which the return receipt is signed on behalf of the foreign LLC or five (5) days after the transmission of the communication as evidenced by the postmark.[53] Service through the registered agent or the alternative means of service by certified

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[46] KY. REV. STAT. ANN. § 14A.4-030.

[47] KY. REV. STAT. ANN. § 14A.9-070(2).

[48] KY. REV. STAT. ANN. § 14A.4-010(3).

[49] KY. REV. STAT. ANN. § 14A.1-040; *id*. § 14A.4-010(3); *id*. § 14A.4-050(2).

[50] KY. REV. STAT. ANN. § 14A.4-040(1), created by 2010 Acts, ch. 151, § 31. Being patterned on then existing law (*see*, *e.g.*, KRS § 271B.5-040(1); *id*. § 275.130(1); *id*. § 362.2-117(2)), prior law as to service through the registered agent and default judgments continues to apply. *See*, *e.g.*, *J.P. Morgan v. Engle*, 2006-CA-001182-MR (Ky. App. Sept. 21, 2007) (assertion by the defendant that they "somehow misplaced the complaint" not accepted as a valid basis to set aside default judgment); *Dakota Enterprises, Inc. v. Carter*, No. 2001-CA-002417-MR (Ky. App. May 30, 2003) (registered agent's regular and long term absence from business address not a basis for setting aside default judgment); *Crop Production Services, Inc. v. Williamson*, No. 1998-CA-000124-MR (Ky. App. June 25, 1999) (default judgment would not be set aside based upon registered agent's failure to properly forward the complaint to the defendant).

[51] *See* KY. REV. STAT. ANN. § 14A.1-040.

[52] While the antecedent acts were clear that the registered agent was the agent of the foreign LLC for not only service of process but also any notice or demand that could be made, the statutes were less than clear as to whether the alternative means of communication by registered or certified mail extended only to service of legal process or as well other notices or demands. To that end, the Business Entity Filing Act has clarified the law to make clear that the alternative means of delivery by registered or certified mail extends to legal process and any other notice or demand that may be served on the foreign LLC.

[53] KY. REV. STAT. ANN. §§ 14A.4-040(2)(a)–(c). This provision repeats the prior rules.

or registered mail are not exclusive of other means by which service of process, of a notice or of a demand may be made.[54]

[6.5.5] Annual Report

All foreign LLCs that qualify to transact business are obligated to file an annual report with the Secretary of State.[55] The fee to accompany the annual report is $15. The annual report is due by June 30 of the first year after the year in which the foreign LLC receives its certificate of authority and each year thereafter.[56]

[6.5.6] Withdrawal of the Certificate of Authority

A foreign LLC that desires to forfeit its right to transact business in Kentucky may do so by delivering for filing a Certificate of Withdrawal. Assuming that the document is complete and other requirements such as the filing fee are satisfied, upon filing the right to transact business is terminated. Proper execution of the certificate will be determined under KRS § 14A.2-020.

The Secretary of State is authorized to create a form Certificate of Withdrawal[57] and is further empowered to make the use of that form mandatory.[58]

A foreign LLC that has withdrawn is well advised to keep current the information provided the Secretary of State as to the mailing address. Service of process is complete upon delivery to the Secretary of State,[59] and likely a failure to receive notice of the suit because a forwarding address is out of date will not be a basis for setting aside a default judgment.

[6.5.7] Revocation of the Certificate of Authority

A foreign LLC may have its certificate of authority revoked for a variety of reasons including the failure to file an annual report, its dissolution in its jurisdiction of organization or failure to answer interrogatories.[60] The Secretary of State, believing grounds exist for revocation of the certificate of authority, will give notice to the foreign LLC at its principal place of business address,[61] and during the sixty days after the mailing of that notice the foreign LLC may remedy or otherwise address the grounds for revocation.[62] Absent cure, the Secretary of State

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[54] KY. REV. STAT. ANN. § 14A.4-040(3).

[55] KY. REV. STAT. ANN. § 14A.6-010(1).

[56] KY. REV. STAT. ANN. § 14A.6-010(4).

[57] KY. REV. STAT. ANN. § 14A.2-050(1)(d).

[58] KY. REV. STAT. ANN. § 14A.2-050(2).

[59] KY. REV. STAT. ANN. §§ 14A.9-060(2)(d), (4)

[60] KY. REV. STAT. ANN. § 14A.9-070; *id.* § 14A.1-050(1).

[61] KY. REV. STAT. ANN. § 14A.9-080(1).

[62] KY. REV. STAT. ANN. § 14A.9-080(2).

may revoke the certificate of authority by signing a certificate of revocation, a copy of which will be sent to the foreign LLC at its principal place of business address,[63] whereupon the foreign LLC's authority to transact business is terminated. While the authority of the previously appointed registered agent is not terminated by revocation of the certificate of authority, the Secretary of State becomes an alternative registered agent.[64] The revocation of the certificate of authority may be appealed to the Franklin Circuit Court.[65]

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[63] *Id*.

[64] KY. REV. STAT. ANN. §§ 14A.9-080(4), (5).

[65] KY. REV. STAT. ANN. § 14A.9-090.

LIMITED LIABILITY COMPANIES IN KENTUCKY
(UKCLE 2011)

2016-1 Cumulative Supplement

Restatement of Chapter 7

Limited Liability Company Operations

Thomas E. Rutledge
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Chapter 7
Limited Liability Company Operations

by Thomas E. Rutledge

CONTENTS

[7.1] The Operating Agreement

[7.1.1] Function

The operating agreement[1] is the core document controlling the operation of the LLC. Analogous in certain respects to a partnership or limited partnership agreement, and in other ways to corporate bylaws, the operating agreement serves to spell out the rights, duties and responsibilities amongst the members. Unlike the Corporation Act, the LLC Act does not address such procedural matters as notice for the calling of meetings, waiver of notice, agenda requirements, quorum definition and requirements, voting by proxy, telephonic attendance, record dates and similar matters. Therefore, these issues should be addressed in drafting the operating agreement. However, it may be unwise to adopt without criticism the rules set forth, for example, in the Business Corporation Act[2] (and widely available in form by-laws) as they may impose a level of formality not necessary in a closely held business, especially one in which all members are actively involved in the day-to-day business.

The operating agreement may set forth any provision that does not conflict with the Articles of Organization or the LLC Act. The various default rules of the LLC Act that permit their modification "in a written operating agreement" may be understood as being subject, in each instance, to a particular statute of frauds. The "particular" qualification is important. While the traditional Statute of Frauds requires that the agreement be signed by the person against who it would be enforced,[3] there is no requirement that the operating agreement (or any amendment thereto) be signed by any member.[4] The requirement that the modification be in a written operating agreement is just that; proving a particular writing is the operating agreement is a matter of general contract law.[5]

Default rules that may be modified only by a written operating agreement include:

- the default formulae of the duty of care and the duty of loyalty;[6]
- the requirement of a majority-in-interest of the Members to amend a written operating agreement;[7]

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[1] *See* KY. REV. STAT. ANN. § 275.015(20) (defining "operating agreement").

[2] KRS ch. 271B.

[3] *See* KY. REV. STAT. ANN. § 371.010.

[4] *See also Seaport Village Ltd. v. Seaport Village Operating Company, LLC*, C.A. No. 8841-VCL (letter opinion, September 24, 2014) (applying Del. Code Ann. tit. 6, § 18-101(7) and holding member who never executed limited liability company agreement to be bound to it); *Battles v. Bywater, LLC*, 2014 NCBC 51, 2014 WL 5512304 (NCBC Oct. 31, 2014) (no requirement that members have signed the operating agreement).

[5] *See also* KY. REV. STAT. ANN. § 275.185(1)(d).

[6] KY. REV. STAT. ANN. § 275.170.

[7] KY. REV. STAT. ANN. § 275.175(2)(a).

- the requirement of a majority-in-interest of the Members to authorize an action in contravention of a written operating agreement;[8]

- the requirement of a majority-in-interest of the Members to amend the articles of organization to change the management structure from member-managed to manager-managed or vice versa;[9]

- the allocation of profits and losses on a per contributed capital basis;[10]

- that distributions will be made in proportion to contributed capital;[11] and

- the requirement of a vote of a majority-in-interest of the members to admit an assignee as a member.[12]

It does not follow, however, that any other provision of the LLC Act may be modified either in writing or otherwise.[13] For example, an LLC may not elect out of the consequences of a judicial dissolution,[14] waive the requirement to maintain a registered office and agent,[15] determine to not amend its articles upon a change from member-managed to manager-managed,[16] alter the apparent agency effect of the election to be member-managed or manager-managed,[17] determine to deprive a judgment-creditor of a member the benefit of a charging order,[18] or decide to waive

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[8] KY. REV. STAT. ANN. § 275.175(2)(b).

[9] KY. REV. STAT. ANN. § 275.175(2)(c).

[10] KY. REV. STAT. ANN. § 275.205.

[11] KY. REV. STAT. ANN. § 275.210.

[12] KY. REV. STAT. ANN. § 275.265(1).

[13] The Kentucky Revised Uniform Partnership Act (2006), the Kentucky Uniform Limited Partnership Act (2006), the Kentucky Uniform Statutory Trust Act (2012) and the Kentucky Uniform Limited Cooperative Association Act all specify provisions of the statute that may not be modified or define the maximum degree to which modification will be permitted. *See* KY. REV STAT. ANN. § 362.1-103(2); *id*. § 362.2-11-(2); *id*. § 272A.1-110(2), (3); *id*. § 386A.1-040(2).

[14] *See* KY. REV. STAT. ANN. § 275.285(5); *id*. § 275.290.

[15] KY. REV. STAT. ANN. § 275.115; *id*. § 14A.4-010(1).

[16] *See* KY. REV. STAT. ANN. § 275.030.

[17] KY. REV. STAT. ANN. § 275.135(1). *See also id*. § 275.025(7)(b).

[18] *See* KY. REV. STAT. ANN. § 275.260; *see also Tupper v. Kroc*, 494 P.2d 1275, 1280 (Nev. 1972) ("Furthermore, the partnership agreements could not divest the district court of its powers provided by statute to charge and sell an interest of a partner in a partnership.")

the obligation to file an annual report.[19] A particularized focus upon the provision at issue must be undertaken to determine whether and how the default rule may be modified.[20]

To the extent the operating agreement is silent, the LLC Act will provide the applicable rule.[21] Essentially, to the extent not inconsistent with the express agreement, the Act is incorporated into every operating agreement.

Unlike the Articles of Organization, the operating agreement is not publicly recorded. Any written operating agreement must be retained as a record at the LLC's principal office.[22]

A question not yet considered, much less resolved, by a Kentucky court is whether modification of the default rules of the LLC Act should be broadly or narrowly construed. While there are individual instances of very broad interpretation,[23] there was no analysis of whether or why that is appropriate. Certain foreign courts have adopted a rule of narrow interpretation.[24]

[7.1.2] Initial Adoption

Generally speaking, the initial adoption of an operating agreement requires the unanimous consent of all members of the LLC.[25] There are, however, exceptions to this rule. For example, upon the merger of one LLC into another, all members of the two entities become bound by the operating agreement of the surviving LLC if that agreement is written and provided for in the plan of merger.[26] As a merger may be effected with the approval of a majority-in-

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[19] *See* KY. REV. STAT. ANN. § 275.190; *id.* § 14A.6-010.

[20] The results of this undertaking will often be unsatisfactory. By way of example, it is unclear whether the basis for judicial dissolution may be restricted or expanded.

[21] *See* KY. REV. STAT. ANN. § 275.003(8) ("To the extent the articles of organization and the operating agreement do not otherwise provide, the Kentucky Limited Liability Company Act shall govern relations among the limited liability company, the members, the managers, and the assignees."). *See also id*. § 275.005 ("A [LLC] may be *organized under this chapter*.") (*emphasis* added); *LJM Corp. v. Maysville Hotel Group, LLC*, No. 2004-CA-000120-MR (Ky. App. April 8, 2005) ("[A]ll existing laws, statutes and ordinances that are applicable are presumed to become part of the contract at the time and place of its making." *citing* 17A AM.JUR.2d *Contracts* § 371); 11 RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS BY SAMUEL WILLISTON § 30:19 (1999).

[22] KY. REV. STAT. ANN. § 275.185(1)(d).

[23] *See, e.g., Lourdes Hospital Pavilion, LLC v. Catholic Healthcare Partners, Inc*., 2006 WL 753080, 2006 U.S. Dist. LEXIS 12550 (W.D. Ky. 2006) (poorly crafted provision of operating agreement served to require approval of potential defendant to LLC bringing suit against that potential defendant); *J & B Energy, Inc. v. Caldwell*, No. 2012-CA-000370-MR, 2014 WL 3973966, n. 9 (Ky. App. Aug. 15, 2014) (broad exclusion of members qua members from management function interpreted as precluding a derivative action to test validity of management actions).

[24] *See, e.g., Lenticular Europe, LLC v. Cunnally*, 2005 WI App. 33, ¶18, 279 Wis. 2d 385, 693 N.W.2d 302 ("we conclude that if an operating agreement is ambiguous as to whether the members intended to override a particular statutory default term, the statutory default term governs.")

[25] KY. REV. STAT. ANN. § 275.275(1)(a).

[26] *See* KY. REV. STAT. ANN. § 275.365(11); *see also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383, 398 (2011).

interest of the members,[27] in effect a minority of the members may be bound to an operating agreement by means of a transaction they voted against.[28]

[7.1.3] Amendment

Unless it provides otherwise, amendment of the operating agreement requires the approval of a majority-in-interest[29] of the members.[30] The operating agreement may require that any amendments to itself be in writing, and that oral modifications of such a written agreement are not enforceable.[31] It may be provided that any amendment of the operating agreement will require an approval threshold different from majority-in-interest.[32] Further, it may be provided that particular provisions may be amended only at a different threshold.[33]

Care needs to be taken in drafting alternative amendment thresholds in order to insure their ultimate application.[34] The Kentucky LLC Act is atypical in permitting as a default the amendment of the operating agreement by a majority-in-interest of the members.[35] With the exception that there cannot be imposed upon a member an obligation to contribute capital to the LLC,[36] the statute is silent as to the maximum degree that operating agreement may be amended over the objection of one or more members. To provide but one example, may a majority-in-interest of the members amend the operating agreement to provide that all disputes arising out of or in connection therewith is to be resolved by binding arbitration? The operating agreement is the agreement of the members as to the LLC, and it certainly may address dispute resolution. Conceptually, it is difficult to define a protocol for what may or may not be an impermissible

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[27] *See* KY. REV. STAT. ANN. § 275.350(1).

[28] *See also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383, 397-99 (2011).

[29] *See* KY. REV. STAT. ANN. § 275.015(14) (defining "majority-in-interests").

[30] KY. REV. STAT. ANN. § 275.175(2)(a).

[31] KY. REV. STAT. ANN. § 275.177.

[32] *See* KY. REV. STAT. ANN. § 275.175(2) ("Unless otherwise provided in a written operating agreement, ..."); *id.* § 275.003(1).

[33] *Id.*

[34] *See, e.g.*, *Frankino v. Gleason*, Civ. A. No. 17399, 1999 WL 1032773, 1999 Del. Ch. LEXIS 219 (Del. Ch. Nov. 5, 1999), aff'd sub nom. *McNamara v. Frankino*, 744 A.2d 988 (Del. 1999) (Table).

[35] *See* KY. REV. STAT. ANN. § 275.175(2)(a). Most states, as a default rule, require the unanimous approval for amendment of the operating agreement. *See, e.g.*, ALA. CODE § 10A-5-4.03(b), 805 ILCS 1480/15-1, IND. CODE § 23-18-4-3(c)(1); VA. CODE § 13.1-1023(B)(2); *see also* REV. PROTOTYPE LLC ACT § 406(c)(1)(A), 67 BUS. LAW. 117, 159 (Nov. 2011).

[36] KY. REV. STAT. ANN. § 275.200(1). There was, until 2012, at least one exception to this categorical order. In a merger the operating agreement of the surviving LLC becomes binding by operation of law upon all members thereof. KY. REV. STAT. ANN. § 275.365(7). It was therefore possible to bind a member by merger to an operating agreement imposing a capital contribution obligation. That fact pattern would have necessitated litigation as to which provisions would control. A 2012 amendment provided, *inter alia*, that KRS § 275.200(1) would control. *See* KY. REV. STAT. ANN. § 275.365(7) as amended by 2012 Ky. Acts, ch. 81 § 113; *see also* Rutledge, *The 2012 Amendments to Kentucky's Business Entity Statutes*, 101 KY. L.J. ONLINE 1 (2012).

amendment. By one measure, the General Assembly has defined an amendment that will not be binding upon opposed members, namely new capital contribution obligations. Having not otherwise defined outer limits to amendment, it may be argued there are none. Furthermore, by entering into an operating agreement that may be altered by less than unanimous approval, a member will be hard pressed to argue they should not be bound by doing so.[37]

Consequent to the rule of independent legal significance,[38] a merger approved by less than all members and the consequent binding of the members to a new operating agreement[39] is not subject to challenge on the basis that the operating agreement of the initial LLC provides that it may be amended only with the approval of all members.[40]

In a recent decision from New York, *Shapiro v Ettenson*,[41] three individuals came together and formed a member-managed LLC, equally owned by the three of them. They did not, however, adopt a written operating agreement. Nearly 2 years after the LLCs organization, two of the members executed a written consent pursuant to which the articles of organization were amended to change the LLC from being member-managed to manager-managed and they also adopted a written operating agreement. In addition to addressing the management of the company, it provided that a majority of the members could determine to make a capital call upon all of the members and, upon a member's failure to satisfy a capital call, their interest in the company would be diluted. After a capital call was made, one of the members, Shapiro, filed a lawsuit challenging the adoption of the written operating agreement and the capital calls.

Shapiro lost, primarily because the New York LLC Act provides a default rule that a majority of the members can adopt or amend the articles of organization or operating agreement.[42]

If the members never adopt an operating agreement per se, then the articles of organization and the LLC Act are the operating agreement.[43] Initially, the Kentucky LLC Act

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[37] *See, e.g., Kentucky Home Mutual Life Ins. Co. v. Leitner*, 302 Ky. 789, 196 S.W.2d 421, 423 (Ky. 1946) ("It is stipulated that the insured was bound by the original reinsurance agreement. Since it provided for amendments thereto, he was likewise bound by the amendments, unless the Company was estopped or unless a consideration separate and distinct from the original consideration is required to support the amendment."); *Carrington v. Kentucky Home Mutual Life Ins. Co*., 61 F. Supp. 424 (W.D. Ky. 1945) .*See also Fox v. I-10 Partners*, 957 P.2d 1018 (Colo. 1998) (limited partners bound by capital contribution obligations approved by less than all partners subsequent to joining the partnership); *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014) (members of nonprofit corporation could be bound by fee shifting bylaw added to corporation's bylaws after the time they became members).

[38] *See* KY. REV. STAT. ANN. § 275.003(5); *Lach v. Man O'War*, 256 S.W.3d 563 (Ky. 2008).

[39] *See* KY. REV. STAT. ANN. § 275.365(11).

[40] *See also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383, 397-99 (2011).

[41] 2015 N.Y. Slip Op 31670 (U) (Aug. 16, 2016).

[42] A detailed analysis of this decision, prepared by Peter Mahler and posted on his (highly recommended) blog, New York Business Divorce, is available at *Can LLC Agreement Be Enforced Against Member Who Doesn't Sign It?*, http://www.nybusinessdivorce.com/2015/09/articles/llcs/can-llc-agreement-be-enforced-against-member-who-doesnt-sign-it/

provides a default rule that the members vote in proportion to their capital contributions, and goes on to provide a default rule that a majority-in-interest of the members may pass on most points, including amendment of the operating agreement.[44] While the LLC Act does not allow a capital contribution obligation to be imposed upon a member absent their written consent,[45] it is open to question whether a majority of the members, over the objection of a particular member, could impose a capital contribution obligation that, even while not specifically enforceable against the objecting member, can still have any of the consequences for lack of performance or otherwise allowed to be set forth in an operating agreement.[46]

[7.1.4] Upon Dissolution

Absent a contrary provision in the operating agreement, it remains binding subsequent to the LLC's dissolution and through the period of winding up and liquidation.[47] A well-crafted operating agreement will address the "fall off" of member obligations as the LLC proceeds to wind up. For example, depending upon the particular facts, a noncompetition obligation might expire immediately or perhaps ninety days after filing of articles of dissolution.

[7.1.5] The Operating Agreement of the Single Member LLC

The operating agreement of a single member LLC is an analytic problem – how can there be an "agreement" to which there is only one party? In order to avoid (or at least limit) such metaphysical considerations, the LLC Act addresses single member LLC operating agreements, stating:

> If a limited liability company has only one (1) member, an operating agreement shall be deemed to include: (a) A writing executed by the member that relates to the affairs of the limited liability company and the conduct of its business regardless of whether the writing constitutes an agreement; or (b) If the limited liability company is managed by a manager, any other agreement between the member and the limited liability company as it relates to the limited liability company and the conduct of its business, regardless of whether the agreement is in writing.[48]

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[43] KY. REV. STAT. ANN. § 275.003(8).

[44] *See* KY. REV. STAT. ANN. § 275.175(1); id. § 275.175(2)(a).

[45] KY. REV. STAT. ANN. § 275.200(1).

[46] *See* KY. REV. STAT. ANN. §§ 275.003(2)(a)-(g).

[47] KY. REV. STAT. ANN. § 275.300(2) ("A dissolved [LLC] shall continue its existence…."); *id*. § 275.300(3)(d); *see also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383, 391 (2011); 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).

[48] KY. REV. STAT. ANN. § 275.015(20).

[7.1.6] The (Purported) LLC Without an Operating Agreement

An LLC may exist without a formal written operating agreement, in which case it will be governed by the default rules of the LLC Act and to the degree permitted the oral and course of conduct agreement of the members.[49] To the extent no contrary provision is set forth in the operating agreement, the terms of the LLC Act are incorporated into and become part of every operating agreement.[50] Consequently, it is not possible for an LLC to "not have an operating agreement." Rather, at minimum every LLC has an operating agreement comprised of the terms of the Articles of Organization and the LLC Act.[51] Further, the qualification that the LLC does not have a "written" operating agreement is incorrect. To state the obvious, both the Articles of Organization and the LLC Act are in writing.

[7.1.7] Oral Operating Agreements and the Statute of Frauds

An LLC may exist without a written operating agreement, in which case it will be governed by an oral and course of conduct operating agreement, if any, and by the default rules of the LLC Act. While not express in the statute, and even as operating agreements may be oral, the Statute of Frauds[52] should apply. To the degree an obligation asserted to have been undertaken in an oral operating agreement would be unenforceable by reason of the Statute of Frauds, the permissibility of an oral operating agreement should not render that obligation enforceable. While this point has not been addressed by a Kentucky court, such an outcome would be consistent with the ruling of the Delaware Supreme Court rendered in *Olson v. Halvorsen*.[53] While, subsequent to the *Olson* decision, the Delaware legislature amended its LLC Act to exempt obligations undertaken in an oral operating agreement from the statute of frauds,[54] no similar effort has been undertaken in Kentucky. By way of example, while a member may in an operating agreement guarantee an indebtedness of the LLC, if that guarantee is not in a

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[49] There exists no statutory obligation that the member adopt an "operating agreement." *Contrast* DEL. CODE ANN. tit. 6, § 18-201(d) ("A limited liability company agreement ***shall*** be entered into…") (***emphasis*** added); ARK. CODE § 4-32-102(11) ("'operating agreement' means the ***written*** agreement") (***emphasis*** added). *See* LARRY E. RIBSTEIN AND ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 4:16 (2nd ed. June 2014); *id*. appendix 4-19.

[50] *See* KY. REV. STAT. ANN. § 275.005 ("A [LLC] may be *organized under this chapter*.") (*emphasis* added); *id*. § 275.003(8) ("To the extent the articles of organization and the operating agreement do not otherwise provide, the Kentucky Limited Liability Company Act shall govern relations among the limited liability company, the members, the managers and the assignees.").

[51] *See* KY. REV. STAT. ANN. § 275.003(8) ("To the extent the articles of organization and the operating agreement do not otherwise provide, the Kentucky Limited Liability Company Act shall govern relations among the limited liability company, the members, the managers, and the assignees."); *see also Racing Investment Fund 2000, LLC v. Clay Ward Agency, Inc.*, 320 S.W.3d 654, 657 (Ky. 2010) ("If the members of a particular LLC do not adopt a written operating agreement or adopt one that is silent on certain matters, KRS Chapter 275 contains default provisions that will govern the conduct of the entity's business and affairs."); RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 4:16, notes 42, 46.

[52] KY. REV. STAT. ANN. § 371.010.

[53] *Olson v. Halvorsen*, 986 A.2d 1150 (Del. 2009). *See also* Rutledge, *Statute of Frauds and Partnerships/Operating Agreements*, J. PASSTHROUGH ENTITIES, Nov./ Dec. 2008, 33.

[54] *See* DEL. CODE ANN. tit. 6, § 18-101(7).

writing signed by that member it will violate the Statute of Frauds and for that reason be unenforceable.[55] To provide a further example, a commitment to contribute real property or to lease real property to an LLC, even if set forth in a written operating agreement, will not be enforceable if that operating agreement is not signed by the member to be bound.[56]

[7.1.8] Freedom of Contract and the Doctrine of Independent Legal Significance

Kentucky, like a number of other jurisdictions including Delaware, has expressly adopted a "freedom of contract" provision in the LLC Act, it being provided that:

> It shall be policy of the General Assembly through this chapter to give maximum effect to the principles of freedom of contract and enforceability of operating agreements.[57]

Likewise, the doctrine of independent legal significance has been expressly incorporated into the LLC Act.[58] Under the doctrine of independent legal significance:

> Action taken in accordance with different sections of that law are acts of independent legal significance even though the end result may be the same under different sections.[59]

This doctrine finds application in circumstances where the effect of a transaction may be accomplished in either of two or more manners that have different procedural or substantive requirements. If the requirements of one "path" are satisfied, the transaction is valid notwithstanding that the requirements of another path are not satisfied. In *Lach v. Man O'War LLC*,[60] the plaintiff argued that the transaction undertaken was invalid as the effect was indistinguishable from a conversion for which the plaintiff's consent would have been required. The Supreme Court rejected that argument of equivalency, noting that in a conversion there is at any one time only a single entity in existence. In that the subject transaction involved a limited partnership and

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[55] *See* KY. REV. STAT. ANN. § 371.010(4). Of course, liability could as well be avoided under Kentucky's statute on personal guarantees. *See id*. § 371.065.

[56] *See* KY. REV. STAT. ANN. § 275.200(1).

[57] KY. REV. STAT. ANN. § 275.003(1). *Accord* ARK. CODE § 4-32-1304(a); DEL. CODE ANN. tit. 6, § 18-1101(b); REVISED PROTOTYPE LIMITED LIABILITY COMPANY ACT § 107(a), 67 BUS. LAW. 117, 134 (Nov. 2011).

[58] *See* KY. REV. STAT. ANN. § 275.003(5) ("Action validly taken pursuant to one (1) provision of this chapter shall not be deemed invalid solely because it is identical or similar in substance to an action that could have been taken pursuant to some other provision of this chapter but fails to satisfy one (1) or more requirements prescribed by such other provision."); *see also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383, 397-99.

[59] *Orzeck v. Englehart*, 195 A.2d 375, 377 (Del. 1963).

The doctrine of independent legal significance applies inter-se the business entity and does not impact upon successor liability to third parties under cases such as *American Railway Express Co. v. Commonwealth*, 228 S.W. 433 (Ky. 1920), *Comm. v. Fales Division of Mathewson Corp.*, 835 F.2d 145 (6th Cir. 1987), *Pearson v. National Feeding Systems, Inc.*, 90 S.W.3d 46 (Ky. 2002), and *Parker v. Henry A. Petter Supply Co.*, 165 S.W.3d 474 (Ky. 2005).

[60] 256 S.W.3d 563 (Ky. 2008).

an LLC, both existing simultaneously, the transaction was not a conversion.[61] To provide another example, consider an LLC owned 60%/20%/20% whose operating agreement requires the consent of 80% of the members for its amendment. The 60% member convenes a meeting of the members to consider a merger of the LLC into another LLC – the first LLC's operating agreement is silent as to mergers and therefore the default of approval by a majority-in-interest of the members applies.[62] While the two 20% members vote against the transaction, the 60% member's vote is sufficient to cause its approval. The members are now bound by the new operating agreement[63] and there is no right to dissent from the merger.[64] In response to the argument that from the perspective of the minority-members the "merger" was nothing but an amendment of the operating agreement for which 80% approval was not granted, the doctrine of independent legal significance would direct that the mere fact that the outcome is identical or similar does not mean it should be set aside. Rather, when a permitted path to the result is followed, that the requirements of another (and perhaps more direct or restrictive) path are not followed does not indicate that the action was inappropriate.

The amendments to the Kentucky LLC Act expressly incorporating the doctrine of independent legal significance track certain Delaware revisions made in 2009.[65] While some may

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[61] *See also Welch v. Via Christi Health Partners, Inc*., 133 P.3d 122 (Kan. 2006) (applying doctrine of independent legal significance and holding that as the statutory provisions pursuant to which the reorganization was accomplished did not provide for dissenter rights, the plaintiff limited partners had no such rights); *Fletcher International Ltd. v. ION Geophysical Corp*., 2011 WL 1167088, n. 39 (Del. Ch. March 29, 2011) (collecting cases); *Twin Bridges Limited Partnership v. Draper*, 2007 WL 2744609 (Del. Ch. Sept. 14, 2007) (dismissing claims that amendment of limited partnership agreement to permit partnership's merger and subsequent amendment of limited partnership into new partnership were invalid).

[62] *See* KY. REV. STAT. ANN. § 275.350(1). This rule is subject to modification in a written operating agreement. It should be noted that a meeting may not be necessary. Absent a provision in the operating agreement requiring a meeting to consider a merger or notice of intent to take that action, the 60% member would be within his or her rights to effectuate the merger and simply give notice thereafter. *Accord Slayton v. Highline Stages, LLC*, 2014 NY Slip Op 24333 (Sup Ct, NY County Oct. 30, 2014) (merger of LLC could be approved without a meeting or notice by written consent of that percentage of members otherwise required to approve the merger); *Paul v. Delaware Coastal Anesthesia, LLC*, C.A. No. 7084-VCG (Del. Ch. May 29, 2012) (removal of one member as a manager by vote of other members without meeting or notice was upheld as valid).

[63] KY. REV. STAT. ANN. § 275.360(4) ("A plan of merger approved in accordance with KRS 275.350 may effect any amendment to an operating agreement for a limited liability company if it is the surviving company in the merger. An approved plan of merger may also provide that the operating agreement of any constituent limited liability company to the merger, including a limited liability company formed for the purpose of consummating a merger, shall be the operating agreement of the limited liability company that is the surviving business entity. Any amendment to an operating agreement or adoption of a new operating agreement made pursuant to this subsection shall be effective at the effective time and date of the merger. The provisions of this subsection shall not be construed to limit the accomplishment of a merger or of any of the matters referred to in this section by any other means provided for in an operating agreement or other agreement or as otherwise permitted by law.").

[64] KY. REV. STAT. ANN. § 275.345(3) ("Unless otherwise provided in the articles of organization, a written operating agreement, or a written agreement and plan of merger, no member of a limited liability company shall have the right to dissent from a merger.").

[65] *See* DEL. CODE ANN. tit 6, § 15-1201 as amended by S.B. 83, 145th Delaware General Assembly; DEL. CODE ANN. tit. 6, § 17-1101(h), created by H.B. 142, 145th Delaware General Assembly; and DEL. CODE ANN. tit. 6, § 18-1101(h), created by S.B. 82, 145th Delaware General Assembly. These amendments were in Delaware adopted to address the ambiguity identified in *Twin Bridges L.P. v. Draper*, 2007 WL 2744609 (Del. Ch. Sept. 14, 2007).

question whether such is the correct rule,[66] a different rule of construction may be provided for in the controlling documents.[67]

[7.1.9] The LLC as a Party to the Operating Agreement

The LLC, as a legal entity, is bound by and a party to the operating agreement.[68]

[7.2] The Member-Managed Versus Manager-Managed Election

[7.2.1] A Positive Law Election

Whether an LLC is "member-managed" or "manager-managed" is determined exclusively by reference to the option elected in the Articles of Organization; every Kentucky LLC must state that it is one or the other.[69] As such, the determination of whether the LLC is one or the other is not made by a substantive review of the inter-se management structure defined in the operating agreement. Rather:

See Peter J. Walsh, Jr. & Dominick T. Gattuso, *Delaware LLCs: The Wave of the Future and Advising Your Clients About What to Expect*, 19 BUS. L. TODAY 11 (2009); Steven D. Goldberg, *2009 Delaware LLC Act Amendments* (Apr. 17, 2009), http://blog.delawarellclaw.com/2009/04/2009-delaware-llc-act-amendments/ (last visited April 19, 2010); Louis G. Hering, *Delaware Amends Alternative Entity Statutes*, http://glogs.law.harvard.edu/corpgov/2009/07/31/delaware-amends-alternative-entity-statutes/ (last visited April 19, 2010).

[66] *See, e.g.*, D. Gordon Smith, *Independent Legal Significance, Good Faith, and the Interpretation of Venture Capital Contracts*, 40 WILLIAMETTE L. REV. 825 at notes 22-24 and accompanying text (2004).

[67] *See* KY. REV. STAT. ANN. § 275.003(1) ("It shall be the policy of the Commonwealth through this chapter to give maximum effect to the principles of freedom of contract and the enforceability of operating agreements."); *see also id.* § 362.1-104(3) ("Subject to KRS 362.1-103(2), it shall be the policy of the Commonwealth through this subchapter to give maximum effect to the principles of freedom of contract and the enforceability of partnership agreements."); *id.* § 362.2-107(3) ("Subject to KRS 362.2-110(2), it shall be the public policy of the Commonwealth in this subchapter to give maximum effect to the principles of freedom of contract and the enforceability of partnership agreements.").

[68] *See* KY. REV. STAT. ANN. § 275.003(4). There are cases from other jurisdictions to the effect that the LLC is not itself a party to and therefore able to enforce the terms of the operating agreement. *See, e.g.*, *Bubbles & Bleach, LLC v. Becker*, 1997 WL 285938 (N.D. Ill. 1997); *Trover v. 419 OCR, Inc.*, 921 N.E.2d 1249 (Ill. App. 5 Dist. 2010). Consequent to the express contrary statement in the Kentucky LLC Act, those cases are not in Kentucky good law. *See also Pannell v. Shannon*, 425 S.W.3d 58 at 79, 80 (Ky. 2014):

> 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.

[69] *See* KY. REV. STAT. ANN. § 275.025(1)(d). Other LLC Acts, including that of Delaware, and the Revised Prototype Limited Liability Company Act, do not utilize this distinction. *See also* Thomas E. Rutledge and Steven G. Frost, *The Fortunate Consequences (and Continuing Questions) of Distinguishing Apparent Agency and Decisional Authority*, 64 BUS. LAW. 37 (Nov. 2008).

> Irrespective of the provisions of the operating agreement, whether an LLC is 'manager-managed,' as that phrase is used in the Act, depends on whether the articles of organization so provide.[70]

By way of example, if the articles provide that the LLC is member-managed, but the operating agreement designates a member as the "managing member," the "manager" or the "president," the LLC remains member-managed, and the LLC lacks a manager as that term is utilized in the LLC Act. Consequently, certain statutes that impose liability upon a manager but not a member[71] are inapplicable in a member-managed LLC, even one in which one or more members are denominated "managers."

As the Articles of Organization require a declaration of whether the LLC will be managed by managers or by the members, and the terms and provisions of the Articles of Organization are of public record, all parties dealing with the LLC may ascertain and are deemed to have notice of the election made by the LLC.[72]

[7.2.2] Effects of the Member-Managed Versus Manager-Managed Election

There follows from the election to be either member- or manager-managed a number of consequences, some of which may be in turn modified in the operating agreement while others may not.

Election to be Member-Managed	***Election to be Manager-Managed***
Any member may execute a document on behalf of the LLC to be delivered to the SoS for filing.[73]	Only a manager may execute a document on behalf of the LLC to be delivered to the SoS for filing.[74]
All management decisions will be made by the members.[75]	All management decisions except matters reserved to the members will be made by the managers.[76]

[70] PROTOTYPE LLC ACT (1992) § 401, comment ("Irrespective of the provisions in the operating agreement, whether an LLC is 'manager-managed,' as that phrase is used in the Act, depends on whether the articles of organization so provide."). The Kentucky Supreme Court, in *Pannell v. Shannon*, 425 S.W.3d 58 (Ky. March 20, 2014), suffered a small foot-fault as to the positive law nature of the member- versus manager-managed election. The Court suggested that the determination of whether the LLC is member or manager managed is determined by a factual assessment of the management structure employed. *See* 425 S.W.3d at 76, n. 17. While clearly dicta, the suggestion of a substantive review of the structure to assess the application of KRS § 275.135 was incorrect.

[71] *See, e.g.*, KY. REV. STAT. ANN. § 136.638.

[72] KY. REV. STAT. ANN. § 275.025(7)(b). *See also* Rutledge, *The 2007 Amendments to Kentucky Business Entity Statutes*, 97 KY. L.J. 229, 244 (2008-09). Only certain information in the Articles is deemed by filing to be notice to third-parties. *See* KY. REV. STAT. ANN. § 275.025(7).

[73] KY. REV. STAT. ANN. § 275.045(6)(a).

[74] KY. REV. STAT. ANN. § 275.045(6)(b).

[75] KY. REV. STAT. ANN. § 275.165(1).

[76] KY. REV. STAT. ANN. § 275.165(2).

Each member has apparent agency authority on behalf of the LLC.[77]	Each manager has apparent agency authority on behalf of the LLC and members *qua* members have no agency authority.[78]
Each member owes a duty of care to the LLC and each other member.[79]	Each manager owes a duty of care to the LLC and each member, and members *qua* members are not bound by the statutory duty of care.[80]
Each member owes a duty of loyalty to the LLC.[81]	Each manager owes a duty of loyalty to the LLC, and members *qua* members are not bound by the statutory duty of loyalty.[82]
Notice to a member is notice to the LLC.[83]	Notice to a manager is notice to the LLC and notice to a member *qua* member is not notice to the LLC.[84]
A statement or representation by a member as to the business and affairs of the LLC is binding on the LLC.[85]	A statement or representation by a manager as to the business and affairs of the LLC is binding on the LLC and a statement by a member *qua* member is not binding.[86]

[7.2.3] Modifying the Consequences of the Election

Only certain of these consequences of the member- versus manager-managed election are subject to contrary ordering in the operating agreement. For example, while the operating agreement of a member-managed LLC may restrict or eliminate the actual authority of a member, as to a third-party without knowledge of those limitations the member may bind the LLC on a transaction in the LLC's ordinary business and affairs.[87] Likewise the rules on the

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[77] KY. REV. STAT. ANN. § 275.135(1).

[78] KY. REV. STAT. ANN. § 275.135(2).

[79] KY. REV. STAT. ANN. § 275.170(1).

[80] KY. REV. STAT. ANN. § 275.170(1); *id*. § 275.170(4).

[81] KY. REV. STAT. ANN. § 275.170(2).

[82] KY. REV. STAT. ANN. § 275.170(2); *id*. § 275.170(4).

[83] KY. REV. STAT. ANN. § 275.145(1). *See also Lopes v. Jetsetdc, LLC*, 994 F. Supp.2d 135, (D. D.C. 2014) (service of complaint upon LLC's member who was not the registered agent held sufficient).

[84] KY. REV. STAT. ANN. § 275.145(2).

[85] KY. REV. STAT. ANN. § 275.140(1).

[86] KY. REV. STAT. ANN. § 275.140(2).

[87] KY. REV. STAT. ANN. § 275.135(1). A statement in the articles of organization limiting the apparent agency authority of a member or a manager will not, simply by filing and being of public record, be effective. Rather, while those limitations may be in the articles of organization (*see* KY. REV. STAT. ANN. § 275.025(4)), those limitations are not of themselves notice. *See* KY. REV. STAT. ANN. § 275.025(7)(b). *Contrast Zions Gate R.V. Resort, LLC v. Oliphant*, 326

binding nature of statements made and notice given are not subject to contrary private ordering absent actual notice to the third-party. Conversely, the rule allocating inter-se managerial authority to the managers of a manager-managed LLC is clearly subject to contrary private ordering.[88] There is the flexibility, in a manager-managed LLC, to deprive the "manager" of any inter-se decisional authority, reserving all decisions to the members or providing an alternative mechanism for decision making. A manager-managed LLC may go so far as not electing a manager. By doing so there is no person with the capacity to speak for or bind the LLC except pursuant to actual authority granted by the members.

[7.2.4] Actual Agents

The default rules that follow from the member-managed or manager-managed election relate exclusively to apparent agency authority.[89] Actual agency on behalf of the LLC will come about consequent to an express delegation of authority,[90] and actual authority to bind the LLC need not be restricted by the member- or manager-managed election. As observed in the comments to § 301 of the Prototype LLC Act:

> This section is not intended to preclude an LLC from authorizing any person, including a member in a manager-managed LLC or a non-member in either kind of LLC, to act as an agent, just as a corporation can designate a shareholder or third party to serve in an agency capacity.

Third-parties are deemed to be on notice of whether the LLC has elected to be member- or manager-managed.[91] If a third-party were to accept, in reliance upon apparent agency authority, a contract on behalf of an LLC signed by a member where the public record shows the LLC to be manager-managed, the third-party may not be able to hold the LLC liable on that agreement. Minimal due diligence of the public record is appropriate with respect to all transactions involving LLCs.

While it is a "best practice" that the signature block of the agreement describe the representational capacity of the signatory (*e.g.*, "By John Doe, Member, on behalf of ABC,

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P.3d 118 (Utah App. May 1, 2014) (applying Utah statute and giving effect to limitations upon authority set forth in articles of organization). Whether a third-party in a foreign state would be bound by the limitations on actual authority of record in Utah is a choice of law position not yet directly addressed. *See also generally* Deborah A. DeMott, *Agency in the alternatives: common-law perspectives on binding the firm*, in RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS (Robert W. Hillman and Mark J. Loewenstein eds.) (Edward Elgar Publishing, 2015).

[88] *See* KY. REV. STAT. ANN. § 275.165(2) ("[E]xcept to the extent otherwise provided in the articles of organization, the operating agreement...").

[89] *See also* RESTATEMENT (THIRD) OF THE LAW OF AGENCY § 2.03 (defining apparent agency).

[90] *See also* RESTATEMENT (THIRD) OF THE LAW OF AGENCY § 2.01 (defining actual authority).

[91] KY. REV. STAT. ANN. § 275.025(7)(b).

LLC"), a facts and circumstances review of the entirety of the agreement will determine who are the contracting parties to the agreement.[92]

Regardless of whether such is committed by a member or manager, an act that is not apparently for the carrying on in the usual business or the affairs of the LLC will not, without specific authorization, bind the LLC.[93] An action undertaken by an apparent agent that exceeds the agent's actual authority exposes the agent to liability on the obligation created.[94]

[7.3] Becoming a Member

Owners of an LLC are denominated "members."[95] Membership in an LLC is open to individuals, corporations, general and limited partnerships, other LLCs, trusts, estates, associations, and any other entities.[96] As such, membership in an LLC is open to a substantially larger group of potential owners than may qualify as shareholders in an S Corporation.[97]

It is important to distinguish "members" from "assignees." The former has a direct interest in the LLC by means of a limited liability company interest, that being an intangible interest.[98] An assignee has only a contractual right vis-à-vis what is or was a limited liability company interest, those rights being typically derivative from and through the assignor.[99]

[7.3.1] Becoming a Member at the Time of Formation

A person may become a member at the time of the LLC's formation, typically by making a contribution and executing a copy of the operating agreement.[100]

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[92] *See, e.g.*, *Pannell v. Shannon*, 425 S.W.3d 58, 64 (Ky. March 20, 2014) ("As for the claim that Shannon did not include her title or otherwise indicate her representative capacity along with her signature, it is worth noting that her signature line was preceded by the word "By," which indicates that the signature is in a representative capacity.). *See also* 7 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 3032 (rev. vol. 2012) (noting that a representative signature is ideally 'preceded by the word 'For' or 'By' or some equivalent'."); *Evans v. Campbell*, No 2012-CA-000080-MR (Ky. App. Feb. 15, 2013) (while signature block was silent as to representational capacity and did not identify the corporation, the agreement provided that the plaintiff would be employed "by the corporation" and that it would be responsible for the employee's compensation and benefits).

[93] KY. REV. STAT. ANN. § 275.135(3).

[94] *See* KY. REV. STAT. ANN. § 275.095 ("All persons … who assume to act for an [LLC] without authority to do so, shall be jointly and severally liable for all liabilities created while so acting."); *see also* RESTATEMENT (Third) OF AGENCY § 6.10 (2006).

[95] KY. REV. STAT. ANN. § 275.015(12).

[96] KY. REV. STAT. ANN. §§ 275.015(12), (14).

[97] This statement remains true even after the Small Business Job Protection Act of 1996, which substantially liberalized the rules regarding permissible shareholders of an S Corporation.

[98] *See* KY. REV. STAT. ANN. § 275.250.

[99] See KY. REV. STAT. ANN. § 275.255(1)(b); *id.* § 275.255(1)(c).

[100] *See* KY. REV. STAT. ANN. § 275.275(1)(a); *id.* § 275.275(2)(a). Note, however, that a member's signature on the operating agreement is not by statute required for member status.

[7.3.2] Becoming a Member by Merger or Conversion

A person may become a member by having been an owner in an entity that has merged or which has converted into an LLC.[101] A person who by merger or conversion becomes a member is bound by any written operating agreement provided for in the plan of merger or the plan of conversion.[102]

[7.3.3] Becoming a Member as the Successor of the Last Member

Pursuant to an amendment to the LLC Act made in 2007, the successor to the last member may unilaterally appoint themselves to member status.[103]

An LLC must have at least one member.[104] Prior to the 2007 amendments, the KyLLCA was silent as to what occurs when a single member LLC ceases to have a member such as upon the death of an individual member or the termination of an entity member.[105] The addition of subsection (4) to KRS § 275.285 addresses this situation.[106] 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.

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[101] *See* KY. REV. STAT. ANN. § 275.365(11) (merger); *id*. § 275.375(2)(d) (conversion); *id*. § 275.377(2)(d) (conversion).

[102] *See* KY. REV. STAT. ANN. § 275.365(11); *id*. § 275.375(2)(d); *id*. § 275.377(2)(d).

[103] *See* KY. REV. STAT. ANN. § 275.285(4)(b); *see also* Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, 97 KY. L.J. 229, 245-46 (2008-09).

[104] 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." REV. UNIF. LTD. LIAB. CO. ACT § 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 VA. L. & BUS. REV. 35, 40-42 (Spring 2008)) and most if not all of the states that have to date adopted RULLCA did not adopt the "Shelf LLC" provisions.

[105] This provision is not limited to what were originally conceptualized as single member LLCs. For example, assume that LLC was organized with members A and B, both natural persons. A dies, and while her estate becomes an assignee of her membership interest, the estate is not admitted by B as a member. KY. REV. STAT. ANN. § 275.280(1)(f)1. The LLC now has a single member, namely B, and new KRS § 275.285(3) may apply upon her dissociation.

[106] A further revision to the introductory language of this provision made in 2007 clarifies the two step process of dissolution and winding up. *See also* Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, 97 KY. L.J. 229, 245-46 (2008-09).

Prior to these amendments, 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.[107] 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 small LLC, member-managed, with a single piece of realty.[108] 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 apparent authority to execute the deed and cause the transfer of the realty.[5] 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 has the capacity to elect themselves to membership and continue the operation of the LLC.

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 heir is an assignee, not 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.

It should be expected that careful compliance with the statutory requirements will be required of the successors.[109]

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.[110]

[7.3.4] Becoming a Member by Contributing to an Existing LLC

A person may join an existing LLC as a member, typically by making a capital contribution thereto. That contribution and admission will be in accordance with the existing operating agreement or in the absence thereof with the approval of all incumbent members.[111]

[7.3.5] Becoming a Member by Admission of an Assignee

A person who is an assignee of a member may become a member either in accordance with the terms of a written operating agreement or with the approval of a majority-in-interest of

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[107] *See* KY. REV. STAT. ANN. § 275.265(1); *see also* Matthew Arnold, *Stanzas From the Grand Chartreuse* ("Wandering between two worlds, one dead, the other powerless to be born.")

[108] KY. REV. STAT. ANN. § 275.135(1); *id.* § 275.245(1); *id.* § 275.255(1)(c).

[109] *See, e.g., L. B. Whitfield, III Family LLC v. Whitfield*, 150 So.3d 171, 2014 WL 803363 (Ala. 2014).

[110] The 2007 amendments do not contain any "grandfather" provisions. Consequently, there does exist some question as to whether new provisions, such as new KRS § 275.285(4), apply to LLCs formed prior to its effective date.

[111] *See* KY. REV. STAT. ANN. § 275.275(1)(a).

the members.[112] The action of the incumbent members to admit an assignee as a member is subject to the requirement that it be in writing, dated, and signed by the requisite members.[113] Unless the written operating agreement provides a contrary rule, the assignor does not vote as to whether the assignee shall be admitted as a member.[114]

[7.3.6] Non-Member Members

Generally speaking, a "member" holds a limited liability company interest. It is possible, however, to be a member without holding such an interest.[115] As amended in 2007, the LLC Act permits a person to be admitted as a member even though they do not hold an interest in the LLC.[116] This provision addresses typically highly lawyered transactions. By way of example, it is not uncommon for loan documents to provide that no amendments will be made to the operating agreement without the lender's consent. If this covenant is violated the lender has such rights as are provided for by contract. At the same time, all else being equal, the operating agreement has been modified. Alternatively, if the operating agreement provides that the lender is a member in the LLC but holding no economic rights consequent to that status, and as well provides that the approval of all members is required to amend the operating agreement, then absent the lender's consent no amendment may be effected. This capability also has application in estate planning as a means of avoiding the "applicable restriction" limitations of Code § 2704.

[7.3.7] The Effective Date of Admission

The admission of a member to an LLC is effective on the latter of the date of formation of the LLC or at such time as provided in the operating agreement.[117] If the operating agreement does not contain a provision relating to when a new member is admitted, the admission is effective when it is reflected in the records of the LLC.[118]

[7.3.8] Resigning as a Member

Under the LLC Act as adopted in 1994, a member had the right to unilaterally resign from the LLC.[119] A member's resignation (a dissociation) effected the dissolution of the

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[112] *See* KY. REV. STAT. ANN. § 275.275(1)(b); *id.* § 275.265(1).

[113] KY. REV. STAT. ANN. § 275.265(1).

[114] KY. REV. STAT. ANN. § 275.265(1). *See also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383, 415-16 (2011).

[115] The statement by the Kentucky Supreme Court in *Spurlock v. Begley*, 308 S.W.3d 657, 661 (Ky. 2010) to the effect that ownership of and membership in an LLC are synonymous (citing this author in support) was incorrect. While the statement was true as of the time of the cited article, the Court's decision failed to account for subsequent changes in the statute as here discussed.

[116] *See* KY. REV. STAT. ANN. § 275.195(3); *see also* Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, 97 KY. L.J. 229, 259 (2008-09) .

[117] KY. REV. STAT. ANN. §§ 275.275(2)(a)-(b).

[118] KY. REV. STAT. ANN. § 275.275(2)(b).

[119] *See* KY. REV. STAT. ANN. § 275.280(3) as adopted 1994 Ky. Acts, ch. 389, § 56 and prior to amendment by 1998 Ky. Acts, ch. 341, § 37; *see also* Thomas E. Rutledge & Lady E. Booth, *The Limited Liability*

company.[120] If the LLC was otherwise continued by the other members, the resigning member was entitled to a liquidating distribution of the fair value of the resigning member's interest in the LLC.[121]

In 1998, the provision allowing a member to unilaterally withdraw from an LLC was deleted from the Kentucky LLC Act, and replaced with the following:

> Unless otherwise provided in a written operating agreement, a member has no right to withdraw from a [LLC]. If the written operating agreement does not specify a time a member may withdraw, a member shall not withdraw without the consent of all other members remaining at the time.[122]

At the same time there was deleted the provision directing that upon dissociation a member would receive the fair value of their interest.[123] Accordingly, after 1998, a member does not have the right to withdraw from a Kentucky LLC unless such a right is set forth in a written operating agreement or, at the time resignation is desired, all of the other members consent.[124] Further, even if resignation is permitted, there is no right to a liquidating distribution of the former member's interest in the LLC. Of course the subject operating agreement could provide for both a right to resign and a right to a liquidating distribution. The point is that they are distinct rights, and the right of resignation does not of itself imply or confer a right to a liquidating distribution.

Company Act: Understanding Kentucky's New Organizational Option, 83 KY. L.J. 1, 36 (1994-95); PROTOTYPE LLC ACT (1992) § 802(C).

[120] *See* KY. REV. STAT. ANN. § 275.285(3) as adopted by 1994 Ky. Acts., ch. 389, § 57 and prior to amendment by 1998 Ky. Acts., ch. 341, § 38; *see also* PROTOTYPE LLC ACT (1992) § 901(C). This treatment was consistent with the predecessor partnership law. *See* UNIF. P'SHIP. ACT § 31, 6 U.L.A. 370 (2001); KY. REV. STAT. ANN. § 362.300; *see also* ALAN R. BROMBERG, CRANE AND BROMBERG ON PARTNERSHIP §§ 74(b), 86(c) (1968).

[121] *See* KY. REV. STAT. ANN. § 275.215 as adopted by 1994 Ky. Acts, ch. 389, § 43 (repealed 1998 Ky. Acts, ch. 341, § 59); *see also* PROTOTYPE LLC ACT (1992) § 602.

[122] KY. REV. STAT. ANN. § 275.280(3) as amended by 1998 Ky. Acts, ch. 341, § 37.

[123] *See* 1998 Ky. Acts, ch. 341, § 59 (repealing KRS § 275.215).

[124] A written operating agreement may provide a threshold other than all of the members to approve, on a case-by-case basis, a resignation. These changes in the law caused LLCs organized in Kentucky to have, absent contrary private ordering, what has been described as "affirmative asset partitioning" or "capital lock-in." *See* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 393-94 (2000); Lynn A. Stout, Symposium, *Uncorporation: A New Age?: On the Nature of Corporations*, 2005 U. ILL. L. REV. 253. It has been observed that:

> The majoritorian character is reinforced by the corporation's potential for perpetual duration. Until the majority decides otherwise, the entity can keep a minority investor's money. This stability permits reliable planning in a way that is simply not possible if the enterprise must deploy its assets to insure that it is able to redeem the assets of an investor who wants to depart.

Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 6 (1995) (citing Robert W. Hillman, *The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations*, 67 MINN. L. REV. 1, 74 (1982)).

In 2010[125] the statute was revised to provide that unless a contrary rule is set forth in a written operating agreement, a member in a member-managed LLC[126] may resign on thirty days' notice.[127] In a manager-managed LLC the 1998 rule remains in place; there is no right of resignation except and unless set forth in a written operating agreement or unless the resignation is approved by all other members.[128] Absent contrary private ordering,[129] a member who has resigned is treated as his or her own assignee, having only the rights of an assignee;[130] a resigning member is not entitled to a liquidating redemption of the member's LLC interest.

The basis for the change made in 2010 is the law of fiduciary obligations as they exists in LLCs.

Directors and officers of a corporation are fiduciaries to the corporation;[131] absent truly extraordinary circumstances, they have a unilateral power to resign from those positions and thereby terminate their ongoing fiduciary obligations.[132] General partners in a general or a limited partnership are fiduciaries[133] (as well as mutual agents) of the partnership and the other partners; they enjoy a unilateral power to resign as general partners and thereby terminate their ongoing fiduciary obligations.[134] Shareholders, qua shareholders, are not fiduciaries either to the corporation or to the other shareholders[135] and have no right to resign. Absent extraordinary

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[125] *See also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383, 399-403 (2011).

[126] Whether the LLC in question is member- or manager-managed is a question of positive law determined by reference to the statement made in the articles of organization. *See* KY. REV. STAT. ANN. § 275.025(1)(d); *see also* PROTOTYPE LLC ACT (1992) § 401, comment.

[127] KY. REV. STAT. ANN. § 275.280(3)(a).

[128] KY. REV. STAT. ANN. § 275.280(3)(b). A written operating agreement may provide a threshold other than all of the members to approve, on a case by case basis, a resignation.

[129] *See also* Rutledge, *You Just Resigned – Now What? Different Paradigms for Withdrawing From a Venture*, J. PASSTHROUGH ENTITIES, Nov./Dec. 2009, 43; Rutledge, *Chapman v. Regional Radiology Associates, PLLC: A Case Study in the Consequences of Resignation*, 100 KY. L.J. ONLINE 15 (2011).

[130] *See* KY. REV. STAT. ANN. § 275.255(1)(b); *id.* § 275.255(1)(c); *see also id.* § 275.280(1)(c)3.

[131] *See, e.g.*, MODEL BUS. CORP. ACT §§ 8.30(a), 8.42(a)(3); KY. REV. STAT. ANN. § 271B.8-300(1)(c); *id.* § 271B.8-420(1)(c).

[132] *See, e.g.*, 1 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 345.

[133] *See, e.g.*, UPA § 21, 6 U.L.A. 194 (2001); KY. REV. STAT. ANN. § 362.250; RUPA § 404, 6 U.L.A. 143 (2001); KY. REV. STAT. ANN. § 362.1-404; DEL. CODE ANN. tit. 6, §§ 15-404(b), (c); ULPA § 408, 6A U.L.A. 439 (2008); KY. REV. STAT. ANN. § 362.2-408.

[134] *See, e.g.*, UPA § 31(1)(b), 6 U.L.A. 370 (2001); KY. REV. STAT. ANN. § 362.300(1)(b); RUPA § 601(a), 6 U.L.A. 163 (2001); KY. REV. STAT. ANN. § 362.1-601(1); DEL. CODE ANN. tit. 6, § 15-601(i); IND. CODE § 23-16-7-2.

[135] The inter-shareholder fiduciary obligation principles of cases following from *Donahue v. Rodd Electrotype Co. of New England*, 328 N.E.2d 505 (1975), and section 7.01(d) of the Principles of Corporate Governance are exceptional, aberrational, analytically flawed and inconsistent with Kentucky law. *See also* Rutledge, *Shareholders Are Not Fiduciaries – A Positive and Normative Analysis of Kentucky Law*, 51 LOU. L. REV. 535 (2012-13); Rutledge, *Minority Shareholder Oppression? – The Problem is Not With the Answer But Rather*

circumstances, limited partners in a limited partnership are not fiduciaries.[136] While certain statutes have afforded them the power to resign,[137] this power is based upon economics and not fiduciary law. Therefore, the general rule is that fiduciaries have the power to unilaterally withdraw from the office giving rise to the fiduciary obligations and thereby prospectively terminate those obligations.

The situation in Kentucky LLCs, after the 1998 amendments eliminating a member's right to resign from the LLC, were substantially different. Members in a member-managed LLC owe fiduciary obligations to either the LLC and the other members or at least to the LLC.[138] While in a manager-managed LLC, the members, qua members, do not *ab initio* have fiduciary obligations to either the LLC or the other members,[139] such obligations can arise by private ordering. What was atypical vis-à-vis other forms of organization is that members, qua members and as fiduciaries, did not have the unilateral power to terminate the position giving rise to those fiduciary obligations unless so provided in a written operating agreement. Absent a provision addressing the power to resign in a written operating agreement, a member desiring to resign from the LLC was at the mercy of the other members in order to be able to do so. Consider the case of a member in a plumbing repair company organized as a member-managed LLC. That member would like to resign and set up his own plumbing company (where, as we know, he will make far more money than he would as an attorney). As a member, he owes a fiduciary duty of loyalty to the LLC,[140] and is therefore precluded from competing with the LLC. Assume the subject operating agreement is silent as to resignation. Therefore, that member is at the mercy of

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With The Question, J. PASSTHROUGH ENTITIES, July/Aug. 2014, 55; Rutledge, *More Evidence that Kentucky Does Not Recognize Fiduciary Duties among Shareholders* (march 20, 2013), *available at* http://kentuckybusinessentitylaw.blogspot.com/search?q=1946.

[136] *See also* KY. REV. STAT. ANN. § 362.2-305(1).

[137] *See, e.g.*, UNIF. LTD. PART. ACT § 603, 6B U.L.A. 286 (2008); IND. CODE. § 23-16-7-3.

[138] KY. REV. STAT. ANN. § 275.170(1) (duty of care obligations in an LLC are owed by members, absent private ordering to the contrary, to both the LLC and the other members); *id.* § 275.170(2) (duty of loyalty obligations of members in an LLC, absent private ordering to the contrary, are owed to the LLC); REV. UNIF. LTD. LIAB. CO. ACT § 409(b), 6B U.L.A. 488 (2008) (member's duty of loyalty); *id.* § 409(c), 6B U.L.A. 489 (2008) (member's duty of loyalty).

[139] KY. REV. STAT. ANN. § 275.170(4). This provision was applied by the Delaware Chancery Court in *Xcell Energy and Coal Co., LLC v. Energy Investment Group, LLC*, C.A. No. 8652-VCN, 2014 WL 2964076 (Del. Ch. June 30, 2014). The Revised Uniform LLC Act contains a similar provision. *See* REV. UNIF. LTD. LIAB. ACT § 409(g)(1), 6B U.L.A. 489 (2008). As to the interpretation of foreign provisions equivalent to KRS § 275.170(4), see *Mitchell v. Smith*, 2009 WL 891908 (D. Utah March 31, 2009) ("Because Defendant's Counterclaim relies solely upon Plaintiffs status as members [of the LLC] for the existence of fiduciary duties, and because Utah law prohibits such a finding based solely upon membership, the Court finds that Defendant has failed to state a cause of action upon which relief may be granted."); *Katris v. Carroll*, 842 N.E.2d 221 (Ill. App. 2005); *ULQ, LLC v. Meder*, 666 S.E.2d 713 (Ga. App. 2008); *Ledford v. Smith*, 618 S.E.2d 627 (Ga. App. 2005); *Dragt v. Dragt/DeTray, LLC*, 161 P.3d 473 (Wash. App. 2007). Whether a particular LLC is member-managed or manager-managed is not determined by a substantive review and characterization of the inter-se management structure defined in the operating agreement. Rather, for purposes of KRS § 275.170(4), reference is made to the election made in the articles of organization. *See* KY. REV. STAT. ANN. § 275.025(1)(d). As set forth in the official commentary to the Prototype LLC Act § 401, "Irrespective of the provisions in the operating agreement, whether an LLC is 'manager-managed,' as that phrase is used in the Act, depends on whether the articles of organization so provide."

[140] KY. REV. STAT. ANN. § 275.170(2).

all the other members in the current LLC consenting (or not) to his departure and opening a competing business. If the member, not released as such by the other members, opens the competing venture, then (a) there is a manifest breach of the duty of loyalty and (b) the member is bound to turn over to the LLC all profits and benefits derived from the new venture.[141] Understandably, from the perspective of that member desiring to open his own business, this is not a very tenable situation.

Having reconsidered the matter and the anomaly of a default rule under which a fiduciary may not unilaterally resign,[142] the statute was in 2010 revised[143] to provide that unless a contrary rule is set forth in a written operating agreement, a member in a member-managed LLC[144] may resign on thirty days' notice.[145] In a manager-managed LLC the old rule remains in place; there is no right of resignation except and unless set forth in a written operating agreement or as approved by all other members.[146] Absent contrary private ordering,[147] a member who has resigned is treated as his or her own assignee, having only the rights of an assignee.[148] While the addition (readoption) of a right of withdrawal of a member in a member-managed LLC will to some degree limit the utility of that structure for estate planning purposes, any actual impact upon valuation discounts should be minimal in that: (a) upon resignation the former member becomes an assignee of his or her own membership interest having, consequently, the same (and no greater) economic rights as before the resignation;[149] (b) there is no right to liquidate the interest (*i.e.*, capital lock-in is retained); and (c) the impact of the change can be entirely avoided by utilizing a manger-managed, rather than a member-managed, LLC.

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[141] *Id.*

[142] *Ti iv Xapvfion exvvyctiv xi) EicOlv repik-zeaov* ("Having escaped Charybdis I fell into Scylla"); ERASMUS OF ROTTERDAM, THE ADAGES OF ERASMUS 83-84 (ed. William Barker) (University of Toronto Press 2001).

[143] *See also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383, 399-402 (2011).

[144] Whether the LLC in question is member- or manager-managed is a question of positive law determined by reference to the statement made in the articles of organization. *See* KY. REV. STAT. ANN. § 275.025(1)(d); *see also* PROTOTYPE LLC ACT (1992), § 401, comment.

[145] KY. REV. STAT. ANN. § 275.280(3)(a), created by 2010 Acts, ch. 133, § 37.

[146] KY. REV. STAT. ANN. § 275.280(3)(b), created by 2010 Acts, ch. 133, § 37.

[147] *See also* Rutledge, *You Just Resigned — Now What? Different Paradigms for Withdrawing From a Venture*, J. PASSTHROUGH ENTITIES, Nov./Dec. 2009, 43.

[148] *See* KY. REV. STAT. ANN. § 275.255(1)(b); *id*. § 275.255(1)(c); *see also id*. § 275.280(1)(c)3. *Accord* OHIO CODE § 1705.12 ("[T]he withdrawing member shall be treated as if the member were an assignee of all of the member's membership interests as of the date of withdrawal."); *see also* Rutledge, *You Just Resigned – Now What? Different Paradigms for Withdrawing From a Venture*, J. PASSTHROUGH ENTITIES, Nov./Dec. 2009, 43, 44-46; Rutledge, *Assigning Membership Interests: Consequences to the Assignor and Assignee*, J. PASSTHROUGH ENTITIES, July/Aug. 2009, 36-38; Rutledge, *Chapman v. Regional Radiology Associates, PLLC: A Case Study in the Consequences of Resignation*, 100 KY. L.J. ONLINE 15 (2011).

[149] *See* KY. REV. STAT. ANN. § 275.255(1)(b).

It needs to be emphasized that Kentucky's treatment of member resignations is unique at least as far as the distinctions in the right to resign vis-à-vis the election to be member- or manager-managed.[150]

[7.3.9] Ambiguities as to the Assignment of Interest

The LLC Act is clear that absent either a contrary provisions in a written operating agreement of the consent of a majority-in-interest of the members other than the assignor, the assignee of an LLC interest may not exercise the management rights of a member.[151] Assuming it is not a SMLLC, upon the assignment of all economic interest in the venture the assignor continues as a member with management rights, but the assignor member may be dissociated from the LLC by the vote of a majority-in-interest of the other members, whereupon the assignor member loses the prospective right to participate in management.[152]

At least a quartet of ambiguities exist under the statutory formula:

- if an assignment is to one who is already a member, does that member come into economic and voting rights vis-à-vis the transferred interest?;

- what is "all" of an LLC interest?;

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[150] As adopted in 1992, the Delaware LLC Act afforded a member the unilateral right to withdraw upon six months prior written notice, whereupon the former member is/was to receive the fair value of their interest in the company. DEL. CODE ANN. tit. 6, §§ 18-603, 18-604 (both as prior to 1996 amendments). Although not retroactive to LLCs formed prior to the 1996 amendments (DEL. CODE ANN. tit. 6, § 18-603), from July 31, 1996 a member of a Delaware LLC does not have a right to resign unless so provided in the operating agreement. *Id.* If resignation is permitted, absent private ordering to the contrary, the member has a right to be redeemed by the company for fair value. DEL. CODE ANN. tit. 6, § 18-604.

The Revised Uniform Limited Liability Company Act ("RULLCA") provides a default rule that a member may withdraw from the LLC. *See* REV. UNIF. LTD. LIAB. CO. ACT § 601(a), 6B U.L.A. 502 (2008); *see also id.* § 602(1), 6B U.L.A. 502 (2008). Not being referred in RULLCA § 110, these provisions may be freely modified by private ordering. A dissociation by resignation will be rightful or wrongful (a wrongful dissolution is defined in RULLCA § 601(b), 6B U.L.A. 502 (2008)), and if wrongful the disassociated member is liable to the company and in certain instances the other members for the damages caused thereby. *See* REV. UNIF. LTD. LIAB. CO. ACT § 601(c), 6B U.L.A. 502 (2008). *Accord* REV. UNIF. PART. ACT § 602(c), 6 U.L.A. 169 (2001). Upon resignation, the resigning member is a transferee of his or her own transferable interest (*see* RULLCA § 603(a)(3), 6B U.L.A. 504 (2008)), and on a prospective basis fiduciary duties owed as a member (*see* RULLCA § 603(a)(2), 6B U.L.A. 504 (2008)) and the right to participate in the LLC's management are terminated. *See* RULLCA § 603(a)(1), 6B U.L.A. 504 (2008).

Under the Revised Prototype LLC Act, a member has the power to resign from the LLC unless restricted by the operating agreement. *See* REV. PROTOTYPE LLC ACT § 602(a), 67 BUS. LAW. 117, 169 (Nov. 2011). A member who has so resigned is treated as an assignee of their own interest in the LLC. *Id.* § 603(a), 67 BUS. LAW. at 171.

[151] *See* KY. REV. STAT. ANN. § 275.265(1). In 2010, the LLC Act was amended to provide that the assignor member does not vote on the admission of the assignee as a member. *See* 2010 Ky. Acts, ch. 133, § 36; *see also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383, 415-16 (2011).

[152] If the LLC is a SMLLC, and the incumbent member assigns his or her entire interest in the LLC, that incumbent member is automatically dissociated. KY. REV. STAT. ANN. § 275.280(1)(c)(3). The assignee is not, however, automatically admitted as a member. *See also id.* § 275.280(5); *id.* § 275.265(1).

- on what basis is the vote of a partial assignor determined?; and
- on what basis are the distributional, allocation and voting rights of a assignee determined?

[7.3.9.1] Assignment to a Current Member

With respect to the assignment of an interest to one who is already a member, the statute simple does not provide a clear answer. For example, KRS § 275.265(1) addresses how an assignee may become a member; it fails to contemplate the situation of an assignee who is already a member.

There are two paradigms for considering the problem. Under the first, the member may be treated as a member as to that portion of the limited liability company interests for which the member has been admitted as a member, holding any balance as an assignee. Alternatively, the person may be treated as a member as to any limited liability company interests held by that person.

No Kentucky court has yet reviewed this question. In the only comprehension review of the point by a court outside of Kentucky, it was determined that a member-assignee would be a member as to those interests received by assignment.[153] Still, focusing upon the Kentucky LLC Act, a transfer of a limited liability company interest to an incumbent member should not vest in the assignee the rights of a member vis-á-vis the assigned interest. Under the LLC Act, the assignment of an interest is simply the condition precedent for the termination of the assignor's rights as a member.[154] If assignment of the interest does not of itself terminate the assignor's position as a member, but an assignment to an incumbent member does vest in the assignee all rights including management rights with respect thereto, then either (i) the interests is being called upon to afford management rights to both the assignor and the assignee simultaneously or (ii) the inter-member assignment has a legal effect at odds with the express terms of the LLC Act. Initially, a single limited liability interest cannot vest in both the assignor and the assignee management rights. Second, where dissociation consequent to an assignment requires as well a second step of action by the other members,[155] an assignment to an incumbent member should not be interpreted as vesting in the assignee the management rights related thereto in that to treat an inter-member assignment as effecting the assignor's dissociation would be to add to the statute a rule not set forth therein, namely that "a member is dissociated from the company upon an assignment of the member's limited liability company interest to a person who is already a member."

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[153] *See Blythe v. Bell*, 2012 NCBC 60, 2012 WL 6163118 (Dec. 10, 2012). *See generally* Rutledge, *Interest Assignments Among Members*, J. PASSTHROUGH ENTITIES, 2016 (*forthcoming*).

[154] *See* KY. REV. STAT. ANN. § 275.280(1)(c)2. In contrast, certain acts provide that the assignment of all or substantially all of the interests in the venture effects the assignor's dissociation. *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-702(b)(3) (member disassociated upon transfer of all economic interest in LLC); MONT. CODE § 35-8-803 (member disassociated upon a transfer of all or substantially all economic interests in LLC).

[155] *See* KY. REV. STAT. ANN. § 275.280(1)(c)2.

Under the second option there is increased complexity, namely the necessity of tracking interests for which the holder has been admitted as a member and those for which the holder is a mere assignee. Also, it is questionable whether the status of "member" should relate at all to a particular interest versus another interest, especially as it is possible to be a member without holding an interest in the LLC.[156]

[7.3.9.2] What is "All" of an Interest

The statute as enacted speaks to the assignment by a member of "all" of his or her interest in the LLC even as, while the economic incidents of ownership are freely assignable,[157] the management rights are not.[158] Upon the assignment of all of the interest in the LLC the remaining members may dissociate the assignor member.[159] If, however, there was no assignment of "all" then no right to dissociate arises. Only by reading "all" to refer to the assignable economic rights does the statute make any sense, otherwise KRS § 275.280(1)(c)2 would never be applicable. Still, at least one trial court was confused by the point, holding there had been no assignment of "all" as the assignor retained the non-assignable management rights. In response thereto the statute was revised to provide, *inter alia*, that upon the assignment of all rights that are unilaterally alienable, the assignor member is subject to dissociation.[160]

There is a question as to whether the statute should define the threshold as "all" or "substantially all."[161] Essentially, if an assignment of 100% of the economic rights in the venture triggers a right of dissociation, should not the same effect follow from an assignment of 99.99% of the economic interest? A written operating agreement may provide both for dissociation upon an assignment of "substantially all" interests in the venture and even define "substantially all."

[7.3.9.3] On What Basis Does a Partial Assignor Vote

Assume a simple LLC comprised of members A, B and C; each contributed $1,000 for a one-third interest in the LLC. In accordance with the LLC Act, voting, allocation and distribution rights are in accordance with capital contributed and not returned.[162] B then unilaterally conveys 50% of his limited liability company interest to D, but D is not admitted to the LLC as a member. It is clear that D is entitled to 50% of the distributions that B, but for the

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[156] *See* KY. REV. STAT. ANN. § 275.195(3).

[157] *See* KY. REV. STAT. ANN. § 275.255(1)(b).

[158] *See* KY. REV. STAT. ANN. § 275.255(1)(c). Unlike the modern partnership and limited partnership acts, the LLC Act does not have a defined term for what is under these statutes a "transferable interest" distinct from the "interest in the partnership." *See* KY. REV. STAT. ANN. § 362.1-101(13); *id*. § 362.1-502; *id*. § 362.2-102(26); *id*. § 362.2-702(1).

[159] *See* KY. REV. STAT. ANN. § 275.280(1)(c)2.

[160] *See* KY. REV. STAT. ANN. § 275.280(1)(c)2 as amended by 2012 Ky. Acts, ch. 81, § 109. *See also* Rutledge, *The 2012 Amendments to Kentucky's Business Entity Statutes*, 101 KY. L.J. ONLINE 1, 13 (2012).

[161] *See, e.g.*, MONT. CODE § 35-8-803 (member disassociated upon an assignment of all or substantially all economic interests in LLC).

[162] *See* KY. REV. STAT. ANN. § 275.210.

assignment, would have received.[163] As such, were the LLC dissolved immediately after the assignment, its net proceeds would go as follows:

A 33.33%

B 16.66%

C 33.33%

D 16.66%

But the LLC does not dissolve. Rather, a vote of the members needs to be taken; the matter under consideration requires the consent of a majority-in-interest of the members.[164] Assume that A and B are in favor of the transaction while C is opposed. D's view does not matter; D is an assignee who has no right to participate in the LLC's management.[165] If B, even after the conveyance of half of his economic rights in the LLC, continues to vote with respect to all of his capital contribution made and not returned, then the motion passes with the approval of 66.66% of the LLC interests. Alternatively, if B votes only in proportion to his capital contribution that he has not, on at least a beneficial basis, assigned, then the motion (a) will pass (49.99 out of 83.32 in favor) if the capital base is reduced by the amount that would be distributed to D or (b) will fail (49.99 out of 100 in favor) if the capital base is not reduced by the amount that would be distributed to D. The statute does not tell you which is the correct answer.[166]

[7.3.9.4] On What Basis Are the Distribution, Allocation and Voting Rights of an Assignee Determined

Continuing with the above example of members A, B and C with D as an assignee, assume now that A and C have now approved D's admission as a member.[167] While they executed a dated written instrument admitting D as a member,[168] they did nothing more than that. It now comes time for a member vote. On what basis is D's vote determined? He will assert a 16.66% vote, being one-half of what was previously enjoyed by B. C, for whatever reason,

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[163] *See* KY. REV. STAT. ANN. § 275.255(1)(b).

[164] *See* KY. REV. STAT. ANN. § 275.175(1).

[165] *See* KY. REV. STAT. ANN. § 275.255(1)(c).

[166] *See also* Rutledge, *Allocating Voting and Economic Rights in LLCs: An Invitation to Confusion (Part I)*, J. PASSTHROUGH ENTITIES, Nov./Dec. 2013, 59; *Allocating Voting and Economic Rights in LLCs: An Invitation to Confusion (Part II)*, J. PASSTHROUGH ENTITIES, Mar./April 2014, 61; J. William Callison, *Achaian and interest transfers among existing partners and members*, in RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS (Robert W. Hillman and Mark J. Loewenstein eds.) (Edward Elgar Publishing, 2015).

[167] KY. REV. STAT. ANN. § 275.265(1).

[168] *See* KY. REV. STAT. ANN. § 275.265(1) (unless a different rule is set forth in a written operating agreement, the consent to the admission of an assignee as a member must be in a writing signed and dated by the consenting members).

insists on strict application of the LLC Act as written, and it says that D's voting rights are in proportion to D's capital contributed to and not returned by the LLC.[169] D has never made a capital contribution to the LLC. While the Internal Revenue Code may provide that upon the transfer of an interest in a partnership the transferee succeeds to the transferor's capital account,[170] there is no provision of the LLC Act which provides "upon the assignment of an LLC interest and the admission of the assignee as a member, the assignee succeeds to that portion of the capital contributed by the assignor." This LLC's operating agreement, while written, is silent as to the point. Again, the LLC Act does not address how the point is to be resolved.

Turning from voting rights to allocations and distributions, by statute they are apportioned among the members in proportion to capital contributed.[171] If D is not deemed to have succeeded to one-half of B's capital contribution then D will have a sharing percentage of 0%. While clearly not the intended result, the LLC Act does not provide a contrary rule. The ambiguity will be avoided only if (i) B agreed to assign credit for 50% of his capital contribution to D and (ii) if A and C's consent to D's admission as a member likewise provided that D would receive credit for 50% of B's capital contribution.

This is yet another point that should be addressed in the operating agreement.

[7.3.10] Succession in Single Member LLCs

An LLC must have at least one member.[172] Prior to the 2007 amendments, the KyLLCA was silent as to what occurs when a single member LLC ceases to have a member such as upon the death of an individual member or the termination of an entity member.[173] The addition of

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[169] *See* KY. REV. STAT. ANN. § 275.175(3).

[170] *See* TREAS. REG. § 1.704-1(b)(2)(iv)(l). While an assignee is entitled to the distributions that would otherwise go to the assignor (KY. REV. STAT. ANN. § 275.255(1)(d)), a distribution is a conveyance of what was formerly a company asset to a member. Only after a distribution is declared and payable does a member have a legal claim on that asset. *See* KY. REV. STAT. ANN. § 275.235; *id*. § 275.240(1). A capital contribution is a company asset. *See also* Rutledge, *Allocating Voting and Economic Rights in LLCs: An Invitation to Confusion (Part I)*, J. PASSTHROUGH ENTITIES, Nov./Dec. 2013, 59; *Allocating Voting and Economic Rights in LLCs: An Invitation to Confusion (Part II)*, J. PASSTHROUGH ENTITIES, Mar./April 2014, 61.

[171] *See* KY. REV. STAT. ANN. § 275.205; *id*. § 275.210.

[172] 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." REV. UNIF. LTD. LIAB. CO. ACT § 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 VA. L. & BUS. REV. 35, 40-42 (Spring 2008)) and in most of the states that have to date adopted RULLCA, the "shelf LLC" provisions were not adopted.

[173] This provision is not limited to what were originally conceptualized as single member LLCs. For example, assume that LLC was organized with members A and B, both natural persons. A dies, and while her estate becomes an assignee of her membership interest, the estate is not admitted by B as a member. KY. REV. STAT. ANN. § 275.280(1)(f)1. The LLC now has a single member, namely B, and new KRS § 275.285(3) may apply upon her dissociation.

subsection (4) to KRS § 275.285 addressed this situation.[174] Generally speaking, the LLC will not be dissolved if:

> (1) a succession mechanism set forth in a written operating agreement is satisfied; or
>
> (2) the successor-in-interest of the last remaining member determines to continue the LLC.

Prior to these amendments, the successor to the last member would be an assignee of the member, unable to effect their own admission as a member.[175] While an operating agreement may provide for the admission of a successor as a 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 small LLC, member managed, with a single piece of realty. 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 apparent authority to execute the deed and cause the transfer of the realty.[176] 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.[177] 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.

[7.4] The Rights of a Member

The rights of a member include (but are not limited to):

- to participate in the LLC's management;[178]
- to initiate legal action on behalf of the LLC;[179]

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[174] *See* 2007 Ky. Acts, ch. 137, § 118. A further revision to the introductory language of this provision clarifies the two step process of dissolution and winding up. *See also* Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, 97 KY. L.J. 229, 244-46 (2008-09).

[175] *See* KY. REV. STAT. ANN. § 275.265(1); *see also* MATTHEW ARNOLD, STANZAS FROM THE GRAND CHARTREUSE ("Wandering between two worlds, one dead, the other powerless to be born.").

[176] KY. REV. STAT. ANN. § 275.135(1); *id.* § 275.245(1); *id.* § 275.255(1)(c).

[177] 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.

[178] *See* KY. REV. STAT. ANN. § 275.165(1).

[179] *See* KY. REV. STAT. ANN. § 275.335(1)(a); *id.* § 275.337.

- to inspect the books and records of the LLC;[180]
- to share in periodic and liquidating distributions;[181] and
- to move for judicial dissolution of the LLC.[182]

[7.5] Inter-Se Decisional Authority

The LLC Act provides maximum flexibility to the members to structure the inter-se decisional authority in the LLC.[183] The LLC Act provides alternative default rules that the right to manage the LLC is retained by the members or is vested in managers.[184] By leaving the management of the LLC in the members, the governance of the LLC will resemble that of a general partnership.[185] Alternately, the authority to manage the LLC may be vested in managers. Except as to matters for which the LLC Act dictates a different voting threshold or for which a different vote has been agreed to in the operating agreement, a majority-in-interest of the members, determined in proportion to capital contributed, will determine the course of the company.[186] Managers vote on a per capita basis with a simple majority controlling.[187] These are, however, only default rules.

Under general principles of contract law, it would be possible for an LLC to provide in its Articles of Organization that management authority is reserved to the members, but then provide by contract amongst the members that management (decisional) authority will be exercised only by certain members. This flexibility with regard to the management will permit an LLC, while retaining the partnership model and allowing each member to serve as an agent of the LLC, to structure an "executive committee" to oversee day-to-day business operations and, on behalf of all members, make decisions within its delegated authority. Alternatively, there could be organized a manager-managed LLC in which no manager is appointed or ever provided for in the operating agreement. No person would have apparent agency authority to bind the LLC, all decisions as to management would be made by the members, and all agents would act pursuant to a grant of actual authority.[188]

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[180] *See* KY. REV. STAT. ANN. § 275.185(2).

[181] *See* KY. REV. STAT. ANN. § 275.210; *id.* §§ 275.310(3), (4).

[182] *See* KY. REV. STAT. ANN. § 275.290(1).

[183] *See* KY. REV. STAT. ANN. § 275.003(1); *id.* § 275.165(1); *id.* § 275.175(1).

[184] *See* KY. REV. STAT. ANN. § 275.135(1).

[185] *See* KY. REV. STAT. ANN. § 362.235(5); *id.* § 362.1-401(6).

[186] *See* KY. REV. STAT. ANN. §§ 275.175(1), (2).

[187] *See* KY. REV. STAT. ANN. § 275.175(1); *see also* Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, 97 KY. L.J. 229, 258 (2008-09).

[188] *See also* Rutledge, *The Lost Distinction Between Agency and Decisional Authority: Unfortunate Consequences of the Member-Managed versus Manager-Managed Distinction in the Limited Liability Company*, 93 KY. L.J. 737 (2004-05).

Some LLCs are organized with a board.[189] This structure, while intending to build upon general familiarity with the board in the corporate structure, is often poorly executed. For example, if each member of the LLC board is a "manager," each has apparent agency authority to bind the LLC[190] even as, in the context of a corporation, a director is not qua a director an agent.[191] The prohibition on a director voting by proxy[192] may not apply.[193] If the board, as a collegial body, is the "manager," or if a collegial board in turn appoints the manager, there is the important question of what are the fiduciary and other obligations of the constituent members of the board?[194] For example, if each "member" and each "manager" is subject to confidentiality obligations, and the manager is the "Board of Thanes," is each Thane likewise bound by the confidentiality obligation? Recall that an individual Thane is not a "manager" of the LLC.

[7.6] Voting Rights

[7.6.1] Upon What Do Members Vote (Default

Distributed throughout the LLC Act are default rules for voting, addressing both the topics upon which a vote of the members is required and the voting threshold for action, namely:

Default Voting Thresholds Under the Kentucky LLC Act		
Action	**Default Threshold**	**KRS**
Approve Sale of Substantially All Assets	Majority-in-Interest of the Members	§ 275.247

[189] The LLC Acts of Minnesota, North Dakota and Tennessee have a statutory board structure.

[190] *See* KY. REV. STAT. ANN. § 275.135(2).

[191] *See, e.g., New York Dock Co., Inc. v. McCollum*, 173 Misc. 106, 16 N.Y.S.2d 844 (N.Y. Sup. 1939) ("In spite of casual language in many opinions, a director of a corporation is not an agent either of the corporation or of its stockholders, ... He derives his powers and authority neither from the stockholders nor from the corporation. His status is *sui generis*. His office is a creature of the law."); HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATIONS § 50 (Rev. Ed. 1946) ("The directors of the corporation are not individually agents of the corporation....").

[192] *See, e.g.*, II ARTHUR W. MACHEN, JR., A TREATISE ON THE MODERN LAW OF CORPORATIONS §§ 1455 and 1458 (1908); 2 WILLIAM MEADE FLETCHER, FLETCHER'S CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 427 ("The directors of a corporation generally can not vote at directors' meeting by proxy, but must be personally present and act themselves .... Their personal judgment is necessary, and they can not delegate their duties or assign their powers.") (citations omitted); ABA CORPORATE DIRECTOR'S GUIDEBOOK at p. 18 ("A director is expected to commit the required time to prepare for, attend regularly and participate (in person when feasible) in board and committee meetings. A director may not participate or vote by proxy; personal participation is required (which may take place by telephone or video when in-person participation is not possible."); MOD. BUS. CORP. ACT § 8.20, comment.

[193] *See also* KY. REV. STAT. ANN. § 275.165(3).

[194] *See generally* Colin Marks, *Piercing the Fiduciary Veil*, 19 LEWIS & CLARK LAW REVIEW 73 (2015).

Default Voting Thresholds Under the Kentucky LLC Act		
Action	**Default Threshold**	**KRS**
Approve Conversion to LP	All of the Members	§ 275.372(2)
Initial Adoption of Operating Agreement	All of the Members	§ 275.015(20)[195]
Amend Operating Agreement	Majority-in-Interest of the Members	§ 275.175(2)(a)
Admit Assignee as Member	Majority-in-Interest of the Members other than the assignor	§ 275.265(1)
Remove a Member as a Member after Assignment of All Interest in the LLC	Majority-in-Interest of the Members other than the assignor	§ 275.280(1)(c)2
Admit New Member	All of the Members	§ 275.275(1)
Waive Agreement to Contribute	All of the Members	§ 275.200(4)
Approve Voluntary Dissolution	All of the Members	§ 275.285(3)
Approve Merger	Majority-in-Interest of the Members	§ 275.350(1)
Amend Articles of Organization	Majority-in-Interest of the Members	§§ 275.030(2), 275.175(1)
Approve Act in Contravention of Written Operating Agreement	Majority-in-Interest of the Members	§ 275.175(2)
Amend Articles of Organization to Change Management Structure	Majority-in-Interest of the Members	§ 275.175(2)(c)
Appointment of Managers[196]	Majority-in-Interest of the Members	§ 275.165(2)(a)
Bring Suit in Name of LLC	Half by number of the disinterested members	§ 275.335
Waive Duty of Loyalty	Majority-in-Interest of the disinterested members	§ 275.170(2)

[195] *But see* KY. REV. STAT. ANN. § 275.365(11) (allowing majority-in-interest of the members approving a merger to adopt the operating agreement of the successor LLC, it then binding all members in the successor-by-merger LLC).

[196] Only if the LLC is manager-managed.

Default Voting Thresholds Under the Kentucky LLC Act		
Action	**Default Threshold**	**KRS**
Permit Voluntary Resignation of a Member from a Manager-Managed LLC Where That Right Is Not Already Set Forth in a Written Operating Agreement	All of the Members	§ 275.280(3)

The members, as a default rule that may be modified by private ordering, retain the right to vote on these matters even if the LLC is manager-managed. The LLC Act was until 2015 not nearly as clear as to this point as would be desired. It is provided that where the company elects in its articles of organization to be manager-managed, "the manager or managers shall have the exclusive power to manage the business and affairs of the [LLC]," with this delegation authority being subject to the "extent otherwise provided in the articles of organization, the operating agreement, or this chapter." The statutory language was not express to the effect that the mere fact that the company is manager-managed does not, of itself, constitute an election out of the requirement that the members act upon these particular matters. A 2015 amendment to the LLC Act made clear that the enumerated actions, and absent contrary private ordering, although the LLC is manager-managed, require member approval.[197] Still, care needs to be exercised to avoid inadvertent contrary private ordering. The statement in the operating agreement "Except as otherwise required by the Act, all decisions as to the business and affairs of the Company shall be made by the Managers." could be interpreted as being sufficient to abrogate the right of the members to vote on the items listed in KRS section 275.175(2).[198]

As to this point, care needs to be taken in the drafting of an operating agreement. A provision to the effect of "except as otherwise required by the Act, all decisions pertaining to or with respect to the management and affairs of the Company shall be made by the Managers" may be read as an override of the members' retained management rights in favor of the managers.[199] The case could be made that, with language of this nature in the operating agreement, there has been vested in the managers the ability to approve a merger of the LLC or to amend the operating agreement.

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[197] *See* KY. REV. STAT. ANN. §§ 275.175(3)(d)-(j), created by 2015 Ky. Acts, ch. 34, § 53. *See also* Rutledge, *The 2015 Amendments to the Business Entity Statutes*, ___ N. KY. L. REV. ___ (2015-16) (*forthcoming*).

[198] The author does not suggest this is the proper interpretation of what is likely simply a poorly drafted provision. *See also Lenticular Europe, LLC v. Cunnally*, 693 N.W.2d 302 (Wisc. App. 2005) ("When the legislature provides a specific default term on a topic and the operating agreement does not explicitly refer to that topic, it is reasonable to conclude the parties did not intend to override that default term.").

[199] *See, e.g.*, *Lourdes Hospital Pavilion, LLC v. Catholic Healthcare Partners, Inc*., 2006 WL 753080, 2006 U.S. Dist. LEXIS 12550 (W.D. Ky. 2006) (poorly crafted provision of operating agreement served to require approval of potential defendant to LLC bringing suit against that potential defendant); *J & B Energy, Inc. v. Caldwell*, No. 2012-CA-000370-MR, 2014 WL 3973966, n. 9 (Ky. App. Aug. 15, 2014) (broad exclusion of members qua members from management function interpreted as precluding a derivative action to test validity of management actions).

With the exception of the requirement of unanimous approval to convert an LLC into a limited partnership, which threshold is not subject to modification by private ordering,[200] the statutory thresholds may be modified in the articles of organization or the operating agreement.

[7.6.2] The Allocation of Voting Rights Among the Members

Under the LLC Act as enacted in 1994, members voted (as a default rule) on a per-capita basis.[201] A 1998 amendment to the LLC Act enacted a new default rule on the voting rights of members. Rather than being per capita (one member = one vote), members vote in proportion to their respective capital contributions. This new provision states:

> Unless otherwise provided in the articles of organization, a written operating agreement, or this chapter, for all purposes of this chapter, the members of a [LLC] shall vote, approve, or consent in proportion to their contributions, based upon the agreed value as stated in the records of the [LLC] as required by KRS § 275.185, made by each member to the extent they have been received by the [LLC] and have not been returned.[202]

The operating agreement needs to detail what is being or will be contributed by each member and the value thereof. The rules of the Internal Revenue Code for the maintenance of "capital accounts" do not apply to those determinations. For example, while a loan guarantee would not be included in a "capital account," it may as between the members be afforded value and treated as a capital contribution. Likewise, value may be attributed to services provided and treated as contributed capital even as it does not add to a tax "capital account."

Regardless of a per capital default voting rule, the members may in an operating agreement provide for a different allocation of voting rights. In addition to the flexibility of defining how voting rights are generally allocated, there is the flexibility to allocate special voting rights to a group smaller than all members, to provide for non-voting interests, springing voting rights, to afford non-members voting rights[203] and other mechanisms for distributing control.[204]

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[200] *See* KY. REV. STAT. ANN. § 275.372(2).

[201] *See* KY. REV. STAT. ANN. § 275.175(1) as enacted 1994 Ky. Acts, ch. 389, § 35 (prior to amendment by 1998 Ky. Acts, ch. 341, § 29). *See also* Thomas E. Rutledge & Lady E. Booth, *The Limited Liability Company Act: Understanding Kentucky's New Organizational Option*, 83 KY. L.J. 1, 36 (1994-95); PROTOTYPE LLC ACT (1992) § 403.

[202] *See* KY. REV. STAT. ANN. § 275.175(3).

[203] *See* KY. REV. STAT. ANN. § 275.003(3).

[204] *See generally* Rutledge, *Allocating Voting and Economic Rights in LLCs: An Invitation to Confusion (Part I)*, J. PASSTHROUGH ENTITIES, Nov./Dec. 2013, 59; *Allocating Voting and Economic Rights in LLCs: An Invitation to Confusion (Part II)*, J. PASSTHROUGH ENTITIES, Mar./April 2014, 61.

[7.6.3] On What do Managers Vote

Where a particular LLC elects to be manager-managed, save as otherwise provided in the articles of organization, the operating agreement or otherwise, the managers "shall have [the] exclusive power to manage the business and affairs of the [LLC]."[205] Still, the members retain the right to pass upon the matters for which a member vote is otherwise provided for in the Act.[206] Because the LLC Act is not as clear as would be desired as to the reservation of voting power in a manager-managed LLC to the members, that should be addressed in the operating agreement. There is the flexibility to provide that the power to pass on matters normally reserved to the members may be exercised by the manager.[207]

It bears noting that when an LLC elects to be manager-managed the members come into a new voting right, namely as to who should be the manager(s).[208]

[7.6.4] The Allocation of Voting Rights Among the Managers

Managers, as a default rule, vote on a per-capita basis.[209] Except when a different rule has been provided for, when there is more than one manager an action requires the consent of a majority of the managers.[210] While there is a requirement of a disinterested vote of the members in approving certain transactions involving the company and a manager,[211] the operating agreement may provide additional circumstances in which the managers must act by only a disinterested majority.

[7.7] Fiduciary Duties, Limitation of Liability and Indemnification of Members and Managers

> "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?"
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> *SEC v. Chenery Corp.*, 318 U.S. 80, 85-86 (1943)

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[205] KY. REV. STAT. ANN. § 275.165(2).

[206] KY. REV. STAT. ANN. § 275.165(2); *id.* §§ 275.175(3)(d)-(j).

[207] *See supra* Section [7.6.1] table.

[208] *See* KY. REV. STAT. ANN. § 275.165(2)(a).

[209] *See* KY. REV. STAT. ANN. § 275.175(1).

[210] *See* KY. REV. STAT. ANN. § 275.175(1); *see also* Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, 97 KY. L.J. 229, 258 (2008-09).

[211] *See* KY. REV. STAT. ANN. § 275.170(3).

[7.7.1] The Duty of Care

The Kentucky LLC Act recites the duty of care in the terms of a standard of culpability, namely that a violation of the care obligation will not be actionable unless the misconduct was "wanton or reckless."[212] This standard is a default that may be modified in a written operating agreement.[213] Unlike the duty of loyalty, which is owed only to the LLC, the standard of care is owed to both the LLC and the other members.[214]

In 2010, as a point of clarification and without any modification to the substantive rule already in place, KRS § 275.170(1) was supplemented to make clear that it constitutes the statutory standard of care, set forth in terms of a standard of culpability, applicable in an LLC.[215] With respect to the standard of care as recited in KRS § 275.170(1), the 2010 amendment[216] was

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[212] *See* KY. REV. STAT. ANN. § 275.170(1).

[213] T hat the standards of care may be modified in a written operating agreement is manifest from the lead-in provision of KRS § 275.170 ("Unless otherwise provided in a written operating agreement").

[214] KY. REV. STAT. ANN. § 275.170(1) ("discussing liability to the [LLC] or the members of the [LLC]").

[215] *See* KY. REV. STAT. ANN. §§ 275.170(1), (2), as amended by 2010 Acts, ch. 133, § 32:

> ***With respect to any claim for breach of the duty of care***, a member or manager shall not be liable, responsible, or accountable in damages or otherwise to the limited liability company or the members of the limited liability company for any action taken or failure to act on behalf of the limited liability company unless the act or omission constitutes wanton or reckless misconduct.
>
> ***The duty of loyalty applicable to*** each member and manager shall ***be to*** account to the limited liability company and hold as trustee for it any profit or benefit derived by that person without the consent of more than one-half (1/2) by number of the disinterested managers, or a majority-in-interest of the members from:
>
> (a) Any transaction connected with the conduct or winding up of the limited liability company; or
>
> (b) Any use by the member or manager of its property, including, but not limited to, confidential or proprietary information of the limited liability company or other matters entrusted to the person as a result of his or her status as manager or member.
>
> It now being even more express then it was before, it is clear that KRS § 275.170(1) sets forth an exclusive formula of the duty of care in LLCs (assuming no private ordering to the contrary) as to: (i) the existence of the duty; (ii) who owes the duty (subject to KRS § 275.170(4)); (iii) to whom the duty is owed; and (iv) the substance of the duty. Being a clarification of the law (*i.e.*, returning it to its intended state pre-*Patmon*), this amendment should have retroactive effect. *See also Moore v. Stills*, 307 S.W.3d 71, 81 (Ky. 2010) ("Among the 'remedial' enactments as statutory amendments that clarify exiting law or that codify judicial precedent.").

[216] *See* KY. REV. STAT. ANN. §§ 275.170(1), (2), as amended by 2010 Acts, ch. 133, § 32:

> ***With respect to any claim for breach of the duty of care***, a member or manager shall not be liable, responsible, or accountable in damages or otherwise to the limited liability company or the members of the limited liability company for

most directly driven by the decision rendered in *Gaunce v. Wertz*, which did not reflect a proper interpretation of the provision. The *Gaunce* court failed to appreciate that in the LLC Act the standard of care was recited in terms of a standard of culpability, namely misconduct that is "wanton or reckless." The *Gaunce* court wrote that the claim was not for breach of fiduciary duty, but rather for wanton or reckless misconduct. In fact, the claim is for breach of the duty of care, but liability will only attach against the member or manager so charged if the violation was itself wanton or reckless. The Kentucky LLC Act as originally written was based primarily upon the ABA's Prototype LLC Act,[217] and KRS § 275.170(1) (as it then existed) was a verbatim adoption of § 402(A) thereof. The commentary to § 402(A) provides in part:

> Subsection (A) sets forth the gross negligence standard of care for those participating in management.[218]

Whether, in the first instance, the member's or manager's aspirational standard of care should be to avoid negligence, gross negligence or some other standard, a point not addressed in

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> any action taken or failure to act on behalf of the limited liability company unless the act or omission constitutes wanton or reckless misconduct.
>
> ***The duty of loyalty applicable to*** each member and manager shall ***be to*** account to the limited liability company and hold as trustee for it any profit or benefit derived by that person without the consent of more than one-half (1/2) by number of the disinterested managers, or a majority-in-interest of the members from:
>
> (a) Any transaction connected with the conduct or winding up of the limited liability company; or
>
> (b) Any use by the member or manager of its property, including, but not limited to, confidential or proprietary information of the limited liability company or other matters entrusted to the person as a result of his or her status as manager or member.
>
> It now being even more express then it was before, it is clear that KRS § 275.170(1) sets forth an exclusive formula of the duty of care in LLCs (assuming no private ordering to the contrary) as to: (i) the existence of the duty; (ii) who owes the duty (subject to KRS § 275.170(4)); (iii) to whom the duty is owed; and (iv) the substance of the duty. Being a clarification of the law (*i.e.*, returning it to its intended state pre-*Patmon*), this amendment should have retroactive effect. *See also Moore v. Stills*, 307 S.W.3d 71, 81 (Ky. 2010) ("Among the 'remedial' enactments as statutory amendments that clarify exiting law or that codify judicial precedent.").

[217] *See* Thomas E. Rutledge & Lady E. Booth, *The Limited Liability Company Act: Understanding Kentucky's New Organizational Option*, 83 KY. L.J. 1, 9 (1994-95).

[218] Language substantially equivalent to KRS § 275.170(1) also appears in section 409(c) of the Uniform Limited Liability Company Act (6B U.L.A. 598 (2008)), where it is expressly labeled a "duty of care," a label that is carried forward in the comment.

the LLC Act,[219] should be addressed in every operating agreement. A written operating agreement needs to as well address the question of what should be the level of culpability.[220]

The formula employed in Prototype § 402(A)/KRS § 275.170(1) reciting no aspirational standard and rather only the standard of culpability is curious, but it is clear that the standard of care is set forth in the statute. In effect, absent private ordering to the contrary, the standard of care in an LLC is the same standard as the limit of the protections provided by the Business Judgment Rule.[221] It needs to be recognized that this is not an incorporation into LLC law of the Business Judgment Rule. The Business Judgment Rule is a rule of judicial review, providing that the court will not pursue investigation of the dispute unless one of its exceptions is shown to apply. Whether and when the Business Judgment Rule should apply in the contractual realm of LLCs and other unincorporated business organizations is subject to debate,[222] but careful drafting of an operating agreement defining standards of care and culpability differing from KRS § 275.170(1) will avoid that issue.

The duty of care as discussed in the LLC Act sets forth a standard of culpability for the discharge of functions otherwise undertaken.[223] Of itself, it imposes no affirmative obligation to do any particular act; whether there will be an obligation to undertake a particular act will be determined under the operating agreement and the LLC Act.[224] If a member undertakes to

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[219] *Contrast* KY. REV. STAT. ANN. § 271B.8-300(2) (defining duty of care as that of an ordinarily prudent person in a like position); *id.* § 362.1-404(3) (partial definition of duty of care as that of a reasonable person in a like position in similar circumstances and in the best interests of the partnership).

[220] A bifurcation of the standard of care and the standard of culpability is set forth in the Kentucky Business Corporation Act, wherein the directors' standard of care and loyalty is defined in KRS § 271B.8-300(1), informed by KRS § 271B.8-300(2), while culpability for monetary damages does not attach except as provided in (i) KRS § 271B.8-300(5), namely upon a demonstration that the failure to satisfy the standard constituted "willful misconduct or wanton or reckless disregard for the best interests of the corporation and its shareholders." and (ii) KRS § 271B.8-300(6), it requiring the plaintiff to show that the breach of duty or failure to act was the legal case of the damages suffered by the corporation. *See also Sahni v. Hock*, 369 S.W.3d 39 (Ky. App. Apr. 23, 2010) (complaint that corporate director breached fiduciary duty but which did not allege director "committed willful misconduct or that he acted with wanton or reckless disregard for the best interests of the corporation and its shareholders" did not "sufficiently allege a cause of action under KRS § 271B.8-300."). *But see Baptist Physicians Lexington, Inc. v. New Lexington Clinic, P.S.C.*, 436 S.W.3d 189, footnote 3 (Ky. 2014).

[221] *See* PROTOTYPE LLC ACT (1992) § 402 comment ("This is similar to the standard commonly applied to corporate directors, managing partners, or general partners of limited partnership. In general, as long as managers avoid self-interested and grossly negligent conduct, their actions are protected by the business judgment rule."); *see also Horton v. United Light, Heat and Power Co.*, 690 S.W.2d 382, 389-90 (Ky.1985) (equating "wanton and reckless" with "gross negligence"); *Turner v. Werner Enterprises, Inc.*, 442 F. Supp.2d 384, 385 (E.D. Ky. 2006) (quoting *Kinney v. Butcher*, 131 S.W.3d 357-359 (Ky. Ct. App. 2004)); 57A AM. JUR. 2D *Negligence* § 232.

[222] *See, e.g.*, Elizabeth S. Miller and Thomas E. Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations*, 30 DEL. J. CORP. L. 343 (2005).

[223] *See* KY. REV. STAT. ANN. § 275.170(1) ("With respect to any claim for breach of the duty of care, a member or manager shall not be liable, responsible, or accountable in damages or otherwise to the limited liability company or the members of the limited liability company for any action taken or failure to act on behalf of the limited liability company unless the act or omission constitutes wanton or reckless misconduct.").

[224] 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."); *id.* § 275.003(8) ("To the extent the articles of organization and the operating agreement do not otherwise provide,

perform a particular act, the member is required to exercise the requisite care. If the member performs the act poorly, the intended beneficiary of the act (assuming it is not gratuitous and is legally enforceable) may recover if the failure of performance is grossly negligent.[225] Under the LLC Act, the standard of culpability addresses liability to the LLC or the members.[226] It will be, however, that intended beneficiary that has the claim for recovery; the fact that the culpability formula references both the LLC and the other members does not create, in the individual members, the right to claim recovery for a failure to perform properly an obligation undertaken with respect to the LLC. The fact that a member may be indirectly damaged due to the diminution in value that member's (or even all other members') interest in the LLC does not give rise to an individual right of action.[227] In the same vein, the LLC cannot recover for an injury that is particular to another member. For example, assume AAA Aardvark, LLC has two lines of business, the first being to invest in gold bullion and the second to install high-end audio-visual equipment. At a particular point in time, the LLC has accumulated three gold bars. In the course of transporting those three gold bars, a member leaves one of them in the back of the cab. The gold bars were the property of the LLC.[228] The LLC has a claim against the member for his negligence in the act of transporting its assets, and will be able to recover if the member's failure of performance constituted gross negligence. At the same time, because no other member of the LLC had an individual ownership interest in those gold bars, they have no individual claim against the careless member. Conversely, if in the audio-visual equipment installation aspect of the LLC's business, one member, in the course of a job, drops a big-screen television on the foot of another member, the injured member has a claim against the careless member; liability will attach if it is determined that dropping the television constituted gross negligence, even though, were the two not co-members, the injured member could recover based on a showing of simple negligence. On those facts, the LLC has no claim against the negligent member for the injury to the one member's foot; the foot of the member upon which the television was dropped is not an asset of the LLC. The LLC does, however, have a claim against the careless member to the extent the television, it being LLC property, was damaged, that claim being dependent upon a showing of gross negligence.

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the Kentucky Limited Liability Company Act shall govern relations among the limited liability company, the members, the managers, and the assignees.").

[225] For purposes of this discussion, "gross negligence" is used as a shorthand for "wanton or reckless misconduct."

[226] KY. REV. STAT. ANN. § 275.170(1).

[227] *See* KY. REV. STAT. ANN. § 275.010(2) ("A limited liability company is a legal entity distinct from its members."); *id*. § 275.250 ("A limited liability company interest shall be personal property."); *id*. § 275.240(1) ("Property transferred to or otherwise acquired by a limited liability company shall be the property of the limited liability company and not of the members individually."). *See also Turner v. Andrew*, 413 S.W. 3d 272 (Ky. 2013) (sole member of LLC could not claim for himself cause of action for lost profits suffered by the LLC); *Chou v. Chilton*, Nos. 2009–CA–002198–MR, 2009–CA–002284–MR, 2014 WL 2154087, *4 (Ky. App. May 23, 2014) (Discretionary review denied, ordered not to be published March 25, 2015) (individual member of LLC could not for himself bring claim for misappropriation of company assets).

[228] *See* KY. REV. STAT. ANN. § 275.240(1).

[7.7.2] The Duty of Loyalty

With respect to the standard of loyalty set forth in KRS § 275.170(2), this provision is a verbatim adoption of § 402(B) of the Prototype, for which the commentary provides in part:

> Subsection (B) which is based on UPA § 21, sets forth the duty of loyalty of LLC managers and managing members – that is, the duty to act without being subject to an obvious conflict of interest.
>
> The duty of loyalty under this section is defined to include two major components: "self-dealing," or a manager's reaping an individual profit by or through an LLC transaction in which the manager participated; and liability for appropriating for personal use property belonging to the LLC without the firm's consent. Such appropriation would amount to, in effect, unauthorized compensation. This duty is based on the fact that LLC property is owned by the firm as a whole rather than by individual managers or members.[229] Note that "property" is defined to include records of the LLC that are in the manager's control. Because of the similarity of this section with the UPA,[230] it is anticipated that the courts will interpret a section such as this to impose duties similar to those in the general partnership, including the duty not to appropriate partnership opportunities.[231]

This provision was based upon prior law governing partnerships. A comparison of KRS §§ 275.170(2) and 362.250(1) make manifest that the law developed under the latter must inform the interpretation of the former:

KRS § 362.250(1)	**KRS § 275.170(2)**
Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the from any use by him of its property.	Each member and manager shall account to the limited liability company and hold as trustee for it any profit or benefit derived by that person without the consent of more than one-half (1/2) by number of the disinterested managers or a majority-in-interest of the members from: (a) Any transaction connected with the conduct or winding up of the

[229] *See* KY. REV. STAT. ANN. § 275.240(1).

[230] *See* UPA § 21(1), 6 (pt. II) U.L.A. 194 (2001), adopted in Kentucky at KY. REV. STAT. ANN. § 362.250(1).

[231] PROTOTYPE LLC ACT (1992) § 402, comment. Language equivalent to KRS § 275.170(2) also appears in section 409(b)(1) of the Uniform Limited Liability Company Act (6B U.L.A. 597 (2008)), language labeled as and described in the comment thereto as a duty of loyalty.

	limited liability company; or (b) Any use by the member or manager of its property, including, but not limited to, confidential or proprietary information of the limited liability company or other matters entrusted to the person as a result of his status as manager or member.

The 2010 clarification of KRS § 275.170(2), expressly labeling it as the applicable standard of loyalty, was driven by the decision rendered in *Patmon v. Hobbs*.[232] Essentially, the *Patmon* decision both applied "corporate opportunity" doctrine law to LLCs, allowing a futility defense, and imposed the burden of proof of a fiduciary breach not on the actor but upon the other members challenging the action. As a matter of normative law both of those assumptions were at minimum questionable.[233]

The 2010 amendment of KRS § 275.170(2), enacted in direct response to *Patmon v. Hobbs*, served to (i) expressly identify that provision as the duty of loyalty in an LLC, (ii) identify it as the exclusive duty of loyalty in an LLC (assuming no private ordering to the contrary), (iii) identify who owes the duty (subject to KRS § 275.170(4)), (iv) identify to whom the duty is owed, and (v) set forth the substance of the duty.[234] A subsequent 2012 amendment precluded a "fair to the LLC" defense to the appropriation or use of an LLC asset, including an opportunity.[235] Ergo, the following aspects of *Patmon v. Hobbs* are no longer good law:

- the existence of a question as to "whether a member of an LLC owes a duty of loyalty to fellow members and the company."[236] Rather, under KRS § 275.170(2), a member owes a statutorily defined duty of loyalty "to the LLC" but not to the other members;

- "this Court finds that Kentucky [LLCs], being similar to Kentucky partnerships and corporations, impose a common-law fiduciary

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[232] 280 S.W.3d 589 (Ky. App. 2009). The *Patmon* decision is the first published ruling of a Kentucky court addressing KRS § 275.170. The unpublished ruling in *Welty v. Sexton*, No. 2000-CA-002847-MR (Ky. Ct. App. Feb. 1, 2002), addressed KRS § 275.170(2), but did not review it as the fiduciary standard of loyalty or address the remedy for a breach thereof.

[233] *See* Thomas E. Rutledge and Thomas Earl Geu, *The Analytic Protocol for the Duty of Loyalty Under the Prototype LLC Act*, 63 ARK. L. REV. 473 (2010).

[234] *See also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383, 404-15 (2011).

[235] *See also* Rutledge, *The 2012 Amendments to Kentucky's Business Entity Statutes*, 101 KY. L.J. ONLINE 1 at 13-14 (2012). *Accord* KY. REV. STAT. ANN. § 386B.10-030(1) ("A trustee is accountable to an affected beneficiary for any profit made by the trustee arising from the administration of the trust, except the reasonable fee charged by the trustee, even absent a breach of trust.").

[236] 280 S.W.3d at 589.

duty on their officers and members in the absence of contrary provisions in the [LLC] operating agreement."[237] Rather, the statute defines a comprehensive duty of loyalty scheme determined within the confines of the LLC Act without reference or analogy to the law of other business organizations;[238]

- "Common sense as well as the law dictates that profits realized by an agent in the execution of his agency belong to the other members in the absence of an agreement to the contrary."[239] Rather, the ill-gotten gains are due and owing "to the LLC" and not the other members; the statutory duty of loyalty is owed to the LLC and not to the other members;

- The imposition upon Patmon of the burden to demonstrate that the LLC had the capacity to perform on the assigned contracts.[240] Rather, under the statute as amended in 2012, "fair to the LLC" is no longer an *ex post* defense to appropriation of company assets. As such there is no need (or opportunity) to allocate a burden of proving either fairness or lack of fairness; and

- "Therefore, given that partners owe good faith to each other, we believe it follows logically and equitably that a managing member of a [LLC] also owes such a duty to the other members

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[237] 280 S.W.3d at 594.

[238] *See also Pannell v. Shannon*, 425 S.W.3d 58, 79, 80, 2014 WL 1101472, *7 (Ky. 2014):

> In fact, '"limited liability companies are creatures of statute,"' controlled by Kentucky Revised Statutes (KRS) Chapter 275," 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 that are in derogation of common law shall not apply to its provision." Thus, to the extent the statutes conflict with common law, the common law is displaced.
>
> This Court must therefore look first to the controlling of statutory law.

(citations omitted). *Accord 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."). *Contrast Mason v. Underhill*, No. 2006-CA-002144-MR, 2008 WL 1917179 (Ky. App. May 2, 2008) (notwithstanding that 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).

[239] 280 S.W.3d at 595.

[240] 280 S.W.3d at 598.

(partners)."[241] Rather, the statute has been amended to expressly identify KRS § 275.170(2) as the applicable duty of loyalty.[242]

In an effort to explore the *Patmon v. Hobbs* decision both in the context of the law at the time it was rendered and as the law has been subsequently amended, [Appendix 7.7.2] sets forth the decision, annotated to the LLC Act and related commentary.

It is important, when considering KRS § 275.170(2) and its statutory formula for the duty of loyalty, to contrast it with KRS § 275.170(1) and its formula for the duty of care/culpability, in assessing to whom the duty is owed and, ergo, who may complain that it has been violated. KRS § 275.170(1) provides that the duty of care is owed to both the limited liability company and the other members. In contrast, the duty of loyalty as set forth in KRS § 275.170(2) refers only to the limited liability company; there is no suggestion that the duty of loyalty is owed individually to the other members.[243] A material consequence to this distinction[244] is that suits brought alleging a breach of the duty of loyalty (*e.g.*, misappropriation of company property, misappropriation of a business opportunity, self-dealing, etc.) may proceed only in the name and for the benefit of the LLC and not on behalf of any individual member.[245]

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[241] 280 S.W.3d at 595.

[242] *See also Pannell v. Shannon*, *supra*.

[243] *See also Griffin v. Jones*, ___ S.W. 3d ___, 2015 WL 4776300, No. 2014-CA-000402-MRS (Ky. App. Aug. 14, 2015). *Accord Remora Investments, LLC v. Orr*, 673 S.E.2d 845 (Va. 2009) (provision of statute that one act in the "best interests of the limited liability company" did not support intra-member fiduciary obligation); *BSA Mull, LLC v. Garfield Investment Co*., 2014 WL 4854306, *6 ("The LLCA's requirement that a manager discharge duties 'in the best interests of the [LLC],' MCL 450.4404(1), indicates that a manager's fiduciary duties are owed to the company, not the individual members.").

[244] These provisions, based originally upon § 402 of the Prototype LLC Act (1992), track the distinction made therein.

[245] *See also Chou v. Chilton*, 2012 WL 6526184 (Ky. App. Nov. 16, 2012) (an individual member of an LLC, Chou, brought suit against the other members of the LLC, alleging that the defendants had diverted from the LLC certain opportunities and otherwise violated the duty of loyalty. The trial court dismissed those claims based upon the lack of standing by Chou to assert them for his individual benefit (the LLC was itself not named as a party in the action), which determination was in turn affirmed by the Kentucky Court of Appeals.)); *R.C. Tway Co. v. High Tech Performance Trailers, LLC*, 2013 WL 842577 (W.D. Ky. Mar. 6, 2013) (LLC held not to be a nominal party to suit involving collection and disposition of LLC assets, alleged breach of the operating agreement, intellectual property infringement and breach of non-compete obligation set forth in operating agreement); *Turner v. Andrew*, 413 S.W.3d 272, 2013 WL 6134372 (Ky. 2013) (sole member of LLC could not in his own name bring a claim for lost profits suffered by the LLC; "The LLC and its solitary member, Andrew, are not legally interchangeable. Moreover, an LLC is not a legal coat that one slips on to protect the owner from liability but then discards or ignores altogether when it is time to pursue a damage claim."); *Chou v. Chilton*, Nos. 2009–CA–002198–MR, 2009–CA–002284–MR, 2014 WL 2154087 (Ky. App. May 23, 2014) (Discretionary review denied, ordered not to be published March 25, 2015) (member of LLC could not for his own account proceed on claims that other members violated duty of loyalty or that they misappropriated assets from the LLC). As a point of disclosure, this author served as the defendant's expert in the *Chou* dispute.

[7.7.3] The provision precluding (absent a contrary provision in a written operating agreement) a "fairness defense" for conduct that is otherwise a breach of the duty of loyalty

The provision precluding (absent a contrary provision in a written operating agreement) a "fairness defense" for conduct that is otherwise a breach of the duty of loyalty may strike those whose frame of reference is that of the corporate modal as aberational.[246] In fact the rule set forth in the LLC Act is consistent[247] with the law of fiduciary obligations generally, and the corporate model needs to be understood as aberational.

Generally, the obligation of a fiduciary with respect to property held or controlled for the benefit of another is absolute; beyond the agreed compensation to be remitted to the agent, the agent is not permitted to benefit from the property. Unlike contract, where the notion of an "efficient breach" is endorsed, the law of fiduciary obligations rejects that concept.[248] Fiduciary duty law mandates that the benefits be enjoyed by the beneficiary.

The law of corporations has moved away from the fiduciary model in permitting a "fairness" defense to the effect that the beneficiary, namely the corporation,[249] realized all that it would in a hypothetical arms-length transaction, leaving the fiduciary who is the counter-party to the transaction to enjoy any marginal gain realized from the transaction. In effect, efficient breach of the duty of loyalty is endorsed. It is for this reason that the corporate law sets forth the fairness defense; it alters the otherwise applicable law.[250] The provision here at issue, namely the

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[246] *Contrast* KY. REV. STAT. ANN. § 271B.8-310(1)(c) ("The transaction was fair to the corporation.")

[247] *Accord* KY. REV. STAT. ANN. § 362.1- 404(5) ("A partner does not violate a duty or obligation under this subchapter or under the partnership agreement merely because the partner's conduct furthers the partner's own interest. That a transaction was fair to the partnership shall not constitute a defense to the breach of the obligation in subsection (2) of this section."); *id*. § 362.2-408(5) ("That a transaction was fair to the limited partnership shall not constitute a defense to the breach of the obligation in subsection (2) of this section.").

[248] *See, e.g.*, DANIEL MARKOVITS, SHARING EX ANTE AND SHARING EX POST at 211-13, in PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW (Andrew S. Gold and Paul B. Miller, eds. 2014).

[249] *See* KY. REV. STAT. ANN. § 271B.8-300(a)(3) ("in the best interest of the corporation.")

[250] *See, e.g.*, Introductory Comment 1 to MBCA Subchapter F:

> The common law, drawing by analogy ion the fiduciary principles of the law of trusts, initially took the position that any transaction between a corporation and a director of that corporation was contaminated by the director's conflicting interest, that the transaction was null and void or at least voidable and, suggesting by implication, that the interested director who benefited from the transaction could be required to disgorge any profits and be held liable for any damages.
>
> Eventually, it was perceived that a flat void/voidable rule could work against a corporation's best interest. Although self-interested transactions carry a potential for injury to the corporation, they also carry a potential for benefit. A director who is self-interested may nevertheless act fairly, and there may be cases where a director either owns a unique asset that the corporation needs or is willing to offer the corporation more favorable terms than are available on the market (for example, where the director is more confident of the corporation's financial ability to perform than a third person would be). Accordingly, the courts dropped the flat void/voidable rule, and substituted in its stead the rule that a self-interested transaction will be upheld if the director shoulders the burden of showing that the transaction was fair.

last sentence of KRS 275.170(3),[251] was added to the LLC Act in 2012 in response to and in in order to invalidate the (incorrect) assumption made in *Patmon v. Hobbs* that the corporate "fairness" defense is available generally across business forms.

The LLC Act preserves the traditional model of fiduciary obligations by *ab initio* precluding a fairness defense to a conflict transaction. Consistent with the rules governing a traditional trustee, a fiduciary, be that a member or a manager (depending upon the election made by the LLC as to be member-managed or manager-managed)[252] must remit to the LLC all of the benefits of the transaction. While the remedy may be characterized as draconian, it (i) is long recognized and effected in the law of fiduciary obligations and (ii) is easily avoided by (a) not engaging in related party and similar transactions in which the duty of loyalty is implicated or (b) engaging in the related party or similar transaction only after full disclosure of the proposed terms and disinterested approval.[253]

That said, and departing from the corporate model in which the fiduciary obligations of the directors and officers is not subject to modification by private agreement.[254] The LLC Act permits modification (up to and including elimination) of the duty of loyalty,[255] which capacity includes the ability to modify or eliminate the exclusion of a fairness defense to what is otherwise a violation of the duty of loyalty. It bears noting that this ability to eliminate the duty of loyalty, while absolute in an LLC, is not absolute in either general or limited partnerships governed by, respectively, the Kentucky Revised Uniform Partnership Act (2006) or the Kentucky Uniform Limited Partnership Act (2006). Rather, in those contexts, elimination of the duty of loyalty is not permitted, and modification is restricted based upon a standard of reasonableness.[256] In so doing the operating agreement, by private ordering within only the context of that LLC, moves the duty of loyalty owed therein away from the traditional model and toward a corporate, expectation model.

> Later still, the Model Act and the state legislatures entered the picture by adopting statutory provisions that sheltered the transaction from any challenge that the transaction was void or voidable where it was approved by disinterested directors or shareholders.

[251] KY. REV. STAT. ANN. § 275.170(3) ("In determining whether a transaction has received the approval of a majority-in-interest of the members, membership interests owned by or voted under the control of the member or manager whose actions are under review in accordance with subsection (2) of this section, and membership interests owned by an entity owned by or voted under the control of that member or manager, shall not be counted in a vote of the members to determine whether to consent, and the membership interests shall not be counted in determining whether a quorum, if required by a written operating agreement, exists to consider whether to consent. That a transaction was fair to the limited liability company shall not constitute a defense to the failure to request and receive the required consent of the disinterested managers or members.")

[252] *See* KY. REV. STAT. ANN. § 275.025(1); *id.* § 275.170(4).

[253] *See* KY. REV. STAT. ANN. § 275.170(3).

[254] Delaware permits corporations to waive the business opportunity doctrine in the certificate of incorporation. *See* DEL. CODE ANN. tit. 8, § 122(17). Kentucky has no such facility.

[255] *See* KY. REV. STAT. ANN. § 275.170 ("except as provided in a written operating agreement, ..."); *see also id.* § 275.003(1) (providing for the maximum enforcement of operating agreements).

[256] *See* KY. REV. STAT. ANN. § 362.1-103(2)(c); *id.* § 362.2-110(2)(e).

The mere fact that something can be done does not mean that it should be done. The standard for the duty of loyalty employed in the LLC Act is the same standard as is employed in the Uniform Partnership Act.[257] The rule set forth in the LLC Act is clear, and there is a century of law against which to assess conduct and determine the consequences of breach. Modifying the statutory duty of loyalty disengages a particular LLC from that history. Further, effective modification of fiduciary obligations is exceptionally difficult. As has been observed by two leading jurist from Delaware.

This difficulty is not limited to organizational documents. For example, The Revised Uniform Limited Liability Company Act included the "business judgment rule," which is usually understood as an abstention principle that is binding upon a reviewing court, as part of the formula of the duty of care.[258] Furthermore, its incorporation into the duty of care adds confusion when that standard is modified in a particular operating agreement.[259]

The genius of the duty of loyalty is that it serves to police conduct that is difficult if not impossible to ex post both anticipate and define the consequences of engagement. The human condition does not encompass the ability to anticipate all future eventualities.[260] The duty of loyalty polices that unanticipated conduct, requiring that whatever might take place, the fiduciary is required to respond to new circumstances in a way that favors the beneficiary. It remains to be seen the manner in which courts will balance the "maximum enforcement of contracts" requirement as to operating agreements with traditional principles requiring that ex ante modifications of the duty of loyalty be specific.

[7.7.4] The Impact of the Member-Managed Versus Manager-Managed Election

Before applying KRS §§ 275.170(1) and 275.170(2), it is necessary to determine who is subject to their respective obligations. The LLC Act requires the organization to elect to be "member-managed" or "manager-managed."[261] Whether an LLC is member-managed or manager-managed is determined by referring to the election made in the articles of organization and is not determined by a substantive review of the *inter se* management structure defined in the

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[257] *Compare* KY. REV. STAT. ANN. § 275.170(2) *with* UPA § 21(1); *see also* Rutledge and Geu, *Analytic Paradigm* at 475-76.

[258] *See* REV. UNIF. LTD. CO. ACT § 409(c), 6B U.L.A. 488 (2008).

[259] *See also* Miller and Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations*, 30 DELAWARE JOURNAL OF CORPORATE LAW 343 (2005), reprinted in III THE ICFAI J. OF CORP AND SEC. LAW 13 (February 2006).

[260] While Leto Atreides may, as a Kwisatz Haderach, enjoy perfect prescience, he also becomes bored with his existence and ultimately welcomed conduct he could not anticipate in the form of Siona Atreides. SEE FRANK HERBERT, DUNE; FRANK HERBERT, GOD EMPEROR OF DUNE.

[261] *See* KY. REV. STAT. ANN. § 275.025(1)(d); *see also generally* Thomas E. Rutledge & Steven G. Frost, *RULLCA Section 301—The Fortunate Consequences (and Continuing Questions) of Distinguishing Apparent Agency and Decisional Authority*, 64 BUS. LAW. 37 (Nov. 2008); Rutledge, *The Lost Distinction Between Agency and Decisional Authority*: *Unfortunate Consequences of the Member-Managed versus Manager-Managed Distinction in the Limited Liabilty Company*, 93 KY. L.J. 737 (2004-05) .

operating agreement.[262] As set forth in the comment to Prototype section 401, "Irrespective of the provisions in the operating agreement, whether an LLC is 'manager managed,' as that phrase is used in the Act, depends on whether the articles of organization so provide."[263] KRS § 275.170(4) clarifies who is subject to the duties imposed by KRS §§ 275.170(1) and 275.170(2), depending upon whether the LLC is member-managed or manager-managed.[264] For example, it provides, *inter alia*, that in a manager-managed LLC, the duty of loyalty is owed only by those who are managers.[265] Alternatively, in a member-managed LLC, the duty of loyalty is required of every member.[266]

Applying the latter rule in *Mitchell v. Smith*, a district court in Utah stated: "Because Defendant's Counterclaim relies solely upon Plaintiffs' status as members [of the LLC] for the existence of fiduciary duties, and because Utah law prohibits such a finding based solely upon membership, the Court finds that Defendant has failed to state a cause of action upon which relief may be granted."[267] Interpreting the equivalent provision in the Georgian LLC Act,[268] the court in *ULQ, LLC v. Meder* held: "Because the plain language of OCGA § 14-11-305 provides that non-managing members in manager-managed LLCs owe no duties to the LLC or other members, we hold that non-managing members owe no fiduciary duties to the LLC or the other members."[269] Similarly, a court applying the Uniform Limited Liability Company Act's ("ULLCA") equivalent to Prototype section 402(C) dismissed a breach of fiduciary duty against a member in *Dragt v. Dragt/DeTray, LLC*, "because the Dragts were merely members of the manager-managed LLC, they owed no fiduciary duties and the trial court erred in imposing

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[262] *See* PROTOTYPE LLC ACT (1992) § 202(D), comment; *see also* KY. REV. STAT. ANN. § 275.025(1)(d). The Kentucky Supreme Court, in *Pannell v. Shannon*, 425 S.W.3d 58 (Ky. March 20, 2014), suffered a small foot-fault as to the positive law nature of the member- versus manager-managed election. The Court suggested that the determination of whether the LLC is member or manager managed is determined by a factual assessment of the management structure employed. *See* 425 S.W.3d at 76, fn. 17. While clearly dicta, the suggestion of a substantive review of the structure to assess the application of KRS § 275.135 was incorrect.

[263] PROTOTYPE LLC ACT (1992) § 401.

[264] This toggle is also applicable to KRS § 275.170(1) duty of care.

[265] PROTOTYPE LLC ACT (1992) § 402(C) ("One who is a member of [an LLC] in which management is vested in managers under § 401 and who is not a manager shall have no duties to the [LLC] or to the other members solely by reason of acting in the capacity of a member."). A similar provision appears in the Uniform Limited Liability Company Act. *See* UNIF. LTD. LIAB. CO. ACT § 409(h)(1), 6B U.L.A. 597 (2008).

[266] For a review of the implications of this duty of loyalty vis-à-vis the power (or not) to resign from the LLC, see Rutledge, *You Just Resigned—Now What? Different Paradigms for Withdrawing From a Venture*, J. PASSTHROUGH ENTITIES, Nov./Dec. 2009, 43.

[267] No. 1:08-CV-103 TS, 2009 WL 891908, at *2 (D. Utah Mar. 31, 2009).

[268] GA. CODE ANN. § 14-11-305(1) (West 2010):

> Except as otherwise provided in the articles of organization or a written operating agreement, a person who is a member of [an LLC] in which management is vested in one or more managers, and who is not a manager, shall have no duties to the [LLC] or to the other members solely by reason of acting in his or her capacity as a member. . . .

[269] 666 S.E.2d 713, 721 (Ga. Ct. App. 2008).

fiduciary duties on them."[270] In *Katris v. Carroll*,[271] the court found that the defendant, as a member of a manager-managed LLC, owed no fiduciary duty to the LLC. Addressing the Kentucky LLC Act, the Delaware Court of Chancery, in *Xcell Energy and Coal Company, LLC v. Energy Investment Group, LLC*,[272] applied KRS § 275.170(4) and found:

> A Kentucky LLC can be managed by its members or by its managers. …. 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 they do not owe fiduciary duties to the LLC.

The "solely by reason of acting in the capacity of a member" language warrants special attention because it is a limitation on the exemptive effect of the balance of the provision.[273] Even in a manager-managed LLC, a member's actions may implicate fiduciary duties, but for that to be the case the member must act other than as a member. By way of example, a member misappropriating company funds entrusted to him for deposit will be liable for breach of the duty of loyalty in addition to exposure to charges of theft and conversion.[274] Conversely, a member who, without utilizing company assets, competes with the manager-managed LLC in which she is a member violates no duty unless otherwise provided in the operating agreement.[275]

KRS § 275.170(4) is an important provision that not only says what it means but means what it says.[276] Clearly ascertaining the structure of the LLC at issue and ascertaining the status of the person to be charged with a breach of fiduciary obligation is a crucial step because, absent a duty, there can be no breach.[277]

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[270] 161 P.3d 473, 482 (Wash. Ct. App. 2007).

[271] 842 N.E.2d 221, 225-27 (Ill. App. Ct. 2005).

[272] C.A. No. 8652 – VCN, 2014 WL 2964076 (Del. Ch. June 30, 2014).

[273] PROTOTYPE LLC ACT (1992) § 402(c).

[274] *See* RESTATEMENT (THIRD) OF AGENCY § 8.01; *id.* § 8.05.

[275] *Contrast* RESTATEMENT (THIRD) OF EMP'T LAW § 8.03 (Tentative Draft No. 3, 2010) (stating that a former employee's breach of the duty of loyalty to a former employer occurs when an employee utilizes his employer's confidential information in competition with his employer).

[276] *See also* THE LAST EMPEROR (Columbia Pictures 1987) ("If you cannot say what you mean, your majesty, you will never mean what you say and a gentleman should always mean what he says.").

[277] *See, e.g.*, *Fastenal Company v. Crawford*, 609 F. Supp.2d 650, 665 (E.D. Ky. 2009) ("In order to prevail on a claim for breach of fiduciary duty, the plaintiff must prove: (1) the defendant owes a fiduciary duty to the plaintiff….") (citing *Sparke v. Re/Max Allstar Realty, Inc.*, 55 S.W.3d 343, 348 n.15 (Ky. App. 2000) and *Biggs v. Eaton Sales, Inc.*, 2011 Ky. App. LEXIS 91, 2011 WL 1901793, *10 (Ky. App. 2011) ("As our court has noted, '[i]f no duty is owed by the defendant to the plaintiff, there can be no breach thereof, and therefore no actionable negligence.'" (quoting *Ashcraft v. Peoples Liberty Bank & Trust Co., Inc.*, 724 S.W.2d 228, 229 (Ky. App. 1986)). *See also In re the Heritage Org., L.L.C.*, No. 04-35574-BJH-11, 2008 WL 5215688, at *18 (Bankr. N.D. Tex. Dec. 12, 2008) ("Without a duty, there can be no breach of duty or resulting harm."); *Turkey Creek, L.L.C. v. Rosania*, 953 P.2d 1306, 1312 (Colo. Ct. App. 1998) ("Before there can be a breach of a fiduciary duty, a fiduciary

In summary, a claim against a member for breach of the duty of care or of loyalty will fail where: (1) the LLC is manager-managed, and the member in question is not a manager; (2) there is no provision in the operating agreement bringing a pseudo-manager[278] within the statutory fiduciary duties or the member does not engage in conduct identified by such a provision; (3) there is no claim that the complained of actions were taken other than as a member; and (4) the operating agreement has not modified the statutory default rules by providing member fiduciary duty for all or select activities.

[7.7.5] The Duty of Candor/Disclosure

Managers in a manager-managed LLC, and members in a member-managed LLC, have an affirmative disclosure obligation to all members to render "true and full information of all matters affecting the members to any member...."[279] The statute is silent as to whether this obligation is only passive or active as well. Clearly it applies in response to an affirmative inquiry. But does it also require active disclosure absent inquiry? That question is not addressed by the LLC Act.

[7.7.6] The Duty to Act Lawfully

Although not express in the LLC Act, there exists an obligation to operate an LLC in accordance with all applicable law.[280]

[7.7.7] Limitation and Elimination of Fiduciary Duties; Indemnification

The operating agreement may eliminate or limit the personal liability of a manager or member for breaches of duty and/or provide for indemnification of members and managers arising in connection with a proceeding in which they are a party because of that status.[281] A 1998 amendment to this provision of the LLC Act requires that such a limitation or elimination of personal liability be in a written operating agreement.

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relationship or a confidential relationship must exist.") (citing *Vikell Investors Pac., Inc. v. Kip Hampden, Ltd*., 946 P.2d 589 (Colo. Ct. App. 1997)).

[278] *See, e.g.*, 805 Ill. COMP. STAT. ANN. 180/15-3(g)(3); W. VA. CODE ANN. § 31B-4-409(h)(3); REV. UNIF. LTD. LIAB. CO. ACT § 409(h)(3):

> [A] member who pursuant to the operating agreement exercises some or all of the rights of a manager in the management and conduct of the company's business is held to the standards of conduct in subsections (b) through (f) to the extent that the member exercises the managerial authority vested in a manager by this [Act]...

[279] *See* KY. REV. STAT. ANN. § 275.185(3).

[280] *See, e.g.*, *Miller v. American Telephone & Telegraph Co.*, 507 F.2d 759 (3d Cir. 1977); *see also* BRANSON, HEMINWAY, LOEWENSTEIN, STEINBERG & WARREN, BUSINESS ENTERPRISES & LEGAL STRUCTURES, GOVERNANCE AND POLICY at 605-11 (2009).

[281] KY. REV. STAT. ANN. § 275.180(2). Not addressed is whether this capacity to afford indemnification in the written operating agreement serves to either supplement or supplant the common-law rights of indemnification of an agent. *See* RESTATEMENT (THIRD) OF AGENCY § 8.14.

[7.7.8] The Obligation of Good Faith and Fair Dealing

The LLC Act was in 2010 amended to make express that the contractual obligation of good faith and fair dealing exists in each operating agreement.[282] The obligation of good faith and fair dealing informs other obligations undertaken in the operating agreement and does not of itself create duties or obligations.[283] The obligation of good faith and fair dealing is not subject to either waiver or modification in the operating agreement or otherwise. Under Kentucky law the obligation of good faith and fair dealing does not preclude a party to a contract, in this instance the operating agreement, from enforcing their rights thereunder.[284]

[7.7.9] Modifying Obligations

The fiduciary obligations of care and loyalty as provided for in the LLC Act are subject to modification in a written operating agreement.[285] This capacity to modify these obligations is consistent with the policy in favor of maximum enforcement of operating agreements.[286] The mere capacity to do something, however, is not indicative that doing so should be lightly undertaken. Any effort to modify the statutory fiduciary obligation must, at minimum, address:

- What is the duty that is being modified;
- What is the contractually defined aspirational standard;
- What is the contractually defined standard of culpability;

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[282] *See* KY. REV. STAT. ANN. § 275.003(7); *see also 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.").

[283] *See, e.g.*, Steven G. Frost, *The Implied Contractual Covenant of Good Faith and Fair Dealing: Recent Delaware Case Law*, J. PASSTHROUGH ENTITIES, Jan./Feb. 2010, 19. *See also* THOMAS E. RUTLEDGE AND ALLAN W. VESTAL, RUTLEDGE & VESTAL ON KENTUCKY PARTNERSHIPS AND LIMITED PARTNERSHIPS at 88-92; Paul M. Altman and Srinivas M. Raju, *Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing*, 60 BUS. LAW. 1469 (2004-05).

[284] *See, e.g., Gulf Coast Farms, LLC v. Fifth Third Bank*, 2013 WL 1688458, *3 (Ky. App. April 17, 2013):

> "[A]n implied covenant of good faith and fair dealing does not prevent a party from exercising its contractual rights." Farmers Bank and Trust Company of Georgetown, Ky. v. Willmott Hardwoods, Inc., 171 S.W.3d 4, 11 (Ky.2005); Big Yank Corp. v. Liberty Mutual Fire Ins. Co., 125 F.3d 308, 313 (6th Cir.1997)("party's acting according to the express terms of a contract cannot be considered a breach of the duties of good faith and fair dealing").

Accord James T. Scatuorchio Racing Stable, LLC v. Walmac Stud Mgmt., LLC, 2014 WL 2116096, *8 (E.D. Ky. May 20, 2014).

[285] *See* KY. REV. STAT. ANN. § 275.170 ("Unless otherwise provided in a written operating agreement...."). The LLC Act does not expressly address the question of whether the duty of disclosure/candor maybe modified in an operating agreement. *See* KY. REV. STAT. ANN. § 275.185.

[286] *See* KY. REV. STAT. ANN. § 275.003(1). *See also generally* Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1 (2007).

- Who owes the duty; and
- To whom is the duty owed.

It goes without saying that the fiduciary obligation to operate the LLC in accordance with applicable law[287] is not subject to modification in the operating agreement, written or otherwise.

[7.7.10] Eliminating Fiduciary Duties

Under the LLC Act, it is clear that the fiduciary duties of care and loyalty may be modified in a written operating agreement. It is clear as well that a written operating agreement may eliminate liability for breach of those duties.[288] There being certain distinctions between the elimination of a fiduciary duty and elimination of culpability for violation thereof,[289] the question is whether, under the Kentucky LLC Act, it is permissible to eliminate fiduciary duties. Prior to the Delaware LLC Act being amended to expressly provide that an operating agreement could eliminate fiduciary duties,[290] it was held that a statute that permitted the fiduciary duties to be restricted was insufficient to permit their elimination.[291] It has been argued that a statute utilizing the same formula as that employed in Kentucky should not be read such that the fiduciary duties may be eliminated.[292] Conversly, in *Xcell Energy and Coal Company, LLC v. Energy Investment Group, LLC*,[293] the Delaware Chancery Court gave effect to the waiver of fiduciary duties in the operating agreement of a Kentucky LLC. In that the LLC Act contemplates that a written operating agreement may modify fiduciary duties in an LLC,[294] imposes no express limitations upon the ability to modify fiduciary duties,[295] expressly authorizes elimination of culpability for breach of fiduciary duties,[296] and provides for the maximum enforcement of operation

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[287] *See, e.g.*, *Miller v. American Telephone & Telegraph Co.*, 507 F.2d 759 (3d Cir. 1977).

[288] *See* KY. REV. STAT. ANN. § 275.180(1).

[289] *See, e.g.*, Rutledge and Geu, *The Analytic Protocol for the Duty of Loyalty Under the Prototype LLC Act*, 63 ARK. L. REV. 473 at 494-96 (2010).

[290] DEL. CODE ANN. tit. 6, § 18-1101(e).

[291] *See Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160, 167-68 (Del. 2002).

[292] *See* Francis 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 (2007-08).

[293] C.A. No. 8652-VCN, 2014 WL 2964076 (Del. Ch. June 30, 2014).

[294] *See* KY. REV. STAT. ANN. § 275.170 ("Unless otherwise provided in a written operating agreement:….").

[295] *Contrast* KY. REV. STAT. ANN. §§ 362.1-103(2)(c) (imposing maximum limitation on modification of duty of loyalty in a partnership); *id.* § 362.1-103(2)(d) (imposing maximum limitation on modification of duty of care in a partnership); *id.* § 362.2-110(1)(e) (imposing limitation upon degree of modification of duty of loyalty in a limited partnership); *id.* § 362.2-110(1)(f) (imposing limitation upon degree of modification of duty of care in a limited partnership).

[296] *See* KY. REV. STAT. ANN. § 275.180(1).

agreements,[297] it is difficult to conceive of a basis upon which to argue that a waiver of duties is not permissible.

[7.7.11] Special Limitations When LLC Used to Organize a Condominium Association

An LLC may be utilized as a form for the organization of a condominium association.[298] In that context, under the Kentucky Uniform Condominium Act as passed in 2010,[299] the applicable standard of care was simple negligence, which standard is not subject to modification.[300] Regrettably, in 2012 this provision was amended to substitute the deferential standards found in the business corporation act for the simple negligence standard in the uniform act.[301] These standards are mandatory in a condominium association organized as an LLC.[302]

[7.7.12] Statute of Limitations

Absent a longer or shorter period provided for in the operating agreement, KRS § 413.120(7) provides the applicable statute of limitations, namely five (5) years, for an alleged breach of fiduciary duty.[303] The equivalency of "breach of fiduciary duty" and "fraud" set forth in *Steelvest*[304] and *Lach*[305] are restricted to the application of the fraud exception to the attorney-client privilege.

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[297] *See* Ky. REV. STAT. ANN. § 275.003(1).

[298] *See* KY. REV. STAT. ANN. § 381.9165.

[299] KY. REV. STAT. ANN. §§ 381.9101 et seq. *See generally* Scott W. Brinkman, *The Kentucky Condominium Act (Part I)*, 99 KY. L.J. ONLINE 1 (2011); Brinkman, *The Kentucky Condominium Act (Part II)*, 99 KY. L.J. ONLINE 13 (2011).

[300] *See* KY. REV. STAT. ANN. § 381.9169 as adopted in 2010 Ky. Acts, ch. 97, § 35.

[301] *See* KY. REV. STAT. ANN. § 381.9169 as amended by 2012 Ky. Acts, ch. 99, § 5; *id*. § 381.9170 as created by 2012 Ky. Acts, ch. 99, § 11. This amendment is regrettable for at least two reasons. First, by this departure from the Uniform Act, Kentucky practitioners and judges cannot reference the laws of the other states that have adopted the uniform act when assessing the propriety of the board's actions. Second, the substitution made in 2012 inserted into the management of a condominium, essentially a trust relationship for the protection of the commonly owned assets, the standard applied to corporate directors who are themselves subject to entrepreneurial obligations.

[302] *See* KY. REV. STAT. ANN. § 381.9107.

[303] *See Ingram v. Cates*, 74 S.W.3d 783, 787 (Ky. App. 2002); *Bariteau v. PNC Fin. Servs. Grp., Inc*., 285 F. App'x 218, 223-24 (6th Cir. 2008); *Gundaker/Jordan American Holdings, Inc. v. Clark*, 2009 U.S. Dist. LEXIS 69530, 2009 WL 2390162, at *7 (E.D. Ky. Aug. 4, 2009); *see also Pixlar v. Huff*, 2012 U.S. Dist. LEXIS 105492, *34 (allegation of breach of fiduciary duty not subject to heightened pleading standard required for an allegation of fraud).

[304] *Steelvest v. Scansteel Services, Inc*., 807 S.W.2d 476, 487 (Ky. 1991).

[305] *Lach v. Man O'War*, 256 S.W.3d 563, 572 (Ky. 2008).

[7.8] Contributions to Capital and Liability for Contribution

The transfer of an ownership interest directly from the LLC to a member typically involves a contribution to capital by the member.[306] A contribution may take the form of cash or property, services performed, or an obligation to contribute services, cash or property.[307]

It was the determination of the LLC Act drafting committee that the then existing Constitutional requirement that "stock" be issued only for services performed or value paid would not apply to interests in an LLC,[308] and that future services or future obligations could serve as consideration for LLC interests.[309] This determination was made with the realization that the Kentucky Constitution defined "corporation" to include joint stock companies and associations,[310] and that "corporation" may include a "partnership, joint stock company or association."[311] The Constitutional limitation upon permissible consideration was repealed in 2002.

A promise to make a contribution is not enforceable unless set out in a writing signed by the member, and neither the death nor disability of the member will render this obligation unenforceable.[312] This rule with respect to the continued enforceability of a contribution obligation on the death or disability of a member may be modified by the operating agreement.[313] While a person may, by means of a merger, become a member in an LLC without that person's approval of the transaction, they are not bound to capital contribution obligations in an operating agreement to which they have not assented.[314]

Should a member fail to make a promised contribution of property or services, the LLC may demand the contribution of an equal value of cash.[315] The operating agreement may impose a variety of other consequences for failure to make a required capital contribution.[316] Save where the Articles of Organization or operating agreement provide a lower voting requirement, a promise to make a contribution to the LLC may be compromised by the unanimous consent of

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306 *See* KY. REV. STAT. ANN. § 275.195(2). The LLC is required to maintain a record of the capital contributions made by each member. *See* KY. REV. STAT. ANN. § 275.185(1)(e)1.

307 KY. REV. STAT. ANN. § 275.195.

308 KY. CONST. § 193 (repealed 2002).

309 *See also* Rutledge & Booth, *The Limited Liability Company Act: Understanding Kentucky's New Organizational Option*, 83 KY. L.J. 1, 25 n. 107 (1994-95); *Farmers No. 4, Inc. v. Lexington Tobacco Board of Trade*, 461 S.W.2d 926 (Ky. 1970) (constitutional requirement that shares be afforded cumulative voting in the election of directors did not apply in nonstock nonprofit corporation).

310 KY. CONST. § 208.

311 KY. REV. STAT. ANN. § 446.010(8).

312 KY. REV. STAT. ANN. §§ 275.200(1)-(2).

313 KY. REV. STAT. ANN. § 275.200(2).

314 *See* KY. REV. STAT. ANN. § 275.365(11).

315 KY. REV. STAT. ANN. § 275.200(2).

316 *See* KY. REV. STAT. ANN. § 275.003(2).

the members, but no compromise will be effective against a creditor who has relied upon the obligation to contribute.[317] In *Racing Investments Fund 2000, LLC v. Clay Ward Agency, Inc.*,[318] the court held that a capital call provision in an operating agreement, exercisable at the option of the manager, did not create a capital contribution obligation binding upon the members requiring that they fund to LLC's debts in excess of its remaining assets. In this instance, the creditor, in extending credit to the LLC, was unaware of the operating agreement generally and the capital call provision.

Each LLC is obligated to keep a written record of all member contributions.[319]

[7.9] Allocation of Profits and Losses

As a default rule, profits and losses are allocated among the members on a per capital basis.[320] The LLC Act provides:

> Profits and losses of a [LLC] shall be allocated among the members and among classes of members in the manner provided in the operating agreement. If a written operating agreement does not otherwise provide, profits and losses shall be allocated on the basis of the agreed value, as stated in the records of the [LLC] as required by KRS 275.185, of the contributions made by each member to the extent they have been received by the [LLC] and have not been returned.[321]

Under principles of partnership taxation, the sharing of profits is an issue of allocation (who bears tax liability for income earned) while distributions are the means by which members receive the profits. Neither the Internal Revenue Code nor the LLC Act provide that an allocation, which will give rise to a tax liability to the individual partner, need be accompanied by a distribution.

The provisions in the LLC Act addressing the allocation of profits and losses are an artifact of the early days of the LLC in which it was conceived that essentially every LLC would be classified as a partnership under the Internal Revenue Code. The continuing utility of this provision is greatly in doubt. First, with respect to those LLCs that are not classified, for purposes of taxation, as a partnership (*i.e.*, most single member LLCs, they being taxed as

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[317] KY. REV. STAT. ANN. §§ 275.200(4)-(5).

[318] 320 S.W.3d 654 (Ky. 2010).

[319] *See* KY. REV. STAT. ANN. § 275.185(1)(e)1.

[320] Under the LLC Act as adopted in 1994, profits and losses were allocated per capita among the members. *See* KY. REV. STAT. ANN. § 275.205 as enacted by 1994 Ky. Acts, ch. 389, § 41 (prior to amendment by 1998 Ky. Acts, ch. 341, § 31). *See also* Rutledge & Booth, *The Limited Liability Company Act: Understanding Kentucky's New Organizational Option*, 83 KY. L.J. 1, 26-27 (1994-95). The default rule was changed to allocation in proportion to capital contributions in 1998. *See* KY. REV. STAT. ANN. § 275.205 as amended by 1998 Ky. Acts, ch. 389, § 41.

[321] KY. REV. STAT. ANN. § 275.205.

"disregarded entities," those LLCs that have elected to be taxed as associations and, further, those LLCs that have elected to be S-corporations), the allocation of KRS § 275.205 is simply incorrect. Further, even as to those LLCs that have multiple members and are classified for tax purposes as a partnership, the rule set forth in KRS § 275.205 does not necessarily comply with the rules of the Internal Revenue Code.[322] In consequence, it is almost always necessary to write around this provision of the LLC Act.[323]

[7.10] Distributions

[7.10.1] Distributions Generally

Distributions of company assets are made among the LLC's members on a per capital basis. The LLC Act provides:

> Except as otherwise provided in KRS 275.310, distributions of cash or other assets of a [LLC] shall be allocated among the members and among classes of members in the manner provided in writing in an operating agreement. If the operating agreement does not so provide in writing, each member shall share in any distribution on the basis of the agreed value, as stated in the records of the [LLC] as required by KRS 275.185, of the contributions made by each member to the extent they have been received by the [LLC] and have not been returned. A member shall be entitled to receive distributions described in this section from a [LLC] to the extent and at the times or upon the happenings of the events specified in an operating agreement or at the times determined by the members or managers pursuant to KRS 275.175.[324]

This section of the LLC Act recognizes that an LLC may have differing classes of interests, and that differing classes of interests may have different rights as to distributions of cash and other assets.[325] This flexibility with respect to distributions is a significant advantage of the LLC over the S corporation. In the latter, only one class of stock is permitted (although this stock may be divided into voting and nonvoting classes), in effect requiring that each unit of ownership be treated equally for economic purposes. The LLC affords businesses the opportunity to customize the economic relationship of the various owners not possible in S corporations due to the limitation to a single class of stock.

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[322] *See also* Rutledge, *Allocating Voting and Economic Rights in LLCs: An Invitation to Confusion (Part I)*, J. PASSTHROUGH ENTITIES Nov./Dec. 2013, 59; *Allocating Voting and Economic Rights in LLCs: An Invitation to Confusion (Part II)*, J. PASSTHROUGH ENTITIES, Mar./April 2014, 61.

[323] The Revised Prototype Limited Liability Company Act (67 BUS. LAW. 117 (Nov. 2012)) does not contain a provision addressing allocations.

[324] KY. REV. STAT. ANN. § 275.210.

[325] *See* KY. REV. STAT. ANN. § 275.210 ("in the manner provided in writing in the operating agreement.")

A provision added to the LLC Act in 2015 makes express that a member of an LLC, in rendering services to the LLC, is not entitled to compensation for having done so.[326] Subject to modification in a written operating agreement, this rule carries forward the rule that a partner is not absent a contrary agreement entitled to compensation for services performed on behalf of the partnership[327] and is consistent with the rule that a member qua member is not an "employee" of the LLC.[328]

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[326] *See* KY. REV. STAT. ANN. § 275.165(4), created by 2015 Ky. Acts, ch. 34, § 52. *See also* Rutledge, *The 2015 Amendments to the Business Entity Statutes*, ___ N. KY. L. REV. ___ (2015-16) (*forthcoming*). A default rule of no compensation avoids disputes over "I'm entitled to" absent agreement to the contrary. *See also CanCan Development, LLC v. Manno*, C.A. No. 6429-VCL, 2015 WL 3400789 (Del. Ch. May 27, 2015) (manager's compensation, not set forth in operating agreement but unilaterally set by manager, is subject to entire fairness test). *Accord Calma v. Templeton*, C.A. No. 9579-CB (Del. Ch. April 30, 2015) (director fees are subject to the entire fairness test). These citations to Delaware law on entire fairness are not meant to imply that in the context of a Kentucky LLC the taking of unauthorized compensation would be subject to the entire fairness test. *See* KY. REV. STAT. ANN. § 275.170(3).

[327] *See* KY. REV. STAT. ANN. § 362.235(6); *id.* § 362.1-401(8). *See also* UNIF. PART. ACT § 401(h), 6 (pt. 1) U.L.A. 133 (2001); UNIF. PART. ACT § 18(f), 6 (pt. II) U.L.A. 101 (2001). This no compensation rule is a basis, in the context of partnerships, of the Unfinished Business Doctrine. *See*, *e.g.*, *Jewel v. Boxer*, 156 Cal. App. 3d 171, 203 Cal. Rptr. (Cal. Ct. App. 1984); *Laford v. Sweeney*, Case No. 12SC205, 2015 WL 333701 (Colo. Jan. 20, 2015). *But see In re Thelen*, 24 N.Y.3d 16, 20 N.E. 3d 264 (N.Y. 2014). *See also* Rutledge and Tara A. McGuire, *Conflicting Views as to the Unfinished Business Doctrine*, 46 TEX. J. BUS. L. 1 (2015).

[328] Assuming that the LLC member is treated as a partner for tax purposes, he or she cannot be treated as an employee of the LLC. *See* 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); *see also Borkowski v. Commonwealth*, 139 S.W.3d 531 (Ky. App. 2004) (member of LLC is not an "employee" for purposes of unemployment insurance benefits); KY. REV. STAT. ANN. § 342.012 (absent special endorsement, member of LLC not covered by workers compensation insurance); *Bowers v. Ophthalmology Group, LLP*, 2012 U.S. Dist. LEXIS 118761 at **14-7 (W.D. Ky. 2012) ("One's status does not change from partner to employee simply because the partner is out-numbered and finds herself in a minority position among the other partners . . . Bowers was a partner in Ophthalmology Group, not an employee."); RESTATEMENT OF THE LAW (3RD) EMPLOYMENT LAW (tentative draft No. 2 (April 3, 2009)) § 1.03 ("Unless otherwise provided by law, an individual is not an employee of an enterprise if the individual through an ownership interest controls all or part of the enterprise."); 54 Alan J. Tarr, USC Law School Institutes on Major Tax Planning ¶ 606.1(c) (2012) ("A partner rendering services in his capacity as a partner is not an employee of the partnership. This mutual exclusivity characterization is made clear in various provisions, especially in the context of employment taxes."); *Paying Yourself*, IRS (May 31, 2013), http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Paying-Yourself ("Partners are not employees and should not be issued a Form W-2 in lieu of Form 1065, Schedule K-1, for distributions or guaranteed payments from the partnership."). The same rule would apply if the LLC were classified for tax purposes as a disregarded entity; the sole member cannot be that sole member's employee. *See also Kentucky Employers' Mutual Insurance v. Ellington*, ___ S.W.3d ___, No. 2013-SC-000802-WC, 2015 WL 2340284 (Ky. May 14, 2015) (sole proprietor is not an employee of the sole proprietorship). Assuming the LLC is taxed as a partnership, agreed compensatory payments to a member will be treated as guaranteed payments under Code § 708. *See also Model LLC Operating Agreement Organizational Checklist*, 69 BUS. LAW. 1251, 1264-65 (Aug. 2014).

[7.10.2] Distributions Upon Disassociation

Absent private ordering to the contrary, a member, upon dissociation, is not entitled to any distribution.[329] This rule applies, for example, upon a member's resignation from that status[330] and as well upon involuntary separations from the LLC. For example, the estate of a deceased member is that member's assignee and is not entitled to a redemption of the assigned interest.[331]

[7.10.3] Distributions In Kind

Unless a written operating agreement provides otherwise, a member may not demand that any distribution be made other than in cash.[332] Furthermore, in kind distributions are restricted, and a member will not be required to accept from the LLC a distribution in kind:

> to the extent that the percentage of the asset distributed to the member exceeds the percentage that the member would have shared in a cash distribution equal to the value of the property at the time of distribution.[333]

In effect, this provision protects a member from receiving a non-cash distribution, the value of which is disproportionate to the non-cash distributions made to other members. This protection can be important to protect members from manipulative valuations by a majority of the members or the managers who may be at odds with the member being called upon to accept a non-cash distribution. However, it may not be advisable to prohibit any in kind distributions as such may force the sale of LLC assets in a disadvantageous market, thereby bringing a lower price for the assets and smaller distributions to the members.

[7.10.4] Restrictions on Distributions and Liability Upon Wrongful Distribution

An LLC is prohibited from making distributions in violation of the operating agreement or that would render the LLC insolvent or otherwise impair its capital.[334] A distribution may not be made if after it is made:

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[329] *See* KY. REV. STAT. ANN. § 275.285(3); *see also Chapman v. Regional Radiology Associates, PLLC*, 2011 Ky. App. Unpub. LEXIS 251 (Ky. App. Mar. 25, 2010); Rutledge, *Chapman v. Regional Radiology Associates, PLLC: A Case Study in the Consequences of Resignation*, 100 KY. L.J. ONLINE 15 (2011).

[330] *See* KY. REV. STAT. ANN. §§ 275.285(3)(a), (4); *see also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383, 399-403 (2011).

[331] *See also* Thomas E. Rutledge, *Assigning Membership Interests: Consequences to the Assignor and Assignee*, J. PASSTHROUGH ENTITIES, July/Aug. 2009, 35 at 38.

[332] KY. REV. STAT. ANN. § 275.220(1). *See also* PROTOTYPE LLC ACT (1992) § 603(A).

[333] KY. REV. STAT. ANN. § 275.220(2). *See also* PROTOTYPE LLC ACT (1992) § 603(B).

[334] KY. REV. STAT. ANN. § 275.225. *See also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383, 415 (2011) .

- the LLC would not be able to pay its debts as they became due in the ordinary course of business; or

- the total assets of the LLC would be exceeded by the sum of its total liabilities and the amount necessary to satisfy the dissolution rights of any interests which are superior to the dissolution rights of the member or members receiving the distribution.[335]

The determination that a distribution is not prohibited may be based upon reference to financial statements prepared under practices and principles reasonable under the circumstances or a fair valuation or other methods reasonable under the circumstances.[336]

The impact of a distribution upon the capital of an LLC is measured as of the date the distribution is authorized, provided payment is to occur within 120 days after the date of the authorization of the payment, or the actual date of distribution, if such occurs more than 120 days after the date of authorization.[337] A distribution may be made contingent upon the ability of the LLC to make such payments,[338] in which instance that contingent liability will not be used to assess the propriety of the distribution,[339] but the effect of the payment on that obligation is measured anew as of the date each payment is actually made.[340]

A member or manager who votes for or assents to an improper distribution is liable to the LLC for the excess over the permissible distribution amount.[341] A member or manager liable to the LLC for the excess over a permissible distribution is entitled to contribution from:

- each other member or manager who could be found liable for violating KRS § 275.230(1); and

- each member who received the impermissible distribution.[342]

Under KRS § 275.230(2)(b), the contribution liability of a member who receives an improper distribution is absolute; the obligation to contribute is not conditioned the member's knowledge that the distribution was in any manner improper.[343]

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[335] KY. REV. STAT. ANN. §§ 275.225(1)(a)-(b).

[336] KY. REV. STAT. ANN. § 275.225(2).

[337] KY. REV. STAT. ANN. §§ 275.225(3)(a)-(b).

[338] KY. REV. STAT. ANN. § 275.225(5).

[339] KY. REV. STAT. ANN. § 275.225(1).

[340] KY. REV. STAT. ANN. § 275.225(6).

[341] KY. REV. STAT. ANN. § 275.230(1).

[342] KY. REV. STAT. ANN. §§ 275.230(2)(a)-(b).

[343] In contrast, with respect to distributions made by a corporation, a shareholder's contribution obligation to a director is first conditioned upon the shareholder "knowingly" receiving an improper distribution. *See* KY. REV. STAT. ANN. § 271B.8-300(2)(b).

An action to hold a member or manager liable for an improper distribution, or to require contribution from those who approved or received the impermissible distribution, must be brought within two years after the effect of the distribution is measured.[344]

The indebtedness of an LLC to a member arising out of the declaration of a distribution, save as subordinated by agreement, is equivalent to that of the LLC indebtedness to its general unsecured creditors.[345]

[7.11] Ownership of LLC Property

The property of an LLC, whether real or personal, is that of the entity, and is not the property of the individual members.[346] Therefore, holding only in the limited liability company interests,[347] and not in the underlying property of the LLC, a member, absent a contrary provision in the operating agreement giving such a right, is unable to bring an action for partition of the LLC's property.[348] An LLC may acquire, hold in any estate and convey real property. Even in the context of a SMLLC, the member, qua member, does not have the capacity to either object to the injury to the LLC's property or to enforce an agreement of the LLC. Rather, those rights are vested within the LLC. Any action to protect that property or enforce those rights must be brought by the LLC in its own name or, in appropriate circumstances, by a derivative action.

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[344] KY. REV. STAT. ANN. § 275.230(3). This two-year statute of limitations likely is subject to tolling under the doctrine of adverse domination. *See Wilson v. Payne*, 288 S.W.3d 284 (Ky. 2009); *see also* Mary C. Garris, *"Adverse Domination" – Tolling the Statute of Limitations in Kentucky Business Organizations*, 99 KY. L.J. ONLINE 36 (2011).

[345] KY. REV. STAT. ANN. § 275.225(4). *See also* KY. REV. STAT. ANN. § 275.235 (granting to each member the status of and remedies available to creditors of an LLC with respect to any right to receive a distribution).

[346] KY. REV. STAT. ANN. §§ 275.240(1), (2). *See also Lairsen v. Figuerado*, 466 Fed. App'x 430, 2012 WL 762887 (6th Cir. Mar. 9, 2012) (member does not have interest in LLC's real property such to make transfer of limited liability company interest subject to statute of frauds); *Baker v. Erpenbeck (In re Erpenbeck)*, 2004 Bankr. LEXIS 739 (Bankr. E.D. Ky. 2004) (property of LLC not property of the members). *Accord Owens v. C.I.R.*, 568 F.2d 1233, 1238 (6th Cir. 1977) ("[S]tock in a corporation represents an ownership interest in a going business organization; the stockholders do not own the corporation's propriety."); *Griffin v. Jones*, No. 2014-CA-000402-MR, 2015 WL 4776300 (Ky. App. Aug. 14, 2015), slip op. at 11. As stated in the commentary to § 701 of the PROTOTYPE LLC ACT (1992):

> The first sentence of subsection (A) is from RUPA § 203. This section clarifies that, unlike a partnership under UPA, LLC property is owned by the firm itself rather than nominally or otherwise by the members. This ensures that the "tenancy in partnership" which has confused partnership law will not plague LLCs. It is implicit in this section that a member may use LLC property for LLC purposes provided the member is authorized to do so.

[347] *See* KY. REV. STAT. ANN. § 275.250 ("A [LLC] interest shall be personal property.")

[348] *See also* KY. REV. STAT. ANN. § 275.220(3); Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383, 416 (2011). In *Gattoni v. Zaccaro*, 1997 WL 139410 (Conn. Super. Ct. March 7, 1997), the court reviewed a situation in which the title owner to certain real property was an LLC. There was a falling out between the members of the LLC. In rejecting a claim for, *inter alia*, partition of the property, the court cited the provisions parallel to KRS § 275.240 and held that the plaintiff had no interest in the real estate of the LLC which would entitle him to bring a partition action.

As recently observed by the Kentucky Supreme Court in *Turner v. Andrew*,[349] responding to the assertion that the single member of a SMLLC should be able to pursue on his own account a claim for lost profits suffered by the LLC:

> The LLC and its solitary member, Andrew, are not legally interchangeable. Moreover, an LLC is not a legal coat that one slips on to protect the owner from liability but then discards or ignores altogether when it is time to pursue a damage claim.[350]

The fact that an LLC owns property in its own name, rather than having the property owned collectively by the members, is a marked distinction between the LLC and the UPA partnership under which property was held by tenancy in partnership.[351] This distinction can make the application of certain decisions under partnership law at best problematic to LLCs. For example, there are decisions rendered under UPA in which a partner was allowed to pursue as a direct claim for injury to "partnership property" rather than being restricted to a derivative action on behalf of the partnership. While it is true that the duty of loyalty formulae in UPA and the Kentucky LLC Act are quite similar,[352] it does not follow that a direct action for its enforcement may be brought for the benefit of a member versus the benefit of the LLC. In an LLC a member has no ownership interest in the LLC's property, and therefore has no direct ownership interest to protect.[353] Ergo, only a derivative action, if a direct action is not authorized by the LLC, is permissible to protect the LLC's property.

[7.12] Transfer of LLC Property

Where the management authority has been vested in managers, the title to LLC property may be transferred by an instrument executed in the name of the LLC by a properly authorized

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[349] 413 S.W.3d 272 (Ky. 2013).

[350] *Id*. *See also Zipp v. Florian*, 2006 WL 3719373 (Conn. Super. Ct. Nov. 13, 2006) (member of an LLC lacked standing to bring suit based upon damage to property owned by LLC); *Finley v. Takisaki*, 2006 WL 1169794 (W.D. Wash. April 28, 2006) (members of an LLC lacked standing to assert a claim for injury to the LLC); *Carey v. Howard*, 950 So.2d 1131 (Ala. 2006) (members of LLC lacked standing to sue for declaratory relief with respect to option agreement between LLC and third-party); *Northeast Realty, L.L.C. v. Misty Bayou, L.L.C.*, 920 So.2d 938 (La. Ct. App. 2006) (members of an LLC lacked standing to intervene in an action against an LLC to quiet the tax title because claim of ownership of property in dispute belongs to the LLC); *Cortellesso v. Town of Smithfield Zoning Board of Review*, 888 A.2d 979 (R.I. 2005) (sole member of LLC lacked standing to appeal zoning decision on property that the sole member had conveyed to the LLC); Rutledge, *Regarding the Disregarded Entity*, J. PASSTHROUGH ENTITIES, Mar./Apr. 2011, 39.

[351] *See* KY. REV. STAT. ANN. § 362.270(1) ("A partner is a co-owner with his partners of specific partnership property holding as a tenant in partnership."); UNIF. PART. ACT § 25(1), 6 (pt. II) U.L.A. 294 (2001); RUTLEDGE & VESTAL ON KENTUCKY PARTNERSHIPS AND LIMITED PARTNERSHIPS at 52-53.

[352] *See* Rutledge and Geu, *The Analytic Protocol for the Duty of Loyalty Under the Prototype LLC Act*, 63 ARKANSAS LAW REVIEW 473, 475-77 (2010).

[353] *See* KY. REV. STAT. ANN. § 275.240(1). *See also Chou v. Chilton*, Nos. 2009–CA–002198–MR, 2009–CA–002284–MR, 2014 WL 2154087 (Ky. App. May 23, 2014) (Discretionary review denied, ordered not to be published March 25, 2015); *Chou v. Chilton*, 2012 WL 5626184 (Ky. App. Nov. 16, 2012).

manager or other agent.[354] Correspondingly, no member, solely by reason of that status, has the authority to transfer the property of a manager-managed LLC.[355]

Where management authority has been retained by the members, any properly authorized member or other agent, in the name of the LLC, may execute an instrument of transfer on behalf of the LLC.[356]

[7.13] Limited Liability to Third Parties

[7.13.1] General Rule of Limited Liability

The cornerstone of the LLC Act is its provision for limited liability.[357] Under the statutory formula, each member, manager, employee and agent of the LLC is afforded limited liability from the LLC's debts and obligations.[358] The scope of the limited liability afforded the members is the same as that afforded the shareholders of a business corporation.[359] At the same time the LLC Act is broader than is the Business Corporation Act in that the former as well provides limited liability to the managers, employees and agents of the LLC; the Business Corporation Act does not address the liability of directors, officers or corporate agents.

[7.13.2] Waiving Limited Liability

A member or manager, in a written operating agreement or other written agreement, may agree to be personally obligated on a debt, obligation or liability of the LLC.[360] The effect of such an election is not that the member or manager is obligated as a guarantor. Rather, they become, with the LLC, a primary obligor. The "any of the debts" enables either a general waiver of limited liability or an agreement as to only certain obligations.

[7.13.3] Liability for Pre-Organization Activities

The legal existence of an LLC does not begin until the latter of the filing by the Secretary of State of the Articles of Organization and there having been reached any delayed effective date specified in the Articles of Organization.[361] Persons who purport to act by or on behalf of the LLC prior to it coming into existence, if they have knowledge that the organization has not yet been accomplished, are jointly and severally liable for all liabilities thereby created.[362] This

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[354] KY. REV. STAT. ANN. § 275.245(2)(b).

[355] KY. REV. STAT. ANN. § 275.245(1).

[356] KY. REV. STAT. ANN. § 275.245(1).

[357] *See Racing Investment Fund 2000, LLC v. Clay Ward Agency, Inc*., 320 S.W.3d 654, 659 (Ky. 2010).

[358] *See also Dzurilla v. All American Homes, LLC*, 2010 WL 55923 at *3 (E.D. Ky. 2010).

[359] *See* KY. REV. STAT. ANN. § 275.150(2).

[360] *See* KY. REV. STAT. ANN. § 275.020(2); *id*. § 14A.2-070.

[361] *See* KY. REV. STAT. ANN. § 275.020(2); *id*. § 14A.2-070(1).

[362] KY. REV. STAT. ANN. § 275.095. *See also* RESTATEMENT (THIRD) OF THE LAW OF AGENCY § 6.04 (2006) ("Unless the third party agrees otherwise, a person who makes a contract with a third party purportedly as an

liability remains in place irrespective of whether the LLC, subsequent to its actual organization, adopts the debts created prior to that time.[363]

[7.13.4 Personal Liability for Own Acts

The LLC Act was amended in 2010 to make express that a person otherwise enjoying limited liability continues to bear personal responsibility for their own wrongful acts.[364] This statutory addition "codified the Kentucky case law."[365] Typically, this exposure will attach when, while acting on behalf of the LLC, a member or manager commits a tort involving the breach of an independent duty owed by the actor to the injured party.

[7.13.5] Piercing the LLC Veil

No decision of the Kentucky Supreme Court has to date addressed the factors to be considered in piercing the veil of an LLC. In an unpublished trial court ruling written by now Justice Abramson of the Kentucky Supreme Court, it was stated:

> While it is true that the foregoing represents the law with respect to the liability of *corporate* officers and shareholders, equity and fairness required that those same theories of liability [piercing and personal responsibility for personally committed torts] should extend to managers and member of limited liability companies as well.[366]

While the Kentucky Supreme Court has recognized the centrality of the rule of limited liability to the LLC Act,[367] in *Rednour Properties, LLC v. Spangler Roof Services, LLC*[368] the

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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."); 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."); *Pierson v. Coffey*, 706 S.W.2d 409 (Ky. App. 1985).

[363] RESTATEMENT (THIRD) OF THE LAW OF AGENCY § 4.04 cmt. c (2006). *See also Pharmacogemetics Diagnostic Laboratory, Inc. v. Essential Molecular Testing Corp, LLC – PGXL Partners, LLC*, Civ. Act. No. 3:13-CV-867-H, 2014 WL 4163859 (W.D. Ky. Aug. 20, 2014) (rejecting effort to declare a contract void on the basis that the alleged counter-party did not exist as a legal entity at the time the contract was entered into).

[364] *See* KY. REV. STAT. ANN. § 275.150(3) as created by 2010 Ky. Acts, ch. 133, § 31.

[365] 5*ifth Element Creations, LLC v. Kirsch*, Civ. Act. No. 5:10-CV-255-KKC, 2010 WL 5139235 (E.D. Ky. Dec. 9, 2010). *See also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383, 384-88 (2011).

[366] *See Fabing v. E Concepts, LLC*, Jeff. Cir. Ct. (Div. 3) No. 01-CI-06835, Order Granting Plaintiff's Motion for Partial Summary Judgment entered June 9, 2003 (emphasis in original).

[367] *See Racing Investment Fund 2000, LLC v. Clay Ward Agency, Inc*., 320 S.W.3d 654, 656 (Ky. 2010).

[368] No. 2009-CA-00159-MR, 2011 WL 2535330 (Ky. App. June 10, 2011; modified July 8, 2011) (opinion designated "To Be Published"; On April 18, 2012, the Kentucky Supreme Court directed that the opinion not be published).

Court of Appeals pierced an LLC to hold its sole member liable for a company obligation, the Court of Appeals writing:

> [W]e hold that there is substantial evidence to support the Circuit Court's decision to pierce the corporate veil in this action. While the record establishes the corporate existence of the entities at issue (Rednour Blake and Rednour Properties, which both list Rednour as the registered agent), it is obvious that these entities were "dummy" corporations [throughout, the Court of Appeals refers to LLCs as "corporations"] designed to protect Rednour from personal liability. Rednour is the sole member and agent of these companies as well as several others, at least one of which is a subsidiary of another LLC, and Rednour admits to having set up the LLCs for tax purposes. Under these circumstances, we aren't able to discern any difference between Rednour and his various LLCs. Accordingly, we must hold that the Circuit Court did not commit any error when it held Ritchie Rednour individually liable for the corporate debts and declined to dismiss him as a defendant.

Needless to say, this decision was a body blow to single-member LLCs as well as single-shareholder corporations in Kentucky; it could be extended as well to multiple owner entities. Without here reciting the myriad analytic failures of this decision, it must be recognized that:

- Every choice of entity decision is going to have a tax component, and if having engaged in tax planning is a reason for setting aside a limited liability entity, then every limited liability entity should be pierced because its election was at least in part for tax purposes;

- It is unclear whether the court was referring to Rednour being the registered agent or rather the apparent agent (see KRS § 275.135(1)) of the LLCs, but it appears more likely that the reference is to the position of registered agent. If that is the case, the sole owner may never be the registered agent of a business organization without thereby supporting an argument that the veil should be pierced; and

- The fact that one elected a limited liability entity with the intention of reducing one's personal liability (and is there any other reason for doing so?) will be a basis for setting aside that limited liability shield.

An expansive criticism of the failings of this decision has been published elsewhere.[369]

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[369] *See* Rutledge, *Rednour Properties, LLC v. Spangler Roof Services, LLC – A Rant in Three Parts*, Kentuckybusinessentitylaw.blogspot.com (Nov. 7, 8 & 9, 2011).

While the appeal to the Kentucky Supreme Court of *Rednour* was pending, on February 23, 2012, the Kentucky Supreme Court issued its tour-de-force opinion (written by Justice Abramson) updating Kentucky's law on piercing the corporate veil, *Inter-Tel Technologies, Inc., v. Linn Station Properties, LLC*,[370] and in so doing superseding, at least in part, *White v. Winchester Land Development*.[371] Relying in part upon Professor Stephen Presser's treatise Piercing the Corporate Veil, the Supreme Court began its analysis by a general review of the development of piercing law nationwide, and from there focusing upon "Kentucky's seminal and leading case on the subject," namely *White v. Winchester Land Development*.[372] From there it reviewed in detail the White decision and its analytic antecedent, namely Professor Campbell's article *Limited Liability for Corporate Shareholders: Myth or Matter-of-Fact*,[373] both reciting the alternative (although acknowledged to be overlapping) theories of instrumentality, alter-ego and equity as alternative basis for piercing the veil. However, where White focused upon a discreet list of five factors under the equity formula, the Supreme Court has expanded that list to eleven, namely:

1. Does the parent own all or most of stock of the subsidiary?

2. Do the parent and subsidiary corporations have common directors or officers?

3. Does the parent corporation finance the subsidiary?

4. Did the parent corporation subscribe to all of the capital stock of the subsidiary or otherwise cause its incorporation?

5. Does the subsidiary have grossly inadequate capital?

6. Does the parent pay the salaries and other expenses or losses of the subsidiary?

7. Does the subsidiary do no business except with the parent or does the subsidiary have no assets except those conveyed to it by the parent?

8. Is the subsidiary described by the parent (in papers or statements) as a department or division of the parent or is the business or financial responsibility of the subsidiary referred to as the parent corporation's own?

9. Does the parent use the property of the subsidiary as its own?

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[370] 360 S.W.3d 152 (Ky. 2012).

[371] 584 S.W.2d 56 (Ky. App. 1979).

[372] 584 S.W.2d 56 (Ky. App. 1979). *See also* Rutheford B. Campbell, *Limited Liability for Corporate Shareholders: Myth or Matter-of-Fact*, 63 KY. L.J. 23 (1974-1975),

[373] 63 KY. L.J. 23 (1975).

10. Do the directors or executives fail to act independently in the interest of the subsidiary, and do they instead take orders from the parent, and act in the parent's interest?

11. Are the formal legal requirements of the subsidiary not observed? [374]

The *Inter-Tel* Court drew particular attention to "grossly inadequate capitalization, egregious failure to observe legal formalities and disregard of distinctions between parent and subsidiary, and a high degree of control by the parent over the subsidiary's operations and decisions, particularly those of a day-to-day nature," stating "We believe that these are the most critical factors…."[375] In further clarification of *White*, the Supreme Court made express that while either "sanctioning fraud or promoting injustice" is necessary for piercing, it remains the rule that "the injustice must be something beyond the mere inability to collect a debt from the corporation."[376] Still, proof or evidence of actual fraud is not required.[377]

The 2012 Kentucky General Assembly, responding to the *Rednour* decision, amended the LLC Act to stipulate that the LLC being a single member LLC is not of itself a basis for piercing.[378] On April 18, 2012, the Kentucky Supreme Court denied discretionary review of the *Rednour* decision while ordering that the ruling of the Court of Appeals not be published. While the order to not publish the Court of Appeals' decision is helpful, and it may be argued that that action stripped the *Rednour* decision of any precedential value, it must be wondered why the Supreme Court did not remand the *Rednour* decision back to the Court of Appeals, and presumably ultimately the trial court, for reconsideration in light of the requirements of *Inter-Tel Technologies*.

The most recent discussion by the Kentucky Supreme Court of the application of piercing law to LLCs is that rendered in *Turner v. Andrew*.[379] Andrew operated a trucking business under the name "Billy Andrew, Jr. Trucking, LLC" even as the individual trucks were in his own name. One of those trucks was damaged in a collision with a truck belonging to M&W Milling Co., Inc.

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[374] 360 S.W.3d at 163-64. This list of factors was drawn from FREDERICK J. POWELL, PARENT AND SUBSIDIARY CORPORATIONS: LIABILITY OF A PARENT CORPORATION FOR THE OBLIGATION OF ITS SUBSIDIARIES (1931).

[375] 360 S.W.3d at 164.

[376] 360 S.W.3d at 164-65.

[377] 360 S.W.3d at 164.

[378] *See* KY. REV. STAT. ANN. § 275.150(1) as amended by 2012 Ky. Acts, ch. 81, § 105 ("That a [LLC] has a single member or a single manager is not a basis for setting aside the rule otherwise recited in this subsection."); *see also* Rutledge, *The 2012 Amendments to Kentucky's Business Entity Statutes*, 101 KY. L.J. ONLINE 1, 3 (2012-13). In 2015 the Virginia General Assembly made a revision to that state's LLC Act of similar import. *See* VA. STAT. ANN. § 13.1-1019 ("Except as otherwise provided by this Code or as expressly provided in the articles of organization, no member, manager, organizer or other agent of a limited liability company, *regardless of whether the [LLC] has a single member or multiple members*, shall have any personal obligation for any liabilities of a limited liability company, whether such liabilities arise in contract, tort or otherwise, solely by reason of being a member, manager, organizer or agent of a [LLC].") (Language added to statute in italics).

[379] 413 S.W.3d 272, 2013 WL 6134372 (Ky. Nov. 21, 2013).

Andrew then brought suit against M&W for both the damage to the truck as well as the lost profits suffered as a consequence of the truck being out of service. Notably, the LLC through which the trucking business was operated was not a party to the action. Thereafter, Andrew seems to have ignored the case, missing numerous discovery deadlines and even, apparently, ignoring a court order compelling him to produce documents. Ultimately, the trial court entered an order in limine excluding from evidence any claim for property damages in excess of the amount estimated by M&W's expert and as well granted M&W judgment on the pleadings with respect to the claim for lost business profits, that on the grounds that any lost profits were suffered by the LLC, a stranger to the action.

The Court of Appeals reversed that determination, "concluding that Andrew could properly pursue the lost business claim in his own name because he is the sole owner of the LLC."[380] The Kentucky Supreme Court would ultimately and resoundingly reject that suggestion.

The Supreme Court began by reciting the law that a limited liability company is a legal entity distinct from its members, citing therefore KRS § 275.010(2). Noting that:

> The Court of Appeals reasoned that because Andrew was the sole owner of the business he was necessarily the real party in interest, a status that allowed him to properly advance the lost profits claim in his own name rather than in the name of the LLC.[381]

, the Supreme Court stated that this position was long ago rejected in *Miller v. Paducah Airport Corp*.[382] From there the Supreme Court wrote:

> The LLC and its solitary member, Andrew, are not legally interchangeable. Moreover, an LLC is not a legal coat than one slips on to protect the owner from liability but then discards or ignores altogether when it is time to pursue a damage claim.[383]

The Court went on to then discuss the notion of piercing the veil, noting that traditional piercing is not here available, and likewise this does not constitute a "outsider reverse" piercing instance. Rather, this is in effect an "insider reverse" pierce, *i.e*., Andrew sought to claim for himself the personal benefit of a company asset. The Court as well noted that there exists a question as to whether Kentucky will recognize insider reverse piercing, but not making a ruling one way of the other. What is clear is that in this case an insider reverse pierce was not allowed.

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[380] 2013 WL 6134372, *2.

[381] 413 S.W.3d 272.

[382] 551 S.W.2d 241 (Ky. 1977).

[383] 413 S.W. 3d 272.

In a recent bankruptcy court decision, the court rejected the effort by a bankruptcy trustee to utilize the concepts of "piercing the veil" in order to, ab initio, bring a third-party defendant into the action. Rather, the Court held that piercing is a remedy, not a cause of action.[384]

After noting that, consequent to the unique position of a Trustee, that this effort could be characterized as either outsider or insider reverse piercing, the court determined that categorization to not be necessary in that neither effort would be permitted to proceed. Initially, relying on Turner v. Andrew and Williams v. Oates, the Bankruptcy Court acknowledged that it is unclear whether a Kentucky court would accept the validity of reverse veil piercing. That controversy did not, however, need to be addressed by the Bankruptcy Court in that it held that piercing could not be used in the affirmative approach sought by the Bankruptcy Trustee. Rather, the court focused upon the fact that, under Kentucky's piercing law, whatever it might be, piercing is a remedy and not itself a cause of action. In that the Trustee sought to use reverse piercing as a theory for imposing the initial liability, rather than as a remedy by which to seek collection on primary liability, the effort was dismissed. Specifically:

> The Trustee argues that disregard of the corporate form of Meadow Lake [it was actually an LLC] would mean the 2010 Transfer is treated as if it were made by the Debtors directly. Under this theory, it does not matter whether the Debtors or Meadow Lake committed the alleged wrongdoing. The assets and liabilities of both parties are treated as merged both prospectively and retroactively. This logic is not consistent with veil piercing as a remedy in Kentucky.[385]

Kentucky's Mixed Message on LLC Piercing

While the Kentucky Court of Appeals has applied veil piercing to LLCs, the Kentucky Supreme Court has for now (maybe) reserved judgment as to whether and how LLCs may be pierced. Specifically, in *Pannell v. Shannon*, the Court wrote:

> This, of course, assumes the doctrine of veil piercing even applies to limited liability companies under Kentucky law. While several decisions have assumed that it does, *see Stettenbenz v. Butch's Rod Shop, LLC*, the question appears to have been raised in only one case, *Howell Contractors, Inc. v. Berling*, which ultimately avoided the question by applying Ohio law, which does allow veil piercing of LLCs. There are, of course, strong arguments for why LLC veil piercing should not be allowed, *see generally* Stephen M. Bainbridge, *Abolishing LLC Veil Piercing*, even when corporate veil piercing is viable in the jurisdiction, *see* Thomas E. Rutledge & Lady E. Booth, *The Limited Liability Company Act: Understanding Kentucky's New Organizational Option* ("An issue

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[384] *Spradlin v. Beads and Steeds Inns, LLC (In re Howland)*, 516 B.R. 163 (Bankr. E.D. Ky. 2014).

[385] *Id*.

> to be considered is the degree to which the common law doctrine of piercing the corporate veil should apply to LLCs. While the use of the LLC's liability shield should not be permitted to protect wrongdoers, the application of the law that has developed in this area is questionable.").[386]

Other Court of Appeals decisions involving the piercing of an LLC include *Mountain Paving and Construction, LLC v. Workman*[387] and *Rednour Properties, LLC v. Spangler Roof Services, LLC.*[388] Subsequent to the *Rednour* decision the LLC Act, as well as the business corporation act, were amended to make express that being a SMLLC or single shareholder corporation are not basis for piercing. In *Sudamax Industria e Comercio de Cigarros, LDTA v. Buttes & Ashes, Inc.*,[389] the federal court presumed that the LLC veil may be pierced, but did not do so based upon insufficient allegations of fraud.

Further, the Supreme Court has recognized that LLCs are statutory constructs that are strangers to the common law.

> In fact, "limited liability companies are creatures of statute," controlled by Kentucky Revised Statutes (KRS) Chapter 275," 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. The obvious place to start, then, is the source of limited liability in the LLC context, KRS 275.150.[390]

, thereby further distancing LLCs from the roots of piercing jurisprudence.

Unfortunately, the apparent categorical reservation of the question of piercing the LLC veil set forth in *Pannell v. Shannon* stands in contradiction to another recent decision of the

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[386] 425 S.W.3d 58, 2014 WL 1101472, *14, fn. 15 (Ky. March 20, 2014) (citations omitted).

[387] No. 2012-CA-001822-MR, 2014 WL 272463 (Ky. Ct. App., Jan. 24, 2014) (Not to be Published) (veil of LLC pierced in order to hold one member liable on LLC debt).

[388] No. 2009-CA-001159-MR, 2011 WL 2535330 (Ky. Ct. App., June 10, 2011, mod. July 8, 2011) (LLC pierced on basis including that it was a single member LLC and was set up for tax purposes and to achieve limited liability).

[389] 516 F. Supp.2d 841 (W.D. Ky. 2007).

[390] 425 S.W.3d 58, 2014 WL 1101472, *7 (citations omitted).

Supreme Court. In *Turner v. Andrew*, the Court wrote "The doctrine [of veil piercing] can also apply to limited liability companies."[391]

The *Turner* decision was written by Justice Abramson, and this language is consistent with an unpublished trial court ruling written by now Justice Abramson when she was on the Circuit Court, she then stating:

> While it is true that the foregoing represents the law with respect to the liability of corporate officers and shareholders, equity and fairness required that those same theories of liability [piercing and personal responsibility for personally committed torts] should extend to managers and member of limited liability companies as well.[392]

It remains to be seen whether the acceptance of LLC veil piercing (*Turner v. Andrew*) or the reservation of the question (*Pannell v. Shannon*) will be determined to be controlling.

[7.13.6] Statutory Liability Notwithstanding Limited Liability

There exists a variety of statutory provisions pursuant to which a member or manager may in that role be held liable for an obligation of the LLC.[393] For example, *J. Stan Developments, LLC v. Lindo*, it was confirmed that, notwithstanding KRS § 275.150, a promoter of an LLC may be held liable for violations of the securities law.[394] A manager may be held liable for unremitted gasoline and special fuel excise taxes,[395] sales and use taxes[396] and employee compensation trust fund taxes.[397]

[7.14] Interstate Application of the Limited Liability Provision

The LLC Act provides that Kentucky LLCs are empowered to conduct business and carry out their operations in any foreign jurisdiction,[398] and the limited liability afforded to the members, managers, employees and agents of a Kentucky LLC, will, in any other state or foreign country, be governed by Kentucky law.[399] While the LLC Act provides that questions of liability

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[391] 413 S.W.3d 272, 277 (Ky. 2013).

[392] *See Fabing v. E Concepts, LLC*, Jeff. Cir. Ct. (Div. 3) No. 01-CI-06835, Order Granting Plaintiff's Motion for Partial Summary Judgment entered June 9, 2003.

[393] *See generally* Rutledge, *Limited Liability (or Not): Reflections on the Holy Grail*, 51 S. DAK. L. REV. 417 (2006).

[394] 2009 WL 3878084 (Ky. App. Nov. 20, 2005).

[395] *See* KY. REV. STAT. ANN. § 138.448(2) (restricted to managers and not extending to members).

[396] *See* KY. REV. STAT. ANN. § 139.185(2) (restricted to managers and not extending to members).

[397] *See* KY. REV. STAT. ANN. § 141.340(3) (restricted to managers and not extending to members); Code § 3102(a); *id.* § 3402(a); *id.* § 6672(c); *id.* § 7501.

[398] KY. REV. STAT. ANN. § 275.160(1).

[399] KY. REV. STAT. ANN. § 275.160(2).

arising in other jurisdictions will be governed by Kentucky law, there is no guarantee that a foreign jurisdiction will believe itself bound by this directive.[400] Rather, the court may investigate whether the law of that jurisdiction or that of Kentucky will control.[401]

[7.15] Series LLCs

Several states provide that an LLC may be organized with "series."[402] To date Kentucky does not provide for series in its LLC Act; series are provided for in the Kentucky Uniform Statutory Trust Act (2012).[403] Whether the series liability shield of a foreign LLC with series would be respected in Kentucky is an open question.[404]

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[400] LLC's are certainly not the first business structure which have presented questions regarding the respect their attributes would be afforded outside their jurisdiction of formation. In *Bank of Augusta v. Earle*, 38 U.S. (13 Pet.) 519, 588-89 (1839), the Supreme Court wrote:

> But it has been urged in the argument that, notwithstanding the powers thus conferred by the terms of the charter, a corporation, from the very nature of its being, can have no authority to contract out of the limits of the State: that the laws of a State can have on extra-territorial operations; and that as a corporation is the mere creature of a law of the State, it can have no existence beyond the limits in which the law operates; and that it must necessarily be incapable of making a contract in another place.
>
> It is very true that a corporation can have no legal existence out of the boundaries of the sovereignty by which it is created. It exists only in contemplation of law, and by force of the law; and where that law ceases to operate, and is no longer obligatory, the corporation can have no existence. It must dwell in the place of its creation, and cannot migrate to another sovereignty. But although it must live and have its being in that State only, yet it does not by any means follow that existence there will not be recognized in other places; and its residence in one State creates no insurmountable objection to its power of contracting in another. It is, indeed, a mere artificial being, invisible and intangible; yet it is a person, for certain purposes in contemplation of law, and has been recognized as such by the decisions of this court.

[401] *See generally* Rutledge, *To Boldly Go Where You Have Not Been Told You May Go: The Restatements' View of LLCs and LLPs in Interstate Commerce*, LLC ADVISOR (April, 1995), reprinted in STATE TAX REVIEW (May 1, 1995); Rutledge, *To Boldly Go Where You Have Not Been Told You May Go: LLCs, LLPs, and LLLPs In Interstate Transactions*, 58 BAYLOR L. REV. 205 (2006).

[402] *See generally* Rutledge, *Again, For the Want of a Theory: The Challenge of the "Series" to Business Organization Law*, 46 AM. BUS. L.J. 311 (2009).

[403] *See* 2012 Ky. Acts, ch. 81, §§ 1-76, as codified in KRS chapter 386A; *see also* Rutledge, *The Kentucky Uniform Statutory Trust Act (2012): A Review*, 40 N. KY. L. REV. 93 (2012-13). For further commentary on series, *see, e.g.*, Rutledge, *Again, For the Want of a Theory: The Challenge of the "Series" to Business Organization Law*, 46 AM. BUS. L.J. 311 (2009); Rutledge, *The Man Who Tells You He Understands Series Will Lie To You About Other Things As Well*, J. PASSTHROUGH ENTITIES, Mar./Apr. 2013, 53; Allan G. Donn, Bruce P. Ely, Robert R. Keatinge and Bahar A. Schippel, *Limited Liability Entities: 2014 Update* (ALI, March 24, 2014).

[404] *See Rutledge, Again, For the Want of a Theory: The Challenge of the "Series" to Business Organization Law*, 46 AM. BUS. L.J. 311, 328-38 (2009); Rutledge, *The Internal Affairs Doctrine and Series Limited Liability – Never the Twain to Meet?*, 17 BUS. ENTITIES 4 (March/April 2015).

[7.16] Assignment of LLC Interests

An interest in an LLC is personal property, and unless the operating agreement provides otherwise, an LLC interest, in whole or part, is assignable.[405] A 2007 addition to the LLC Act serves to preempt KRS §§ 355.9-406 and 355.9-408, which may be interpreted to preempt limitations upon pledges of LLC membership interests contained in a written operating agreement.[406] The interest may be evidenced by a certificate, which itself may provide for the assignment of the interest represented.[407]

However, while the interest is freely assignable, the rights of management incident to that interest are not freely transferable. Therefore, while a member may unilaterally transfer the prospective interest in distributions made by the LLC (*i.e.*, the "economic rights"), a member may not unilaterally transfer the right to take part in the direction and management of the LLC (*i.e.*, the "management rights").[408] As detailed in KRS § 275.255(1)(e):

> An assignment … shall not … entitle the assignee to participate in the management and affairs of the [LLC] or to become or exercise any rights of a member ….

The non-assignable management rights include the right to:

- participate, either directly or by election, in management;
- inspect the records of the LLC;
- vote on the admission or replacement of additional members; and
- vote on the voluntary dissolution or continuation of the business after a dissolution event.

A member who has made an assignment of the economic rights of membership remains a member, exercising only the management rights of membership, until such time as the assignee becomes a member or the assignor member is removed.[409] A member who assigns all of their economic interest in an LLC, those being the only rights that may be unilaterally assigned, may be dissociated and shall cease to be a member upon the consent of a majority-in-interest of the non-assigning members.[410] A 2012 revision made to the LLC Act, namely the addition of "that they may unilaterally transfer," addresses (and rejects) the argument that not "all" of a member's

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[405] KY. REV. STAT. ANN. § 275.255(1)(a). *See generally* Rutledge, *Assigning Membership Interests: Consequences to the Assignor and Assignee*, J. PASSTHROUGH ENTITIES, July/Aug. 2009, 35.

[406] KY. REV. STAT. ANN. § 275.255(4). *See also* Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, 97 KY. L.J. 229, 249 (2008-09).

[407] KY. REV. STAT. ANN. § 275.255(2).

[408] KY. REV. STAT. ANN. §§ 275.255(1)(b)-(c).

[409] KY. REV. STAT. ANN. § 275.255(1)(d).

[410] *See* KY. REV. STAT. ANN. § 275.280(1)(c)2.

interest has been conveyed, and therefore he cannot be dissociated, because the non-transferrable rights to participate in management have not been assigned.[411] As clarified, the LLC Act provides that when a member has transferred all of his or her economic interest in a venture that may be unilaterally assigned, he or she is thereafter subject to dissociation by the other members. Until that dissociation (or in a member-managed LLC a voluntary resignation[412]) the assignor remains bound by all fiduciary and other obligations applicable absent the assignment. An assignment of an LLC interest does not dissolve the LLC.[413]

An assignee who has not yet received an assignment of the management rights of membership has no liability as a member consequent to the assignment, and the assignment does not release the assignor of any liability they incurred while a member.[414]

The rights of an assignee are very limited when compared to those of a member. Unlike members, who typically hold management rights, an assignee does not have inspection rights or other related information rights,[415] nor a right to participate in management[416] even with respect to modification of the underlying operating agreement when the modifications have a negative effect on the assignee.[417] Put another way, an assignee is not a member or otherwise a party to the operating agreement and lacks standing to object to its amendment.[418] Finally, the assignee is typically owed neither fiduciary obligations nor obligations of good faith or fair dealing.[419]

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[411] *See* 2012 Ky. Acts, ch. 81, § 109, amending KRS § 275.280(1)(c)2.

[412] *See supra* Section [7.3.8].

[413] KY. REV. STAT. ANN. § 275.255(1)(c).

[414] KY. REV. STAT. ANN. §§ 275.255(1)(e)-(f).

[415] *See* KY. REV. STAT. ANN. § 275.185(2) (inspection rights are available to "members"); *id*. § 275.185(3) (obligation to disclose information to "members"); *id*. § 275.255(1)(c) (assignee does not have the rights of a member); *see also Prokupek v. Consumer Capital Partners LLC*, C.A. No. 9918-VCN, 2014 WL 7452205 (Del. Ch. Dec. 30, 2014); *Dame v. Williams*, 727 N.Y.S.2d 816, 818 (N.Y. App. Div. 2001).

[416] *See* KY. REV. STAT. ANN. § 275.255(1)(c) (providing in part "An assignment of a [LLC] interest shall not ... 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.").

[417] *See, e.g*., *Bauer v. The Blomfield Co*., 849 P.2d 1365 (Alaska 1993) (assignee of partnership interest not owed obligations of good faith and fair dealing); *Bailey v. Fish & Neave*, 868 N.E.2d 956, 837 N.Y.S.2d 600 (N.Y. Ct. App. 2007) (amendment of partnership agreement altering post-withdrawal benefits to already withdrawn partners permitted). *See also* 1 LARRY E. RIBSTEIN AND ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 7.5 (2nd ed. June 2014), notes 19-20 and accompanying text.

[418] *See, e.g*., *Wiggs v. Summit Midstream Partners, LLC*, C.A. No. 7801-VCN Memorandum Opinion (Del. Ch. Mar. 28, 2013) (Non-member had no standing to object to amendment of operating agreement).

[419] *Bayside Petroleum, Inc. v. Whitmar Exploration Co*., 1997 WL 34690262 (D. Okla. 1997) ("no fiduciary duty" is owed the assignee of a partner); *Haynes v. B&B Realty Group, LLC*, 633 S.E.2d 691 (N.C. 2006) (no fiduciary duties owed to transferee of LLC interest); *Landskroner v. Landskroner*, 797 N.E.2d 1002, 1014 (Ohio Ct. App. 2003) (fiduciary duties are not owed to former member of LLC); Thomas E. Rutledge, Carter G. Bishop & Thomas Earl Geu, *No Cause for Alarm: Foreclosure and Dissolution Rights of a Member's Creditor*, PROBATE & PROPERTY, May-June 2007, 35.

Unless the operating agreement provides otherwise, a pledge, granting a security interest in, lien against or encumbrance of an LLC interest does not constitute an assignment and does not terminate or impair the rights of the member.[420] Rather, they entitle the assignee to receive, to the extent made, the distributions and other economic rights to which the assignor would be entitled.[421]

Permitting the bifurcation of the rights of membership between management rights and economic rights may lead to a situation in which the ownership of an LLC is divided into three camps: members with both economic rights and management rights; assignor members who retain only management rights but have no economic rights; and assignees who have economic rights but no management rights in the LLC. While the absence of management rights in an assignee[422] is a necessary element of the desired *in delectus personae* aspect of the LLC,[423] problems may arise in permitting the assignor to continue to exercise management rights. Having no further interest in the economics of the venture, the assignor has little incentive to participate or, for their own account, seek to maximize the success of the LLC. If the assignor has agreed to exercise management authority on behalf of or in accordance with instructions from the assignee, then *in delectus personae* is violated and management is being exercised, albeit indirectly, by one not admitted as a member.[424] In order to avoid that eventuality the Act permits the incumbent members to dissociate the assignor, whereupon the assignor ceases to be a member and to have any voice in the LLC's management.[425] Upon the dissociation of the assignor *in delectus personae* is recovered, the LLC being comprised of assignees with no right to participate in management and members with interests in both the management and the economics of the LLC.

[7.17] Right of Assignee to Become a Member

An assignee of an LLC interest does not have a right to become a member (*i.e.*, to enjoy management rights) in the LLC.[426] 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.[427] Prior to the adoption of the 1998 Amendments, the default provision for the consent to vesting management rights in an assignee, which consent admitted that assignee as a full member of the

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[420] KY. REV. STAT. ANN. § 275.255(3).

[421] KY. REV. STAT. ANN. § 275.255(1)(b).

[422] KY. REV. STAT. ANN. § 275.255(1)(c).

[423] *See, e.g.*, KY. REV. STAT. ANN. § 275.265(1); *id.* § 275.275(1)(a).

[424] *See also* Rutledge, *In Delectus Personae and Proxies*, J. PASSTHROUGH ENTITIES, July/Aug. 2011, 43.

[425] KY. REV. STAT. ANN. § 275.280(1)(c)2. *Accord id.* § 362.1-601(4)(b) (expulsion of a partner who has transferred all or substantially all of his transferrable interest); *id.* § 362.2-603(4)(b) (same); *id.* § 362.2-601(2)(d)2 (same).

[426] *See* KY. REV. STAT. ANN. § 275.255(1)(c) ("An assignment of a [LLC] interest shall not ... entitle the assignee ... to become ... a member ....").

[427] A written operating agreement could provide that the right to participate in management is freely assignable.

LLC, was the unanimous consent of the non-assigning members.[428] The requirement of a unanimous vote to vest management rights in an assignee could be modified by a written operating agreement. This rule was changed in the 1998 Amendments, wherein the requirement of unanimity was deleted, and a rule requiring the consent of a majority-in-interest was substituted.[429]

A 2010 addition made clear that the assignor does not vote with respect to the admission to membership of the assignee.[430]

The operating agreement may specify the manner in which the consent will be evidenced, the default provision being for a written instrument signed and dated by all members.[431]

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 dissociation of the assignor member, the management rights previously enjoyed evaporated. Whe (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[432] may, by coincidence, be 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.

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.[433] 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.[434] Regardless of whether the assignee becomes liable on the assignor's obligation to

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[428] KY. REV. STAT. ANN. § 275.265 (prior to the 1988 Amendments).

[429] KY. REV. STAT. ANN. § 275.265 as amended by 1998 Ky. Acts, ch. 341, § 36. A written operating agreement may provide for an alternative mechanism (*e.g.*, the manager, a super-majority of the members) for vesting management rights in the assignee.

[430] *See* KY. REV. STAT. ANN. § 275.265(1); *see also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383, 415-16 (2011) .

[431] KY. REV. STAT. ANN. § 275.265(1).

[432] *See* KY. REV. STAT. ANN. § 275.265(2).

[433] KY. REV. STAT. ANN. § 275.265(2).

[434] 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

make a contribution to the LLC, the assignor member remains liable to the LLC for the contribution;[435] this rule may be amended by a written operating agreement.

The LLC Act is silent with respect to whether an assignee member, in addition to becoming liable for the assignor's liability to make a contribution to the LLC, is similarly liable to satisfy any obligation to return a prior improper distribution from the LLC.[436] Permitting recovery of a distribution from an assignee member may serve as a significant impediment to the assignment of interests. In addition, unlike an obligation to make a contribution which will increase the capital of the LLC and presumably its ability to carry on business and earn profits, an assignee member enjoys no benefits from distributions made prior to the time he or she became a member.

Upon the admission of the assignee to membership, the assignor ceases to be a member.[437] This rule may be amended by a written operating agreement.

[7.18] Rights of a Member's Judgment-Creditor

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.[438] Since its adoption in 1994,[439] the charging order provision of Kentucky's LLC Act[440] has been repeatedly amended, namely in 1998,[441] in 2007[442] in 2010,[443] and in 2011.[444] The 2007 amendments were aimed at precluding a result similar to that rendered

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> 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.

[435] KY. REV. STAT. ANN. § 275.265(3).

[436] *See supra* Section [7.10.4].

[437] KY. REV. STAT. ANN. § 275.265(4).

[438] 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.

[439] *See* 1994 Ky. Acts, ch. 389, § 52.

[440] KY. REV. STAT. ANN. § 275.260.

[441] *See* 1998 Ky. Acts, ch. 341, § 35.

[442] *See* 2007 Ky. Acts, ch. 137, §§ 117, 149 and 156; *see also* Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, 97 KY. L.J. 229, 252-53 (2008-09) .

[443] *See* 2010 Ky. Acts, ch. 133, § 35; *see also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383, 396-97 (2011) .

in *Hubbard v. Talbott Tavern, Inc.*,[445] where a charging order was treated as an assignment of the underlying LLC interest which triggered the member's disassociation from the company. In 2010, the charging order provisions were supplemented to (a) make express that the entity is not a party to the proceeding in which an order is entered against the judgment-debtor, and (b) authorize that notice of the issuance of the charging order may be by the awarding court or as it should direct.[446] The 2010 Amendments were part of an effort to utilize the same formulas across all of the statutes incorporating the changing order.[447] Amendments made in 2011 limit the use of single member LLCs as abusive asset protection vehicles.[448]

Essentially, the charging order is a lien attaching to any distributions that might be made to a member or assignee.[449] 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,[450] its *sine qua non* is asset partitioning[451] and the preservation of the venture's assets and operations.[452] The charging order is subject to redemption prior to foreclosure,[453] and the LLC interest to which the charging order relates is subject to foreclosure.[454]

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[444] *See* 2011 Ky. Acts, ch. 29, § 23.

[445] Nos. 2003-CA-001468-MR, 2003-CA-001543, and 2004-CA-002184-MR, 2006 WL 2089308 (Ky. App. July 28, 2006).

[446] The 2010 Amendments also deleted the extant charging order provisions of the prior partnership and limited partnership acts, substituting in place provisions equivalent to the new partnership and limited partnership acts. *See* 2010 Ky. Acts, ch. 133, §§ 49, 51.

[447] 2010 Ky. Acts, Ch. 133, § 35.

[448] *See* 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); *see also* Thomas Earl Geu, Thomas E. Rutledge and John W. DeBruyn, *To Be Or Not To Be Exclusive: Statutory Construction of the Charging Order In the Single Member LLC*, 9 DEPAUL BUS. & COM. L.J. 83 (Fall, 2010).

[449] 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.").

[450] 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").

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

[452] *See* Thomas E. Rutledge, *I May Be Lost But I'm Making Great Time: The Failure of the Olmstead Court to Correctly Recognize the Sine Qua Non of the Charging Order*, J. PASSTHROUGH ENTITIES, Nov./Dec. 2010, at 65.

[453] KY. REV. STAT. ANN. § 275.260(5).

[454] KY. REV. STAT. ANN. § 275.260(4).

It is expressly provided that the LLC is not a necessary party to an action seeking a charging order against a judgment-debtor's interest in the LLC.[455] The statute is silent as to whether notice to the LLC is necessary prior to foreclosure on the charging order lien.

A comprehensive review of the charging order has been otherwise prepared, and is updated as new chapter 7B, infirm.[456]

[7.19] Records and Information

LLCs are required to maintain certain records relating to the structure, operation and finances of the LLC.[457] This provision requires that each LLC maintain:

- current and past lists of the names and last mailing address of each member and manager;
- copies of the articles of organization and amendments thereto, along with any powers of attorney pursuant to which those articles were executed;
- copies of the LLC's federal, state and local income tax returns and financial statements for the three most recent years or, if such were not prepared, copies of the information which was or should have been provided to the members to enable them to prepare their federal, state and local income tax returns; and
- copies of any effective written operating agreements and amendments thereto, along with copies of all previous written operating agreements.[458]

Unless such are contained in the written operating agreement, each LLC must also maintain:

- a record of the amount or agreed value of all contributions to the LLC;
- the times or events which will trigger additional contributions from the members;
- the events upon which the LLC will be dissolved and its affairs wound up; and

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[455] KY. REV. STAT. ANN. § 275.260(6). *See also Bank of America, N.A. v. Freed*, 971 N.E.2d 1087, 2012 WL 6725894 (Ill. App. I Dist., Dec. 28, 2012).

[456] *See* Thomas E. Rutledge and Sarah S. Wilson, *An Examination of the Charging Order under Kentucky's LLC and Partnership Acts* (*Part I*), 99 KY. L.J. ONLINE 85 (2011); *An Examination of the Charging Order under Kentucky's LLC and Partnership Acts* (*Part II*), 99 KY. L.J. ONLINE 107 (2011).

[457] KY. REV. STAT. ANN. § 275.185(1).

[458] KY. REV. STAT. ANN. §§ 275.185(1)(a)-(d).

- any other writings required by the operating agreement.[459]

The failure to maintain the required records and information is not grounds for imposing personal liability on any member or manager for the debts and obligations of the LLC.[460]

The LLC Act does not specify who within the LLC bears the burden of preparing and safe-guarding the required records. This is a point that should be addressed in the operating agreement.

Upon a reasonable written request and at their own expense, members may inspect and copy any record of the LLC.[461] With respect to the review and copying of business records, the LLC Act does not, as does the Corporation Act, divide records into classes, some of which may be reviewed only upon a showing of a proper purpose, or inquire as to the member's purpose for reviewing the records.[462] While a member may not be vexatious in requesting records as such conduct would violate the obligation of good faith and fair dealing,[463] the LLC may not object to a request based upon the member's failure to proffer a proper purpose. The LLC Act expressly permits a written operating agreement to impose reasonable limitations upon a member's access to and/or use of the records and information of the LLC.[464] If the restrictions are in a written operating agreement to which the member assented, the limitations are, as to that member, deemed reasonable. As to limitations not assented to by the member in question, the LLC bears the burden of showing them to be reasonable.[465] While it may be possible to restrict access to records,[466] there then arises the problem that the members lose the ability to police those in control of the LLC.

Absent a contrary provision in the operating agreement, assignees do not have inspection or information rights.[467]

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[459] KY. REV. STAT. ANN. §§ 275.185(1)(e)1-3.

[460] KY. REV. STAT. ANN. § 275.185(4).

[461] KY. REV. STAT. ANN. § 275.185(2). Prior to 2013 the statute was silent as to the addressee of a member's request to inspect books and records. Absent a provision in the operating agreement, any or all of the company, the managers (if any) and/or all other members were possible answers. A 2013 amendment makes clear that, in the absence of a contrary provision in the operating agreement, the request is to be addressed to the company. *See* KY. REV. STAT. ANN. § 275.185(2) as amended by 2013 Ky. Acts, ch. 106, § 7.

[462] *Compare* KY. REV. STAT. ANN. § 271B.16-020.

[463] KY. REV. STAT. ANN. § 275.003(7).

[464] KY. REV. STAT. ANN. § 275.185(5).

[465] *See also* Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, 97 KY. L.J. 229, 239 (2008-09) .

[466] *See* KY. REV. STAT. ANN. § 275.003(1).

[467] *See* KY. REV. STAT. ANN. § 275.185(2) (inspection rights are available to "members"); *id.* § 275.185(3) (obligation to disclose information to "members"); *id.* § 275.255(1)(c) (assignee does not have the rights of a member); *see also Prokupek v. Consumer Capital Partners LLC*, C.A. No. 9918-VCN, 2014 WL ___ (Del. Ch. Dec. 30, 2014); *Dame v. Williams*, 727 N.Y.S.2d 816, 818 (N.Y. App. Div. 2001).

Members in a member-managed LLC, and managers in a manager-managed LLC, are required to give full information to all members on the matters affecting the members.[468]

Additional obligations exist under the Internal Revenue Code. For example, an LLC that is both (i) taxed for purposes of the Internal Revenue Code as a partnership and (ii) required to file a Form 1065, must furnish each partner (for these purposes an assignee will be a partner) with a Schedule K-1 that provides the partner's distributive share of partnership income, gain, loss, deduction, or credit and any additional information that is necessary to enable the partner to determine the correct income tax treatment of a partnership item.[469] The Schedule K-1 must be furnished to each partner by the partnership on or before the due date of the partnership return (Form 1065) for the tax year (determined without regard to extensions).

[7.20] Suits By and On Behalf of the LLC

An LLC may file suit in, and suits may be filed against the LLC, in its own name.[470] A member, by virtue of that status, is not a proper party to a proceeding by or against the LLC.[471] However, a member will be a proper party to a suit when the suit is brought by the LLC against the member to enforce an obligation to the LLC, or in a proceeding by the member against the LLC to enforce a right of the member against that LLC.[472]

In addition to such other locations as may be appropriate, an LLC is subject to suit in the county in which it maintains its registered office and agent.[473]

An amendment to the LLC Act in 2012 provides that members and managers of an LLC are deemed to have consented to the jurisdiction of the Kentucky courts with respect to any suit brought by or on behalf of the organization.[474] While not intended to limit any existing basis for

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[468] KY. REV. STAT. ANN. § 275.185(3).

[469] *See* TEMPORARY REG. §§ 1.6031(b)-1T(a)(3).

[470] KY. REV. STAT. ANN. § 275.330.

[471] As stated in the commentary to Prototype LLC Act § 305 (1992):

> Because members, in their status as such, are not liable for the debts of the LLC, they should not be proper parties in third-party actions against the LLC. This section is intended to affirm that the LLC is an entity separate and apart from its members for purposes of litigation by or against the LLC.

At least one court has taken the admonition that LLC members are not proper parties to heart, and imposed Rule 11 sanctions against counsel who named an individual member as a party in a suit against an LLC. *See Page v. Roscoe, LLC*, 497 S.E.2d 422 (N.C. Ct. App. 1998).

[472] KY. REV. STAT. ANN. § 275.155.

[473] *See* KY. REV. STAT. ANN. § 452.450; *KEM Manufacturing Corp. v. Kentucky Gem Coal Co., Inc*., 610 S.W.2d 913 (Ky. App. 1980).

[474] *See* KY. REV. STAT. ANN. § 275.335(2), created by 2012 Ky. Acts, ch. 81, § 112.

asserting jurisdiction,[475] these provisions preclude, for example, the argument that a manager of a Kentucky LLC who resides in a foreign jurisdiction and who has never attended a meeting or otherwise acted in Kentucky is exempt from the jurisdiction of Kentucky's courts when an action for violation of the manager's fiduciary obligations to the LLC is filed against that manager.[476]

[7.21] Authority to Sue on Behalf of an LLC

KRS § 275.335,[477] the provision addressing how an LLC may initiate a lawsuit, is a curious provision in several respects.

Initially, KRS § 275.335 is an exception to the generally applicable rules of LLC management set forth in KRS § 275.165. Pursuant thereto, if the LLC is member-managed, then all decisions as to the LLC's management, a class of action that would otherwise include initiating a lawsuit on its behalf, would require the approval of a majority-in-interest of the members.[478] Alternatively, if the LLC is manager-managed, the decision for the LLC to bring suit would be made by the managers with the members not having a voice therein.[479] But then KRS § 275.335 is an exception to KRS § 275.165.

Under KRS § 275.335, which only addresses how an LLC may be authorized to bring suit, a per-capita majority of the members may authorize a member to on the LLC's behalf bring suit. Particular to this circumstance: (i) an alternative mechanism for counting the members is utilized;[480] (ii) in the case of a vote of the members a disinterested limitation is *sometimes* imposed; [481] and (iii) the restriction of exclusive management of a manager-managed LLC to the managers is eliminated. If the LLC is manager-managed, suit may be initiated by a majority of the managers, but an interested manager is barred from participation in that vote.[482] All of these rules are subject to modification in a written operating agreement.

Irrespective of whether the LLC is member-managed or manager-managed, unless a written operating agreement provides a contrary rule,[483] the member remain empowered to cause

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[475] *See, e.g., Clark v. Wenger*, Civ. Act. No. 1:14-CV-00002–TBR, 2014 WL 4742989 (W.D. Ky. Sept. 22, 2014) (actions of California resident individual as to Kentucky with respect to "informal" partnership were sufficient to create personal jurisdiction).

[476] A similar provision exists in Delaware. *See* DEL. CODE ANN. tit. 10, § 3114 (2010).

[477] Based upon § 1102 of the Prototype LLC Act (1992).

[478] *See* KY. REV. STAT. ANN. § 275.165(1); *id.* § 275.175(1).

[479] *See* KY. REV. STAT. ANN. § 275.165(2).

[480] Under KRS § 275.165, modified by KRS § 275.175(3), members vote in proportion to their respective capital contributions to the LLC. For purposes of authorizing suit under KRS § 275.335, members vote on a per-capita (one member = one vote) basis.

[481] *See* KY. REV. STAT. ANN. § 275.335(1)(a).

[482] *See* KY. REV. STAT. ANN. § 275.335(1)(b).

[483] There is to date a dearth of guidance as to what would constitute "otherwise provided in a written operating agreement." At one end of the spectrum would be a multi-paragraph provision addressing how suit may be brought on behalf of the LLC – no real question there arises. In contrast is the statement in the operating agreement of a manager-managed LLC that "all management decision on behalf of the LLC still be made by the

legal action to be initiated by the LLC.[484] This capacity exists even in a manager-managed LLC in which the managers have "exclusive power to manage the business and affairs of the [LLC]."[485] If the members are considering whether the LLC should bring suit, the members vote per-capita, and the suit is authorized if it is approved by more than one-half of the members "entitled to vote thereon." The statute does not explain or expand upon who is or is not a member "entitled to vote thereon"; the next sentence of the statute does not fill that role. The second sentence of KRS § 275.335(1)(a) provides:

> In determining the vote required under KRS 275.175, the vote of any member who has an interest in the outcome of the suit that is adverse to the interest of the limited liability company shall be excluded.[486]

This provision is applicable only if the operating agreement has required[487] that all members approve the LLC bringing the action. Thus, in the face of a requirement of unanimity, the member "who has an interest in the outcome of the suit that is adverse to the interest of the [LLC] shall be excluded."[488] Where, in contrast, the applicable operating agreement is silent as to bringing suit, there is not a statutory directive to exclude from the determination of whether one-half of the number of members have approved doing so those members having an interest adverse to that of the LLC. While a court could find such an exclusion to be what is intended by "eligible to vote thereon," it will do so without support from the statute itself or the commentary to the Prototype LLC Act.[489] Alternatively, if the operating agreement provides, *inter alia*, "that all decisions as to the management and affairs of the company will be made by a majority-in-interest of the members," and the agreement is silent as to both bringing suit and barring conflicted members from voting, it may be credibly argued that the written operating agreement has "otherwise provided" and no exclusion based upon an alleged adverse interest is appropriate.

If the LLC is manager-managed, the managers by majority vote[490] may authorize the LLC to bring suit. The vote of the managers, regardless at the simple per-capita majority

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managers." Some might argue this is insufficient to constitute "otherwise provided in a written operating agreement." Alternatively, "all management decisions on behalf of the LLC, including bringing suit on its behalf, shall be made by the manager" likely would be sufficient.

The only court in Kentucky to have considered the degree of language required to satisfy the "otherwise provided in a written operating agreement" is *Lourdes Medical Pavilion, LLC v. Catholic Healthcare Partners, Inc*., 2006 WL 753080 (W.D. Ky. 2006).

[484] KY. REV. STAT. ANN. § 275.335(1).

[485] *See* KY. REV. STAT. ANN. § 275.165(2).

[486] Emphasis added.

[487] Any requirement would have to be in writing. *See* KY. REV. STAT. ANN. § 275.335 ("Unless otherwise provided in a written operating agreement"); *id*. § 275.175(1) ("Unless otherwise provided in the articles of organization, a written operating agreement, or this chapter,….").

[488] KY. REV. STAT. ANN. § 275.335(1)(a).

[489] KRS § 275.335(1) enacts section 1102 of the Prototype Limited Liability Company Act (1992).

[490] Managers vote per capita. *See* KY. REV. STAT. ANN. § 275.175(1).

threshold of the statute or a different threshold in a written operating agreement, must be disinterested.[491]

In that an action under KRS § 275.335 is bought by the LLC, it will be aligned as the plaintiff in the action, and any member or manager acting on the LLC's behalf should not be named as a party except to the extent, if any, they are pursuing individual claims.[492]

It needs to be recognized that KRS § 275.335 is by its terms a quite limited provision. It addresses only the approval of bringing a suit on behalf of the LLC; it says nothing about the prosecution and settlement of the suit. These lacuna can be quite troubling in the case of a suit arising out of a dispute internal to the LLC. Consider Lilliput LLC having eleven members, one holding a 60% interest, and ten other members, each holding a 4% interest. Lilliput LLC, which is member-managed, has no written operating agreement and is as to these matters governed by the default rules of the LLC Act.[493] Irrespective of whether Gulliver, the 60% member, is or is not eligible to vote thereon,[494] a group of seven of the various 4% members are a clear per-capita majority, and they decide the LLC should bring suit against Gulliver. Assume as well that the suit is against Gulliver for misappropriation of the LLC's assets. KRS § 275.335 does not provide that the suit is after filing under control of the members who on the LLC's behalf initiated it, and it does not provide that any member not "entitled to vote thereon" is after initiation barred from participating in any company actions involving the suit. Specifically, KRS § 275.335(1) does not say that Gulliver may not, as the majority-in-interest member of Lilliput LLC, direct the LLC's legal counsel to drop the suit.[495] This is not to say that Gulliver has free reign to do exactly that. Rather, such an action may violate his obligation to avoid self-dealing and may even constitute waste of the LLC's property. A court sitting in equity[496] could find that Gulliver may not so act, but in so doing the court will not be relying upon the words of KRS §

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[491] *See* KY. REV. STAT. ANN. § 275.335(2). The distinction between the second sentence of each of KRS § 275.335(1) and (2) arises out of the former's application when reference needs to be made to KRS § 275.335(2) while the latter does not. For ease of comparison:

2nd sentence, KRS § 275.335(1) (emphasis added)	2nd sentence, § 275.335(2)
In determining the vote required under KRS 275.175, the vote of any member who has an interest in the outcome of the suit that is adverse to the interest of the limited liability company shall be excluded;	In determining the required vote, the vote of any manager who has an interest in the outcome of the suit that is adverse to the interest of the limited liability company shall be excluded.

[492] *See* KY. REV. STAT. ANN. § 275.335(1) ("a suit on behalf of the [LLC]"); *id.* § 275.330 (an LLC may sue or be sued in its own name); *id.* § 275.155 (member not a proper party to an action by or against LLC except as to individual claims or liabilities).

[493] *See* KY. REV. STAT. ANN. § 275.003(3).

[494] *See* KY. REV. STAT. ANN. § 275.003(1).

[495] *See also* Ky. S.Ct. R. 1.13.

[496] *See* KY. REV. STAT. ANN. § 275.003(1).

275.335. Alternatively, a court could determine that after the suit is brought KRS § 275.175 controls and that it is not for the court to write protections not provided for in the LLC Act or the operating agreement.

As revised in 2015, the statute is significantly simplified. First, an individual member may, on behalf of LLC, initiate a legal action in its name when authorized to do so by more than one half (per capita) of the members entitled to vote with respect to whether that action should be brought. This right of the members to bring on the LLCs behalf a lawsuit exist irrespective of whether the LLC is member managed or manager managed.[497] A member will be disqualified from participation in this vote if they have an interest in the outcome that is adverse to the interest of the LLC.[498] Any member vote to bring action must be in a record signed or otherwise approved by the members giving the authorization.[499] If the LLC is manager-managed as provided in its articles of organization, the prior statute referred to the operating agreement, in contrast to the articles of organization, vesting management in the managers. This provision introduced an unfortunate substantive analysis, this in contrast to the normal positive review of an LLC being either member managed or manager managed as provided in the election made in the articles of organization. By changing the reference from the operating agreement to the articles of organization, is intended that this determination likewise be a positive one made based upon the provision of the articles of organization. Legal action may be brought by any manager authorized by more than one half of the number of managers authorized to vote on the action. The same rule as to the capacity to vote of a member is applied as well to the managers, namely not having an interest adverse to that of the LLC. Also consistent with the rules as to member action, the action of the managers must be in a record form signed or otherwise approved by each manager.

Even as clarified in 2015, there are at least three particularly curious implications of this provision. First, it is important to recognize that this is the only provision in the LLC Act in which the members vote on a per capita, rather than a per contributed capital, basis. Second, clumsy drafting within the operating agreement can easily add confusion to this point. For example, a provision in the operating agreement providing "except as may be required by the LLC Act, all decisions will be made by a majority of the members," could be interpreted as overriding both the per capita voting provision, it here being assumed that "majority" refers to the members voting on the basis of contributed capital or some rule other than per capita and as well excluding from participation in that vote those members having an interest adverse to the LLC. In effect, such a provision could be read to preclude a majority of the minority members from, on the LLCs behalf, bringing action to challenge the majority members self-interested transactions with the LLC and to recover the benefits derived therefrom.[500] Of course, in such a circumstance, derivative action may be brought. Third, it needs to be recognized that this provision has and continues to address only the authority to initiate legal action.

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[497] KY. REV. STAT. ANN. § 275.335(2), created by 2015 Ky. Acts, ch. 34, § 54.

[498] KY. REV. STAT. ANN. § 275.335(3), created by 2015 Ky. Acts, ch. 34, § 54.

[499] *See* KY. REV. STAT. ANN. § 275.335(4), created by 2015 Ky. Acts, ch. 34, § 54.

[500] *See also* KY. REV. STAT. ANN. § 275.170(2).

As clarified in the amendments, the prosecution of the action on behalf of the company remains a matter of company management to be governed by the terms of the operating agreement. Unless there is a vote sufficient to amend the operating agreement, such that authority to prosecute this action will be vested as determined by the members, whether or not the suit should be continued is not governed by KRS section 275.335. Again, careful drafting of the operating agreement is necessary in order to avoid this admittedly surprising result. For example, returning to a suit initiated by a majority of the minority members to, the LLC's behalf, seek recovery from the majority member for the benefits of self-interested transactions with the company, even if the majority member cannot vote with respect thereto because he or she has an interest adverse to the LLC, that same majority member could conceivably determine that it should be dismissed. Such an action seeking dismissal might itself be a breach of the managing member's fiduciary duties. It here being assumed that the LLC in question is member-manage and that, consequent thereto, that managing member owes fiduciary duties that have not been either modified or eliminated in the written operating agreement. But that is a separate question whose remedy is as well subject to the confusion here identified.

[7.22] Former KRS § 275.340

Prior to its repeal in 2010, KRS § 275.340 provided that the determination that there was not proper authority to initiate an action on behalf of an LLC could not be "asserted as a defense to an action brought by the LLC or as the basis for the LLC to bring a subsequent suit in the same cause of action." KRS § 275.340 caused mischief in that was applied in a manner not intended, and for that reason was in 2010 deleted.

KRS § 275.340 was based upon Section 1103 of the Prototype LLC Act, it being the primary source document for the original 1994 Kentucky LLC Act.[501] The official comment to Prototype section 1102 provides in part "Section 1103 provides for the consequences of unauthorized suits vis-à-vis third parties." The rationales for KRS § 275.340 provision were twofold. The first was to preclude an LLC, having not prevailed in an action brought in its name, to assert that it was not bound by the action and thereby avoid issues of res judicata, collateral estoppel, law of the case, claim preclusion, etc. Second, it was intended that the defendants in an action brought by an LLC not be able to have the action dismissed due to a lack of authority, necessitating that the LLC take whatever steps that are thereafter necessary to in fact authorize the action, during which time the statute of limitations on the claim may have run or the defendant may have otherwise come into additional defenses.

This statute has seen its application not vis-à-vis actions between the LLC and third parties, but rather inter-se the members. In *Lourdes Medical Pavilion, LLC v. Catholic Health Care Partners, Inc.*,[502] the operating agreement at issue required the consent of both members to initiate legal action on behalf of the LLC. One member, in their own name as well as in the name of the LLC, brought an action against the other member. The Court found that, in bringing the

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[501] *See* Rutledge & Booth, *The Operative Provisions of the LLC Act* (ch. 7), LIMITED LIABILITY COMPANIES IN KENTUCKY (University of Kentucky College of Law Monograph Series, 1994) at 9.

[502] *Lourdes Medical Pavilion, LLC v. Catholic Healthcare Partners, Inc.*, 2006 WL 753080 (W.D. Ky. 2006).

action, the one member was acting outside the bounds of the operating agreement. However, based upon KRS § 275.340, the Court determined that the action should not be dismissed notwithstanding the lack of actual authority in the one member to bring suit on behalf of the LLC against the other member. In doing so the *Lourdes* court eviscerated KRS § 275.335 and ignored the "maximum enforcement of operating agreements" directive now codified at KRS § 275.003(1).[503]

To avoid results similar to the *Lourdes* decision, KRS § 275.340 was in 2010 deleted from the LLC Act.[504] Actual authority to bring an action on behalf of an LLC will continue to be determined under the operating agreement and KRS § 275.335, and questions as to whether the action has been properly authorized and whether the LLC is bound by any determination rendered will be made under generally applicable principles of law. The deletion of KRS § 275.340 from the LLC Act does not create a gap. None of the KyBCA, KyRUPA, KyULPA, KyNPCA or the other business organization acts contains a provision equivalent to KRS § 275.340. It needs to be recognized that KRS § 275.335 is not a derivative action provision. Rather, it defines alternative means by which the LLC may be authorized to itself bring an action. Ergo, even where an LLC is manager-managed, the decision to bring an action may still be brought by the members, and when that action is initiated by either the members or the managers, this provision sets forth the required thresholds for consent (absent contrary private ordering).

Until 2015 the LLC Act was silent as to derivative actions.[505] The statute having not modified or limited any of the rules that have arisen in equity with respect to derivative actions, they were applicable to any derivative action that might be brought.[506]

Note that an LLC is not permitted to appear *pro se*; rather, it must be represented by counsel.[507]

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[503] 2006 U.S. Dist. LEXIS 12550 (W.D. Ky. Mar. 22, 2006).

[504] At the time of the *Lourdes* decision, the "maximum enforcement of operating agreements" language was codified at KRS § 275.015(14). *See also* Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, 97 KY. L.J. 229, 260 (2008-09).

[505] The LLC Act does not affirmatively provide for derivative actions as a means of recovering misappropriated assets or opportunities. *See, e.g.*, PROTOTYPE LLC ACT (1992), section 1102, Commentary ("It is important to emphasize that this section does not permit derivative suits unless they are provided for in the operating agreement."). However, the LLC Act in no way forbids such suits. *See* Rutledge and Booth, *The Limited Liability Company Act: Understanding Kentucky's New Organizational Option*, 83 KY. L.J. 1, 41, fn. 202 (1994-95) ("The LLC Act does not provide for derivative actions as a means of recovering misappropriated assets or opportunities. However, the LLC Act in no way forbids such suits.").

[506] *See also* Rutledge, *Who Will Watch the Watchers?: Derivative Actions in Nonprofit Corporations*, 103 KENTUCKY LAW JOURNAL ONLINE 31 (2015).

[507] *See Bobbett v. Russellville Mobile Park, LLC*, No. 2007-CA-000684-DG (Ky. App. Sept. 12, 2008; modified Oct. 17, 2008); *see also* Rutledge, *Regarding the Disregarded Entity*, J. PASSTHROUGH ENTITIES, Mar./Apr., 2011, 39 (collecting cases).

Questions as to whether an action has been properly authorized and whether the LLC, under principles of res judicata, claim preclusion, etc., is bound are determined under generally applicable principles.[508]

[7.23] Derivative Actions

In 2015 a new section was been added to the LLC Act to set forth rules applicable as to derivative actions in LLCs. While the LLC Act as originally adopted did not provide expressly for derivative actions, neither did it preclude them.[509] Clearly such actions exist under the rules of equity,[510] and the Kentucky courts have both entertained express derivative actions with respect to LLCs and otherwise maintained the direct versus derivative distinction.[511] By means of this new statute, it being based upon that adopted by the Kentucky General Assembly in 2012 with respect to statutory trusts,[512] there are set forth the procedural limitations and requirements as to bringing a derivative action.[513] With this addition to the LLC Act, Kentucky law is brought more consistent with that of Delaware, the Revised Uniform Limited Liability Company Act and

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[508] *See also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383 (2011).

[509] *See, e.g.*, Rutledge and Booth, *The Limited Liability Company Act: Understanding Kentucky's New Organizational Option*, 83 KY. L.J. 1, 41, fn. 202 (1994-95) ("The LLC Act does not provide for derivative actions as a means of recovering misappropriated assets or opportunities. However, the LLC Act in no way forbids such suits."); CARTER G. BISHOP AND DANIEL S. KLEINBERGER, BISHOP & KLEINBERGER ON LIMITED LIABILITY COMPANIES ¶ 10.07[2] (2012 and 2014-2 cum. supp.) ("Many LLC statutes expressly authorize derivative actions, but some do not. This distinction should make little difference. Derivative litigation began in the corporate context over 150 years ago without the benefit of statutes, and remains essentially equitable in nature."). *See also generally* Rutledge, *Who Will Watch the Watchers?: Derivative Actions in Nonprofit Corporations*, 103 KY. L. J. ONLINE 31 (2015).

[510] *See also* KY. REV. STAT. ANN. § 275.003(1).

[511] *See, e.g.*, *Pixler v. Huff*, Civ. Act. No. 3:11-CF-000207-JHM, 2012 WL 3109492 (W.D. Ky. July 31, 2012) (in the context of an LLC, applied the test traditionally applied in corporations as to the direct versus derivative distinction and determined whether certain claims brought by a member could be brought only on a derivative basis); *id.*, 2012 WL 3109492, *3 ("Therefore, Plaintiff may maintain her claims against the Defendants only where she has suffered an injury that is separate and distinct from that which would be suffered by other members or the LLC as an entity."); *R.C. Tway Co. v. High Tech Performance Trailers, LLC*, No. 3:2012-CV-00122, 2013 WL 842577, *3 (W.D. Ky. Mar. 5, 2013) ("Each of the claims identified above clearly alleges that High Tech or Hanusosky violated some duty it owed directly to [Performance Trailers], thus causing [Performance Trailers] injury. As [Performance Trailers] is the allegedly injured party for each of these claims, it is the one that is entitled to enforce the rights granted by substantive law. Accordingly, [Performance Trailers] is not a nominal party, but instead is a real party in interest as to those claims."); *Chou v. Chilton*, Nos. 2009-CA-002198-MR, 2009-CA-002284-MR, 2014 WL 2154087 (Ky. App. May 23, 2014) ("[The LLC] and not Chou himself would benefit from any recovery for breach of the operating agreement, fraud, misappropriation, breach of fiduciary duty or gains taken by the defendants. While Chou may or may not receive funds from [the LLC] on dissolution of that company, any wrongs for breach of the operating agreement, fraud, misappropriate, breach of fiduciary duty or gains taken by the defendants perpetrated by any of the [defendants] or possibly [a separate LLC controlled by the defendants] would be wrongs against [the LLC] and not Chou individually."); *Turner v. Andrews*, 413 S.W.3d 272 (Ky. 2013) (rejecting effort by the sole member of an LLC to bring on his own behalf (rather than on behalf of the LLC), a claim for lost profits.).

[512] *See* KY. REV. STAT. ANN. § 386A.6-110.

[513] *See* KY. REV. STAT. ANN. § 275.337, created by 2015 Ky. Acts, ch. 34, § 50.

the Revised Prototype Limited Liability Company Act.[514] Not addressed is the question of whether the operating agreement may (a) modify (presumably by raising additional thresholds) the standing requirements or (b) alter the rules for the potential for fee shifting. That said, neither should be possible. Initially, while such is of itself not determinative, the provision's modification by the operating agreement is not provided for.[515] Second, there exists a strong argument that the parties to an operating agreement may not, by private ordering, alter or limit the equitable powers of the court, by means of a derivative action, to review and as necessary correct abuses and breaches of duty. [516]

The distinction between a direct and derivative action, the former involving a unique injury to the plaintiff while the former involves an injury to the LLC as a distinct legal person, has been incorporated into the statute.[517] A direct action is not subject to the standing, procedural and pleading requirements of a derivative action.[518] A derivative action is subject to: (i) a demand requirement or the pleading of futility;[519] and (ii) the requirement of member status at the time the action is commended and at the time of the complained of actions.[520] All proceeds of the action are property of the LLC.[521] Dismissal or settlement of a derivative action requires court approval.[522] The proper venue for a derivative action is the circuit court of the county in which the LLC maintains its registered office.[523] If the derivative action results in substantial

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[514] *See* DEL. CODE ANN. tit. 6, §§ 18-1001 through 18-1004 (governing derivative actions in Delaware LLCs); REVISED PROTOTYPE LIMITED LIABILITY COMPANY ACT §§ 901 through 908, 67 BUS. LAW. 117, 194-198 (Nov. 2011) (governing derivative actions); REV. UNIF. LTD. LIAB. CO. ACT § 902 et seq., 6B U.L.A. 523 (2008). Looking at the states adjoining Kentucky, all of their LLC Acts, except that of Indiana, expressly provide for derivative actions. *See* OHIO CODE § 1705.49 thru 1705.52; TENN. CODE § 48-249-801 et seq.; MO. CODE § 347.173; 805 LLCs 180/4001 et seq.; W. VA. CODE § 31B-11-1101 et seq.; VA. CODE § 13.1-1042.

[515] *Contrast* KY. REV. STAT. ANN. § 275.170 ("Unless otherwise provided in a written operating agreement"); *id*. § 275.220 (same).

[516] *See* KY. REV. STAT. ANN. § 275.003(1) ("Unless displaced by particular provisions of this chapter, the principles of law and equity shall supplement this chapter."); *In re Carlisle Etcetera*, C.A. No. 10280-VCL, 2015 WL 1947027 (Del. Ch. Apr. 30, 2015).

[517] *See* KY. REV. STAT ANN. § 275.337. *Accord id*. § 386A.6-110(i); *id.* §§ 362.2-931(1), (2). *See also CMS Inv. Holdings, LLC v. Castle*, C.A. No. 9468-VCP, 2015 WL 3894021 (Del. Ch. June 23, 2015) (applying direct versus derivative distinction under Delaware law).

[518] *See also Marhula v. Grand Forks Curling Club, Inc*., 2015 ND 130, 2015 BL 166358 (N.D. May 27, 2015) (action challenging termination of membership in nonprofit corporation is not subject to derivative action requirements).

[519] KY. REV. STAT. ANN. §§ 275.337(2), (4). *Accord id*. § 271B.7-400 (2); *id.* § 362.2-832; *id.* § 362.2-934; *id.* § 272A.13-010; *id.* § 272A.13-060; *id.* § 386A.6-110(2).

[520] KY. REV. STAT. ANN. § 275.337(3). The requirement of having been a member at the time of the action complained of may be derived from an assignor if the assignment was by operation of loss or pursuant to the terms of the operating agreement. *Accord id.* § 271B.7-400(1); *id.* § 272A.13-020(1); *id.* § 362.2-933; *id.* § 386A.6-110(3).

[521] KY. REV. STAT. ANN. § 275.337(5).

[522] KY. REV. STAT. ANN. § 275.337(6). *Accord id*. § 271B.7-400(3); *id.* § 272A.13-040; *id.* § 386A.6-110(6).

[523] KY. REV. STAT. ANN. § 275.337(7). Almost never may a derivative action by brought in federal court on the basis of diversity jurisdiction. Rather, as the LLC will be either a plaintiff or a defendant in any derivative

benefit to the LLC, the court may require it to pay the plaintiff member's reasonable expenses including counsel fees.[524] Conversely, to the extent the suit or an aspect thereof was brought without reasonable cause or for an improper purpose, the court may order the plaintiff member to pay each defendant's reasonable expenses including counsel fees.[525]

It is to be expected that disputes as to the alignment of the LLC will oft occur. Where an individual or other minority of the member asset they are vindicating the LLC's rights through a derivative action, the LLC will typically, at least initially, be aligned as a plaintiff. An argument may be made that the initial alignment should be as a defendant as the suit has two components, namely (a) against the LLC for failure to bring a direct action to vindicate its rights and (b) against the person or persons who are alleged to have injured the LLC.

Where the LLC is initially aligned as a plaintiff, realignment as a defendant may be appropriate where there is animosity (when will there not be?) between the minority-member plaintiff and those exercising control over the LLC. This treatment reorganizes that even as the minority may have the right to on the LLC's behalf initiate and maintain a derivative action, the majority members or the manager who the target of the suit will typically retain control over the LLC. Still being controlled by the targets of the suit, animosity may dictate the LLC's alignment as a defendant.[526]

[7.24] Dissociation

[7.24.1] Dissociation is the label applied to the termination of the status as a member in an LLC.[527] Dissociation of a member, unless they are the only member and a

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action, *see, e.g.*, *Gabriel v. Preble*, 396 F.3d 10 (1st Cir. 2005) (regarding the plaintiff or defendant alignment of the entity), and as the entity will have the citizenship of all members, there will never be diversity of citizenship. *See, e.g.*, *Lotan v. Horizon Properties LLC*, No. 14-Civ. 3134 (S.D.N.Y. May 27, 2014) ("Plaintiffs common citizenship with the LLC destroys complete diversity."); *Bischoff v. Boar's Head Provisions Co., Inc.*, 436 F. Supp.2d 626 (S.D.N.Y. 2006) ("There is no dispute that as long as [Plaintiff] may bring derivative claims on behalf of [the LLC] is a true defendant that destroys complete diversity in this case."); *Richardson v. Edward D. Jones & Co.*, 744 F. Supp. 1023 (D. Colo. 1990); *General Technology Applications, Inc v. Exro Ltda.*, 388 F.3d 114 (4th Cir. 2004); *Cook v. Toidze*, 950 F. Supp.2d 386, 391 (D. Conn. 2013) ("If the action at hand is a derivative suit, the [LLC] is not a nominal party.").

[524] KY. REV. STAT. ANN. § 275.337(8)(b). *Accord id.* § 272A.13-050(2)(b); *id.* § 362.2-935(2); *id.* § 386A.6-110(9)(b).

[525] KY. REV. STAT. ANN. § 275.337(8)(a). *Accord id.* § 272A.13-050(2)(a); *id.* § 362.2-953(3); *id*. § 386A.6-110(9)(a). With respect to the apportionment of costs on a claim by claim basis, *see also Wanandi v. Black*, No. 2013-CA-000459-MR. (Ky. App. May 1, 2015), citing *Kentucky Farm Bureau Mut. Ins. Co. v. Burton*, 922 S.W.2d 385, 389-90 (Ky. App. 1996).

[526] *See, e.g.*, *Hildebrand v. Lewis*, 281 F.Supp.2d 837, 844-45 (E.D. Va. 2003).

[527] *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.")

successor does not elect to become a member, does not effect the dissolution of the LLC.[528] The effect of dissociation is that the former member becomes, to the extent not otherwise assigned, an assignee of their own limited liability company interest[529] and has with respect thereto only the rights of an assignee.[530]

The statute lists a variety of events upon which a member is dissociated; each deserves particular attention.

[7.24.2] *Voluntary Resignation.*

A member is dissociated upon a permitted voluntary resignation from the LLC.[531] This provision is effective if and only if the member is permitted to withdraw; by default under the Act, the right is restricted to member-managed companies.[532] 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.[533]

[7.24.3] *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.[534] If, however, the assignee is admitted as a member in the LLC, that admission has the effect of dissociating the assignor.[535] If by private ordering in

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[528] *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. *See also* Rutledge and Booth, *The Limited Liability Company Act: Understanding Kentucky's New Organizational Option*, 83 KENTUCKY LAW JOURNAL 1, 36 (1994-95).

[529] *See* KY. REV. STAT. ANN. § 275.280(5).

[530] *See* KY. REV. STAT. ANN. § 275.255(1)(b); *id*. § 275.255(1)(c).

[531] *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.")

[532] *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).

[533] *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.").

[534] *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.").

[535] *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").

the operating agreement it is provided that assignment of all (or substantially all) interests in the LLC effects a member's dissociation, 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.

[7.24.4] *Removed as a Member.*

Initially, a written operating agreement may provide that a member is dissociated upon whatever terms are set forth in the agreement.[536] If an event so defined comes to pass, the member is dissociated.

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[537] consent,[538] the assigning member is dissociated.[539] Note that this is a two-step process; assignment of all interests in the LLC without more does not effect dissociation.[540]

A different rule is provided with respect to what is a single member LLC. As noted above, in a multiple member LLC, dissociation 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 dissociation.[541] The fourth component of the statute; namely "upon resignation as a member,"[542] 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.

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[536] *See* KY. REV. STAT. ANN. § 275.255(1)(c)1; *see also id.* § 275.003(1).

[537] *See also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 NORTHERN KENTUCKY LAW REVIEW 383, 415-16 (2011).

[538] The consent to the assigning member's disassociation must be in writing.

[539] *See* KY. REV. STAT. ANN. § 275.255(1)(c)2.

[540] The consent is to the dissociation, not to the assignment.

[541] *See* KY. REV. STAT. ANN. § 275.255(1)(c)3.

[542] *See* KY. REV. STAT. ANN. § 275.255(1)(c)4.

[7.24.5] *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 dissociation from the LLC.[543]

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 dissociation.

In the context of a single-member LLC, the courts have held that the bankruptcy estate include the right to manage the LLC.[544] As such, the bankruptcy estate/transfer are not treated as a mere assignor of the former member.

In the context of a multiple-member LLC, the courts generally reject the notice that the estate holds only the economic rights of membership without management rights. Rather, the ipso facts claims as of the bankruptcy code preserve those rights.[545]

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[546] as well as other properties. That estate is then managed for the benefit of the bankrupt's creditors. The Bankr. 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 Bankr. 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.[547]

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[543] *See* KY. REV. STAT. ANN. § 275.280(1)(e); *id.* § 275.280(1)(e).

[544] *See, e.g., In re First Protection, Inc*., 440 B.R. 821, 830 (B.A .P. 9th Cir.2010); *In re B & M Land & Livestock, LLC*, 498 B.R. 262, 267 (Bankr.D.Nev.2013); *In re Albright*, 291 B.R. 538, 541 (Bankr. D. Colo. 2003). *See also Thomas E. Rutledge and Thomas Earl Geu, The Albright Decision - Why a SMLLC is Not an Appropriate Asset Protection Vehicle*, BUSINESS ENTITIES, Sept./Oct., 2003, 16.

[545] *See, e.g., In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 707-08 (E.D. Va. 2000) (bankruptcy estate includes both economic and non-economic rights in the LLC); *In re Ehmann* 319 B.R. 200 (Bankr. D. Arz. 2005). *See also* Thomas E. Rutledge and Thomas Earl Geu, *In re Ehmann, Guess Who's Coming to Dinner?: The Bankruptcy Trustee's Ability to Become a Member and the Ehmann Decision*, BUSINESS ENTITIES, March/April 2005, 32; *In re Ehmann II - Now You See It, Now You Don't*, BUSINESS ENTITIES, May/June 2006, 44.

[546] Bankr. Code § 541(a)(1).

[547] 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 --
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> (A) that restricts or conditions transfer of such interest by the debtor; or
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> (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

Bankr. Code § 365(b)(2) also addresses ipso facto provisions[548] and addresses the cause of defaults in and the ability of a trustee to assume an "executory agreement."[549]

A crucial provision is Bankr. 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.[550]

> effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

[548] 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.

[549] 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 then 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.

[550] Bankr. Code § 365(c)(1)(A). Similar language appears at Bankr. Code § 365(e)(2)(A)(1), which needs to be read in concert with § 365(e)(1):

These provisions provide, *inter alia*, that notwithstanding Bankr. 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.*[551] 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,[552] 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)*[553] 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

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> (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 contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
>
> (ii) such party does not consent to such assumption or assignment; or ...

[551] 188 B.R. 607 (D. Neb. 1995).

[552] *In re Cardinal Industries, Inc.*, 116 B.R. 964 (Bankr. D.C. Ohio 1990).

[553] *Broyhill v. DeLuca* (*In re DeLuca*), 194 B.R. 65 (Bankr. E.D.Va. 1996). The *DeLuca* bankruptcy also led to the opinion in *In re DeLuca*, 194 B.R. 79 (Bankr. D.C. Va. 1996). For contemporaneous reviews of the *DeLuca* and *Daugherty* opinions, *see* James J. Wheaton, *Dumping Deadbeats & Enforcing Limited Liability Entity Agreements in Bankruptcy*, 3 J. LIMITED LIABILITY COS. 60 (Fall 1996) and Anthony M. Sabino, *Litigating the Limited Liability Company, Part II: A Tale of Two Bankruptcy Courts*, 69 N.Y.ST.B.J. 22 (Mar./Apr. 1997).

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).[554] Ergo, the bankruptcy trustee could not substitute himself for the DeLucas as managing members over the objection of the other members.[555]

Reaching a different conclusion than the *DeLuca* rulings was *In re Garrison-Ashburn, L.C.*[556] 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 LLC. Pursuant to the amendments, events that formerly triggered dissolution of the entity became events of dissociation of a member from the entity. Under the amended statute, bankruptcy of a member results in dissociation, 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.[557] The court stated that such a person would stand in an analogous position to the LLC as a shareholder to a corporation.[558] Under these circumstances, the court said the operating agreement was not an executory contract.[559]

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."[560] It is important to note that

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[554] *Id.* at 75.

[555] *Id.* at 78.

[556] 253 B.R. 700 (Bankr. E.D. Va. 2000).

[557] *Id.* at 704.

[558] *Id.* at 708.

[559] *Id.*

[560] *Ehmann*, 2005 WL 78921 at *1.

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.[561]

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,"[562] 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.[563]

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."[564] Fiesta argued that these limitations on the rights of a transferee are authorized by the Arizona LLC Act,[565] that the trustee was a mere assignee and not a member, and posited, but in the court's view did not argue well,[566] 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."[567]

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

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[561] *Id*.

[562] *Id*.

[563] *Id*.

[564] *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 one of the authors (Rutledge) that the Trustee had sought the consent of the other members to the Trustee's admission as a member, and consent was denied.

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

[566] "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.

[567] *Id*. at *2.

those conditions and restrictions would be ignored. Applying the "Countryman Test"[568] 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.[569] 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 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.[570]

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.[571]

[7.24.6] *Death or Incompetency.*

The death or determination of the incompetency of a member effects dissociation.[572] Either of these events may be waived by a majority-in-interest of the other members.[573] This

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[568] "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.).

[569] *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.")

[570] *Id*. at *5.

[571] *Id.*

[572] *See* KY. REV. STAT. ANN. § 275.255(1)(f).

[573] *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").

express right of waiver is somewhat confusing. If death is waived as an event of dissociation, 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 dissociation 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?[574]

As to an incompetent member, a waiver of dissociation has the same problems. Is the waiver of dissociation 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?

[7.24.7] *Termination of a Trust.*

If a trust is a member of the LLC, the termination of the trust will effect the trust's dissociation from the LLC.[575] 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.[576]

The dissociation of the trust upon termination may be waived by majority-in-interest of the other members.[577] However, how this would operate in is unclear. As to the terminated trust, what would be the effect of a waiver of the dissociation?; 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 dissociation 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.

[7.24.8] *Dissolution of an LLC Member*.

If another LLC is a member of an LLC, the dissolution of the other LLC and the commencement of it's winding up effects it's dissociation.[578] As with most of the other provisions of this section of the LLC act, the dissolution 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 dissociation; 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 dissolution is unclear. As to the dissolved and wound up LLC, what would be effect of a waiver of the dissociation;

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[574] *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.").

[575] *See* KY. REV. STAT. ANN. § 275.280(1)(g).

[576] *See* KY. REV. STAT. ANN. § 275.255(5).

[577] *Id*.

[578] *See* KY. REV. STAT. ANN. § 275.255(1)(h).

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 dissociation be treated as the admission of the beneficiaries as members into the LLC.

[7.24.9] *Dissolution of a Corporate Member*.

If a corporation is a member of an LLC, the dissolution of the corporation effects its dissociation.[579] As with most of the other provisions of this section of the LLC Act, the dissolution 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 dissociation; 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 dissociation. Assuming the ninety-day period has transpired, a corporation's dissolution effects the dissociation even if winding up is never commenced. For example, if a corporation is administratively dissolved,[580] and that dissolution is not cured within 90 days but is thereafter cured (the effect of that cure being retroactive),[581] the corporation is still dissociated from the LLC notwithstanding the reinstatement. The reinstated corporation will be, in effect, its own assignee.[582]

[7.24.10] *Termination of an Estate Member*.

If an estate is a member of the LLC, the termination of the estate will effect the estate 's dissociation from the LLC.[583] 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.[584]

The dissociation of the estate upon termination may be waived by majority-in-interest of the other members.[585] However, how this would operate in is unclear. As to the terminated estate, what would be the effect of a waiver of the dissociation?; 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 dissociation be treated as the admission of the beneficiaries as members into the LLC?

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[579] *See* KY. REV. STAT. ANN. § 275.255(1)(i).

[580] *See* KY. REV. STAT. ANN. § 14A.7-020.

[581] *See* KY. REV. STAT. ANN. § 14A.7-030(3).

[582] *See* KY. REV. STAT. ANN. § 275.280(5).

[583] *See* KY. REV. STAT. ANN. § 275.280(1)(j).

[584] *See* KY. REV. STAT. ANN. § 275.255(5).

[585] *Id*.

[7.24.11] *Other Events Defined in the Operating Agreement.*

The operating agreement may define either events that will effect a member's disassociation.[586] Examples of the application of this provision include:

- dissociation of an attorney from a law firm PLLC upon being disbarred;
- dissociation of an accountant from an accounting firm PLLC upon losing the license to practice accounting; and
- dissociation of a member who is convicted of a DUI from an LLC that holds a liquor license.

[7.25] LLCs and Federal Diversity Jurisdiction

For purposes of federal diversity jurisdiction,[587] an LLC is deemed to be a citizen of the jurisdiction of domicile of each of its members.[588] An LLC is not a citizen of either the jurisdiction of organization or of its principal place of business unless one of its members has that citizenship.[589] Put another way, neither the jurisdiction of organization nor the jurisdiction in

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[586] KY. REV. STAT. ANN. § 275.280(2).

[587] 28 U.S.C. § 1332.

[588] *See, e.g., Homfeld II, L.L.C. v. Comair Holdings, Inc.*, 53 Fed. Appx. 731, 2002 WL 31780184 (6th Cir. 2003) (adopting the rule of *Cosgrove v. Bartolotta* in the 6th Circuit to the effect that "a limited liability company is not treated as a corporation and has the citizenship of its members."); *Delay v. Rosenthal Collins Group, LLC*, 585 F.3d 1003, 1005 (6th Cir. 2009) (reiterating the *Homfeld* decision to the effect that an LLC "has the citizenship of each of its members."); *Delay v. Rosenthal Collins Group, LLC*, 585 F.3d 1003, 1005 (6th Cir. 2009) ("When diversity jurisdiction is invoked in a case in which a limited liability company is a party, the court needs to know the citizenship of each member of the company. And because a member of a limited liability company may itself have multiple members – and thus may itself have multiple citizenships – the federal court needs to know the citizenship of each 'sub-member' as well."); *Realco Ltd. Liability Co. v. AK Steel Corp*., 2008 WL 19990810 (E.D. Ky 2008) ("It is well established that an LLC has the citizenship of each of its members.") (*citing Homfeld II, LLC v. Comair Holdings, Inc*., 2002 WL 31780184 (6th Cir. 2002)); *Rich & Rich Partnership v. Poetman Records USA*, 2008 WL 1868028 (E.D. Ky. 2008); *Gibraltar Kentucky Development, LLC v. Cantrell*, 2008 WL 1771921 (E.D. Ky. 2008). *See generally* Rutledge, *Which Courthouse Door? - Diversity Jurisdiction and Unincorporated Business Organizations (and even some that are Incorporated)*, J. PASSTHROUGH ENTITIES, Nov./Dec. 2005, 21.

[589] *See Citizens Bank v. Plasticware, LLC*, 2011 WL 5598883 (E.D. Ky. 2011) ("Plasticware's principal place of business, however, is not relevant to its citizenship determination."); *see also Marom v. JBS USA LLC*, 2012 U.S. Dist. LEXIS 78116 (D. Conn. June 5, 2012) ("citizenship of a limited liability company is not the state in which it is organized or has its principal place of business, but rather, each of the states in which it has members."); *Ludell Manufacturing Company v. Leisure Pools USA, LLC*, Case No. 13-C-133 (E.D. Wisc. Feb. 14, 2013) ("However, for purposes of diversity jurisdiction, the citizenship of a limited liability company is determined by the citizenship of all its members, not on its principal place of business or the jurisdiction under whose laws it is organized."); *Master v. Quiznos Franchise Co.*, 2007 WL 419287 (D. N.J. Feb. 1, 2007) ("limited liability companies are (1) unincorporated associations, and (2) deemed citizens of each state in which their members are citizens, not the states in which they were formed or have their principal places of business."); *JMTR Enterprises, L.L.C. v. Duchin*, 42 F. Supp.2d 87 (D. Mass. 1999) (the citizenship of a LLC is determined is that of the citizenship of its members, and it is not deemed a citizen of the state in which it is organized); *Muhlenbeck v. KI, LLC*, 304 F.

which the principal place of business is maintained by an LLC have any bearing upon the question of the LLC's citizenship for purposes of diversity.[590] Where a member of an LLC is a corporation, the LLC will have the citizenship of both the corporation's jurisdiction of incorporation and that of its principal place of business.[591] Where the member of an LLC is in turn another LLC, partnership, statutory or business trust or other unincorporated form of business, the LLC takes on the citizenship of each of constituent owners thereof.[592] There is no exemption from the obligation of demonstrating complete diversity on the grounds that doing so is burdensome or that the citizenship of certain members should not be counted on the basis that that have de minimus interests in the LLC.[593] Failure to properly assert the citizenship of an LLC

Supp.2d 797, 2004 WL 292111 (E.D. Va. 2004) ("[T]he citizenship of a limited liability company depends not on the state in which it is organized or the state in which it does most of its business, but rather on the citizenship of the entities that own the LLC."); *IFC Credit Corp. v. Mahon*, 2003 WL 503601 (N.D. Ill. February 24, 2003) (characterizing as "wholly irrelevant for diversity purposes" the jurisdiction of formation and the principal place of business of a limited liability company.); *TPS Utilicom Services, Inc. v. AT&T Corp.*, 223 F. Supp.2d 1089, 1102 (N.D. Ca. 2002) ("[T]he place of organization of an L.L.C. is not relevant to its citizenship for diversity purposes."); *Bank One Nat. Ass'n v. Pickens*, 2002 WL 1008456 (D.C. Ill. 2002) (the principal place of business of a partnership or any other unincorporated association, as well as its jurisdiction of formation, are totally irrelevant for purposes of determining whether diversity is present); *Johnson v. SmithKline Beecham Corp.*, 724 F.2d 337, 348 (3rd Cir. 2013) (the principal place of business of n unincorporated entity is therefore irrelevant to determining its citizenship); *Rupp v. City Brewing Company, LLC*, No. 12-CV-676-BBC (W.D. Wisc. May 21, 2013) (the citizenship of a limited liability company is not determined by the state in which it is organized or the location of its principal place of business); *Principle Solutions LLC v. Feed.Ing BV*, Case No. 13-C-223 (E.D. Wisc. June 5, 2013) (the allegation of a limited liability company's principal place of business is irrelevant to the issue of subject matter jurisdiction); *Hale v. MasterSoft Int'l Pty. Ltd.*, 93 F. Supp.2d 1108 (D.C. Colo. 2000) (a limited liability company is not a citizen of the state in which it is organized unless one of its members is a citizen of that state); *Dragon v. Wolline*, 856 F. Supp. 456 (D.C. Ill. 1994) (the location of a partnership's principal place of business is irrelevant for determining the citizenship of the partnership for purposes of diversity jurisdiction); *Yards Developers Ltd. Partnership v. Subway Real Estate Corp*., 904 F. Supp. 843 (D.C. Ill. 1995) (allegations as to a limited partnership's principal place of business are irrelevant in determining whether diversity exists, as is the citizenship of the partners, and not that of the partnership itself, that is relevant). *See also Lincoln Property Co. v. Christopher Roche*, 126 S.Ct. 66 at fn. 1 (2005) ("We note, however, that our prior decisions do not regard as relevant to subject-matter jurisdiction the locations at which partnerships conduct business.")

[590] The one exception to this rule is when the LLC is involved, as a plaintiff, in a suit subject to the federal Class Action Fairness Act.

[591] *See* 28 U.S.C. § 1332(c) (corporation has citizenship of it jurisdiction of incorporation and its principal place of business); *Hertz v. Friend*, 559 U.S. 77, 130 S. Ct. 1181 (2010) (defining the test for determining a corporation's principal place of business).

[592] *See, e.g., Cerberus Partners, L.P. v. Gadsby Hannah*, 976 F. Supp. 119 (D. R.I. 1997); *Community Preservation Corp. v. MYG Mgmt. LLC*, 2008 WL 4792531 (D. N.J. 2008); *JBG/JER Shady Grove, LLC v. Eastman Kodak Co*., 127 F. Supp. 2d 700 (D. Md. 2001). *See also* Thomas E. Rutledge and Christopher E. Schaefer, *The Trust as an Entity and Diversity Jurisdiction: Is Navarro Applicable to the Modern Business Trust?*, 48 REAL PROPERTY, TRUST & ESTATE LAW JOURNAL 83 (Spring 2013).

[593] *See, e.g., James v. Myers*, 2012 WL 525583 (S.D. Ill. Feb. 16, 2012) (…as defendants admit it is "virtually impossible" to allege the citizenship of Wayzata's members, defendants have not met their burden of presenting competent proof, or a reasonable probability, that complete diversity exist among the parties); *Fadel Machinery Center, LLC v. Mid-Atlantic CNC, Inc*., 2012 WL 8669 (9th Cir. Jan. 3, 2012) (rejecting the suggestion that there is a *de minimis* exception to the requirement of complete diversity); *Schaftel v. Highpointe Business Trust*, 2012 WL 219511 (D. Md. Jan. 24, 2012) ("by simply complaining that it is too cumbersome to parse its own structure, Highpointe does not meet its burden and the Court finds that Highpointe has not established that his action was properly removed").

will lead to dismissal of the action and may well result in both public humiliation and other consequences.[594]

[7.26] Low-Profit LLCs ("L3Cs")

There was introduced to the 2010 Kentucky General Assembly a proposal that Kentucky authorize the formation of the so called "low-profit limited liability company" or "L3C."[595] In light of the significant controversy that exists with respect to the utility and effectiveness of the L3C structure,[596] 2010 S.B. 150 was amended by the House Judiciary Committee to provide that the interim committee, working in concert with various stake holders, would review the issue and prepare a recommendation for the 2011 General Assembly.[597] While this author did, in response to a request from Senator Tom Jensen, submit comments as to the L3C proposal, it is unclear whether that review ever took place; it is clear that it never came before the interim Judiciary Committee. A similar 2011 effort to adopt L3Cs[598] never received a committee hearing.

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[594] *See, e.g., Belleville Catering v. Champaign Marketplace, LLC*, 350 F.3d 691(7th Cir. 2003) (case remanded by Seventh Circuit Court of Appeals for lack of diversity jurisdiction; counsel required to re-litigate the action in state court without additional cost to clients); *Johnson-Brown v. 2200 M Street, LLC*, 257 F. Supp. 2d 175 (D. D.C. 2003) (plaintiff awarded costs and expenses incurred as a result of defendant's improper removal on basis of diversity); *Myerson v. Showboat Marina Casino Partnership*, 312 F.3d 318 (7th Cir. 2002) (show cause order as to why sanctions should not be imposed on counsel for flawed Rule 28 disclosures).

[595] H.B. 371, introduced February 3, 2010.

[596] Examples of that criticism include David Edward Spenard, *Panacea Or Problem: A State Regulator's Perspective On The L3C Model*, 65 EXEMPT ORGANIZATION TAX REVIEW 131 (February, 2010); J. William Callison, *L3Cs: Useless Gadgets?*, 19 ABA BUSINESS LAW TODAY 55 (Nov./Dec. 2009); Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment By Proxy Or Perversion?*, Suffolk University Law School, Legal Studies Research Paper Series, Research Paper 10-09 (Feb. 12, 2010); David S. Chernoff, *L3Cs: Less Than Meets The Eye*, 22 TAXATION OF EXEMPTS 3 (May/June 2010); J. William Callison And Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment In Entrepreneurial Ventures*, 35 VT. L. REV. 273, 274 (2010):

> But a funny thing happened on the way to the L3C party. Congress has not enacted L3C tax legislation, and substance and form have not aligned. Notwithstanding this setback, the L3C promoters have continued to lobby for state adoption and additional states have considered L3C legislation in 2010. In our view, without changes to federal PRI rules, the L3C construct has little or no value. Indeed, the existence of the state law form, without matching federal income tax substance, is dangerous since the ill-advised may assume value and use the Form. Therefore, unless and until tax law embraces the L3C, the form should be shelved. Further, the L3C concept is flawed as a matter of federal tax law, and it seems unlikely that the substance will be created to match the form. In our view, this is particularly the case with respect to "tranched" investment L3Cs due to the 'private benefit" rule. Therefore, we conclude that the L3C is business entity device before its time, a time which likely will never come.

[597] 2010 Ky. Acts, ch. 133, § 78 (not codified in Kentucky Revised Statutes). On April 23, 2010, the Committee on LLCs, Partnerships and Unincorporated Entities, Section of Business Law, American Bar Association, passed a resolution against further state adoption of L3C legislation. The proposed form of that resolution was set forth in XXVII PUBOGRAM 5 (April, 2010).

[598] H.B. 110, introduced Jan. 4, 2011.

[Appendix 7.7.2]

***Patmon v. Hobbs*, annotated to the law prior to and post the 2010 and the 2012 amendments to KRS § 275.170**

Set forth below is the *Patmon v. Hobbs* decision, annotated against both (a) the law at the time it was decided and (b) the subsequent changes in the LLC Act, most importantly 2010 Ky. Acts, ch. 133, § 32. In consequence, as to a number of points *Patmon v. Hobbs* is no longer good law, a fact of which both practitioners and the bench need to be aware.

All references to "*Analytic Protocol*" are to Thomas E. Rutledge and Thomas Earl Geu, *The Analytic Protocol for the Duty of Loyalty Under the Prototype LLC Act*, 63 ARK. L. REV. 473 (2010).

Ann PATMON, Individually and in her Representative Capacity for American Leasing and Management, LLC, Appellant,
v.
Lanier HOBBS, Appellee.

No. 2007-CA-002527-MR
280 S.W.3d 589

Court of Appeals of Kentucky.

March 27, 2009.

***590** Ian T. Ramsey, Chadwick A. McTighe, Louisville, KY, for appellant.

F. Larkin Fore, Sarah Fore Whittle, Louisville, KY, for appellee.

Before COMBS, Chief Judge; CLAYTON and CAPERTON, Judges.

OPINION

CLAYTON, Judge.

Ann Patmon (Patmon) individually and on behalf of American Leasing and Management, LLC (American Leasing),[1] appeals from the Jefferson Circuit Court September 24, 2007, judgment wherein the court found that damages could not be awarded for the value of the build-to-suit ***591** lease agreements that Lanier Hobbs (Hobbs) transferred from American Leasing to American Development and Leasing, LLC (American Development). The court determined that,

[1] The LLC was organized pursuant to articles of organization filed with the Secretary of State on December 9, 2002. The LLC elected to be member-managed.

because American Leasing would have been unable to perform the contracts, no corporate "opportunity," as defined under the common law of other states, could exist, thus barring any claim for damages for the build-to-suit leases. Patmon, however, contends that under Kentucky Revised Statutes (KRS) 275.170, certain fiduciary duties are owed by the manager-member to the company and its members, that Hobbs breached these duties, and therefore must compensate American Leasing and/or her for the value of the build-to-suit leases. We affirm in part and in so doing we adopt the doctrine of corporate opportunity, under which one entrusted with active corporate management, such as officer or director or manager-member, occupies fiduciary relationship and may not exploit this position by appropriating a business opportunity properly belonging to the corporation. But we vacate and remand the matter to the trial court for further proceedings consistent with this opinion and its adoption of the doctrine of corporate opportunity.

FACTUAL BACKGROUND

American Leasing is a Kentucky limited liability company that is involved in construction and build-to-suit lease projects. Generally, American Leasing would purchase land in a predetermined location and then construct a building according to a client's specification. After the building is completed, the client then becomes a long-term tenant under a lease agreement. The build-to-suit leases produce a guaranteed long-term stream of rental income by allowing for the payment of the land purchase through rental income, which ultimately adds real estate assets to a company's (American Leasing's) balance sheet.

In early 2004, American Leasing was working on a $520,000 build-to-lease project for O'Reilly Auto Parts (O'Reilly) in Shively, Kentucky, and a $700,000 strip center construction project for Dr. Raley. Additionally, American Leasing and O'Reilly were in negotiations for three build-to-suit leases (Preston Highway in Louisville; Jeffersonville; and Clarksville, Indiana.) Initially, Hobbs was not an owner/member of American Leasing but worked as a contractor on the O'Reilly Auto Parts store. Hobb's company performed the excavating and concrete work. Through this interaction, he met Richard D. Pearson (Pearson), then the managing member of American Leasing, and began discussions about joining American Leasing. On February 9, 2004, Hobbs and Pearson entered into an Executive/Partnership Agreement wherein Hobbs owned 51 percent, Pearson owned 44 percent, and Bruce Gray (Gray) owned 5 percent. Subsequently, around March 15, 2004, Hobbs and Pearson signed a "Consent Resolution and Agreement," which recognized that Hobbs was a 51-percent owner of American Leasing and the managing member of the Company.

At this time, Hobbs also learned that American Leasing was experiencing difficulty in paying the U.S. Bank loan for the O'Reilly project; therefore, he paid $5,823 to the bank to bring the loan into balance and later signed a personal guaranty on the loan. Following this transaction, Hobbs testified he discovered that American Leasing did not have the financial wherewithal to pursue the three additional O'Reilly projects. Specifically, Hobbs said that U.S. Bank indicated it would provide no additional financing to the company, the company had inadequate funding for other projects, and Hobbs himself did not have the funds to finance these projects.

***592** Patmon's history in this action begins with her work with Hobbs in his excavation and concrete business. Further, in October 2003, Patmon loaned $30,415.16 to American Leasing and Pearson. When Pearson defaulted on the loan, Patmon obtained a default judgment against him on March 1, 2004. Later at a sheriff's sale held on May 5, 2004, Patmon purchased Pearson's membership

certificate in American Leasing and became 44-percent owner of the company.[2] Eventually, American Leasing paid Patmon in full for her loan to American Leasing and Pearson.

Meanwhile, Hobbs, on March 3, 2004, formed another company, American Development. He was the sole member of the company. After forming the company, he sent a letter to Ed Randall (Randall) at O'Reilly instructing that the pending Preston, Jeffersonville, and Clarksville leases be changed to reflect American Development as the proposed landlord rather than American Leasing.

In his deposition, Randall stated that, prior to Hobbs's letter, O'Reilly was prepared to enter into three agreements with American Leasing. In fact, Randall said he had never heard of American Development. Randall asked Hobbs to provide evidence to support this request. Hobbs provided the "Consent Resolution and Agreement" between Hobbs and Pearson that showed Hobbs as the managing member of American Leasing with authority to make such a change.[3] The three leases were then transferred to American Development with no consideration paid to American Leasing by Hobbs or his new company.[4] Subsequently, Hobbs and Steve Habeeb (Habeeb) formed another limited liability company which was eventually assigned these leases. The company was started so that Hobbs would provide the leases and Habeeb would obtain the financing for the projects. Habeeb had originally informed Hobbs that he would not be involved in any project with Pearson and was unwilling to finance any American Leasing projects.

Then, notwithstanding that Hobbs knew American Development would be landlord and construction manager for the three projects, he paid the deposits with American Leasing resources.[5] On the same day that Hobbs formed American Development, March 4, 2004, American Leasing paid $2,000 for the Preston project, $100 for the Jeffersonville project, and $5,000 for the Clarksville project. Later, on April 28, 2004, American Leasing paid another $2,000 for the Preston project. In addition, on July 23, 2004, Hobbs used $1,527.46 in American Leasing funds to pay for signage for an American

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[2] The opinion does not explain the mechanism by which Patmon, having acquired at the sheriff's sale Pearson's interest in the LLC and thereby having become an assignee (*see* KRS § 275.255(1)(b)) became a member of the LLC enjoying management rights therein. *See also* KRS § 275.265.

[3] It is worth wondering whether Randell was advised by Hobbs that Hobbs was also the sole owner of American Development, the transferee of American Leasing's rights. If that was the case it may be questioned whether Randell had any right to rely upon Hobbs' statements, he being clearly on both side of the transaction. *See, e.g.*, *Synectic Ventures I, LLC v. EVI Corp*., 251 P.3d 216 (Or. App. 2011).

As for Hobbs, irrespective of a principal's delegation of authority to an agent, an agent may not trade in the subject matter of agency for the agent's personal gain. *See, e.g.*, RESTATEMENT (THIRD) OF THE LAW OF AGENCY § 8.05 (2006) ("An agent has a duty (1) not to use the property of the principal for the agent's own purposes or for those of a third party….").

[4] In certain respect this is a case about waste. Even assuming that Hobbs was correct in his assertion that American Leasing did not have the financial wherewithal to perform on the transferred agreements, that inability did not extinguish the fact that those contracts had value that could and should have been realized upon any otherwise permissible transfer. By analogy, the purchaser of a ticket to a concert, now not able to attend because of a scheduling conflict, still holds an asset (the ticket) that can be sold and value thereby realized. *See also Analytic Protocol* at 511, fn. 195.

[5] This action, using an asset of American Leasing to satisfy an obligation of a third-party, is a clear violation of the statutory duty of loyalty set forth in KRS § 275.170(2) both as it existed at the time of the *Patmon v. Hobbs* decision and under the statute as revised in 2010. That these funds were misappropriated in order to further the prior misappropriation of the build-to-suit contracts simply adds insult to injury.

Development project. By the end of November 2004, Habeeb and Hobbs had secured financing for all three projects with American Development serving as the general contractor. This arrangement allowed Hobbs to profit from the construction phase as well as the leases themselves.

PROCEDURAL BACKGROUND

On November 4, 2004, the first of two bench trials occurred in this case. The trial was held to resolve the membership of American Leasing. On March 31, 2005, the court held that Hobbs, Patmon and Gray were members of the company holding respectively 51 percent, 44 percent, and 5 percent ownership. Furthermore, the court deemed that Hobbs and Gray were owners as of February 9, 2004, denied Pearson's claim of ownership, and found that Patmon became a member on May 5, 2004, when she acquired Pearson's interest.

***593** Following the court's first decision, Patmon, in her name and American Leasing's name, sued Hobbs because she had learned that American Leasing's three build-to-suit leases with O'Reilly had been diverted by Hobbs, without membership consent,[6] to American Development. Following the second bench trial, on September 24, 2007, the court held that Hobbs must pay American Leasing $18,980.45, which included $9,100 in down payments to secure land for the build-to-suit leases later completed by American Development; $1,527.45 for signage for these projects; $7,500 for Hobbs's personal legal expenses; and $853 for his personal telephone bill.

The court, however, did not award damages for the value of the build-to-suit lease agreements. Patmon asserted at the trial that the value of these diverted leases is derived from the construction income, profits from the rental income, and value of the land purchased through the rental income. But as to the damages claimed for the statutory breach under KRS 275.170, the court held that because American Leasing was unable to perform the contracts, no "opportunity," as defined under the common law of other states, could exist, thus barring any claim for damages under KRS 275.170.[7] Nonetheless, the court did note that it was unaware of any Kentucky cases specifically addressing diverted opportunity for fiduciary duty purposes.

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[6] In 2004 and at the time Hobbs transferred the three build-to-suit contracts from American Leasing to American Development, KRS § 275.170 did not contain what is now subsection (3) thereof. That section (3) directs that unless a contrary rule is set forth in the operating agreement, the approval of a conflict transaction be disinterested. *See* 2007 Ky. Acts, ch. 137, § 109 (adding KRS § 275.170(3) and recodifying what was § 275.170(3) as § 275.170(4)). Irrespective of whether other law then applicable would mandate that the approval be given by a majority-in-interest of the disinterested members, no consent was ever sought.

[7] There are numerous problems with this analysis; here I will discuss only two of them.

- First, there is the previously described problem of waste. Even if the LLC could not perform on the contracts, there was still value that should have been realized for the benefit of the LLC.

- Second, irrespective of whether the contract rights at issue had value to American Leasing, fiduciary duty of loyalty principles as set forth in the LLC Act at the time of the *Patmon v. Hobbs* decision precluded a member from using a company asset for personal gain.

At the risk of redundancy, the scope of a member's duty of loyalty, including as to who owes the duty, to who the duty is owed, the duty itself, and the consequences of a breach of the duty, are as set forth in KRS § 275.170(2). The 2010 amendments to the LLC Act preclude a contrary reading of the statute.

ANALYSIS

1. Standard of Review

At a bench trial, the factual findings of the trial court shall not be set aside unless they are clearly erroneous; that is, not supported by substantial evidence. *Cole v. Gilvin*, 59 S.W.3d 468, 472 (Ky. App.2001). If not clearly erroneous, the findings shall not be set aside. Kentucky Rules of Civil Procedure (CR) 52.01. Additionally, any questions of law that are resolved at trial are reviewed *de novo. Gosney v. Glenn,* 163 S.W.3d 894 (Ky.App. 2005).

2. Limited Liability Company

A limited liability company is a hybrid business entity having attributes of both a corporation and a partnership.[8] Its owners are its members. Like corporations and limited partnerships, limited liability companies are creatures of statute. In Kentucky, there is relatively little caselaw regarding limited liability companies and no caselaw concerning fiduciary duties in the limited liability company

[8] This description is impoverished and misleading in that it indicates that partnership and corporate law are in some manner melded in the LLC and that the question is whether to apply one or the other to a particular question. While a description of an LLC as "a hybrid business entity having attributes of both a corporation and a partnership" may have been substantially correct in the early days of the LLC (*see, e.g.*, Thomas E. Rutledge & Lady E. Booth, *The Limited Liability Company Act: Understanding Kentucky's New Organization Option*, 83 KY. L.J. 1, 6-8 (1994-95)), today this formula is so limiting as to be misleading. In a realm in which limited liability is available in not only the LLC but also in general and limited partnerships (*see* KRS § 362.1-306(3) (eliminating partners' liability when partnership elects to be a limited liability partnership); *id.* § 362.2-303 (eliminating liability for limited partners in a KyULPA limited partnership); *id.* § 362.2-404(3) (eliminating general partner's liability in a KyULPA LLLP)), citing the corporation as the archetype for limited liability is misleading, especially as that characteristic is not intrinsic to the corporate form. *See, e.g.*, WILLIAM L. CLARK, JR., HANDBOOK OF THE LAW OF PRIVATE CORPORATIONS 16 (Francis B. Tiffany ed., 2d ed. 1907) (stating that limited liability is "not an essential attribute" of the private corporation). As to tax classification, many LLCs are not taxed as partnerships, but rather as either associations taxable as corporations or as disregarded entities. *See* Treas. Reg. § 301.7701-3 (2006). In today's environment, the LLC, like each other form of business organization, must be understood as a unique construct of formulas and characteristics that may or may not be shared with other organizational forms. *See also* Rutledge, *Vampires and the Law of Business Organizations: The Fruitless Search for Authenticity*, J. PASSTHROUGH ENTITIES, Nov./Dec. 2011, 51; Rutledge, *Let's Stop Describing LLCs as "Hybrids,"*, J. PASSTHROUGH ENTITIES, Sept./Oct. 2014, 29. *Accord Pannell v. Shannon*, 425 S.W.3d 58, 79, 80, 2014 WL 1101472, *7 (Ky. 2014):

> In fact, '"limited liability companies are creatures of statute,"' controlled by Kentucky Revised Statutes (KRS) Chapter 275," 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 that are in derogation of common law shall not apply to its provision." Thus, to the extent the statutes conflict with common law, the common law is displaced.

This Court must therefore look first to the controlling of statutory law.

context.[9] Hence, the parties present this Court with an issue of first impression: whether under KRS 275.170 or by common law,[10] Hobbs owed a fiduciary duty to American Leasing and Patmon.[11]

While Kentucky courts have not directly addressed whether a member of a limited liability company owes a duty of loyalty to fellow members and the company, some jurisdictions have found such a duty. *See Credentials Plus, LLC v. Calderone*, 230 F.Supp.2d 890, 899 (N.D.Ind.2002).

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[9] This statement ignores the fact that the Kentucky LLC, as adopted in 1994, was substantially based upon the ABA's Prototype LLC Act. As such, guidance from the many other states that adopted the Prototype may be utilized in interpreting portions of the Kentucky LLC Act. *See also Analytic Protocol* at 447. The Prototype LLC Act is reproduced in 3 LARRY E. RIBSTEIN AND ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES, Appendix C.

[10] Any suggestion that a member's or manager's (subject to KRS § 275.170(4)) duty of loyalty is determined by common law is no longer viable subsequent to the 2010 Amendments to the LLC Act. The duty of loyalty (KRS § 275.170(2)) is dictated by a comprehensive statutory formula. The 2010 Amendment of KRS § 275.170(2) superseded *Patmon* as to this point; the duty of loyalty is and only is as set forth in KRS § 275.170(2). *See also* NORMAN J. SINGER AND J.D. SHAMBIE SINGER, 2B SUTHERLAND STATUTES AND STATUTORY CONSTRUCTION § 50:5 (7th ed.) ("But general and comprehensive legislation, where a course of conduct, the parties, the things affected, and limitations and exceptions are minutely described, indicates a legislative intent that a statute should totally supersede and replace the common law.", citations including *Fiscal Court of Fulton County v Nashville C. & St. L. Ry. Co.*, 261 S.W. 617, 618-19 (1924) ("In short, it [the statute] appears to be dealing with the whole question and for that reason must be interpreted as exclusive of and in lieu of all existing rights as between the parties in such matters.") Furthermore, as discussed in the comments below, the language of KRS § 275.170(2) at the time of the *Patmon* decision set forth the entirety of the duty of loyalty applicable to LLC members and managers. The *Patmon* Court was entirely in error to look to common law; the statutory formulation in KRS § 275.170 was the sum total of the duties owed. *See also Pannell v. Shannon*, 425 S.W.3d 58, 79, 80, 2014 WL 1101472, *7 (Ky. 2014):

> In fact, '"limited liability companies are creatures of statute,"' controlled by Kentucky Revised Statutes (KRS) Chapter 275," 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 that are in derogation of common law shall not apply to its provision." Thus, to the extent the statutes conflict with common law, the common law is displaced.

This Court must therefore look first to the controlling of statutory law. Because the 2010 Amendments to KRS § 275.170 simply clarified this fact, the amendments should have retroactive effect. *See, e.g., Moore v. Stills*, 307 S.W.3d 71, 81 (Ky. 2010) ("Among the 'remedial' enactments are statutory amendments that clarify existing law or that codify judicial precedent.").

[11] Here is where the wheels began to come off the wagon. Essentially, even while having cited KRS § 275.170, by some means the court failed to recognize that the statute sets forth a statutorily defined duty of care and a duty of loyalty. KRS § 275.170, as in effect in 2004, was but for an immaterial revision made in 1998, a direct adoption of section 402 of the Prototype Limited Liability Company Act. Section 402 sets forth the specific fiduciary duties owed by members and managers of an LLC. The first sentence of the Commentary to section 402 provides:

> This section sets forth the fiduciary duties of managers and managing members of LLCs.

A clear failure of the *Patmon* court was not recognizing KRS § 275.170(2) as the duty of loyalty in LLCs as defined by statute. With the 2010 amendment to the statute that fact has been clarified to avoid further confusion ("The duty of loyalty applicable . . . .")

3. Duty of Loyalty

The Kentucky Supreme Court described the nature of a fiduciary duty:

> 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.

Steelvest, Inc. v. Scansteel Service Center, Inc., 807 S.W.2d 476, 485 (Ky.1991)(quotation omitted). Further, the Court held that even in the absence of a statutorily imposed duty, an officer or director of a ***594** company owes a fiduciary duty to the company. *Aero Drapery of Kentucky, Inc. v. Engdahl*, 507 S.W.2d 166, 168 (Ky.1974). *Aero* goes further in describing the duty of loyalty:

> [w]henever a reasonably prudent fiduciary is aware of a conflict between his private interest and the corporate interest, he owes the duty of good faith and full disclosure of the circumstances to the corporation.

Id. at 169. Regarding partnership and the duty of loyalty, a "partner has a duty to share with the partnership those business opportunities clearly related to the subject of its operations." *See* 59A Am.Jur.2d Partnership § 295 (2003). *See also Van Hooser v. Keenon*, 271 S.W.2d 270, 273 (Ky.1954). For the foregoing reasons, this Court finds that Kentucky limited liability companies, being similar to Kentucky partnerships and corporations, impose a common-law fiduciary duty on their officers and members in the absence of contrary provisions in the limited liability company operating agreement.[12]

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[12] And now the wheels are completely off.

> • First, as noted just above, the statute already defined the fiduciary duties that exist in LLCs – there was no need to look to the common law for guidance – it is right there in the statute. It was erroneous for the Court to do so. *See also Willis v. Louisville/Jefferson County Metropolitan Sewer District*, 2011 WL 4137492 (Ky. App. Oct. 22, 2010) ("We are ever mindful 'that the judicially created common law must always yield to the superior policy of legislative enactment and the Constitution.'") (quoting *Comm. ex rel. Cowan v. Wilkinson*, 828 S.W.2d 610, 614 (Ky. 1992), overruled on other grounds by *Comm. ex rel. Conway v. Thompson*, 300 S.W.3d 152 (Ky. 2009)). *See also* KRS § 275.003(1) ("this chapter is in derogation of common law…").
>
> • Second, the analogies sought to be drawn between LLCs on the one hand and either corporations and/or partnerships on the other are deficient, especially as those two forms are so distinct from one another. *See* Rutledge, *Shareholders Are Not Fiduciaries – A Positive and Normative Analysis of Kentucky Law*, 51 LOUISVILLE L. REV. 535 (2012-13); Rutledge, *Let's Stop Describing LLCs as "Hybrids,"* J. PASSTHROUGH ENTITIES, Sept./Oct. 2014, 29.
>
> LLCs have distinct attributes and it is not appropriate to graft partnership law onto the LLC statute. The only legitimate use of partnership law is described in note 22.

In sum, a breach-of-loyalty claim is based on the existence of a fiduciary duty between a principal and an agent. In general, members of a limited liability company are agents for the purpose of its business or affairs. KRS 275.135(1).[13] But where the articles vest authority in a manager or managers, every manager is an agent of the limited liability company for the purpose of its business or affairs. KRS 275.135(2)(b).[14] Consequently, as the managing member of American Leasing,

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> • Third, continuing that point, it was stated above that the owners of an LLC are its members. From that point the owners of a partnership are the partners and the owners of a corporation are its shareholders. Partners are mutual agents of one another and are liable for the debts and obligations of the partnership. KRS § 362.190(1); *id*. § 362.220(1). Members are not mutual agents of one another and are not liable on the LLC's debts and obligations. KRS § 275.135(1); *id.* § 275.150(1). So where is the similarity between partners and members? Limited partners are neither agents of the limited partnership nor of one another and they are not liable for its debts and obligations. KRS § 362.2-302; *id.* § 362.2-303(1). As such members of an LLC and limited partners exactly parallel one another. But then limited partners owe no fiduciary duties. KRS § 362.2-305(1).
>
> • Fourth, turning to shareholders, they have no agency authority on behalf of the corporation, have no direct voice in its management (see KRS § 271B.8-010(2)), and owe no fiduciary duties to either the corporation or to the other shareholders. In contrast, if the LLC is, like American Leasing, member-managed, then each member is an agent of the LLC (KRS § 275.135(1)), each member has a direct voice in the LLC's management (KRS § 275.165(1)), each member owes a fiduciary duty of care to the LLC and the other members (KRS § 275.170(1)) and a fiduciary duty of loyalty to the LLC (KRS § 275.170(2)). So where is the similarity between shareholders and members?
>
> • Fifth, this statement, were it true, would eviscerate and render a nullity KRS § 275.170(4). This provision works as a switch; in a member-managed LLC the members owe the KRS §§ 275.170(1), (2) duties while in a manager-managed LLC the managers owe those duties and the members do not. If members owe common law fiduciary duties that arise outside the terms of the LLC Act, how is the switch of KRS § 275.170(4) to operate? It is only by restricting a member's or manager's fiduciary obligations to those set forth in the statute that the switch can have its intended effect.
>
> • Sixth, to what statute will the analogy be made? Kentucky has two general partnership acts and four limited partnership acts. Should the analogies be to the modern 2006 Acts, or to the acts most recently adopted at the time the LLC Act was written? Or? Or?

[13] That may be true, but it does not dictate the fiduciary obligations. In a member-managed LLC each member is an apparent agent of the LLC and owes fiduciary obligations. KRS § 275.135(1); *id*. §§ 275.170(1), (2). But that apparent agency authority can be and often is limited in the operating agreement, restricting thereby the actual agency authority of the members. In fact a member-managed LLC may be structured such that no member has any positional actual agency authority on behalf of the LLC. It does not follow then that the member's fiduciary obligations arise out of the position of agent. Agents are held to a standard of care of simple negligence. *See* RESTATEMENT (THIRD) OF THE LAW OF AGENCY § 8.08 (2006). Members of an LLC are held to a gross negligence ("wanton or reckless misconduct") standard of care. KRS § 275.170(1).

It bears noting that were the agency of the members the source of a member's fiduciary duties, that would preclude an argument that there is a duty of loyalty inter-se the members. Members, in a member-managed LLC, are agents of the LLC (KRS § 275.135(1)); it is not provided that a member is the agent of any other member. If fiduciary duties arose consequent to agency status, it necessarily follows that the fiduciary obligation is in favor of and may be enforced by the party represented, namely the LLC.

[14] A point irrelevant as American Leasing was a member-managed LLC. However, it is worth noting that, pursuant to the applicable LLC agreements, Hobbs had total control over the affairs of the LLC, having been designated the "managing member."

Hobbs had a duty to act not only in the interests of American Leasing but also owed a basic duty of faithfulness and loyalty to the company. *See Steelvest*, 807 S.W.2d at 483.[15]

As a result, one who acts as agent for another is not permitted to deal in the subject matter of the agency for his own benefit without the consent of the principal[16]—the other members.[17] Common sense as well as the law dictates that profits realized by an agent in the execution of his agency belong to the other members in the absence of an agreement to the contrary.[18] The duty between principal and agent was discussed in *Stewart v. Kentucky Paving Co., Inc.*, 557 S.W.2d 435 (Ky.App.1977). The agent is bound to a high degree of good faith and is not entitled to avail himself of any advantage that his position may give him to profit at the employer's expense beyond the terms of the employment agreement. *Id* at 437. *Stewart* is particularly illustrative of the duty of loyalty and its breach. The parties therein misappropriated several leads, contract proposals, and contracts, resulting in the jobs being done by the parties' company, not the employer's company. Our Court found that the parties violated their fiduciary duty and upheld the trial court's measure of damages, which was the gross profit that the employer's company would have earned on the contracts. *Id.* at 436-39. Likewise, contrary to his fiduciary duty, Hobbs, who was the manager-partner of American Leasing, formed a competing business and transferred the build-to-suit leases from American Leasing to it. Hobbs's activity posits the question whether Hobbs acted in compliance with his duty of loyalty to the company. This duty is confirmed in the Executive/Partnership Agreement drafted and signed by Hobbs.

4. Liability of Members and Managers

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[15] True, but it has nothing to do with *Steelvest* and its determination that a corporate director violated his duty of loyalty to the corporation. Rather, Hobbs had a duty of loyalty because the statute said he did. KRS § 275.175(2). In 2010, KRS § 275.175(2) was amended to add "The duty of loyalty applicable to" in order to make it even more manifest that it recites the applicable duty of loyalty. *See* 2010 Ky. Acts, ch. 133, § 32.

[16] Entirely true. KRS § 275.170(2). *See also* RESTATEMENT (THIRD) OF THE LAW OF AGENCY § 8.05 (2006).

[17] I ncorrect. It is only the LLC that is the beneficiary of a member's duty of loyalty. *See* KRS § 275.170(2) ("to account **to the [LLC]** and hold as trustee for **it**") (**emphasis** added). Moreover, pursuant to KRS § 275.135(1), in a member-managed LLC, each member is an agent of the LLC. The principal, therefore, is the LLC, and not the individual members. *See also* KRS § 275.010(2) ("A limited liability company is a legal entity distinct from its members.") The duty of loyalty is not owed to the other members. It is because the LLC (as contrasted with the individual members) is the beneficiary of the duty of loyalty that claims for misappropriation of assets, self-dealing, etc. flow to the benefit of the LLC itself. *See, e.g., Chou v. Chilton*, __ S.W.3d ___, 2014 WL 2154087 (Ky. App. May 23, 2014); *Chou v. Chilton*, 2012 WL 5626184 (Ky. App. Nov. 16, 1012); *R.C. Tway Co. v. High Tech Performance Trailers, LLC*, 2013 WL 842577 (W.D. Ky. Mar. 6, 2013); *see also Pixler v. Huff*, 2012 U.S. Dist. LEXIS 106492, *12 (W.D.Ky. July 30, 2012) ("The claim that the Plaintiff was damaged by the misappropriation of MMM's assets is similar to the 'diminution in the value of corporate stock resulting from some depletion of or an injury to corporate assets[,]' which Kentucky courts have found does not permit a direct cause of action."). Vested in the other members is the capacity to sanction what would otherwise be a prohibited transaction between the LLC and a member. *See* KRS § 275.170(3) as amended by 2007 Ky. Acts, ch. 137, § 109.

[18] To quibble, but it is an important quibble, the profits belong to the LLC, and not to the other members. *See* KRS § 275.170(2) ("account to the [LLC]"). Ergo, using the parties' names in the statutory formula:

> Hobbs must account to American Leasing and hold as a trustee for it any profit or benefit derived by him from his use of American Leasing's property.

The liability of members and managers of limited liability companies is outlined in KRS 275.170. It states that:

> Unless otherwise provided in a written operating agreement:
>
> (1) A member or manager shall not be liable, responsible, or accountable in damages or otherwise to the limited *595 liability company or the members of the limited liability company for any action taken or failure to act on behalf of the limited liability company unless the act or omission constitutes wanton or reckless misconduct.[19]

Further explanation is provided by the next subsection,[20] which describes what a member/manager may not do unless more than one-half of the disinterested managers or a majority-in-interest of the members consent:

> (2) Each member and manager shall account to the limited liability company and hold as trustee for it any profit or benefit derived by that person without the consent of more than one-half (1/2) by number of the disinterested managers, or a majority-in-interest of the members from:
> (a) Any transaction connected with the conduct or winding up of the limited liability company; or
> (b) Any use by the member or manager of its property, including, but not limited to, confidential or proprietary information of the limited liability company or other matters entrusted to the person as a result of his status as manager or member.

KRS 275.170(2)(a)(b).[21] To summarize, a member or manager must account to and hold as a trustee for a limited liability company any profit or benefit derived from the use of company property by that member or manager including, but not limited to, confidential, proprietary, or other matters entrusted to that person's status as manager or member. Hobbs concedes and the court found that he never obtained consent from any member of American Leasing to divert O'Reilly leases to American Development. These leases qualify as "confidential or proprietary information."

5. Diverted Corporate Opportunity

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[19] This is actually the statutory duty of care, articulated in terms of a standard of culpability. *See, e.g.*, PROTOTYPE LLC ACT § 402, comment ("Subsection (A) sets forth the gross negligence standard of care for those participating in management.").

[20] This is not correct. KRS § 275.170 sets forth two independent duties, a duty of care (KRS § 275.170(1)) and a duty of loyalty (KRS § 275.170(2)). The duty of loyalty does not modify the duty of care. By way of example, the statute does not require a manager to be careful while misappropriating a company opportunity.

[21] Again, KRS § 275.170(2) is a statutory definition of the duty of loyalty.

The next step in our analysis is to ascertain, in the absence of clear caselaw and statutory guidance,[22] the duty of loyalty required by a managing member[23] of a limited liability company. In the absence of a Kentucky case delineating the duty of loyalty in a limited liability company and based on the hybrid nature of a limited liability company, we look at an explanation of the duty of loyalty in the partnership context:

> Under Kentucky law, partners owe the utmost good faith to each and every other partner. *See Axton v. Kentucky Bottlers Supply Co.*, 159 Ky. 51, 166 S.W. 776, 778 (1914).... Indeed, it has often been said, "there is no relation of trust or confidence known to law that requires of the parties a higher degree of good faith than that of a partnership." *Van Hooser v. Keenon*, 271 S.W.2d 270, 273 (Ky.1954).

Lach v. Man O'War, LLC, 256 S.W.3d 563, 569 (Ky.2008).

Therefore, given that partners owe good faith to each other, we believe it follows logically and equitably that a managing member of a limited liability company also owes such a duty to other members (partners).[24] Furthermore, this standard, in combination with KRS 275.170,[25] leads us to the conclusion that Hobbs violated the duty of loyalty, and therefore, breached his fiduciary duty to his fellow members and to the company.

Indeed, in its finding of fact, conclusion of law, the trial court itself concluded:

> Kentucky courts have not yet addressed the applicability of fiduciary duties in the limited liability company contest.

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[22] And again, the supposition that there is an absence of statutory guidance is manifestly wrong. KRS § 275.170(2) is and since 1994 has been the statutorily defined duty of loyalty.

As for the claimed "absence of clear case law," but for alterations in nomenclature, the KRS § 275.170(2) duty of loyalty is for all intents and purposes identical to the duty of loyalty that has long existed in partnership law. *Compare* KRS § 275.170(2) *with* KRS § 362.250(1). *See also Analytic Protocol* at 475-77. In consequence, the extensive existing case law on obligations owed by a partner to the partnership may be utilized and applied. *See* Prototype LLC Act § 402, commentary ("Because of the similarity of this section with the UPA, it is anticipated that the courts will interpret a section such as this to impose duties similar to those in the general partnership, including the duty not to appropriate partnership opportunities."). It is important to appreciate that this application of partnership law to LLCs is not consequent to any similarity between the forms but rather actual similarity between the language employed in the statutes.

[23] Hobbs had total control over the company's affairs. Although *Patmon* is not good law on the subject of the duties owed by members or managers, the holding did not go beyond describing the duty owed by a controlling member.

[24] *See* footnote 12 on the failure of the analogy drawn.

[25] What combination? If partners owe a duty, and that duty has been reduced to statute in KRS § 362.150(1) (note that both the *Axton* and *Van Hooser* decisions predate Kentucky's 1954 adoption of the Uniform Partnership Act), and members of member-managed LLCs owe a substantially identical duty of loyalty defined by KRS § 275.170(2), where can you combine common law with statute? As previously discussed, in an LLC it is the LLC Act, and not the common law as developed under other organizational forms, that controls. The only appropriate opportunities for looking to other organizational law is when the LLC Act and those other forms utilize functionally identical statutory formulae.

> ... KRS 275.170(2) creates a statutory duty of loyalty for self-interested transactions ...[26] *596
>
> The Court finds that Hobbs violated the statutory standards in KRS 275.170[.]

But the court limited damages to the actual dollar amount of American Leasing's resources that Hobbs used for himself and for American Development.[27] After awarding damages based only on this amount, the court, in essence, found no violation of KRS 275.170 when Hobbs took the three pending O'Reilly build-to-suit leases for his limited liability company, American Development. Rather than continuing with an analysis of fiduciary duty, the court, without any explanation, moved to a discussion of misappropriation of corporate opportunity. One theory of this doctrine holds that opportunity does not exist for a business if the business is financially unable to undertake the opportunity. Then, while observing that no Kentucky case details diverted opportunity as obviating fiduciary duty, the court cited cases from other jurisdictions explaining this rationale. *See Miller v. Miller*, 301 Minn. 207, 225, 222 N.W.2d 71, 81, 77 ALR 3d 941 (Minn. 1974); *Jundt v. Jurassic Resources Development*, 656 N.W.2d 15, 24 (N.D.2003); and, *In re Sullivan*, 305 B.R. 809, 52 Collier Bankr.Cas 2d 526 (Bkrtcy.W.D.Mich. 2004).

In fact, Hobbs's entire rationale for disputing his liability for taking the leases from American Leasing to American Development is based on the doctrine of misappropriation of corporate opportunity and is based solely on three cases from other jurisdictions. But his analysis is limited. First, he does not discuss the *Miller* two-part test for establishing a *prima facie* case of usurpation of corporate opportunity, which states that the new business opportunity must be "so closely related to the existing or prospective activity of the corporation" that it constitutes a corporate opportunity. *Miller*, 222 N.W.2d at 81. Then Hobbs provides no discussion of whether he, by acquiring the opportunity, must have violated the duties of loyalty, good faith, and fair dealing toward the corporation. *Id.* Implicit in the use of this doctrine, however, is an acknowledgment that it was a business opportunity of American Leasing and that he violated his duties to the company. We would be remiss to not point out that the *Miller* case involves a discussion based on a corporation rather than a limited liability company. However, we see no difference between the fiduciary duties a director owes a corporation with shareholders or a member owes to a limited liability corporation.[28]

In Kentucky, however, the focus is on the fiduciary's duty-not the lost opportunity. For instance, returning to *Aero*, we find the following cite:

> There are numerous instances where a legitimate conflict of interest exists between a fiduciary and his corporation. Whenever a reasonably prudent fiduciary is aware of a conflict between his private

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[26] Yes, Exactly Correct!!!

[27] So close but a miss. The statute dictates that all profits realized from the use of LLC property must be held in trust for the LLC's benefit. *See* KRS § 275.170(2) ("to account to the [LLC] and hold as trustee for it").

[28] First, there is no organizational form with the name "limited liability corporation." Second, as the statutes define materially different fiduciary standards for directors of a corporation versus the members or managers of an LLC (*compare* KRS § 271B.8-300(1) *with* KRS §§ 275.170(1), (2)), it cannot be said there is "no difference between the fiduciary duties a director owes a corporation with shareholders or a member owes a" LLC.

> interest and the corporate interest, he owes the duty of good faith and full disclosure of the circumstances to the corporation. "If dual interests are to be served, the disclosure to be effective must lay bare the truth, without ambiguity or reservation, in all of its stark significance." *Wendt v. Fischer,* 243 N.Y. 439, 154 N.E. 303, 304 (1926).

Aero, 507 S.W.2d at 169. Further illustration of this principle is provided by *Urban J. Alexander Co. v. Trinkle,* 311 Ky. 635, 224 S.W.2d 923 (Ky.1949), where the Court held the director was allowed to avail himself personally of an opportunity after making diligent efforts to pursue the opportunity for the company notwithstanding the fact that the company definitely could not have availed itself of the opportunity. *Id.* at 925-27. Hobbs shows no action in this regard other than his opinion that the ***597** company could not have completed the projects. More importantly, he never gives notice to any other member.[29] Nonetheless, the court based its decision on a doctrine from another jurisdiction without explanation of Hobbs's fiduciary responsibility to his fellow members about the company's build-to-suit leases. Even though the court describes Hobbs's conduct as "dubious," it moves directly to the diverted corporate opportunity with no discussion of Hobbs's breach of the duty of loyalty or his actions in light of KRS 275.170.

Based on the court's use of the diversion of corporate opportunity as the basis for its decision, we shall examine Kentucky statutes that codify corporate conflict of interest for directors of a corporation.[30] KRS 271B.8-310(1) states:

> A conflict of interest transaction shall be a transaction with the corporation in which a director of the corporation has a direct or indirect interest. A conflict of interest transaction shall not be voidable by the corporation solely because of the director's interest in the transaction if any one (1) of the following is true:

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[29] This is a crucial point – disclosure is an absolute prerequisite to the fiduciary making personal use of the property otherwise subject to the fiduciary relationship. *See also* RESTATEMENT (THIRD) OF THE LAW OF AGENCY § 8.06 (1)(a)(ii); *id*. 8.06, comment c. Only with full disclosure and informed consent is the agent's self-interested conduct permissible (*i.e*., exempt from the recapture of benefits provided for in KRS § 275.170(2)).

[30] The entire discussion of the rules used in the business corporation act has no place in a discussion of LLCs.

- Initially, the LLC has its own rules for the duty of loyalty. *See* KRS § 275.120(2).
- Second, the law of corporations is not a general "gap filler" for the law of other business organizations. Corporate law governs corporations, and that is all it governs. *See also 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.").
- Third, KRS § 271B.8-310(1) is not the standard of loyalty governing corporate directors. A directors' duties are set forth in KRS § 271B.8-300(1). Rather, KRS § 271B.8-310(1) defines, for a limited class of interested transactions, a series of safe-harbors for sanctioning the transaction.
- It is worth noting that partnership law expressly provides that it does not apply in business organizations formed under different organizational statues. *See* KRS § 362.1-202(2); *id*. § 362.175(2).

> (a) The material facts of the transaction and the director's interest were disclosed or known to the board of directors or a committee of the board of directors and the board of directors or committee authorized, approved, or ratified the transaction;
> (b) The material facts of the transaction and the director's interest were disclosed or known to the shareholders entitled to vote and they authorized, approved, or ratified the transaction; or
> (c) The transaction was fair to the corporation.

Obviously, this statute is referring to directors of corporations rather than manager-members of limited liability, but we believe this statute is illustrative of Kentucky law regarding the primacy of fiduciary duty over misappropriation of corporate opportunity. But in order to concur with the trial court, we must determine not only that Hobbs's activities breached the statutory standards found in KRS 275.170 and KRS 271B.8-310(1),[31] but we also must recognize the doctrine of diverted corporate opportunity. In light of the fact that Kentucky jurisprudence has never addressed this issue of lost opportunity and that this case is one of first impression, we adopt the business opportunity doctrine.

In doing so, however, we rely on the analysis found in *Miller:*

> [W]e believe a more helpful approach is to combine the "line of business" test with the "fairness" test and to adopt criteria involving a two-step process for determining the ultimate question of when liability for wrongful appropriation of a corporate opportunity should be imposed. The threshold question to be answered is whether a business opportunity presented is also a "corporate" opportunity, i.e., whether the business opportunity is of sufficient importance and so closely related to an existing or prospective activity of the corporation as to warrant judicial sanctions against its personal acquisition by a managing officer or director of the corporation.

Miller, 222 N.W.2d at 81. Herein, the trial court has already determined that Hobbs's diversion of the O'Reilly build-to-suit lease projects was indeed a corporate opportunity of American Leasing that he diverted for his own use.

Having adopted the doctrine of corporate opportunity, we must next analyze whether American Leasing had the ability to undertake the O'Reilly project. During the bench trial, Hobbs argued that the three O'Reilly projects required completion by March 1, 2005. Moreover, he ***598** opined that American Leasing would have been unable to acquire the financing for the projects because U.S. Bank would not finance the projects and Habeeb refused to finance any project that involved Pearson. Hobbs posits that for these reasons, he had to form American Development so as not to lose the business prospect. This line of reasoning, however, is disingenuous. First, regardless of the

[31] Again, the reference to KRS § 271B.8-310(1) is entirely inappropriate. First, it has no application in the law of LLCs; rather, it governs Kentucky business corporations. Second, it is impossible to "breach" this statute – it sets forth only a safe harbor for sanctioning certain conduct that would otherwise violate KRS § 271B.8-300(1); you can't violate a safe harbor.

company's ability to complete the projects, Hobbs could have and should have informed the other members. Moreover, notwithstanding the membership dispute, the record is clear that Hobbs knew the players—Pearson, Patmon, and Gray. The record shows no attempt by Hobbs to communicate his actions to the other members, explain his lack of communication to them, or to ask their assistance in obtaining financing for the projects. Further, a possibility exists that American Leasing could have sold its business opportunity to another venture and profited in that manner. At this juncture, it is pure speculation to assume that, even if Hobbs had exercised his duties of loyalty to American Leasing, it could not have completed or sold the leases.

Thus, we believe for the most part, that the court's legal analysis was correct. While it is true that transactions between a limited liability company and its managers are subject to fewer restrictions than are transactions between a corporation and its officers and directors, the transactions are still limited by the managers' obligation of good faith and fair dealing.[32] Accordingly, the primary jurisprudence here is not whether the company could have completed the projects but whether Hobbs breached the statutory requisites found in KRS 275.170 and the common law as delineated in Kentucky.[33] A member or manager must account to and hold as a trustee for the limited liability company any profit or benefit derived from transactions involving the use of a limited liability company's property by that member or manager without the consent of (i) one-half of the disinterested managers, (ii) one-half of the other persons (whether or not members) participating in management or (iii) a majority-in-interest of the members. *See* KRS 275.170(2).[34] Hence, clearly the first prong of the business opportunity doctrine has been met: that is, Hobbs breached his fiduciary duty to American Leasing. After meeting the first prong of the doctrine of corporate opportunity, however, it is still necessary for Patmon to establish that American Leasing had the financial wherewithal to undertake the O'Reilly project. *Miller*, 222 N.W.2d at 81.[35] While we are aware that

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[32] No, they are limited by his statutory duty of loyalty as set forth in KRS § 275.170(2). The obligation of good faith and fair dealing is a principle of contract law that serves to inform a contract's application and to fill certain interstices therein. *See also* KRS § 275.003(7) (expressly adopting good faith and fair dealing in LLCs). Good faith and fair dealing does not modify or supplement fiduciary duty. *See also Ballard v. 1400 Willow Council of Co-Owners*, 430 S.W.3d 229 (Ky. Nov. 21, 2013).

[33] To repeat the point already made, consequent to the 2010 Amendments to KRS § 275.170, it is clear the duty of care and the duty of loyalty there set forth are complete and comprehensive as to who owes the duty, to whom is it owed, what is the duty and, in the case of the duty of loyalty, what is the remedy for breach. As such there is no place for the operation of common law.

[34] This paraphrase of KRS § 275.170(2) is of the statute as of the time of Hobbs' actions and prior to its amendment in 2007. The direct quotation on page 597 of the decision is of the statute after its 2007 amendment.

[35] This conclusion, imposing upon Patmon (the plaintiff) a burden of showing American Leasing could have performed on the subject leases, is entirely in error. Hobbs violated his duty of loyalty by taking for himself the contracts – he had no right to them even if the LLC could not perform on them. Having taken the LLC's property for his own benefit, KRS § 275.170(2) dictates that all profits derived therefrom are to be held in trust for the LLC. As set forth in *Analytic Protocol* at 509-511 (citations omitted):

> The duty of loyalty in a Kentucky LLC developed under partnership law and it provides that expropriation of the opportunity gives rise to the obligation to disgorge all of the benefits derived therefrom irrespective of the ability of the venture to directly exploit the opportunity. The violation of the duty to the LLC is the taking of the opportunity irrespective of the LLC's capacity to perform. That is, it is the action, not the consequent damage that is the focus of the duty of loyalty under the Prototype LLC Act as adopted by Kentucky. It is as to this point that the *Patmon* opinion most clearly fails. Even having determined that Hobbs diverted LLC

Patmon opined during the course of the litigation that she did not know how American Leasing would have financed the project, she did so prior to the adoption of this doctrine. Thus, Patmon must now have the opportunity to address the burden of proof as to this issue.

6. Damages

Thus, we remand this case to the trial court to determine a remedy for Hobbs's common-law breach of fiduciary duty and failure to follow the statutory guidelines of KRS 275.170.[36] Pursuant to KRS 275.170, at a minimum, Hobbs is required to hold in trust all benefits and profits derived by him as the result of his misuse of the build-to-suit leases. In so doing, the court shall determine the value of the build-to-suit leases that Hobbs diverted to American Development. We note that typically a breach of fiduciary duty in the partnership context results in an accounting (because profits, assets or opportunities have been diverted), or simply damages (again for the profits lost or losses incurred as a result of the breach.) *Bromberg and Ribstein on Partnership* ¶ 16.07(i) (2005). For instance, the measure of damages in a similar case where company opportunity ***599** was misappropriated was the gross profit a company would have earned on the contracts.[37] *See Kentucky Paving*, 557 S.W.2d at 436-39.

> property for his own benefit, the court imposed the burden of demonstrating that the LLC had or could acquire the capacity to perform on the agreements on Patmon (the plaintiff).
>
> The two position are irreconcilable. The build-to-suit lease agreements cannot be assets of the LLC diverted by Hobbs in violation of his fiduciary duty, on one hand, but not assets for purposes of determining the remedy for the breach, on the other hand. The Court implicitly takes those inconsistent positions by requiring Patmon to demonstrate the LLC's capability to perform. Having determined that Hobbs violated his duty of loyalty the question should turn immediately to the question of damages and other relief. Were financial capability to perform an element of the duty it would go to the question of whether company property has been appropriated – if capacity is a factor in defining what is the property, and capacity is lacking, then there has been no property. If there is no property there can be no breach of loyalty for having appropriated what does not exist.
>
> It appears that the Court of Appeals has made "ability to perform" an element of the proof of damages, *i.e.*, if the LLC could not perform it lost nothing. This implication, however, conflicts with the Court's recognition that the contracts had value even if the LLC could not perform thereon. Even if lack of capacity to perform were a factor in determining whether the opportunity was property, the burden of demonstration should be upon the agent and not upon the principal.

[36] This statement is no longer good law. The 2010 amendments to the LLC Act make it clear that the statutory formula of KRS § 275.170(2) is the entirety of the fiduciary duty of loyalty. "The duty of loyalty applicable to each member and manger shall be to …." is an exclusive formula. *Contrast, e.g.*, KRS § 362.1-404(2) (partner's duty of loyalty "includes, but is not limited to.…"); *id.* § 386A.5-070(1) ("Each trustee . . . owes a duty of loyalty to the statutory trust . . . including but not limited to the following"). Furthermore, being a clarification of the existing law, the amendment should have retroactive effect. *See, e.g.*, *Moore v. Stills*, 307 S.W.3d 71, 81 (Ky. 2010) ("Among the 'remedial' enactments are statutory amendments that clarify existing law or that codify judicial precedent.").

[37] The measure of damages employed in *Kentucky Paving* has no relevance in an LLC breach of loyalty case. *Stewart Pavin*g involved an employee who violated his common law duty of loyalty. *See also* RESTATEMENT (THIRD) OF EMPLOYMENT LAW § 8.01(a) (Tentative Draft No. 3 (Apr. 8, 2010)) ("Employees owe a duty of loyalty…."). In consequence the measure of damages was a question of common law. Here the statute defines the

Further, pursuant to KRS 275.290 and KRS 275.300(1)(b), based on Hobbs's misconduct, the court is authorized to order the dissolution of American Leasing. The dissolution of the company will allow American Leasing to conclude its affairs, collect its assets and distribute the assets to its members. In light of Hobbs's misconduct, the court will need to decide, in the interest of justice, the percentage to be used in dividing the assets among the members.[38]

Finally, Patmon will be able to present evidence as to whether American Leasing could have taken advantage of the business opportunity of the O'Reilly build-to-suit leases.[39]

CONCLUSION

Accordingly, we remand the September 24, 2007, judgment of the Jefferson Circuit Court for additional proceedings consistent with this opinion.

CAPERTON, Judge, concurs.

COMBS, Chief Judge, Concurs and Files Separate Opinion.

COMBS, Chief Judge, concurring.

I concur with the well reasoned majority opinion in this unique and significant case. But I write separately in order to emphasize that this is indeed a case of first impression.

The trial court made numerous calls correctly. Its only error involved filling a hiatus in the law that often may only be decided in the course of an appeal. Short of clairvoyance, which is lacking in most humans, the trial court acted carefully and correctly within the only parameters of the precedent before it.

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measure of damages, namely disgorgement to the LLC of "any profit and benefit derived." *See also Analytic Protocol* at 490, fn. 76.

[38] Beyond requiring the return of the ill-gotten gains to the LLC, the LLC Act is silent as to what further penalty may be visited upon the bad actor. Here, presumably employing equity, it is suggested that Hobbs' sharing ratio may be reduced. Directing that all distributions of proceeds of the previously misappropriated opportunity be to members other than the bad actor has merit, but as well leads to complicated issues of accounting. Requiring the disloyal fiduciary to pay the LLC's legal costs incurred in seeking recovery has merit. *See also Analytic Protocol* at 512-13. Any such award, however, will be based upon either the applicable operating agreement or the court's powers in equity to fashion a remedy – the statute is silent as to those matters.

[39] As previously noted, no burden to demonstrate ability to perform should have been imposed upon Patmon, and the statute as amended in 2012 now precludes such a requirement. *See* KRS § 275.170(3) as amended by 2012 Ky. Acts, ch. 81, § 106.

LIMITED LIABILITY COMPANIES IN KENTUCKY
(UKCLE 2011)

2016-1 Amendment & Restatement of Chapter 8

Statutory Transactions: Conversion, Mergers and Share Exchange

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Chapter 8
Statutory Transactions: Conversions, Mergers and Share Exchanges

by Thomas E. Rutledge

CONTENTS

[8.1] Introduction

This chapter will discuss certain fundamental and frequently occurring LLC transactions and examine their treatment under the LLC Act. These statutory transactions are conversion, merger and share exchange.

[8.2] 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 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.

[8.3] 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.[1] It is also possible for an LLC to convert into a limited partnership.[2]

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[1] KY. REV. STAT. ANN. § 275.370.

[2] 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.

Conversion	**Authorized by KRS**
General partnership into LLC	§ 275.370
Limited partnership into LLC	§ 362.2-1102(3); § 275.372
Business corporation into LLC	§ 271B.12-030; § 275.376
LLC into limited partnership	§ 362.2-1102(4)
Nonprofit corporation into nonprofit LLC	§ _____

[8.4] Approval of a Conversion

[8.4.1] General Partnership into LLC

The conversion of a general partnership into an LLC required the approval of either all partners or that threshold set forth in the partnership agreement for approval of a conversion.[3]

[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.[4]

[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.[5] 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[6] 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;

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[3] 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).

[4] KY. REV. STAT. ANN. § 275.370(2).

[5] KY. REV. STAT. ANN. § 275.376. The conversion of a cooperative association with shares into an LLC should be permitted. *See id.* § 272.042.

[6] There is no statutory requirement that the plan be in writing or otherwise in record form, but the benefits of such are obvious.

- 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.[7] The plan of conversion may set forth any other desired provision.[8]

[8.4.4] 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.[9] The LLC must adopt a written[10] 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.[11]

[8.4.5] Nonprofit Corporation into Nonprofit LLC

A provision added to the LLC Act in 2015 will permit a nonprofit corporation to convert into a nonprofit LLC.[12] 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.[13] 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.[14] To provide an example, consider an affiliated group of nonprofit hospitals, each organized as a nonprofit corporation and

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[7] KY. REV. STAT. ANN. § 275.376(3).

[8] KY. REV. STAT. ANN. § 275.376(4).

[9] KY. REV. STAT. ANN. § 275.372(2).

[10] The statute requires that the plan of merger be "in a record." *See also* KY. REV. STAT. ANN. § 362.2-102(12).

[11] KY. REV. STAT. ANN. § 362.2-1102(5).

[12] *See* KY. REV. STAT. ANN. § 275.376(13), created by 2015 Ky. Acts, ch. 34, § 47.

[13] *Id*.

[14] *Id.*

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.[15]

The conversion of a nonprofit corporation into a nonprofit LLC will require the approval of the corporation's board of directors.[16] While members of a nonprofit corporation may have the right to vote as to a merger,[17] as a manager is not a conversion (and vise versa) that right does not carry forward in a conversion.[18]

[8.5] Conversion Filing Requirements

[8.5.1] General Partnership into LLC

Once approved, the converting partnership files Articles of Organization with the Secretary of State.[19] These Articles of Organization must set forth the basic information called for in Articles of Organization filed when forming an LLC,[20] 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.[21]

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.[22]

[8.5.2] Limited Partnership into LLC

Once approved, the converting limited partnership files Articles of Organization with the Secretary of State.[23] These Articles of Organization must set forth the information called for in Articles of organization filed when forming an LLC,[24] plus certain additional information relating

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[15] *See also* Rutledge, *The 2015 Amendments to the Kentucky Business Entity Statutes*, __ NORTHERN KENTUCKY LAW REVIEW __ (2015-16) (*forthcoming*).

[16] *See* KY. REV. STAT. ANN. § 273.283(1); *id.* § 275.376(2).

[17] *See* KY. REV. STAT. ANN. § 273.283.

[18] *See also* KY. REV. STAT. ANN. § 275.003(5).

[19] KY. REV. STAT. ANN. § 275.370(3).

[20] *See* KY. REV. STAT. ANN. § 275.025; *see also supra* Chapter 5, § 5.2.

[21] *Id.*

[22] *See* KY. REV. STAT. ANN. § 275.370(4); *id.* § 14A.2-070.

[23] KY. REV. STAT. ANN. § 275.370(3).

[24] *See* KY. REV. STAT. ANN. § 275.025; *see also supra* Chapter 5, § 5.2.

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
- A statement that the vote necessary to approve the conversion was obtained.[25]

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.[26]

[8.5.3] Business Corporation into LLC

Once approved, the converting corporation files Articles of Organization with the Secretary of State.[27] These Articles of Organization must set forth the information called for in Articles of organization filed when forming an LLC,[28] plus certain additional information relating to the conversion. The additional information required for the conversion of a corporation into an LLC is:

- A statement that the limited partnership was converted to an LLC;
- The former name of the converted limited partnership; and
- A statement that the vote necessary to approve the conversion was obtained.[29]

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.[30]

[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[31] and as well as setting forth:

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[25] KY. REV. STAT. ANN. § 275.370(3)(a)-(e).

[26] *See* KY. REV. STAT. ANN. § 275.370(4); *id.* § 14A.2-070.

[27] KY. REV. STAT. ANN. § 275.376(11).

[28] *See* KY. REV. STAT. ANN. § 275.025; *see also supra* Chapter 5, § 5.2.

[29] KY. REV. STAT. ANN. § 275.376(11)(a)-(c).

[30] *See* KY. REV. STAT. ANN. § 275.376(12); *id.* § 14A.2-070.

[31] *See* KY. REV. STAT. ANN. § 362.2-201.

- A statement that a LLC was converted into the LP;
- The name of the LLC and its jurisdiction of organization;
- A statement that the conversion was approved as required by KyULPA;
- A statement that the conversion was approved as required by the statute governing the converting LLC;[32] 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).[33]

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.[34]

[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 LLC[35] and as well as setting forth:

- A statement that a nonprofit corporation was converted into the LLC;[36]
- The former name of the converted corporation;[37]

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.[38]

[8.6] 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.[39]

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[32] *See also* KY. REV. STAT. ANN. § 275.372(2).

[33] KY. REV. STAT. ANN. § 362.2-1104(1).

[34] KY. REV. STAT. ANN. § 362.2-1104(2); *id*. § 14A.2-070.

[35] *See* KY. REV. STAT. ANN § 275.025(1)

[36] and KY. REV. STAT. ANN. § 275.376(11)(a).

[37] and KY. REV. STAT. ANN. § 275376(11)(b).

[38] KY. REV. STAT. ANN § 275.376(12); *id*. § 14A.2-070.

[39] KY. REV. STAT. ANN. § 275.375(1).

Conversion is not therefore deemed an event of dissolution or termination of the partnership for purposes of partnership law. Any LLP election[40] made by the predecessor partnership is cancelled by the conversion,[41] as is any statement of partnership authority.[42] The certificate of limited partnership of any converting limited partnership is cancelled by the conversion.[43]

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.[44] The LLC Act specifically provides that title to all partnership property remains "vested" in the converted entity.[45] 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.[46] 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.[47]

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.[48]

The effect of a conversion on the individual personal liability of the former partners[49] 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.[50] 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

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[40] *See* KY. REV. STAT. ANN. § 362.555; *id*. § 362.1-1001.

[41] KY. REV. STAT. ANN. § 275.370(3)(d).

[42] *Id*. *See also* KY. REV. STAT. ANN. § 362.1-303.

[43] KY. REV. STAT. ANN. § 275.370(3)(e).

[44] KY. REV. STAT. ANN. § 275.375(2).

[45] KY. REV. STAT. ANN. § 275.375(2)(a).

[46] *See* KY. REV. STAT. ANN. § 362.015(8).

[47] *See* KY. REV. STAT. ANN. § 275.375(2)(c).

[48] KY. REV. STAT. ANN. § 275.375(2)(d).

[49] *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).

[50] KY. REV. STAT. ANN. § 275.370(5).

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 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.[51] 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.[52]

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.[53]

[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.[54] 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.[55] At the same, all obligations of the converting corporation continue as obligations of the converted LLC.[56] Actions or proceedings against the converting corporation may be continued notwithstanding the conversion with the name of the converting LLC substituted in its place.[57] Any written operating agreement of the LLC[58] shall upon the conversion become binding upon each person who is a member in the converted LLC.[59]

[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.[60] Upon the conversion taking effect, all property and contract

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[51] 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.

[52] 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.

[53] KY. REV. STAT. ANN. § 275.370(5).

[54] KY. REV. STAT. ANN. § 275.377(1).

[55] KY. REV. STAT. ANN. § 275.377(2)(a).

[56] KY. REV. STAT. ANN. § 275.377(2)(b).

[57] KY. REV. STAT. ANN. § 275.377(2)(c).

[58] *See also* KY. REV. STAT. ANN. § 275.376(3)(b).

[59] KY. REV. STAT. ANN. § 275.377(2)(d).

[60] KY. REV. STAT. ANN. § 362.2-1105(1).

rights of the converting LLC as well as all its rights, privileges and immunities remain vested in the converted limited partnership without assignment, reversion or impairment.[61] At the same, all obligations of the converting LLC continue as obligations of the converted limited partnership.[62] 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.[63] The written partnership agreement of the converted limited partnership becomes binding upon each person who becomes a partner in the converted limited partnership.[64]

[8.7] 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.[65]

Upon a conversion, the shareholders in the cooperative association should have the dissenter rights provided for in the cooperative corporation act.[66] The cooperative association act does not expressly provide a right of dissent upon a "conversion," but the right to dissent may be inferred from (a) the inclusion of a consolidation as an event giving rise to the right to dissent and (b) the gap filler incorporation of the Business Corporation Act.[67] There exists, however, authority to the contrary.[68]

[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[69]), a member may exercise those rights. Absent such a contractual right, there is no right to dissent.[70]

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[61] KY. REV. STAT. ANN. § 362.2-1105(2)(a).

[62] KY. REV. STAT. ANN. § 362.2-1105(2)(b).

[63] KY. REV. STAT. ANN. § 362.2-1105(2)(c).

[64] KY. REV. STAT. ANN. § 362.2-1105(2)(d). *See also id*. § 362.2-1102(5)(d).

[65] *See* KY. REV. STAT. ANN. § 271B.13-020(1)(d); *see also* Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, 97 KY. L.J. 225 at 250 (2008-09).

[66] *See* KY. REV. STAT. ANN. § 272.321.

[67] *See* KY. REV. STAT. ANN. § 272.042.

[68] *See Lach v. Man O'War, LLC*, 256 S.W.3d 563, 569-70 (Ky. 2008) (conversion not equivalent to a merger).

[69] KY. REV. STAT. ANN. § 275.372(2).

[70] *See also* Rutledge, *The 2007 Amendments*, *supra* note 65 at 248.

[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.[71]

[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.

[8.8] 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.[72]
- 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.[73]
- A domestic LLC may merge with a:
- domestic business corporation;[74]
- domestic limited partnership governed by the Kentucky Uniform Limited Partnership Act (2006);[75]
- domestic limited partnership governed by the Kentucky Revised Uniform Limited Partnership Act;[76] and
- domestic general partnership governed by the Kentucky Revised Uniform Partnership Act (2006).[77]

[8.9] 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.[78] With respect to foreign entities that

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[71] KY. REV. STAT. ANN. § 362.1-904(3); *id.* § 362.2-1103(3).

[72] KY. REV. STAT. ANN. § 275.345(1).

[73] *See* KY. REV. STAT. ANN. § 275.345(1).

[74] *See* KY. REV. STAT. ANN. § 275.345(1); *id.* § 271B.11-080.

[75] *See* KY. REV. STAT. ANN. § 275.345(1); *id.* § 362.531.

[76] *See* KY. REV. STAT. ANN. § 275.345(1); *id.* § 362.2-1106.

[77] *See* KY. REV. STAT. ANN. § 275.345(1); *id.* § 362.1-908.

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.[79] The organic law of each other domestic entity party to the merger must be satisfied in connection with any merger.[80] The constituent parties to the merger are required to enter into a written plan of merger[81] 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.[82]

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[83] where the shareholders are invited to review and either approve or not approve the transaction.[84] The notice to the shareholders must provide that a purpose of the shareholder meeting is to consider the plan

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[78] KY. REV. STAT. ANN. § 275.350(1).

[79] KY. REV. STAT. ANN. § 275.350(2).

[80] *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).

[81] KY. REV. STAT. ANN. § 275.355(1).

[82] KY. REV. STAT. ANN. § 275.355(2).

[83] KY. REV. STAT. ANN. § 271B.11-030(2)(a).

[84] KY. REV. STAT. ANN. § 271B.11-030(2)(b).

of merger, which notice must as well include a copy or a summary of that plan.[85] 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.[86] Rather, in the Business Corporation Act, consequent to the mandated utilization of the board of directors,[87] it being separate and distinct from the body of shareholders, various notice requirements have been mandated.[88] In contrast, LLCs are governed by the LLC Act,[89] and the LLC Act allows the determination, by private agreement, amongst the parties to the venture as to these matters.[90] 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.[91] Rather, in the case of an LLC, whatever rules and procedures have been dictated by the operating agreement will control.

[8.10] 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.[92] It should be recognized that the filing requirements for mergers involving LLCs (and business corporations) were simplified in 2015.[93] The import of the 2015 amendments were to (a) eliminate the requirement that the plan of merger be filed along with the

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[85] KY. REV. STAT. ANN. § 271B.11-030(4).

[86] *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 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."); Rutledge, *Vampires and the Law of Business Organizations: The Fruitless Search for Authenticity*, J. PASSTHROUGH ENTITIES, Nov./Dec. 2011, 51. None of the Kentucky Revised Uniform Partnership Act (2006), the Kentucky Uniform Limited Partnership Act (2006) nor the Kentucky Uniform Statutory Trust Act (2012) mandate procedural requirements as to the approval of a merger similar to those imposed by the Business Corporation Act. The corporate law paradigm, rather than being normative, is in fact atypical.

[87] *See* KY. REV. STAT. ANN. § 271B.8-010(1).

[88] The Kentucky Uniform Limited Cooperative Association Act, which like a business corporation provides for management in a board that is distinct from the membership (*see* KY. REV. STAT. ANN. § 272A.8-010(2)), likewise imposes notice and requirements similar to those used in the BCA. *See* KY. REV. STAT. ANN. § 272A.16-050(2).

[89] *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.")

[90] *See* KY. REV. STAT. ANN. § 275.003(1).

[91] *See also 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.").

[92] KY. REV. STAT. ANN. § 275.360(1).

[93] *See* KY. REV. STAT. ANN. § 275.360 as amended by 2015 Ky. Acts, ch. 34, § 56; *see also* KY. REV. STAT. ANN. § 271B.11-050 as amended by 2015 Ky. Acts, ch. 34, § 9.

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.[94]

The Article of Merger must set forth:

- The name and jurisdiction of organization of each business entity constituent to the merger;
- The name of the business entity surviving the merger;
- The information required by KRS § 275.355(2)(d);[95]
- 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.[96]

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.[97]

[8.11] 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;

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[94] *See* Rutledge *The 2015 Amendments to the Kentucky Business Entity Statutes*, __ NORTHERN KENTUCKY LAW REVIEW __ (2015-16) (*forthcoming*).

[95] *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".

[96] KY. REV. STAT. ANN. §§ 275.360(1)(a)-(e).

[97] KY. REV. STAT. ANN. § 275.360(2); *id.* § 14A.2-070.

- 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;

- 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.[98]

[98] KY. REV. STAT. ANN. §§ 275.365(1), (2), (3), (4), (5), (6), (7), (8), (10) and (11).

[8.12] 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,[99] may not merge with a LLC in that mergers are not authorized for those partnerships.[100] A general partnership organized under the Kentucky Revised Uniform Partnership Act (2006),[101] may merge with a LLC.[102]

[8.12.2] Merger of a Limited Partnership into an LLC

A limited partnership organized under the Kentucky Revised Uniform Limited Partnership Act[103] may merge with a LLC.[104] Likewise, a limited partnership organized under the Kentucky Uniform Limited Partnership Act (2006)[105] may merge with an LLC.[106]

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[107] 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.[108]

[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.[109]

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[99] KY. REV. STAT. ANN. ch. 362.

[100] *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.")

[101] KY. REV. STAT. ANN. ch. 362.1.

[102] *See* KY. REV. STAT. ANN § 275.345(1); *id.* § 362.1-908.

[103] KY. REV. STAT. ANN. §§ 362.401 through 362.546.

[104] *See* KY. REV. STAT. ANN. § 275.345(1); *id.* § 362.531.

[105] KY. REV. STAT. ANN. ch 362.2.

[106] KY. REV. STAT. ANN. § 275.345(1); *id.* § 362.1-908.

[107] *See* KY. REV. STAT. ANN. § 362.2-1204(2).

[108] *See* KY. REV. STAT. ANN. § 271B.11-080; *id.* § 272.042; *id.* § 275.345(1).

[8.13] 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.[110]

[8.14] Dissenter Rights in a Merger

[8.14.1] Mergers involving a Corporation

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.[111]

[8.14.2] Mergers involving Partnerships, Limited Partnership and LLCs

Partners in a domestic general or limited partnership and members in a domestic LLC will not have dissenter rights unless they are provided for by private ordering.[112]

[8.14.3] Mergers involving Foreign Entities

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

[8.15] Share Exchanges Involving a LLC

In 2007, the LLC Act was amended to enable LLCs to engage in share exchanges with corporations.[113] 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.[114] 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

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[109] KY. REV. STAT. ANN. § 275.345(4).

[110] *See* KY. REV. STAT. ANN. § 275.365(9).

[111] *See* KY. REV. STAT. ANN. § 271B.13-020(1)(a).

[112] *See* KY. REV. STAT. ANN. § 275.345(3); *id.* § 362.1-906(6); *id.* §362.2-1107(4).

[113] *See* KY. REV. STAT. ANN. § 275.500; *see also* Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, 97 KY. L.J. 229, 257-58 (2008-09).

[114] KY. REV. STAT. ANN. § 275.500(1).

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
- 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.[115]

With respect to the LLC, the plan of share exchange requires the approval of the majority of the members.[116] As to the business corporation, a plan of share exchange must be approved as is dictated by the law governing the corporation.[117]

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.[118]

The share exchange is effective upon the effective date of the articles of share exchange.[119] 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.[120]

[8.16] 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

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[115] KY. REV. STAT. ANN. § 275.500(2)(a)-(b).

[116] KY. REV. STAT. ANN. § 275.505(1). *See also id.* § 275.175(1).

[117] KY. REV. STAT. ANN. § 275.505(2).

[118] KY. REV. STAT. ANN. § 275.510(1).

[119] KY. REV. STAT. ANN. § 275.510(2); *id.* § 14A.2-070.

[120] KY. REV. STAT. ANN. § 275.515.

dissent from the share exchange.[121] Whether the shareholders in the corporation subject to the right to dissent will be determined pursuant to the law governing the corporation.[122]

[8.17] Sale of Subtantially 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 the transaction[123] without defining the legal affect of the transaction. That is left to the private agreement of the buyer and the seller.

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[121] KY. REV. STAT. ANN. § 275.500(5).

[122] *See*, *e.g.*, KY. REV. STAT. ANN. § 271B.13-020(1)(b).

[123] KY. REV. STAT. ANN. § 275.247.

LIMITED LIABILITY COMPANIES IN KENTUCKY
(UKCLE 2011)

2016-1 Amendment & Restatement of Chapter 9

Dissolution of a Limited Liability Company

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Chapter 9
Dissolution of a Limited Liability Company

by Thomas E. Rutledge

CONTENTS

[9.1] Introduction

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;[1]
- as otherwise dictated by a written operating agreement;[2]
- by agreement of the members;[3]
- for the failure to have a member;[4]
- pursuant to judicial order;[5] or
- by administrative dissolution by the Secretary of State.[6]

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.[7] Having reached the end of its term as defined in its articles of organization, the LLC is dissolved,[8] but with a limited opportunity for retroactive cure. Within the 60 days after the date of dissolution, the LLC may amend 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 of termination, and the existence of the entity will not be interrupted.[9] Conversely, after the 60 day cure period has run,

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[1] KY. REV. STAT. ANN. § 275.285(1).

[2] KY. REV. STAT. ANN. § 275.285(2).

[3] KY. REV. STAT. ANN. § 275.285(3).

[4] KY. REV. STAT. ANN. § 275.285(4).

[5] KY. REV. STAT. ANN. § 275.285(5).

[6] KY. REV. STAT. ANN. § 275.285(6).

[7] KY. REV. STAT. ANN. § 275.025(2).

[8] KY. REV. STAT. ANN. § 275.285(1).

[9] 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).

amendment of the organic filing is no longer permitted, and the organization must proceed to wind up and terminate.[10]

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.[11] 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 existence[12] 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.[13] 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.[14] 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.

[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.[15]

[9.1.4] Dissolution for Failure to Have a Member

An LLC must have at least one member.[16] 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

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[10] KY. REV. STAT. ANN. § 14A.8-010(2).

[11] KY. REV. STAT. ANN. § 14A.8-010(3).

[12] KY. REV. STAT. ANN. § 14A.2-130.

[13] KY. REV. STAT. ANN. § 275.285(2).

[14] KY. REV. STAT. ANN. § 275.315.

[15] KY. REV. STAT. ANN. § 275.285(3); *see also* Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, 97 KY. L.J. 229 at 244-45 (2008-09). The alternative threshold must be in writing.

[16] 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

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.[17] 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.[18] 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.[19] 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."[20] 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.[21] The decision dissolving

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have received significant criticism (*see, e.g.*, Larry E. Ribstein, *An Analysis of the Revised Uniform Limited Liability Company Act (2006)*, 3 VA. 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.

[17] *See* KY. REV. STAT. ANN. § 275.265(1).

[18] KY. REV. STAT. ANN. § 275.135(1); *id*. § 275.245(1); *id*. § 275.255(1)(c).

[19] 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.

[20] KY. REV. STAT. ANN. § 279.290(1).

[21] KY. REV. STAT. ANN. § 275.290(1). Presumably only a Kentucky court, and not a foreign court, may order judicial dissolution of a Kentucky organized LLC. *See* Peter B. Lading and Kyle Evans Gray, *Judicial*

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.[22] Upon the entry of the order of dissolution the LLC will enter the winding up phase.[23]

No cases interpreting the "is not reasonably practicable to carry on the business of the limited liability company in conformity with the operating agreement" standard has been decided under Kentucky law. A Kentucky partnership case, *Allen v. Cummings*,[24] 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.[25] A New York decision[26] 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,[27] 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.[28]

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.[29] In contrast, a New York court denied a request for dissolution of a profitable and functioning LLC in which the members were deadlocked.[30] In contrast, in a Delaware decision,[31] 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

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Dissolutions Are the Courts of the State That Brouth You In The Only Courts That Can Take You Out?, 70 BUS. LAW. 1059 (Fall 2015).

[22] 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.

[23] KY. REV. STAT. ANN. § 275.290(3).

[24] 500 S.W.2d 795 (Ky. 1973).

[25] *In re Hefel*, 2011 Bank. LEXIS 3750 (Bankr. N.D. Iowa 2011).

[26] *In the Matter of 1545 Ocean Ave, LLC*, 72 AD 3d 121, 131 (NY. App. Div. 2d Dept. 2010).

[27] *See* DEL. CODE ANN. tit. 6, § 18-802.

[28] *In re Silver Leaf LLC*, 2005 Del. Ch. LEXIS 119 (citing *P.C. Tower Ctr. Inc, v. Tower Ctr. Dev. Assoc. LP*, 1989 Del. Ch. LEXIS 72).

[29] *Kirksey v. Grohmann*, 754 N.W.2d. 825 (S.D. N.Y. 2008).

[30] *Schindler v. Niche MediaHoldings, LLC*, 772 N.Y.S. 2d. 781 (N.Y. Sup.Ct. 2003).

[31] *Vila v. BVWebTies LLC*, No. 4308-VCS (Del. Ch. 2010).

dispute even as, in an earlier decision, a contentious relationship between the two parties to the venture was not sufficient to justify dissolution.[32] 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]."[33]

Similar at least difficult to reconcile decisions can be found across the other states in which there are decisions.

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.[34] This provision will have 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.[35] 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.[36]

[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;[37]
- that does not file its annual report by the due date;[38]
- that does not have a registered office or registered agent for sixty 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.[39]

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[32] *Cincinnati Bell Cellular Systems Co. v. Ameritech Mobile Phone Serv. of Cincinnati, Inc.*, Civ. Act. No. 13389, 1996 WL 506906, *6-7 (Del. Ch. Sept. 3, 1996).

[33] *Lindsay v. Pacific Topsoils, Inc*., 2003 WL 22121055 (Wash. Ct. App. Sept. 15, 2003).

[34] KY. REV. STAT. ANN. § 275.290(5), created by 2015 Ky. Acts, ch. 34, § 76.

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

[36] *See, e.g.*, MINN. STAT. ANN. § 322B.83; TENN. CODE § 48-245-801.

[37] *See also* KY. REV. STAT. ANN. § 14A.1-040.

[38] *See also* KY. REV. STAT. ANN. § 14A.6-010.

A LLC will be given notice of the grounds for administrative dissolution[40] sent to the principal office address.[41] 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.[42] A LLC administratively dissolved continues to exist but is restricted to activities necessary to wind up and liquidate its affairs.[43] Administrative dissolution may be cured and relates back to the date of dissolution,[44] but reinstatement is not possible if the entity has taken certain steps to wind up it affairs.[45] The denial of an application to reinstate may be appealed to the Franklin Circuit Court.[46]

[9.2] The Effect of Dissolution upon the LLC

A dissolved LLC, irrespective of the event precipitating its dissolution, continues to exist as an LLC.[47] A dissolved LLC may "not carry on any business except that appropriate to wind up and liquidate its business and affairs"[48] and must commence to wind up its affairs.[49] The statute is specific as to numerous consequences that do not follow from dissolution, namely:

- unless written operating agreement provides to the contrary, dissolution does not transfer title to any of the LLC's property;[50]

- 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;[51]

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[39] KY. REV. STAT. ANN. §§ 14A.7-010(1)(a)-(d).

[40] KY. REV. STAT. ANN. § 14A.7-020(1).

[41] KY. REV. STAT. ANN. § 14A.2-010(12).

[42] KY. REV. STAT. ANN. § 14A.7-020(2).

[43] KY. REV. STAT. ANN. § 14A.7-020(3); *see also id*. § 275.300(2).

[44] KY. REV. STAT. ANN. § 14A.7-030.

[45] KY. REV. STAT. ANN. § 14A.7-030(4).

[46] KY. REV. STAT. ANN. § 14A.7-040.

[47] 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.")

[48] KY. REV. STAT. ANN. § 275.300(2).

[49] KY. REV. STAT. ANN. § 275.285.

[50] 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).

- 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;[52]

- 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;[53]

- dissolution does not prevent the commencement of a proceeding against the LLC in its own name;[54]

- dissolution does not abate or suspect any proceedings pending by or against the LLC as of the time of its dissolution;[55]

- dissolution does not terminate the authority of the LLC's registered agent;[56]

- dissolution does not alter the LLC's obligations and responsibilities with respect to federal and state tax returns and remission of taxes due;[57] or

- dissolution does not alter the rule of limited liability otherwise applicable.[58]

While it is clear that the limited liability enjoyed by members and managers survives dissolution[59] under agency law those acting on behalf of the dissolved LLC on matters outside

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[51] KY. REV. STAT. ANN. § 275.300(3)(b).

[52] KY. REV. STAT. ANN. § 275.300(3)(c).

[53] KY. REV. STAT. ANN. § 275.300(3)(d); *see also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383, 391-92 (2011).

[54] KY. REV. STAT. ANN. § 275.300(4)(a).

[55] KY. REV. STAT. ANN. § 275.300(4)(b).

[56] KY. REV. STAT. ANN. § 275.300(4)(c).

[57] KY. REV. STAT. ANN. § 275.300(4)(d).

[58] KY. REV. STAT. ANN. § 275.300(4)(e); *see also* Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, 97 Ky. L.J. 229 at 239-43 (2008-09).

[59] *See* KY. REV. STAT. ANN. § 275.300(3)(i).

those appropriate for winding up and termination may be personally liable on claims arising therefrom.[60]

[9.3] 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.[61]

The articles of dissolution may contain such information as may be desired.[62]

There is no separate filing made to indicate that the winding up has been completed.

[9.4] 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 the circuit court.[63] 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.[64]

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 are not necessary to satisfy its liabilities.[65] 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;

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[60] 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).

[61] KY. REV. STAT. ANN. §§ 275.315(1)-(3).

[62] KY. REV. STAT. ANN. § 275.315(4).

[63] KY. REV. STAT. ANN. § 295.300(1).

[64] KY. REV. STAT. ANN. § 275.300(1)(b).

[65] KY. REV. STAT. ANN. § 275.300(2).

- 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.[66]

[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.[67] 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.[68] 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.[69] 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.[70]

[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.[71] Thereafter, assuming a balance remains in the assets, they are distributed in satisfaction of declared but unpaid distributions.[72] 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.[73] Fourth, any balance thereafter is distributed amongst the members in proportion to their respective sharing ratios.[74] 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 the appreciation that this provision substantially serves to protect the interest of third parties indicate that its requirements as to the order of distribution

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[66] KY. REV. STAT. ANN. §§ 275.300(2)(a)-(d).

[67] KY. REV. STAT. ANN. § 275.305(1)(a); *id.* § 275.305(3).

[68] KY. REV. STAT. ANN. § 275.305(1)(b).

[69] KY. REV. STAT. ANN. § 275.305(2).

[70] *But see* section [9.5.1] *infra*.

[71] KY. REV. STAT. ANN. § 275.310(1).

[72] KY. REV. STAT. ANN. § 275.310(2).

[73] KY. REV. STAT. ANN. § 275.310(3).

[74] KY. REV. STAT. ANN. § 275.310(4).

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.[75]

[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 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.[76]

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;[77]
- the mailing address to which any claim should be sent;[78]
- 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;[79] and
- a statement that the claim will be barred if not received by the deadline.[80]

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

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[75] *See, e.g.*, *New Horizons Supply Cooperative v. Hack*, 1999 WL 33499 (Wisc. App. 1999).

[76] *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 such does not give rise to an obligation to give notice of dissolution).

[77] KY. REV. STAT. ANN. § 275.320(2)(a).

[78] KY. REV. STAT. ANN. § 275.320(2)(b).

[79] 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.

[80] KY. REV. STAT. ANN. § 275.320(2)(d).

claim.[81] Likewise, there will be barred any claims not presented to the LLC within the applicable deadline.[82]

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.[83]

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.[84] 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.[85] 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.[86] Where the LLC in question is a professional LLC, the two-year period is extended to five-years from the publication of the notice.[87] 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;[88]
- a claimant who submitted a timely claim to the LLC that was not acted upon;[89] or
- a claimant whose claim is contingent or based upon events occurring after the effective date of dissolution.[90]

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

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[81] KY. REV. STAT. ANN. § 275.320(3)(b).

[82] KY. REV. STAT. ANN. § 275.320(3)(a).

[83] KY. REV. STAT. ANN. § 275.320(4).

[84] KY. REV. STAT. ANN. § 275.325(2)(a).

[85] 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.

[86] KY. REV. STAT. ANN. § 275.325(2)(c).

[87] *Id.*

[88] KY. REV. STAT. ANN. § 275.325(3)(a).

[89] KY. REV. STAT. ANN. § 275.325(3)(b).

[90] 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).

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.[91]

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 corporate creditor.[92]

[9.5] 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,[93] 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.[94]

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.[95] 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,[96]

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[91] KRS § 275.325(4).

[92] *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 corporate debt to the extent of the value of the corporate property received."). *See also Reeves v. East Cairo Ferry Co.*, 158 S.W.2d 937, 938 (Ky. 1942).

[93] KY. REV. STAT. ANN. § 14A.7-030(4).

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

[95] *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.

[96] *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).

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,[97] 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*.[98]

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*,[99] 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.[100] Further, in this era there was neither administrative dissolution nor, crucially for these purposes, reinstatement after dissolution with retroactive effect.[101] Under the modern system, a dissolved entity continues to exist and retains the power and authority to wind up and liquidate its affairs.[102] 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.[103] 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,[104] the outcome often hinges on the specific statutory

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

[98] 425 S.W.3d 58 (Ky. 2014).

[99] 35 S.W.2d 867 (Ky. 1931).

[100] *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 contracted by it, in their natural capacities."); JAMES GRANT, A PRACTICAL TREATISE ON THE LAW OF CORPORATIONS IN GENERAL AS WELL AGGREGATE AS SOLE 314 (T. & J.W. Johnson 1854) (upon dissolution "The corporation is wholly gone, and with it are also lost and avoided all its claims, debts, and liabilities of all kinds.")

[101] 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.

[102] *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").

[103] *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.

[104] *See generally* Annotation, *Reinstatement of Repealed, Forfeited, Expired, or Suspended Corporate Charter as Validating Interim Acts of Corporation*, 42 A.L.R. 4th 392.

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.[105] The statute is silent as to the limited liability that is enjoyed by both the directors and the officers.[106] In contrast, the LLC Act, in addition to providing that the 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.[107] 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.[108] 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.

[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.[109] From the administrative dissolution, the LLC is restricted to activities appropriate for its winding up and liquidation.[110] Upon reinstatement, it is as if the administrative dissolution had never taken place;[111] the existence of the LLC continues without interruption. In that an effect of reinstatement is that the LLC's

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[105] KY. REV. STAT. ANN. § 271B.6-220(2).

[106] 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 THE LAW OF AGENCY § 320 (1958). While it is unquestioned that directors enjoy limited liability, the analytic underpinnings for that determination are open to debate.

[107] KY. REV. STAT. ANN. § 275.150(1).

[108] KY. REV. STAT. ANN. § 275.300(2) ("A dissolved [LLC] shall continue its existence…."); *id.* § 14A.7-020(3) ("An entity administratively dissolved continues its existence…."). Simply put, the "dissolution" of an LLC does not terminate its existence.

[109] *See* KY. REV. STAT. ANN. § 14A.7-020(3).

[110] *See id.*

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

existence has not been interrupted, then the limited liability enjoyed by its agents is likewise uninterrupted.[112]

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.

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[113] and is potentially liable to TP on the obligation.[114] Still, by ratification[115] 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:

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[112] *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.").

[113] *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.").

[114] *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.").

[115] *See* RESTATEMENT (THIRD) OF AGENCY § 4.02 (2006).

> 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.[116]

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.[117]

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,[118] upon reinstatement the entity's ratification of such actions causes the agent to have been vested with actual authority.[119] 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.[120]

This analysis is consistent with recent Kentucky decisions with the exception of the unsound *Forleo* decision. In that unpublished decision, in partial reliance upon *Steele v. Stanley*,[121] the Court held that the corporation's reinstatement after administrative dissolution[122]

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[116] *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.").

[117] 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):

> 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.

[118] *See, e.g.*, KY. REV. STAT. ANN. § 14A.7-020(4); RESTATEMENT (THIRD) OF AGENCY § 3.04(2) (2006).

[119] *See* RESTATEMENT (THIRD) OF AGENCY, Ch. 4, Introductory Note (2006); *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.").

[120] *See* 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. *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, ….").

[121] *Forleo*, 2006 WL 2788427, *1.

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)."[123]

As will be reviewed below, the *Forleo* decision conflicts with prior law and is an aberrational decision.

Esselman v. Irvine[124] 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.'"[125] Further, *Esselman* considered and rejected the notion that "resume" limited the effect of "shall relate back."[126]

The next consideration of the issue by the Court of Appeals was *Fairbanks Arctic Blind Co. v. Prather & Associates, Inc.*,[127] wherein it addressed an effort to dismiss a suit seeking enforcement of an agreement entered into while the corporation was administratively dissolved.[128] The Court of Appeals[129] held that:

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[122] 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. *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.") *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.") *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.").

[123] *Forleo*, 2006 WL 2788429, *2.

[124] No. 1997-CA-001155-MR (Ky. App. 1999).

[125] *Id*., Slip op. at 5; *see also 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 shall relate back to the date of the administrative dissolution and shall operate as if the administrative dissolution has 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.") (emphasis in original).

[126] *Id*. at 8.

[127] 198 S.W.3d 143 (Ky. App. 2005).

[128] *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.").

> 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 *J.B. Wolfe* and *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 reinstatement, it is "as if the administrative dissolution … had never occurred."[130]

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.[131]

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

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[129] Apparently unaware of its prior decision in *Esselman*, the *Fairbanks* Court thought "Since this is an issue of first impression in the Commonwealth, …." *Id*. at 145.

[130] *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*.

[131] 16A FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 8117.

Forleo appeal,[132] 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*,[133] 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. Irvine*[134] 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 *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*,[135] 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.[136] 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

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[132] *See* Brief for Appellants Dean Forleo and John Tandy dated September 6, 2005 and Brief for Appellees dated November 2, 2006.

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

[134] *See supra* notes 124 through 126 and accompanying text.

[135] 2011 WL 3793415 (Ky. Ct. App. 2011).

[136] *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.").

> 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.[137]

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."[138] Clearly, at least this panel of the Court of Appeals accepted that *Fairbanks* is the final authority on this point.

Thereafter, the question was considered by Judge Coffman in *eServices, LLC v. Energy Purchasing, Inc*.[139] 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…[140]

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.[141]

> In *Harshman Construction & Electric, Inc. v. Witte*,[142] 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

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[137] *Id*. at 4.

[138] *Id*., note 22.

[139] 2012 WL 404957 (E.D. Ky. Feb. 6, 2012).

[140] 2012 WL 404957,*2.

[141] 2012 WL 404957, *2-3.

[142] 2012 WL 2471445 (Ky. App. June 29, 2012) (Not To Be Published).

> 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.[143]

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*)[144] 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.[145] 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.[146]

The Kentucky Supreme Court brought this debate to a clear conclusion in *Pannell v. Shannon*.[147]

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.[148] The Court recognized that these are distinct questions based upon distinct legal principles:

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[143] Slip Op. at 6.

[144] *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.").

[145] *See* KY. REV. STAT. ANN. § 14A.7-030(3)(b) as amended by 2012 Ky. Acts, ch. 81, § 83.

[146] *See* KY. REV. STAT. ANN. § 14A.7-030(3)(c) as created by 2012 Ky. Acts, ch. 81, § 83; *see also* Rutledge, *The 2012 Amendments to Kentucky's Business Entity Statues*, 101 KY. L.J. ONLINE 1, 11 (2012-13).

[147] 425 S.W.3d 58 (Ky. 2014).

[148] 425 S.W.3d at 68.

> [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.[149]

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 company is reinstated before a final judgment is rendered against the member.[150]

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. *See* KRS 275.295(3)(a). And that certificate of existence took effect, by statute, retroactively on the date of dissolution.[151]

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:

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[149] 425 S.W.3d at 77.

[150] 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 *Forleo* decision, but it is out of step with and adds ambiguity to what is otherwise a clear application of unambiguous statutory law.

[151] 425 S.W.3d at 68.

> 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 existence. The limitation on the agent's liability simply for being an agent is likewise seamless.[152]

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.[153]

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

> The immunity provided by KRS 275.150 extends only to liability *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.[154]

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:

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[152] 425 S.W.3d at 78.

[153] 425 S.W.3d at 78.

[154] 425 S.W.3d at 81.

> 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.[155]

[155] 425 S.W.3d at 79, 80.

LIMITED LIABILITY COMPANIES IN KENTUCKY
(UKCLE 2011)

2016-1 Amendment & Restatement of Chapter 9A

Developments in the Law of Kentucky LLCs

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Chapter 9A
Developments in the Law of Kentucky LLCs

by Thomas E. Rutledge

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Developments in the Law of Kentucky LLCs
Chapter 9A
LIMITED LIABILITY COMPANIES IN KENTUCKY

[9A.1] Generally

All in all, Kentucky's LLC Act is at least as good and is better than many of the acts that are in place in the other states.

This chapter will begin with a chronological review of statutory and other developments in or involving the Kentucky LLC Act and other unincorporated entities. The second part of the chapter reviews, on a topical basis, numerous of the changes made to the Act, often in response to court decisions. Last, it considers developments made in other states that have not been adopted in Kentucky and (some of) the existing ambiguities in the Act.

[9A.2] Chronology

The original Kentucky LLC Act, adopted in 1994,[1] was substantially based upon the Prototype LLC Act, a product of a task force of the ABA's Committee on Partnerships and Unincorporated Associations.[2] At that time the so called "Kintner" classification regulations imposed limits upon the structuring of LLCs that desired to be classified for purposes of the IRC as "partnerships" (*i.e.*, subchapter K). Utilized as well in the drafting was the then working draft of what would become the Uniform LLC Act, which was itself not finalized until 1996.

Certain early LLC Acts (*e.g.*, Wyoming and Florida) were "bulletproof" in that they did not allow flexibility to elect out of the characteristics that would yield classification as a partnership. The Prototype Act and the Kentucky LLC Act, in contrast, were "flexible-bulletproof;" there was the flexibility under the act to modify the tax-classification characteristics such that the LLC would not be taxed as a partnership (but rather as a corporation), but if no alterations were made the LLC would by default meet the requirements for partnership classification.

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[1] 1994 Ky. Acts, ch. 389 (1994 S.B. 184).

[2] The PROTOTYPE LIMITED LIABILITY COMPANY ACT (1992) is reproduced as Appendix C in 3 LARRY E. RIBSTEIN AND ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES. The statement of the Court of Appeals in *Randy Wenty and Hartford Fire Insurance Company v. Hargus Sexton*, No. 2000-CA-002847-MR (Ky.App. Feb. 1, 2002) (unpublished) that "The Kentucky Limited Liability Company Act ... is generally similar to the model act promulgated by the Uniform Law Commissioners." is accurate only to the extent that ULLCA is similar to the Prototype Act. In fact ULLCA and the Prototype are more dissimilar than similar. Furthermore, ULLCA was not completed until 1996, well after the 1994 LLC Act was drafted and adopted.

In 1995 (the first full year in which the LLC Act was in effect):

- 8,193 business corporations were incorporated against 1,355 LLCs organized.

In 1996:

- the Uniform Limited Liability Company Act was finalized and released;[3] and

- 9,371 business corporations were incorporated against 1,917 LLCs organized.

In 1997:

- effective January 1, 1997, the "Kintner" classification regulations were replaced with the so-called "Check-the-Box" regulations under which every LLC will be taxed as either: (i) a disregarded entity if the LLC has only a single owner, or (ii) a partnership if the LLC has two or more members.[4] AN LLC desiring to be taxed as a corporation may elect to do so;

- NCCUSL completed the Revised Uniform Partnership Act;[5] and

- 9,162 business corporations were incorporated against 2,265 LLCs organized.

In 1998:

- 7,481 business corporations were incorporated against 3,381 LLCs organized;

- the Department of Financial Institutions issued a regulatory safe harbor on the definition of an interest in an LLC as a "security;"[6]

- the Kentucky General Assembly approved a number of amendments to the LLC Act[7] to account for the greater flexibility available under Check-the-Box including:

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[3] UNIF. LTD. LIAB. CO. ACT, 6B U.L.A. 545 (2008).

[4] TREAS. REG. § 301.7701-2 *et seq*.

[5] REV. UNIF. PART. ACT, 6 (pt. 1) U.L.A. 1 (2001).

[6] 808 KAR 10:360 (eff. June 25, 1998).

(i) permitting single member LLCs;[8]

(ii) changing the allocation of voting rights from per-capita to based upon capital contributions;[9]

(iii) changing the allocation of allocations and distributions from per-capita to based upon capital contributions;[10]

(iv) reducing the threshold for voluntary dissolution from all to a majority-in-interest of the members;[11]

(v) reducing the threshold for approving a merger from all to a majority-in-interest of the members;[12] and

- the assumed name statute was amended to permit LLCs to file an assumed name.[13]

In 1999:

- 7,250 business corporations were incorporated against 5,321 LLCs organized.

In 2000:

- the Kentucky Supreme Court amended its rules to permit law firms to be organized as LLCs, subject to the

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[7] 1998 Ky. Acts, ch. 341 (1988 H.B. 666).

[8] *See*, *e.g.*, KY. REV. STAT. ANN. § 275.015(8) as amended by 1998 Ky. Acts, ch. 341, § 21 (LLC defined as having one or more members); *id*. § 275.015(14) as amended by 1998 Ky. Acts, ch. 341, § 21 (expanding upon definition of "operating agreement" to address that of a single member LLC); *id*. § 275.025 as amended by 1998 Ky. Acts, ch. 341, § 23 (deleting prior requirement that articles of organization recite that LLC has two or more members).

[9] *See* KY. REV. STAT. ANN. § 275.175(3) as created by 1998 Ky. Act, ch. 341, § 29.

[10] *See* KY. REV. STAT. ANN. § 275.205 as amended by 1998 Ky. Acts, ch. 341 § 30; *id*. § 275.210 as amended by 1998 Ky. Acts, ch. 341, § 31.

[11] *See* KY. REV. STAT. ANN. § 275.285 as amended by 1998 Ky. Acts, ch. 341, § 38.

[12] *See* KY. REV. STAT. ANN. § 275.350 as amended by 1998 Ky. Acts, ch. 341, § 40.

[13] *See* KY. REV. STAT. ANN. § 365.015 as amended by 1998 Ky. Acts, ch. 341, § 56.

requirement that the firm maintain malpractice insurance or other means of financing liability for client claims;[14] and

- 6,743 business corporations were incorporated against 6,222 LLCs organized.

In 2001:

- 7,227 LLCs were organized against 6,049 business corporations incorporated; and

- NCCUSL completed the Uniform Limited Partnership Act (2001).[15]

In 2002:

- the Kentucky Constitution was amended to delete a number of provisions that imposed substantive limitations upon corporations.[16] While not directly addressing LLCs, the deletion of these provisions eliminated that argument that those same requirements should bind as well LLCs;[17]

- 9,780 LLCs were organized against 5,772 business corporations incorporated; and

- coincident with the amendment of the Constitution, a number of amendments to the business corporation act went into effect.[18]

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[14] *See* Ky. SCR 3.022 ("Forms of practice of law"); *id*. 3.024 ("Requirements for practicing law in limited liability entities").

[15] UNIF. LTD. PART. ACT, 6A U.L.A. 325 (2008).

[16] 2002 Ky. Acts, ch. 341 (2002 S.B. 120). *See generally* Cynthia W. Young, *Modernizing Kentucky's Corporate Laws*, KY. BENCH & BAR, May 2003, 12; Rutledge, *The 2002 Amendments to the Kentucky Business Corporation Act*, KY. BENCH & BAR, May 2003, 13.

[17] For example, § 193 of the Kentucky constitution provided that "stock" could be issued by a "corporation" only for money paid or services done. Stock issued in consideration of an unsecured promissory note was invalid *ab initio*. *See, e.g*., *Kirk v. Kirk's Auto Electric, Inc*., 728 S.W.2d 529 (Ky. 1987). Section 208 of the Constitution defined "corporation" to include "joint stock companies and associations." If "joint stock" and "associations" were to be read as "joint stock associations" then LLCs were not subject to § 193, but if "associations" were a free standing label then an LLC could have been an association subject to § 208's limitations.

[18] 2002 Ky. Acts, ch. 102.

In 2003:

- 11,980 LLCs were organized against 5,584 business corporations incorporated.

In 2004:

- 14,624 LLCs were organized against 5,389 business corporations incorporated.

In 2005:

- 13,986 LLCs were organized against 4,858 business corporations incorporated; and

- coincident with the abolition of the corporate license tax, the first incarnation of the entity level taxation of LLCs went into effect.[19]

In 2006:

- 13,235 LLCs were organized against 4,507 business corporations incorporated;

- NCCUSL finalized and released the Revised Uniform Limited Liability Company Act;[20]

- the General Assembly approved the Kentucky Revised Uniform Partnership Act (2006) and the Kentucky Uniform Limited Partnership Act (2006);[21] and

- the ABA released the Model LLC Membership Interest Redemption Agreement.[22]

In 2007:

- the General Assembly passed a series of miscellaneous amendments to the LLC Act;[23]

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[19] *See* KY. REV. STAT. ANN. § 141.010(24) as amended by 2005 H.B. 272, § 3 (changing the definition of "corporation" to include LLCs).

[20] REV. UNIF. LTD. LIAB. CO. ACT, 6B U.L.A. 407 (2008).

[21] 2006 Ky. Acts, ch. 149, codified at KRS chapters 362.1 (general partnerships) and 362.2 (limited partnerships).

[22] *Model Limited Liability Company Membership Interest Redemption Agreement*, 61 BUS. LAW. 1197 (May 2006).

- the current Limited Liability Entity Tax went into effect;[24]

- the validity of the Check-the-Box classification regulations was upheld;[25] and

- 14,778 LLCs were organized against 4,025 business corporations incorporated.

In 2008:

- 14,385 LLCs were organized against 3,530 business corporations incorporated.

In 2009:

- 14,439 LLCs were organized against 3,069 business corporations incorporated.

In 2010:

- 14,907 LLCs were organized against 2,775 business corporations incorporated;

- the General Assembly approved the Kentucky Business Entity Filing Act;[26] and

- the General Assembly passed a series of miscellaneous amendments to the LLC Act.[27]

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[23] 2007 Ky. Acts, ch. 137. *See also* Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, 97 KY. L.J. 229 (2008-09).

[24] *See* 2006 (1st Ex. Sess.) Ky. Acts, ch. 2, § 4 (codified at KRS § 141.0401); *see also* M. Foster, *Kentucky Modifies Recent Tax Act to Give Small Business Tax Relief, Pass-Through Entity Changes*, J. MULTISTATE TAX'N AND INCENTIVES, Oct. 2006, 42.

[25] *See*, *e.g.*, Thomas E. Rutledge and Scott E. Ludwig, *Second Circuit Affirms McNamee: Validity of Check the Box Regulations Again Confirmed*, J. TAX'N, July 2007, 32; Rutledge and Ludwig, *The Sixth Circuit Affirms Littriello: "Check-the-Box" Classification Regulations Are Upheld*, J. TAX'N, June 2007, 325.

[26] 2010 Ky. Acts, ch. 151. *See also* Thomas E. Rutledge and Laura K. Tzanetos, *The Kentucky Business Entity Filing Act: The Next Step Forward in the Rationalization of Business Entity Law*, 38 N. KY. L. REV. 423 (2011); Thomas E. Rutledge and Laura A. D'Angelo, *The Kentucky Business Entity Filing Act: An Introduction*, KY. BENCH & BAR, Sept., 2010, 6.

[27] 2010 Ky. Acts, ch. 133. *See also* Rutledge, *The 2010 Amendments to Kentucky's Business Entity Laws*, 38 N. KY. L. REV. 383 (2011); Thomas E. Rutledge and Dennis R. Honabach, *Kentucky Business Entity Laws: The 2010 Amendments*, KY. BENCH & BAR, Sept., 2010, 6.

In 2011:[28]

- 15,760 LLCs were organized against 2,657 business corporations incorporated;
- the ABA Committee of LLCs, Partnerships and Unincorporated Entities released the Revised Prototype Limited Liability Company Act;[29] and
- the General Assembly passed a series of miscellaneous amendments to the LLC Act.[30]

In 2012:

- the General Assembly approved the Kentucky Statutory Trust Act[31] and the Kentucky Uniform Limited Cooperative Association Act;[32]
- the General Assembly passed a series of miscellaneous amendments to the LLC Act;[33] and
- 16,439 LLCs were organized against 2,512 business corporations incorporated.

In 2013:

- the General Assembly approved miscellaneous amendments to the LLC Act;[34] and

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[28] In December, 2011, Professor Larry E. Ribstein, a leading authority on LLCs and business entity law generally, passed away suddenly. Larry had served as a mentor to this author and innumerable others in the field. Even when I or anyone disagreed with his ultimate argument/conclusion, everyone left the discussion better informed as to the nature and implications of the discussion.

[29] Revised Prototype Limited Liability Company Act Editorial Board, LLCs, Partnerships and Unincorporated Entities Committee, ABA Section of Business Law, *Revised Prototype Limited Liability Company Act*, 67 BUS. LAW. 117 (Nov. 2011).

[30] 2011 Ky. Acts, ch. 29. *See also* Rutledge, *The 2011 Amendments to Kentucky's Business Entities Laws*, 75 BENCH & BAR Hot Topics (July, 2011) (http://www.kybar.org/425)

[31] 2012 Ky. Acts, ch. 81 (2012 H.B. 341). *See also* Rutledge, *The 2012 Amendments to Kentucky's Business Entity Statutes*, 101 KY. L.J. ONLINE 1 (2012); Rutledge, *The Kentucky Uniform Statutory Trust Act (2012): A Review*, 40 N. KY. L. REV. 93 (2012-13).

[32] 2012 Ky. Acts, ch. 160, codified at KRS ch. 386A.

[33] 2012 Ky. Acts, ch. 81, codified at KRS ch. 272A.

[34] 2013 Ky. Act, ch. 106.

- 17,309 LLCs were organized against 2,489 business corporations incorporated.

In 2014:

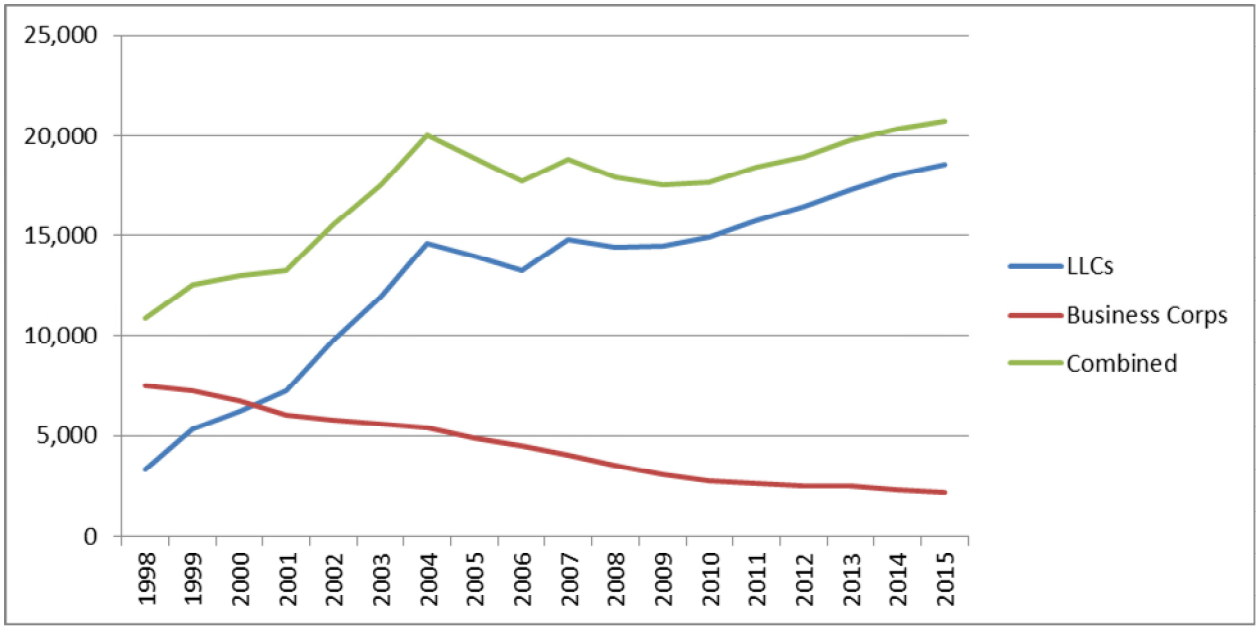
- 18,022 LLCs were organized against 2,326 business corporations incorporated.

In 2015:

- the General Assembly approved the Kentucky Uniform Unincorporated Nonprofit Association Act;[35]
- the General Assembly approved miscellaneous amendments to the LLC Act;[36] and
- 18,527 LLCs were organized against 2,203 business corporations incorporated.

[9A.3] The Dominant Form

That the LLC has become the dominant organizational form in Kentucky is clear:



[35] 2015 Ky. Acts, ch. 34, §§ 12-44, codified at KRS ch. 273A.

[36] 2015 Ky. Act, ch. 34, *passim*. *See also* Rutledge, *The 2015 Amendments to the Kentucky Business Entity Statutes*, ___ N. KY. L. REV. ___ (2015-16) (*forthcoming*).

[9A.4] Points of Comparison and Developments Since 1994

[9A.4.1] Flexibility – General

The LLC Act is exceptionally flexible. While, for example, (i) the requirements for documents to be filed with the Secretary of State,[37] (ii) the required records to be maintained by the LLC[38] and, (iii) if utilized, the requirements for notices to creditors, known or unknown, upon dissolution,[39] are not subject to modification in the articles of organization or the operating agreement, the internal affairs rules of the LLC Act are almost infinitely modifiable.

[9A.4.2] Statute of Frauds

The Kentucky LLC Act generally requires that departures from the default rule be set forth in a written operating agreement.[40] Still, Kentucky does not require that there be a written operating agreement,[41] and there is no requirement that the members sign the operating agreement. At the other end of the spectrum is Delaware, which by statute precludes the application of any statute of frauds to operating agreements.[42]

[9A.4.3] Ease of Filing with the Secretary of State

Anyone who is regularly dealing with other secretary of state offices has to realize that the Kentucky office is as helpful and responsive as it gets. From an internet page that lets you access copies of filed documents[43] to no fee pre-clearance[44] to same day (or even sooner if you walk it in) processing without an expediting fee,[45] the Secretary of State's office is helpful and responsive.

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[37] KY. REV. STAT. ANN. § 14A.2-010(1).

[38] KY. REV. STAT. ANN. § 275.185 ("A [LLC] shall …) (emphasis added).

[39] KY. REV. STAT. ANN. § 275.320(2); *id*. § 275.325(2).

[40] *See*, *e.g*., KY. REV. STAT. ANN. § 275.170 (fiduciary obligations may be modified "in a written operating agreement"); *id*. § 275.175 (allowing modification of default allocation of voting rights in "a written operating agreement"); *id*. § 275.205 (allowing modification of default rules for allocation of profits and losses in "a written operating agreement"); and *id*. § 275.255 (allowing a "written operating agreement" to modify the rules governing the assignment of an LLC interest).

[41] *See* KY. REV. STAT. ANN. § 275.015(20) (operating agreement may be oral). *Contrast*, *e.g*., NEW YORK LLC ACT § 417(a) ("the members of a [LLC] shall adopt a written operating agreement"). *See generally* 1 RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES, Appendix 4-19 (Second Ed. June, 2014).

[42] *See* DEL. CODE ANN. tit. 6, § 18-101(7).

[43] You can't do that in, for example, California, Delaware, New Jersey, South Carolina, Tennessee or Virginia.

[44] It is $10 per document in Indiana.

[45] In Delaware same day processing will cost you $100-200, two hour processing $500 and one hour processing $1,000. In early 2013 it was reported that the California Secretary of State's turn-around

[9A.4.4] Allocation of Voting & Economic Rights

The initial rule for the allocation of economic and voting rights in an LLC was per capita.[46] In 1998 all of these provisions were modified to the effect that economic rights and voting power would be allocated in proportion to capital contributed to and received by the LLC.[47] Certain states continue to utilize a per capita rule.[48]

[9A.4.5] Flexibility to Address Breaches of the Operating Agreement

Avoiding, *inter alia*, *Man O'War Restaurants, Inc. v. Martin* limitations upon defining consequences for beach of the operating agreement,[49] the LLC Act expressly authorizes provisions addressing the consequences of breach, including forfeiture of the interest in the LLC.[50] While certain other states provide similar flexibility,[51] most do not.

[9A.4.6] Apparent Agency Authority

The primary effect of the member-managed versus manager-managed election as made in the articles of organization[52] is the determination of whether the members, qua members, have apparent agency authority to bind the LLC to third-parties.[53] In

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time on most filings was six weeks. *See, e.g.*, Timm Herdt, *Bill Seeks to End State Business-Filing Backlog*, VCSTAR.COM, March 18, 2013 (last visited April 17, 2013); John Kabateck, *Assembly Bill 113-Cutting Red Tape for California Entrepreneurs*, FOX & HOUNDS (March 20, 2013), http://www.foxandhoundsdaily.com/2013/03/assembly-bill-113-cutting-red-tape-for-california (last visited April 18, 2013); Melody Gutierrez, *California Assembly Votes $2 Million to Reduce Business Filing Backlog*, SACRAMENTO BEE (March 19, 2013), http://www.sacbee.com/2013/03/18/v-print/5273264/California-assembly-votes-2-million (last visited April 18, 2013).

[46] *See* KY. REV. STAT. ANN. § 275.200 as enacted in 1994 Ky. Acts, ch. 389, § 41; *id.* § 275.205 as enacted 1994 Ky. Acts, ch. 389, § 42; *id.* § 275.175(1) as enacted in 1994 Ky. Acts, ch. 389, § 35.

[47] *See* KY. REV. STAT. ANN. § 275.175(3); *id.* § 275.205; *id.* § 275.210. *See also* Rutledge, *Allocating Economic and Voting Rights in an LLC: An Invitation to Confusion (Part I)*, J. PASSTHROUGH ENTITIES, Nov./Dec. 2013, 59; *Allocating Economic and Voting Rights in an LLC: An Invitation to Confusion* (*Part II*), J. PASSTHROUGH ENTITIES, Mar./Apr. 2014, 61.

[48] *See* 1 LARRY E. RIBSTEIN AND ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES, Appendix 5-2 (default allocations of profits, losses and distributions), Appendix 8-4 (default allocations of voting rights) (Second Ed. June, 2014).

[49] In *Man O'War Restaurants, Inc. v. Martin*, 932 S.W.2d 366 (Ky. 1996), the Ky. Supreme Court struck down as an impermissible penalty or excess liquidated damages a requirement that a shareholder/employer, upon termination of employment, surrender his stock for the price he had paid for it. This aspect of the *Man O'War* decision was prospectively overruled in 2002 by the amendment of KRS § 271B.6-270. *See* 2002 Ky. Acts, ch. 122, § 13.

[50] *See* KY. REV. STAT. ANN. § 275.003(2). This provision was added in 2010. *See* 2010 Ky. Acts, ch. 133, § 28.

[51] *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-306; *id.* § 18-502(d); REV. PROTOTYPE LLC ACT §§ 110(4), (5), 67 BUS. LAW. at 137.

[52] *See* KY. REV. STAT. ANN. § 275.025(1)(d)

[53] *See* KY. REV. STAT. ANN. § 275.135; *see also id.* § 275.145.

consequence, "member-managed" and "manager-managed" are misnomers in that the operating agreement may provide a different structure for *inter-se* decisional authority.[54] It is permissible to organize a "manager-managed" LLC that has no managers.

Not all states follow this distinction. For example, under Delaware law, while the LLC certainly may have managers,[55] the statute does not provide that when there are managers the members are not agents of the LLC.[56] Also, neither of the Revised Uniform LLC Act nor the Revised Prototype LLC Act makes the same distinction as does Kentucky law.[57]

It should be kept in mind by all persons holding apparent (and actual) authority to act on behalf of an LLC must police their own conduct to stay within the scope of their authority. An agent who exceeds their actual authority may be held responsible upon the obligation so created.[58] By way of example, while a member of a member-managed LLC may have apparent agency to bind the LLC, the operating agreement may provide, *inter alia*, that no member may unilaterally bind the company to a contract exceeding $500 in value. If a member unilaterally binds the LLC on a $1,500 contract with a third-party who is without knowledge of the limitation in the operating agreement, likely the LLC is obligated to perform. The LLC will have a claim against the member for exceeding their authority, and if the LLC cannot perform the third-party has a claim against the member.

[9A.4.7] Duties of Care and Loyalty

There has been ongoing a debate in Delaware as to whether there are and if there are what are the default fiduciary duties in a Delaware LLC.[59] No such question exists in

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[54] *See* KY. REV. STAT. ANN. § 275.165(2) ("except to the extent otherwise provided in … the operating agreement").

[55] DEL. CODE ANN. tit. 6, § 18-101(1); *id*. § 18-402.

[56] *See* DEL. CODE ANN. tit. 6, § 18-402.

[57] *See* REV. PROTOTYPE LLC ACT § 301, 67 BUS. LAW. at 151; REV. UNIF. LTD. LIAB. CO. ACT § 301(a), 6B U.L.A. 469 (2008); *see also* Thomas E. Rutledge and Steven G. Frost, *RULLCA Section 301 - The Fortunate Consequences (and Continuing Questions) of Distinguishing Apparent Agency and Decisional Authority*, 64 BUS. LAW. 37 (Nov. 2008).

[58] *See* KY. REV. STAT. ANN. § 275.095; *see also* RESTATEMENT (THIRD) OF AGENCY § 8.10.

[59] *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 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

Kentucky – the LLC Act clearly provides for a duty of care, set forth in terms of a standard of culpability,[60] a standard of loyalty,[61] and addresses who does and does not owe these duties in the context of member-managed versus manager-managed LLC.[62] The Act is as well specific as to who is the beneficiary of each duty.[63] These statutory standards are subject to modification in a written operating agreement.[64]

[9A.4.8] Amendment of the Operating Agreement

Under the LLC Act as enacted in 1994, amendment of the operating agreement required the approval of all members.[65] In 1998 the threshold was dropped to "majority-in-interest" of the members,[66] a measure determined in accordance with the agreed value of contributions of the members received by the LLC.[67] This provision is curious. The typical rule for the amendment of an agreement is the consent of all of the parties thereto, and an operating agreement is a contract among the members.[68] The desire to avoid the requirement of unanimity has obvious basis; it the parlance of the devotees of "law and economics" it precludes "rent seeking" by the minority participants in the venture.[69] While it is not possible to amend an operating agreement to impose an enforceable capital contribution obligation on a member,[70] the ability to have the agreement modified "out

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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.

[60] *See* KY. REV. STAT. ANN. § 275.170(1).

[61] *See* KY. REV. STAT. ANN. § 275.170(2).

[62] *See* KY. REV. STAT. ANN. § 275.170(4). *See also Xcell Energy and Coal Company, LLC v. Energy Investment Group, LLC*, C.A. No. 8652-VCN, 2014 WL 2964076 (Del. Ch. June 30, 2014).

[63] *See* KY. REV. STAT. ANN. § 275.170(1) (duty of care owed to the LLC and the other members); *id*. § 275.170(2) (duty of loyalty owed "to the LLC").

[64] *See* KY. REV. STAT. ANN. § 275.170 ("Unless otherwise provided in a written operating agreement, ….").

[65] *See* KY. REV. STAT. ANN. § 275.175 (1994 Ky. Acts, ch. 389, § 35) prior to amendment by 1998 Ky. Acts, ch. 341, § 29.

[66] *See* KY. REV. STAT. ANN. § 275.175(2)(a).

[67] *See* KY. REV. STAT. ANN. § 275.175(3); *see also id*. § 275.015(14) (definition of "majority-in-interest of the members").

[68] *See* KY. REV. STAT. ANN. § 275.015(20).

[69] *See also* Alexander Hamilton, *Other Defects of the Present Confederation*, THE FEDERALIST NO. 22, New York Packet, Friday, December 14, 1787:

> The necessity of unanimity in public bodies, or of something approaching towards it, has been founded upon a supposition that it would contribute to security. But it's real operation is to embarrass the administration, to destroy the energy of the government, and to substitute the pleasure, caprice, or artifices of an insignificant, turbulent, or corrupt junto, to the regular deliberations and decisions of a respectable majority.

[70] *See* KY. REV. STAT. ANN. § 275.200(1).

from under" the minority, dependent upon your perspective, is either a powerful tool for rightly structuring the organic document or a device for abusing and oppressing the minority members.[71]

The default rules for amendment of the operating agreement are more typically the unanimous approval of the members, including under the Revised Prototype LLC Act,[72] the Revised Uniform LLC Act,[73] and the LLC acts of Delaware[74] and Indiana.[75]

[9A.4.9] Non-Economic Members

In 2007 the LLC Act was amended[76] to permit:

- the issuance of an LLC interest without the requirement that the member make a contribution to the LLC;[77] and

- to permit a member of an LLC who does not hold an LLC interest.[78]

Based upon Delaware law,[79] these provisions afford additional flexibility in "highly lawyered" transactions for structuring bankruptcy remote vehicles and lending documentation. A member without any participation in the economic fruits of the LLC, while a member for purposes of state law, will not be considered a "partner" for tax purposes.[80]

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[71] *See also* Rutledge, *Minority Members and Operating Agreement*, J. PASSTHROUGH ENTITIES, Nov./Dec. 2007, 21.

[72] REV. PROTOTYPE LLC ACT § 406(c)(1)(A), 67 BUS. LAW. at 159.

[73] *See* REV. UNIF. LLC ACT § 407(b)(5), 6 U.L.A. 484 (2008).

[74] *See* DEL. CODE ANN. tit. 6, § 302(f) (applicable only to LLCs with certificates of formation filed on or after January 1, 2012).

[75] IND. CODE § 23-18-4-3(c)(1).

[76] *See* 2007 Ky. Acts, ch. 137, § 113, amending KY. REV. STAT. ANN. § 275.195.

[77] KY. REV. STAT. ANN. § 275.195(2).

[78] KY. REV. STAT. ANN. § 275.195(3).

[79] *See* DEL. CODE ANN. tit. 6, § 18- _____.

[80] *See Historic Boardwalk Hall, LLC v. Comm'r*, 694 F.3d 425 (3rd Cir. 2012); Office of Chief Council Memorandum 20124002F (Oct. 5, 2012); *see also* PLR 199911033 (Dec. 18, 1998); LARRY E. RIBSTEIN AND ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 19:2 (2nd ed. June 2014) ("Thus, even if a person is a member under state law, that person will be disregarded if the person has no interest in the economics of the LLC."); Rutledge, *When a Single-Member LLC Isn't and When a Multiple-Member LLC Is*, J. PASSTHROUGH ENTITIES, July/August 2015, 49.

[9A.4.10] Charging Orders

While Kentucky has not seen published rulings on the purpose and effect of the charging order, they have nationwide become a hot topic, this backwater provision of partnership law brought to the fore by the combination of the rise of the LLC and the Great Recession.

Unique among all the states, all seven (LLC, UPA GP, RUPA GP, RULPA LP, ULPA LP, KyUSTA and KyULLCA) of Kentucky's charging orders utilize substantially the same formula.[81]

Responding to the erroneous conclusion that the entry of a charging order effects a transfer of the LLC interest to the judgment-creditor and the member's dissociation from the LLC,[82] it has been made express that the issuance of a charging order does not effect a dissociation of the judgment-debtor member. Resolving certain of the cases exemplified by *In re Ashley Albright*[83] and *Olmstead v. FTC*,[84] both which highlight the possibility of using a SMLLC for abusive asset protection planning, revisions made to KRS section 275.280[85] address a transfer of all of a member's limited liability company interest, drawing distinctions between single and multiple member LLCs. The prior rule, namely that dissociation following the transfer of the entire interest in the LLC required a vote of the other members, has been retained for LLCs in which, prior to the transfer, there were at least two members.[86] The revisions go to what were, prior to the assignment, single member LLCs. In those situations, the class of non-assigning members bring a null set, no post-transfer action is required, and the transferor member ceases to be a member of the LLC upon the effective time and date of the transfer.[87]

One effect of this amendment is to address single-member LLCs used for abusive asset protection. By way of example, assuming a SMLLC, the judgment-debtor against whom a charging order has been issued[88] will be dissociated upon the foreclosure on the

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[81] *See* KY. REV. STAT. ANN. § 275.260; *id*. § 362.285; *id*. § 362.1-504; *id*. § 362.481; *id*. § 362.2-703; *id*. § 386A.6-060; *id*. § 272A.6-050.

[82] *See Hubbard v. Talbott Tavern, Inc*., No. 2003-CA-001468-MR, 2006 WL 2089308 (Ky. App. July 28, 2006).

[83] *In re Ashley Albright*, 291 B.R. 538 (Bankr. Colo. 2003). *See also* Thomas E. Rutledge and Thomas Earl Geu, *The Albright Decision - Why a SMLLC is Not an Appropriate Asset Protection Vehicle*, BUSINESS ENTITIES, Sept./Oct., 2003, 16.

[84] *Olmstead v. FTC*, 44 So.3d 76 (Fla. 2010). *See also* Thomas E. Rutledge, Thomas Earl Geu and John DeBruyn, *To Be Or Not To Be Exclusive: Statutory Construction of the Charging Order In the Single Member LLC*, 9 DEPAUL BUSINESS & COMMERCIAL LAW JOURNAL 83 (Fall, 2010).

[85] Essentially section 802 of the Prototype LLC Act.

[86] *See* KY. REV. STAT. ANN. § 275.280(1)(c)2 as amended by 2011 Ky. Acts, ch. 29, § 15.

[87] *See* KY. REV. STAT. ANN. § 275.280(1)(c)3 as created by 2011 Ky. Acts, ch. 29, § 15.

[88] *See* KY. REV. STAT. ANN. § 275.260. For a review of the charging order under Kentucky LLC, partnership and limited partnership acts, see Thomas E. Rutledge and Sarah S. Wilson, *An Examination of the Charging Order under Kentucky's LLC and Partnership Acts (Part I)*, 99 KY. L.J. ONLINE 85 (2011);

charged limited liability company interest. Foreclosure will require a court order and the plaintiff demonstrating that foreclosure is appropriate, presumably on the basis that the SMLLC and its assets are not expected to generate distributions from which the judgment can be satisfied.[89] From there the holder of the interest may elect themselves a member of the LLC[90] or permit the LLC to dissolve for the lack of a member;[91] either way the assets of the SMLLC, subject to other creditor claims, will be available to satisfy the judgment.[92]

[9A.4.11] The Notice Effect of the Articles of Organization

As originally enacted, the KyLLCA did not address the notice effect of the Articles of Organization.[93] However, the notice effect of the member- or manager-manager election in the articles of organization[94] is implied.[95] Under the Act as amended in 2007, the articles of organization are notice of the formation of the LLC, of the information set forth in response to the mandatory requirements of KRS § 275.025(1), including whether it is member- or manager-managed, whether it is a professional LLC, and whether it is a non-profit LLC.[96] Other statements made in the articles do not, merely by filing, give notice.[97] Still, one acting as an agent for an LLC must properly identify that principal in order to avoid personal liability on the obligations undertaken on its behalf.[98]

An Examination of the Charging Order under Kentucky's LLC and Partnership Acts (Part II), 99 KY. L.J. ONLINE 107 (2011).

[89] The requirement of a court determining that foreclosure is appropriate protects the generally applicable rule of asset segregation. *See* KY. REV. STAT. ANN. § 275.240(1) (property of the LLC is not property of the members). The Kentucky LLC Act's charging order does not define the test for when foreclosure is appropriate.

[90] *See* KY. REV. STAT. ANN. § 275.285(4)(b).

[91] *See id*.; *see also id.* § 275.015(11) (an LLC must have at least one member).

[92] *See also* Rutledge, *I May Be Lost But I'm Making Great Time: The Failure of Olmstead to Correctly Recognize the Sine Qua Non of the Charging Order*, J. PASSTHROUGH ENTITIES, Nov./Dec., 2010, 65 (discussing the mechanism of foreclosure as a means for addressing SMLLCs used for abusive asset protection).

[93] *Contrast* KY. REV. STAT. ANN. § 271B.18-050. *See also id*. § 362.429; *id*. § 362.2-103.

[94] KY. REV. STAT. ANN. § 275.135.

[95] *See* KY. REV. STAT. ANN. § 275.135; *id*. § 275.145. *See also* Thomas E. Rutledge, *The Lost Distinction Between Agency and Decisional Authority: Unfortunate Consequences of the Member-Managed versus Manager-Managed Distinction in the Limited Liability Company*, 93 KY L.J. 737, 744 (2004-05).

[96] KY. REV. STAT. ANN. § 275.025(8), created by 2007 Acts, ch. 137, § 95.

[97] *Contrast Zions Gate R.V. Resort, LLC v. Oliphant*, ____ P.3d _____, 2014 UT App. 98, 2014 WL 17171026 (Utah App. May 1, 2014) (applying Utah statute providing that information in articles of organization (even if not required) is binding upon third-parties).

[98] *See also* RESTATEMENT (THIRD) OF AGENCY §§ 6.01, 6.02 and 6.03 (2006). In *Perry v. Ernest R. Hamilton Associates, Inc.*, 485 S.W.2d 505 (Ky. 1972), an individual retained an engineering firm to lay

[9A.4.12] Effect of Reinstatement after Administrative Dissolution

Although the LLC Act has since its adoption in 1994 mirrored the prior corporate law to the effect that reinstatement relates back to and cures the administrative dissolution and it shall be as if the dissolution "had never occurred,"[99] in numerous cases it has been asserted that there exists personal liability for actions taken during the period of dissolution prior to reinstatement. In all cases save one the court properly found that upon reinstatement there exists limited liability for actions taken between administrative dissolution and reinstatement.[100] The only voice of dissent is the *Forleo* decision,[101] a decision that is easily distinguished upon the basis that the corporation's reinstatement was not accomplished until after the award against the defendant directors/officers/shareholders.

A 2012 amendment makes express the existing common law,[102] namely that upon reinstatement the liability of any agent for actions on behalf of the LLC during the period between administrative dissolution and reinstatement "shall be determined as if the administrative dissolution or revocation had never occurred."[103]

[9A.4.13] Effect of Dissolution on Limited Liability

In *Forleo v. American Products of Kentucky, Inc.*,[104] the Ky. Court of Appeals held that the officers, directors and shareholders of a business corporation would be held liable for all debts and obligations of the corporation incurred after administrative dissolution, a decision rendered in the face of the statutory directive that a corporation, upon dissolution, continues to exist.[105] In response to this at best highly questionable

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out a proposed subdivision, but did not disclose that proposed subdivision was owned by a corporation. When that engineering firm sued to collect on the fees, and the individual cited the existence of the corporation as a defense to personal liability, the court held the individual was personally liable for the fees as he had failed to disclose the existence of the corporation or to put the engineering firm on notice that it was dealing with a corporation. *See also Water, Waste & Land, Inc. v. Lanham*, 1998 WL 112869 (Colo. March 9, 1998); *Hopkins Advertising and Public Relations, Inc. v. Morris*, 1997 WL 306653 (Conn. Super. May 29, 1997) (where individual signed agreement without noting that he did so as agent for an LLC and did not disclose the existence of the LLC principal, he took on personal liability on that obligation); *Hosale v. Warren*, No. 01A01-9810-CV-00523, 1999 WL 548538 (Tenn. App. July 29, 1999); *Baumstein v. Myklebust*, No. 01-0614, 2001 WL 869506 (Wis. App. August 2, 2001).

[99] *See* KY. REV. STAT. ANN. § 275.295(3)(c) as adopted in 1994 Ky. Acts, ch. 389, § 59. This rule is now codified at KY. REV. STAT. ANN. §§ 14A.7-030(3)(a)-(b).

[100] Those cases are collected and reviewed in Rutledge, ¶ 9.5, *Dissolution of a Limited Liability Company*, in LIMITED LIABILITY COMPANIES IN KENTUCKY (2011 and 2014 supp.).

[101] *Forleo v. American Products of Kentucky, Inc.*, 2006 WL 2788429 (Ky. App. 2006) (Not to be Published).

[102] *See, e.g.*, RESTATEMENT (THIRD) OF AGENCY § 4.01, comment b.

[103] *See* KY. REV. STAT. ANN. § 14A.7-030(3)(c) as created by 2012 Ky. Acts, ch. 81, § 83.

[104] 2006 WL 2788429 (Ky. App. 2006) (Not to be Published).

[105] KY. REV. STAT. ANN. § 271B.14-050(1). *Accord id.* § 275.300(4)(e).

decision, the LLC and Corporate acts were, was amended to provide that dissolution does not "abate or suspend" the rule of limited liability applicable to, in the case of LLCs, members, managers, employees and agents, and with respect to business corporations, the shareholders.[106]

[9A.4.14] Dissenters' Rights in LLC

Dissenters rights do not exist at common law.[107] Several states provide for corporate-style dissenters rights in their LLC Acts;[108] Kentucky does not. A 2007 amendment to the KyLLCA expressly provides that dissenter's rights may be provided for in the articles of organization, in a written operating agreement, in an agreement of merger or in an agreement to sell substantially all assets of the LLC, and that absent such a provision, members have no dissenters rights.[109]

[9A.4.15] Reconciling Ability of Operating Agreement to Preclude Pledge of LLC Interests with UCC §§ 9-406 and 9-408

The LLC Act provides that a written operating agreement may limit or preclude the pledge of a limited liability company interest.[110] In the parlance of the Uniform Commercial Code, a limited liability company interest is a "general intangible" and pursuant to §§ 9-406 and 9-408, contractual limitations upon the ability to pledge a general intangible are unenforceable (*i.e.*, with respect to a general intangible, notwithstanding a contractual limitations on the ability to pledge same, the pledge is valid and effective.). Obviously these two provisions are in conflict with one another. Seeking to remedy the conflict, in 2007 the LLC Act was amended to provide that the limitation in an operating agreement precluding the pledge will control over UCC §§ 9-406 and 9-

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[106] *See* KY. REV. STAT. ANN. § 275.300(3)(i) as created by 2007 Ky. Acts, ch. 137, § 120 (LLC Act); *id*. § 271B.14-050(2)(i) as created by 2007 Ky. Acts, ch. 137, § 68 (Business Corporation Act). In 2010, what had been KRS § 275.300(3)(i) was recodified as KRS § 275.300(4)(e). *See* 2010 Ky. Acts, ch. 133, § 39. *See also Pannell v. Shannon*, 425 S.W.3d 58 (Ky. 2014).

[107] *See, e.g.*, 12B WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5906.10 (2000 Perm. Ed.) ("The appraisal remedy is entirely the product of statute.").

[108] *See, e.g.*, CALIF. CODE §§ 17600 through 17613; FL. CODE § 608.4384; N. H. CODE § 304-C:22; OHIO CODE § 1705.40 *et seq*.; WISC. CODE § 183.1206.

[109] *See* KY. REV. STAT. ANN. § 275.030(6); *id*. § 275.175(4); *id*. § 275.345(3); *id*. § 275.350(4); *id*. § 275.247. This paradigm of providing that dissenter rights exist only if provided in the organic documents of the LLC is utilized in certain other states including Delaware and Iowa. *See* DEL. CODE ANN. tit. 6, § 18-210; IOWA CODE § 490A.711.

[110] *See* KY. REV. STAT. ANN. § 275.255(1)(a) ("Unless otherwise provided in a written operating agreement, ….").

408,[111] a revision consistent with policies employed in, for example, Colorado, Delaware, Texas and Virginia.[112]

[9A.4.16] The Absence of Authority to Bring Suit on Behalf of an LLC

KRS section 375.335 recites who has the authority to initiate a legal action on behalf of and in the name of an LLC.[113] KRS section 375.340 provided that the determination that there was not proper authority to initiate an action on behalf of an LLC may not be "asserted as a defense to an action brought by the LLC or as the basis for the LLC to bring a subsequent suit in the same cause of action." The rationales for this provision were twofold. The first was to preclude an LLC, having not prevailed in an action brought in its name, to assert that it was not bound by the action and thereby avoid issues of res judicata, collateral estoppel, law of the case, claim preclusion, etc. Second, it was intended that the defendants in an action brought by an LLC not be able to have the action dismissed due to a lack of authority, necessitating that the LLC take whatever steps that are thereafter necessary to in fact authorize the action, during which time the statute of limitations on the claim may have run or the defendant may have otherwise come into additional defenses.[114]

KRS section 275.340 caused mischief in that it was applied in a manner not intended, and for that reason it has been deleted. This statute saw its application not vis-à-vis actions between the LLC and third parties, but rather inter-se the members. In *Lourdes Medical Pavilion, LLC v. Catholic Health Care Partners, Inc.*,[115] the operating agreement at issue required the consent of both members to initiate legal action on behalf of the LLC. One member, in their own name as well as in the name of the LLC, brought an action against the other member. The Court found that, in bringing the action, the one

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[111] *See* KY. REV. STAT. ANN. § 275.255(4); *see also* Rutledge, *The 2007 Amendments to the Kentucky Business Entity Statutes*, 97 KY. L.J. 229, 249 (2008-09).

[112] KY. REV. STAT. ANN. § 275.255(4). *Accord* KY. REV. STAT. ANN. § 362.1-503(7); *id.* § 362.2-702(8). *See also* ROBERT R. KEATINGE AND ANN E. CONAWAY, KEATINGE & CONAWAY ON CHOICE OF BUSINESS ENTITY § 8:32 (Thomson West 2011).

[113] The authority to bring an action on behalf of an LLC may be expanded or restricted in the operating agreement. *See* KY. REV. STAT. ANN. § 275.335 ("Unless otherwise provided in a written operating agreement"). In *Maitland v. Int. Registries, LLC*, 2008 WL 2440521 (Del. Ch. June 6, 2008), the 50% member of an LLC filed suit against the LLC; the other member sought, on behalf of the LLC, to retain counsel and defend the suit. The operating agreement in question provided that "the decision of the members holding a majority of the LLC interest as to all such matters shall be controlling." On that basis, the court determined that the second member did not have the authority to retain counsel on behalf of the LLC. In *Ward v. Hornik*, 2002 WL 1199249 (E.D. Pa. June 3, 2002), a complaint authorized by members holding 64% of the voting interests was dismissed when the operating agreement required two-thirds of the voting interests to take action.

[114] KRS § 275.340 is based upon Section 1103 of the Prototype Limited Liability Company Act, the primary source document for the original 1994 Kentucky LLC Act. The official comment to Prototype § 1102 (KRS § 275.345) provides in part "Section 1103 provides for the consequences of unauthorized suits vis-à-vis third parties." (emphasis added).

[115] 2006 WL 753080, 2006 U.S. Dist. LEXIS 12550 (W.D. Ky. Mar. 22, 2006).

member was acting outside the bounds of the operating agreement.[116] However, based upon KRS section 275.340, the Court determined that the action should not be dismissed notwithstanding the lack of actual authority in the one member to bring suit on behalf of the LLC against the other member.[117] In doing so the *Lourdes* court eviscerated KRS section 275.335[118] and ignored the "maximum enforcement of operating agreements" directive of the LLC Act.[119] To avoid this and similar results, KRS section 275.340 has been deleted from the LLC Act.[120] Actual authority to bring an action on behalf of an LLC will continue to be determined under the operating agreement and KRS section 275.335, and questions as to whether the action has been properly authorized and whether the LLC is bound by any determination rendered will be made under generally applicable principles of law.[121]

[9A.4.17] Compensatory Payments and Distributions

An LLC is precluded from making a distribution (i) in violation of limits set forth in its operating agreement,[122] (ii) that render the LLC balance sheet insolvent or (iii) when the LLC cannot pay its debts and obligations as they come due in the ordinary course.[123] Surprising to many was the fact that these limitations upon "distributions" were applicable to compensatory payments made to members of an LLC. For example, on February 2, 2007, the Jefferson Circuit Court, in *Steiner v. Coffee*,[124] held that distributions that had been made to a member of an LLC as "salary" fell within the scope of "distributions" subject to the limitations of KRS § 275.225. Having determined, based upon the balance sheet prepared by the LLC's accountant, that the company was in fact

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[116] The determination in the operating agreement that all decisions would be made by the unanimous vote of the members was sufficient to satisfy the "except as otherwise provided in a written operating agreement" of KRS § 275.335.

[117] Although not an issue in this decision, it must be wondered whether the defendant member had a viable cause of action against the plaintiff member for breach of the operating agreement and, if so, what would be the damages.

[118] *See* KY. REV. STAT. ANN. § 275.335 (reciting who may bring suit on behalf of an LLC and making that authority subject to a contrary rule in a written operating agreement).

[119] *See* KY. REV. STAT. ANN. § 275.003(1). At the time of the *Lourdes* decision, the "maximum enforcement of operating agreements" language was codified at KRS § 275.015(14).

[120] *See* 2010 Ky. Acts, ch. 133, § 77.

[121] In this respect, the deletion of KRS § 275.340 from the LLC Act does not create a gap in the Act. None of the KyBCA, KyRUPA, KyULPA, KyNPCA or the other business organization acts contains a provision equivalent to KRS § 275.340. With respect to the determination, in the context of a non-profit corporation, that there was not authority to initiate legal action in the name of the corporation, see *Covington Housing Development Corp. v. City of Covington*, 381 F. Supp. 427 (E.D. Ky. 1974), aff'd without op. 513 F.2d 630 (6th Cir. 1975), cert. denied sub. nom. *Thompson v. Covington*, 423 U.S. 869 (1975).

[122] *See* KY. REV. STAT. ANN. § 275.225(1)(c) as created by 2010 Ky. Acts, ch. 133, § 34.

[123] *See* KY. REV. STAT. ANN. §§ 275.225(1)(a), (b).

[124] Case No. 06-CI-08253 (Div. 3).

balance sheet insolvent in that its liabilities exceeded its assets,[125] the Court enjoined the further payment of "salary" to the member in question.

Setting aside this foot fault, in 2007 the LLC Act was amended to exclude, for purposes of limits on "distributions," compensatory payments made for services rendered to or on behalf of the LLC or as part of a retirement or other benefits program.[126] The issue that arises is that while corporate officers and employees will typically receive salaries that are not construed as "distributions," payments to members for services rendered are treated as "distributions" under both state and tax law. This can give rise to a fundamentally unfair distinction in treatment. Imagine two entities ABC, Inc. and XYZ, LLC. Mary is a shareholder and an employee of ABC, Inc. and is a member of XYZ, LLC for which she performs services. ABC, Inc. pays to Mary $1,000 in salary when the corporation is insolvent as determined under KRS § 271B.6-400(3). XYZ, LLC makes a $1,000 "distribution" to Mary for services rendered when the LLC is insolvent. Absent this new provision, the $1,000 paid Mary by ABC, Inc. is not subject to recovery as a wrongful distribution, while the $1,000 paid Mary by XYZ, LLC may be subject to recovery as a wrongful distribution.[127] The provision precludes this result.

In 2015 the Act was amended to make clear that absent an agreement to the contrary, a member is not entitled to compensation for services rendered on behalf of the LLC.[128]

[9A.4.18] Members and Managers Consent to Jurisdiction of Kentucky Courts

Provisions added in 2012 provide that members and managers of an LLC are deemed to have consented to the jurisdiction of the Kentucky courts with respect to any suit brought by or on behalf of the organization.[129] While not intended to limit any existing basis for asserting jurisdiction, these provisions preclude, for example, the argument that a manager of a Kentucky LLC who resides in a foreign jurisdiction and who has never attended a meeting or otherwise acted in Kentucky is exempt from the

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[125] KY. REV. STAT. ANN. § 275.225(1)(b).

[126] *See* KY. REV. STAT. ANN. § 275.225(7) as created by 2007 Ky. Acts, ch. 137, § 115.

[127] A broader review of this issue appears in Marshall Paul, Stuart Levine & Joyce Kuhns, *Righting the Wrong Approach to Wrongful Distributions in Limited Liability Entities*, J. OF LIMITED LIABILITY COMPANIES, Spring 1997, 164. *See also* Allan G. Donn, *Limited Liability Entities for Law Firms - 10 Years Later*, PASSTHROUGH ENTITIES, Aug. 2004, 19 at 23. Similar provisions exempting a compensatory payment from the characterization as a "distribution" appear in the LLC acts of Virginia (VA. CODE § 13.1-1035(3)), Delaware (DEL. CODE ANN. tit. 6 § 18-607(a)), and Colorado (COLO. CODE § 7-80-606).

[128] *See* KY. REV. STAT. ANN. § 275.165(4) created by 2015 Ky. Acts, ch. 34, § 52. *See also* supra section [7.10.1].

[129] *See* KY. REV. STAT. ANN. § 275.335(2) as created by 2012 Ky. Acts, ch. 81, § 112.

jurisdiction of Kentucky's courts when an action for violation of the manager's fiduciary obligations to the LLC is filed against that manager.[130]

[9A.4.19] Preserving Limited Liability with Respect to Agreements Entered into in the Course of Dissolution

In *Martin v. Pack's Inc*.,[131] the Court of Appeals held the shareholders personally liable on a contract entered into by the corporation after its dissolution. In response to this holding, numerous provisions have been amended to expressly authorize a dissolved entity to on its own behalf enter into agreements appropriate for its winding-up and liquidation.

Martin v. Pack's Inc. involved a claim for construction services rendered to Pack's prior to the administrative dissolution of Southeastern Construction, Inc. After the administrative dissolution of Southeastern, Ed Martin, on the corporation's behalf, entered into two agreements with Pack's, Southeastern's creditor, for resolution of that debt. Ultimately, Pack's sought to enforce the debt against not only Southeastern but also Martin and Jeff Collinsworth, Southeastern's shareholders. Granting summary judgment to Pack's, the trial court held, and the Court of Appeals affirmed, that both Martin and Collinsworth may be held liable on the debt. The grounds for that determination were erroneous,[132] and in partial response thereto various statutes have been amended to preclude a similar result in the future.

One basis upon which the Court of Appeals affirmed holding Martin liable on the obligation to Pack's was that the agreement at issue was entered into after the corporation's administrative dissolution. The court reasoned that, after dissolution, there was neither a corporation nor the consequent limited liability.[133] It appears that the 2007 amendment to the business corporation act providing that dissolution does not "abate or suspend" the shareholder's limited liability[134] was neither identified to the court nor unearthed by its own research. That 2007 amendment was directed at legislatively overruling *Forleo*,[135] a 2006 decision in which the court held that subsequent to a corporation's administrative dissolution the shareholders do not enjoy limited liability. Consequently, to the extent that the Court of Appeal's affirmation of the trial court's

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[130] A similar provision exists in Delaware. *See* DEL. CODE ANN. tit. 10, § 3114 (2010).

[131] *Martin v. Pack's Inc*., 358 S.W.3d 481 (Ky. App. 2011). This case settled while the petition for discretionary review was pending.

[132] *See* Thomas E. Rutledge, *Martin v. Pack's Inc.*, KY. BUS. ENTITY L. BLOG (Nov. 18, 2011), http://kentuckybusinessentitylaw.blogspot.com/2011/11/martin-v-packs-inc.html.

[133] *See Martin*, 358 S.W.3d at 487 ("To reiterate, Martin cannot be shielded from personal liability by virtue of KRS § 271B.6-220(20), because his corporation was dissolved at the time of his actions.").

[134] KY. REV. STAT. ANN. § 271B.14-050(2)(i).

[135] *Forleo v. Am. Products of Ky., Inc*., No. 2005-CA-000196-MR, 2006 WL 2788429 (Ky. Ct. App. Sept. 29, 2006).

ruling was based upon the notion that, subsequent to dissolution, the shareholders do not enjoy limited liability, that ruling was directly contrary to the controlling statute.

As to a second questionable point, the Court of Appeals held, in effect, that contracts may not be entered into on behalf of a corporation after its dissolution. That has not, however, been the law. A long time ago[136] it was the rule that upon dissolution a corporation simply ceased to exist – its property became vested in the shareholders, its debts were extinguished and suits by or against it were terminated.[137] Those rules have been long repealed.[138] Under the formula now employed, a corporation continues as a corporation after its dissolution,[139] but dissolution effects a limitation upon the proper activities of the dissolved organization, restricting it to those that are "appropriate to wind up and liquidate its business and affairs."[140] Whether any particular activity is appropriate for the winding up of a particular venture is a fact dependent issue. For example, in the winding up of a retail store, it is difficult to contemplate a situation in which the acquisition of additional inventory would be appropriate. Conversely, in the winding up of a landscaping business, the purchase of additional mulch with which to complete a job that is under contract and partially completed likely would be appropriate.

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[136] *See* STAR WARS, introductory scroll.

[137] *See, e.g.*, 16A WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 8113 (perm. ed., rev. vol. 2008); II STEWART KYD, A TREATISE ON THE LAW OF CORPORATIONS 516 (1794) ("The effect of the dissolution of a corporation is, (sic) 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 contracted by it, in their natural capacities."); JAMES GRANT, A PRACTICAL TREATISE ON THE LAW OF CORPORATIONS IN GENERAL, AS WELL AGGREGATE AS SOLE 303 (T. & J.W. Johnson 1850) ("The corporation is wholly gone [upon dissolution], and with it are also lost and avoided all its claims, debts, and liabilities of all kinds.").

[138] *See, e.g.*, *Stearns Coal & Lumber Co. v Douglas*, 185 S.W.2d 385, 386 (Ky. 1944); *Greene v. Stevenson*, 175 S.W.2d 519, 523-24 (Ky. 1943); *Potter v. Blue Flame Energy Corp.*, No. 2002-CA-001404-MR (Ky. App. Oct. 21, 2003) (Sterns Coal and Greene "clearly state that all the old rules relating to reversion of interests in corporate real estate were abrogated by the enactment of K.S. 561, Carroll's KentucKySTAtutes."); *see also Mumma v. Potomac Co.*, 8 Pet. (U.S.) 281 ("The obligation of those contracts [of a now dissolved corporation] survives, and the creditors may enforce their claims against any property belonging to the corporation which has not passed into the hands of bona fide purchasers, but is still held in trust for the company, or for the shareholders thereof at the time of its dissolution, in any mode permitted by the local laws."); CHARLES B. ELLIOTT, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS (1911) § 606 (prior rule that upon corporation's dissolution its real estate reverted to the original grantor and the heirs thereof and that the debts of obligations of the corporation were extinguished "is no longer applicable to business corporations, and the courts of equity will see that the assets of the corporation are collected and applied to the payment of its debts and any surplus distributed among the stockholders.") (citations omitted).

[139] *See* KY. REV. STAT. ANN. § 271B.14-050(1) ("A dissolved corporation shall continue its corporate existence . . . ."); *accord id.* § 275.300(2) ("A dissolved [LLC] shall continue its existence . . . .").

[140] *See, e.g.*, KY. REV. STAT. ANN. § 271B.14-050(1) ("A dissolved corporation . . . may not carry on any business except that appropriate to wind up and liquidate its business and affairs . . . ."); *accord id.* § 275.300(2) ("A dissolved [LLC] but shall not carry on any business except that appropriate to wind up and liquidate its business and affairs . . . . ").

In the resolution of claims with creditors, whether they are known or unknown, there will often be a need for a new agreement detailing the amount and manner of resolution. While some of these agreements may constitute only a modification of existing agreements, a claim arising, for example, in quasi-contract will not. In a similar vein, under the rule espoused in *Martin v. Pack's Inc*., settlement of suits brought by known and unknown creditors against the business organization expose the shareholders/members to personal liability.[141] Further, assume a creditor initiates an action against a dissolved corporation. Is the corporation precluded from entering into an engagement with an attorney for the purpose of making a defense or asserting a counter-claim?

To address these issues and to avoid confusion in the future, the various statutes have been amended to provide that, in the course of dissolution, it is permissible to enter into contracts for the purpose of discharging the liabilities of the dissolving organization.[142]

[9A.4.20] KRS § 275.250 Says What It Means and Means What It Says

A 2012 decision of the Sixth Circuit Court of Appeals, it reversing the decision of the District Court for the Eastern District of Kentucky, confirmed that KRS § 275.250 both says what it means and means what it says.[143]

Lairsen brought suit against Figuerado and Neves claiming compensation for having facilitated their acquisition of a limited liability company that in turn owned a marina. The District Court granted Figuerado and Neves summary judgment, holding that as the LLC held real property, the transaction was subject to both the statute of frauds and Kentucky's law governing the licensing of real estate agents. In that the agreement that Lairsen sought to enforce involved real property owned through an LLC, the trial court held that the statute of frauds governing transfers of real property applied. Further, in that Lairsen was not licensed as a real estate broker, Kentucky law precluded his claim for services.[144] Both of these determinations were reversed on appeal.

The Sixth Circuit observed that KRS § 275.250 provides that an interest in a limited liability company is personal property.[145] In that the transaction sued upon involved the conveyance of interest in an LLC, rather than a transfer of the underlying real property, the transaction did not fall within the requirements applicable to the

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[141] *See, e.g.*, KY. REV. STAT. ANN. § 271B.14-060(3)(6) (suits brought by known creditors against a dissolved business corporation); *id*. § 271B.14-070(3) (suits brought by unknown creditors against a dissolved business corporation); *id*. § 275.320(3)(b) (suits brought by known creditors against a dissolved LLC); *id*. § 275.325(3) (suits brought by unknown creditors against a dissolved LLC).

[142] *See* KY. REV. STAT. ANN. § 275.300(2)(b) as created by 2012 Ky. Acts, ch. 81, § 111.

[143] *Lairsen v. Figuerado*, 466 Fed. Appx. 480, 2012 WL 762887 (6th Cir. Mar. 9, 2012).

[144] 2010 WL 1740881 (E.D. Ky. 2010).

[145] Although not cited by the Court of Appeals, it should be noted that KRS § 275.240 provides, *inter alia*, that the LLC's property is its own and not that of the members.

licensing of real estate brokers. "Thus, the proposed transaction facially involved a sale of personal, not real, property, and a transaction of personal property generally would not require a real-estate broker's license."[146] Likewise, as it involved the sale of intangible property, and not real property, the Statute of Frauds was not applicable.[147]

[9A.4.21] The Fiduciary Duty Formulae in KRS § 275.170

The fiduciary duty formulae in KRS § 275.170 originally adopted the formula set forth in section 402 of the Prototype LLC Act. The first sentence of the commentary to this provision of the Prototype LLC Act states:

> This section sets forth the fiduciary duties of managers and managing members of LLCs.

This provision has to date been amended four times.

First, in 1998, subsection (2) was amended to provide greater specificity as to the required threshold of the members or managers required to approve what is otherwise a conflict of interest transaction.[148]

Second, in 2007 a trio of amendments were effected. First, it was mandated that any departure from the default rules must be in a written operating agreement.[149] Second, the mechanism for approval of a transaction otherwise violating the duty of loyalty was simplified.[150] Third, a new subsection (3)[151] was added, it dictating that any vote approving a conflict transaction between the LLC and a member or manager be disinterested.[152]

Third, the statute was in 2010 amended to respond to the misreadings of KRS § 275.170 that pervaded the *Patmon v. Hobbs* decision.[153] By means of those amendments:[154]

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[146] 2012 WL 762887, *3.

[147] 2012 WL 762887, *3.

[148] *See* 1998 Ky. Acts, ch. 341, § 28.

[149] *See* 2007 Ky. Acts, ch. 137, § 109 (adding "written" to introductory phrase of the statute). The effect of this addition was to impose a statute of frauds upon any departure from the statutory formulae.

[150] *See* KY. REV. STAT. ANN. § 275.170(2) as amended by 2007 Ky. Acts, ch. 137, § 109.

[151] What had been subsection (3) was re-designated subsection (4).

[152] *See* KY. REV. STAT. ANN. § 275.170(3) as created by 2007 Ky. Acts, ch. 137, § 109.

[153] 280 S.W.3d 589 (Ky. App. 2009). For a review of the errors and deficiencies in that decision, see Thomas E. Rutledge and Thomas Earl Geu, *The Analytic Protocol for the Duty of Loyalty Under the Prototype LLC Act*, 63 ARKANSAS LAW REVIEW 473 (2010).

[154] 2010 Ky. Acts, ch. 133, § 32.

- the duty of care of KRS § 275.170(1) was expressly labeled as such;

- the duty of loyalty of KRS § 275.170(2) was expressly labeled as such; and

- the LLC Act was clarified to the effect that the duty of loyalty is exclusive and all encompassing.[155]

With the 2010 amendments, the aspects of *Patmon v. Hobbs* that question whether and what are the fiduciary duties in an LLC and that would supplement the statutory formula of the duty of loyalty with common law are no longer good law.[156]

Fourth and last (as least for now), in 2012 the statute was again amended, making it express that a "fair to the LLC" defense is not available to what is an otherwise unsanctioned violation of the duty of loyalty.[157] This provision overturns that aspect of *Patmon v. Hobbs* that allocated to the plaintiff a burden of demonstrating that the LLC could have performed on the contracts misappropriated by the defendant Hobbs.

[9A.4.22] Derivative Actions

A new section was in 2015 added to the Limited Liability Company Act to set forth rules applicable to derivative actions in LLCs. While the LLC Act as originally adopted did not provide expressly for derivative actions, neither did it preclude them.[158] Clearly such actions exist under the rules of equity,[159] and the Kentucky courts have both entertained express derivative actions with respect to LLCs and otherwise maintained the

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[155] *See also* NORMAN J. SINGER AND J.D. SHAMBIE SINGER, 2B SUTHERLAND STATUTES AND STATUTORY CONSTRUCTION § 50:5 (7th ed.) ("But general and comprehensive legislation, where a course of conduct, the parties, the things affected, and limitations and exceptions are minutely described, indicates a legislative intent that a statute should totally supersede and replace the common law.", citations including *Fiscal Court of Fulton County v Nashville C. & St. L. Ry. Co.,* 261 S.W. 617, 618-19 (1924) ("In short, it [the statute] appears to be dealing with the whole question and for that reason must be interpreted as exclusive of and in lieu of all existing rights as between the parties in such matters.")).

[156] *See also infra* Section [7.7].

[157] *See* 2012 Ky. Acts, ch. 81, § 106.

[158] *See*, *e.g*., Rutledge and Booth, *The Limited Liability Company Act: Understanding Kentucky's New Organizational Option*, 83 KY. L.J. 1, 41, fn. 202 (1994-95) ("The LLC Act does not provide for derivative actions as a means of recovering misappropriated assets or opportunities. However, the LLC Act in no way forbids such suits."); CARTER G. BISHOP AND DANIEL S. KLEINBERGER, BISHOP & KLEINBERGER ON LIMITED LIABILITY COMPANIES ¶ 10.07[2] (2012 and 2015-1 cum. supp.) ("Many LLC statutes expressly authorize derivative actions, but some do not. This distinction should make little difference. Derivative litigation began in the corporate context over 150 years ago without the benefit of statutes, and remains essentially equitable in nature."). *See also generally* Rutledge, *Who Will Watch the Watchers?: Derivative Actions in Nonprofit Corporations*, 103 KY. L. J. ONLINE 31 (2015).

[159] *See also* KY. REV. STAT. ANN. § 275.003(1).

direct versus derivative distinction.[160] By means of this new statute, it being based upon that adopted by the Kentucky General Assembly in 2012 with respect to statutory trusts,[161] there are set forth the procedural limitations and requirements as to bringing a derivative action.[162] With this addition to the LLC Act, Kentucky law is brought more consistent with that of Delaware, the Revised Uniform Limited Liability Company Act and the Revised Prototype Limited Liability Company Act.[163] Not addressed is the question of whether the operating agreement may (a) modify (presumably by raising additional thresholds) the standing requirements or (b) alter the rules for the potential for fee shifting. That said, neither should be possible. Initially, while such is of itself not determinative, the provision's modification by the operating agreement is not provided for.[164] Second, there exists a strong argument that the parties to an operating agreement may not, by private ordering, alter or limit the equitable powers of the court, by means of a derivative action, to review and as necessary correct abuses and breaches of duty.[165]

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[160] *See, e.g.*, *Pixler v. Huff*, Civ. Act. No. 3:11-CF-000207-JHM, 2012 WL 3109492 (W.D. Ky. July 31, 2012) (in the context of an LLC, applied the test traditionally applied in corporations as to the direct versus derivative distinction and determined whether certain claims brought by a member could be brought only on a derivative basis); *id.*, 2012 WL 3109492, *3 ("Therefore, Plaintiff may maintain her claims against the Defendants only where she has suffered an injury that is separate and distinct from that which would be suffered by other members or the LLC as an entity."); *R.C. Tway Co. v. High Tech Performance Trailers, LLC*, No. 3:2012-CV-00122, 2013 WL 842577, *3 (W.D. Ky. Mar. 5, 2013) ("Each of the claims identified above clearly alleges that High Tech or Hanusosky violated some duty it owed directly to [Performance Trailers], thus causing [Performance Trailers] injury. As [Performance Trailers] is the allegedly injured party for each of these claims, it is the one that is entitled to enforce the rights granted by substantive law. Accordingly, [Performance Trailers] is not a nominal party, but instead is a real party in interest as to those claims."); *Chou v. Chilton*, Nos. 2009-CA-002198-MR, 2009-CA-002284-MR, 2014 WL 2154087 (Ky. App. May 23, 2014) ("[The LLC] and not Chou himself would benefit from any recovery for breach of the operating agreement, fraud, misappropriation, breach of fiduciary duty or gains taken by the defendants. While Chou may or may not receive funds from [the LLC] on dissolution of that company, any wrongs for breach of the operating agreement, fraud, misappropriate, breach of fiduciary duty or gains taken by the defendants perpetrated by any of the [defendants] or possibly [a separate LLC controlled by the defendants] would be wrongs against [the LLC] and not Chou individually."); *Turner v. Andrews*, 413 S.W.3d 272 (Ky. 2013) (rejecting effort by the sole member of an LLC to bring on his own behalf (rather than on behalf of the LLC), a claim for lost profits.).

[161] *See* KY. REV. STAT. ANN. § 386A.6-110.

[162] *See* KY. REV. STAT. ANN. § 275.337, created by 2015 Ky. Acts, ch. 34, § 50.

[163] *See* DEL. CODE ANN. tit. 6, §§ 18-1001 through 18-1004 (governing derivative actions in Delaware LLCs); REVISED PROTOTYPE LIMITED LIABILITY COMPANY ACT §§ 901 through 908, 67 BUS. LAW. 117, 194-198 (Nov. 2011) (governing derivative actions); REV. UNIF. LTD. LIAB. CO. ACT § 902 et seq., 6B U.L.A. 523 (2008). Looking at the states adjoining Kentucky, all of their LLC Acts, except that of Indiana, expressly provide for derivative actions. *See* OHIO CODE § 1705.49 thru 1705.52; TENN. CODE § 48-249-801 et seq.; MO. CODE § 347.173; 805 LLCs 180/4001 et seq.; W. VA. CODE § 31B-11-1101 et seq.; VA. CODE § 13.1-1042.

[164] *Contrast* KY. REV. STAT. ANN. § 275.170 ("Unless otherwise provided in a written operating agreement"); *id*. § 275.220 (same).

[165] *See* KY. REV. STAT. ANN. § 275.003(1) ("Unless displaced by particular provisions of this chapter, the principles of law and equity shall supplement this chapter."); *In re Carlisle Etcetera*, C.A. No. 10280-VCL, 2015 WL 1947027 (Del. Ch. Apr. 30, 2015); BISHOP & KLEINBERGER, *supra* note 61 at ¶

The distinction between a direct and derivative action, the former involving a unique injury to the plaintiff while the flatter involves an injury to the LLC as a distinct legal person, has been incorporated into the statute.[166] A direct action is not subject to the standing, procedural and pleading requirements of a derivative action.[167] A derivative action is subject to: (i) a demand requirement or the pleading of futility;[168] and (ii) the requirement of member status at the time the action is commended and at the time of the complained of actions.[169] All proceeds of the action are property of the LLC.[170] Dismissal or settlement of the derivative action requires court approval.[171] The proper venue for a derivative action is the circuit court of the county in which the LLC maintains its registered office.[172] If the derivative action results in substantial benefit to the LLC, the court may require it to pay the plaintiff member's reasonable expenses including counsel fees.[173] Conversely, to the extent the suit or an aspect thereof was brought

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10.07[3] ("However, derivative suits began as, and remain, essentially equitable in nature. It is questionable (at best) whether private agreements can restrain a court's power to do equity.") (citations omitted).

[166] *See* KY. REV. STAT ANN. § 275.337. *Accord id*. § 386A.6-110(i); *id.* §§ 362.2-931(1), (2). *See also CMS Inv. Holdings, LLC v. Castle*, C.A. No. 9468-VCP, 2015 WL 3894021 (Del. Ch. June 23, 2015) (applying direct versus derivative distinction under Delaware law).

[167] *See also Marhula v. Grand Forks Curling Club, Inc*., 2015 ND 130, 2015 BL 166358 (N.D. May 27, 2015) (action challenging termination of membership in nonprofit corporation is not subject to derivative action requirements).

[168] KY. REV. STAT. ANN §§ 275.337(2), (4). *Accord id*. § 271B.7-400 (2); *id.* § 362.2-832; *id.* § 362.2-934; *id.* § 272A.13-010; *id.* § 272A.13-060; *id.* § 386A.6-110(2).

[169] KY. REV. STAT. ANN. § 275.337(3). The requirement of having been a member at the time of the action complained of may be derived from an assignor if the assignment was by operation of loss or pursuant to the terms of the operating agreement. *Accord id.* § 271B.7-400(1); *id.* § 272A.13-020(1); *id.* § 362.2-933; *id.* § 386A.6-110(3).

[170] KY. REV. STAT. ANN. § 275.337(5).

[171] KY. REV. STAT. ANN. § 275.337(6). *Accord id.* § 271B.7-400(3); *id.* § 272A.13-040; *id.* § 386A.6-110(6).

[172] KY. REV. STAT. ANN. § 275.337(7). Almost never may a derivative action by brought in federal court on the basis of diversity jurisdiction. Rather, as the LLC will be either a plaintiff or a defendant in any derivative action, *see*, *e.g.*, *Gabriel v. Preble*, 396 F.3d 10 (1st Cir. 2005) (regarding the plaintiff or defendant alignment of the entity), and as the entity will have the citizenship of all members, there will never be diversity of citizenship. *See*, *e.g.*, *Lotan v. Horizon Properties LLC*, No. 14-Civ. 3134 (S.D.N.Y. May 27, 2014) ("Plaintiffs common citizenship with the LLC destroys complete diversity."); *Bischoff v. Boar's Head Provisions Co., Inc.*, 436 F. Supp.2d 626 (S.D.N.Y. 2006) ("There is no dispute that as long as [Plaintiff] may bring derivative claims on behalf of [the LLC] is a true defendant that destroys complete diversity in this case."); *Richardson v. Edward D. Jones & Co.*, 744 F. Supp. 1023 (D. Colo. 1990); *General Technology Applications, Inc v. Exro Ltda.*, 388 F.3d 114 (4th Cir. 2004); *Cook v. Toidze*, 950 F. Supp.2d 386, 391 (D. Conn. 2013) ("If the action at hand is a derivative suit, the [LLC] is not a nominal party.").

[173] KY. REV. STAT. ANN. § 275.337(8)(b). *Accord id.* § 272A.13-050(2)(b); *id.* § 362.2-935(2); *id.* § 386A.6-110(9)(b).

without reasonable cause or for an improper purpose, the court may order the plaintiff member to pay each defendant's reasonable expenses including counsel fees.[174]

[9A.5] Points Not in the LLC Act

[9A.5.1] L3Cs

Several states have enacted statutes providing for the "Low Profit Limited Liability Company" or "L3C," a structure that purports to put the L3C in the position to receive from a private foundation a Code § 4944 Program Related Investment ("PRI"). Notwithstanding arguments by the promoters of the L3C to this capacity, the disinterested commentary finds the structure ineffective.[175] A 2007 effort to have Kentucky adopt L3Cs was turned into a study project,[176] and then the idea has not been pursued.

[9A.5.2] Restricted LLCs

Several years ago Nevada amended its LLC Act to provide for "restricted LLCs," a format particularized for estate planning as a (purported) mechanism for avoiding the "applicable restrictions" provision of the Code. For reasons elsewhere reviewed the restricted LLC is likely ineffective,[177] and no similar format has been proposed in Kentucky.

[9A.5.3] Series

Several states provide in their LLC Acts that the LLC may organize "series" to which assets and liabilities are assigned and which, if the statutory requirements are satisfied, afford limited liability vis-à-vis claims against other series or the LLC as a whole.[178] While Kentucky does not have series in its LLC Act, it does in its Statutory

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[174] KY. REV. STAT. ANN. § 275.337(8)(a). *Accord id.* § 272A.13-050(2)(a); *id.* § 362.2-953(3); *id.* § 386A.6-110(9)(a). With respect to the need to apportion costs on a claim by claim basis, *see also Wanandi v. Black*, No. 2013-CA-000459-MR. (Ky. App. May 1, 2015), citing *Kentucky Farm Bureau Mut. Ins. Co. v. Burton*, 922 S.W.2d 385, 389-90 (Ky. App. 1996).

[175] *See, e.g.*, J. William Callison and Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VERMONT L. REV. 273 (2010).

[176] *See* 2010 Ky. Acts, ch. 133, § 78 (not codified in KRS).

[177] *See* Rutledge, *The Nevada Restricted LLC/LP: Damned If You Do and Damned If You Do*, J. PASSTHROUGH ENTITIES, Mar./Apr. 2010, 43.

[178] Series are provided for in the LLC acts of Delaware (DEL. CODE ANN. tit. 6, § 18-215), the District of Columbia (D.C. CODE § 29-802.06), Illinois (805 ILCS 180/37-40), Iowa (IOWA CODE § 490A.305 (until January 1, 2009); IOWA CODE §§ 489.1201 thru 489.1206 (after January 1, 2009)), Kansas (KANSAS CODE § 17-76,143), Missouri (MO. REV. STAT. § 347.186), Nevada (NEV. REV. STAT. § 86.296.3), Oklahoma (18 OKLA. STAT. § 2054.4B), Tennessee (TENN. CODE ANN. § 48-249-309), Texas (TEX. CODE §§ 101.601 through 101.621), and Utah (UTAH CODE ANN. §§ 48-3-1201 through 1210). Series provisions appear as well in the Revised Prototype Limited Liability Company Act. *See generally*

Trust Act.[179] Whether the limited liability afforded a series by foreign law to a series of an LLC would be respected in Kentucky has not been addressed.[180]

[9A.5.4] Benefit LLCs

Several states, parroting the recent efforts to create a "benefit corporation," have created a "benefit LLC."[181] Just as the utility of the benefit corporation model is questionable,[182] so is that of the benefit LLC. To date Kentucky has not adopted either the benefit corporation or the benefit LLC.[183]

Allan G. Donn, Bruce P. Ely, Robert R. Keatinge and Bahar A. Schippel, *Limited Liability Entities*: *2014 Update* (ALI, March 24, 2014).

[179] The series provisions of the Statutory Trust Act are set forth in subtitle 4 thereof. *See also* Rutledge, *The Kentucky Uniform Statutory Trust Act (2012): A Review*, 40 N. KY. L. REV. 93 (2012-13).

[180] *See, e.g.*, 2 CARTER G. BISHOP AND DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES-TAX AND BUSINESS LAW ¶ 14.06, 14-109 (2003 & Supp. 2005) ("Many (perhaps most) LLC statutes make foreign law controlling where the question is the liability of a member for the obligations of a foreign LLC. However, Delaware's internal shields do not implicate that question. Instead, they raise an entirely different question – namely, whether a forum state should defer to a foreign state's rules on an entity's ability to segregate its assets and its creditors' access to those assets.") (footnote omitted); Rutledge, *Again, For the Want of a Theory: The Challenge of the "Series" to Business Organization Law*, 46 AMERICAN BUSINESS LAW JOURNAL 311 (2009); Rutledge, *The Man Who Tells You He Understands Series Will Lie To You About Other Things As Well*, 16 J. PASSTHROUGH ENTITIES 53 (March/April 2013).

[181] *See, e.g.*, MD. CODE §4A-1201 et seq.

[182] *See, e.g.*, J. William Callison, *Putting New Sheets on a Procrustean Bed: How Benefit Corporations Address Fiduciary Duties, the Dangers Created, and Suggestions for Change*, 2 AMER. U. BUS. L. REV. 85 (2012).

[183] 2014 H.B. 66, introduced by Representative Kelly Flood, would have added benefit corporation provisions to the Kentucky Business Corporation Act. It passed out of the House by a vote of 58 yea and 34 no, and received no committee hearing in the Senate.