State Law & State Taxation Corner

By Thomas E. Rutledge

Allocating Voting and Economic Rights in LLCs: An Invitation to Confusion (Part I)

The earliest LLC Acts, reflecting their origin in partnership law, typically provided that members would vote and participate in the proceeds of the venture on a per capita basis. Under these formulae, there existed little opportunity for disputes as to the allocation of voting authority and economic rights; count the total number of members to derive the total number of possible votes and shares. In the case of voting, while there could still exist disputes as to quorum requirements, whether any majority or other vote at a threshold lower than unanimous would be by a constitutional majority or a majority of a quorum and whether voting by proxy was permissible, it was relatively easy from there to determine whether the necessary voting threshold had been satisfied. In the same way, count the total number of members (for now let’s ignore the complexity of a partial assignee), divide the items requiring allocation by that number and proceed to prepare the Forms K-1.

Since the early days of the LLC, most LLC Acts have moved away from the default rule of per capita voting and sharing, adopting formulae tied to capital or other financial measure. While the adoption of these new default rules may better comport with the typical practice in a negotiated transaction, in doing so the opportunity for confusion and dispute has been increased.

Allocating Voting and Economic Rights

Partnerships have traditionally employed, as at least a default rule, per capita voting rights, thereby affording each partner an equal voice in partnership management. While it is now the accepted rule in
corporations that shareholders vote in proportion to their share ownership, this is a departure from the prior law; rather, initially, shareholders voted on a per capita basis. Likewise, the economic fruits of the partnership (including liability for its debts and obligations) are shared, as a default rule, on a per capita basis. Generally speaking, the early LLC Acts, tracking their partnership predecessors, utilized per capita voting among the members. The allocation of voting (and as well economic) rights on a per capita basis has the merit of simplicity. Consider if you will a simple LLC with three members, namely Laura, Cristin and Heather. They are contributing to the venture, respectively, working capital up to a defined limit, intellectual property and sweat equity. Assuming they have not attempted to craft an agreement valuing their respective contributions, a per capita allocation formula is a workable gap filler that avoids the problem of valuing the various contributions vis-à-vis one another and as well avoids complicated timing issues. For example, is Heather’s agreement to provide sweat equity to be valued in its entirety on day one, or does the value of her contribution accumulate as work is performed? Is Laura to be credited with the total value of her commitment to the venture, or is credit given only as she satisfies her obligations to contribute the working capital?

Rather quickly, however, many of the various LLC acts were modified to depart from the default rule of per capita voting and allocation of economic rights. Today, while a few LLC Acts retain a default allocation of voting rights on a per capita basis, other states provide that voting rights are in proportion to financial interests in the venture. Likewise, the states have moved away from per capita allocation of economic rights in the venture. It bears noting that these departures from per capita are not necessarily in lockstep. For example, while Colorado has a default of per capita allocation of voting rights, the default rule for allocating economic rights is in proportion to contributions made to the venture.

The Failed Default Rule of Allocations and Distributions in Proportion to Capital Contributions

By way of example, let’s start with the default rule of the Indiana Business Flexibility Act for allocating profits and losses, namely:

Unless otherwise provided in the operating agreement, profits and losses must be allocated on the basis of the agreed value, as stated in the records of the limited liability company, of the contributions made by each member to the extent the contributions have been received by the limited liability company and not previously returned.

Applying this formula to our simple hypothetical of the LLC formed by Laura, Cristin and Heather, we can see how the statutory default can cause confusion. As of the time the LLC is organized, Cristin’s intellectual property becomes the property of the LLC.

For the sake of argument, Cristin’s agreed value is $50, and Cristin’s sharing ratio of allocations and distributions is 50/x. Our denominator remains, however, undetermined. Laura has agreed to contribute capital in an amount up to $50. She is not, however, placing all $50 in the LLC’s bank account; rather, she simply has an obligation to pay in that capital. Assuming that her commitment is legally enforceable, has the LLC, at its inception, “received” $50, or rather only the $5 she that day surrendered to the company? If the former, at least as far as we have here proceeded, our denominator is $100 and each of Cristin and Laura are entitled to one-half of the allocations and distributions from the venture. Alternatively, our numerator is $55 ($50 from Cristin and $5 from Laura), and while Laura is entitled to 9.1 percent of allocations and distributions from the LLC, Cristin enjoys a 90.9-percent sharing ratio. Even without proceeding to the treatment of Heather’s sweat equity, it is clear that the default rule has failed to provide a clear rule for the sharing of allocations and distributions among the members. Only by going to the next step, namely an express and in many states written agreement providing, in the alternative, that Laura’s capital contribution would be (i) credited as actually received or (ii) treated as fully received upon the commitment to provide the funds, will the ambiguity in the statute be resolved.

The problem continues as we consider Heather’s commitment to provide services as her capital contribution. Initially, has there been any agreement among the members as to the value of her services? Perhaps only in the way that she is to receive one-third of the LLC in return for the services to be rendered and another third of the company was sold for $50. But does it follow that her agreement to provide 10 hours of work is to be pro-rated to $5 per hour? Some jobs have no value unless and until they are completed.
Statutes such as that of Arizona, which provide that “the value of a capital contribution of services is the fair market value of the services at the time they are rendered,” simply beg the question. If that is the case, then there is a question as to whether any portion of her contribution should be credited as “received” by the LLC until all of the work she has committed to provide has been performed. Once again, the default rule fails in that it does not provide a clearly workable rule, much less a rule that mimics that which would be the likely outcome of a negotiated resolution.

Assume that one-half of Laura’s $50 commitment has been paid over to the company, and as well that Heather has performed 60 percent of the total hours of work she has committed to for the company, yielding a total received capital of $105. Assume as well that we have come to the end of the first tax year of the venture, and the only tax item that needs to be allocated amongst the members of the LLC is $200 of gain. Should that gain be allocated one-third to each of Laura, Cristin and Heather, in effect affording Laura and Heather credit for their total commitment to the company and treating it as having been “received”?

Alternatively, should the $200 of gain be allocated 47.62 percent to Cristin, 23.81 percent to Laura and 28.57 percent to Heather? Simply put, the statutes that direct that allocations be made in proportion to “contributions made” often fail when applied to all but the most simple fact situations. To that extent, the default rule is a failure in that it does not provide a workable rule when the parties do not agree on a different rule by means of an operating agreement.

An Additional Complexity—Statutes of Frauds

In the same manner as there is confusion with respect to the allocation of tax items and distributions of the economic fruits from the venture, there exists, under the standard default rules not utilizing per capita voting, confusion as to the allocation of voting rights. It is reasonable to expect that, upon joining the venture, each of Laura, Cristin and Heather anticipated they would have an equal voice with respect to its operations and affairs. This expectation will be realized, however, if and only if there is agreement that all of their contributions will be treated as having been “received” by the LLC at the time the commitment to contribute is made. Note, however, that various of the statutes may preclude the enforcement of anything other than a written agreement to that effect by virtue of the various statute of fraud provisions contained therein requiring that any departure from the statutory default be in writing.

Further, various acts mandate that the LLC retain a written record of the value of goods and services contributed to the LLC. Working from the supposition that the LLC fails to maintain this statutorily required record, it remains to be determined what will be the effect of that failure on the members. On the one hand, if the required record is not maintained, is that to serve as evidence that there was no agreement that the unrecorded contribution was never undertaken.
and there remains no unsatisfied commitment? If that is the correct path of analysis, the member benefits by the LLC’s failure to maintain the required record, but the other members bear the cost of a windfall. Assume it is Laura’s obligation to contribute up to $50 to the LLC; all that is recorded is the $5 she paid in on the first day of the LLC’s existence. Assume that on that first day, the three agreed they were each one-third members, an agreement premised upon, in part, Laura’s agreement to contribute working capital. When, however, Cristin and Heather request the next installment of funds, Laura may respond that there is no writing signed by her evidencing an agreement to contribute and there is no LLC record of any such commitment. While clearly opportunistic, Laura’s conduct does fall within the scope of the statute of frauds protections written into various of the LLC Acts.

With respect to any notion that either Laura or Heather should, at the time of the LLC’s formation, be credited for the full amount of their respective contribution obligations, in effect treating them as having been “received by the LLC,” consideration should also be given to whether those commitments are even enforceable. In most jurisdictions, although Delaware is an exception to this rule, an agreement to contribute is enforceable only if set forth in a writing signed by the person to be obligated thereon. If, pursuant to the terms of the LLC Act, an agreement to contribute either property or services in the future is unenforceable, will it ever be appropriate to treat the commitment as reflecting value that has been “received” by the LLC? At one end of the spectrum would be a commitment to contribute capital that is reflected in a negotiable promissory note that is backed by a line of credit. A determination to treat the full amount of the commitment as received would not be out of order. At the other end of the spectrum is an entirely oral commitment that is in no manner memorialized in writing, much less one signed by its maker. On these facts, it would not seem possible to treat the amount of the commitment as having been received.

In any LLC in which member capital contributions are other than in cash, there needs to be a writing describing the goods or services contributed and the agreed value thereof. A variety of ambiguities exist under the statutory formula; for these purposes, the focus is upon assessing the basis on which the distributional, allocation and voting rights of a transferee is determined.

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. B then unilaterally conveys 50 percent 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 percent of the distributions that B, but for the assignment, would have received. As such, were the LLC dissolved immediately after the assignment, its net proceeds would be distributed 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, and the matter under consideration requires the consent of a majority-in-interest of the members. 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. 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 percent of the LLC interests. Alternatively, if B votes only in proportion to his capital contribution that he has not, on 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 upon liquidation 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. As to the argument that the capital base should be reduced to account for the amount, upon dissolution, to be distributed to D, the LLC acts provide, inter alia, that the members vote in proportion to the capital contributed and not returned; capital beneficially assigned to an assignee has not been returned.

Continuing with the above example of the initial members A, B and C with D as a transferee, assume now that A and C have now approved D’s admission as a member. While they executed a dated written instrument admitting D as a member, 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-percent vote, being one half of what was previously enjoyed by B. C, for whatever reason, 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. 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, there is no provision of any LLC Act I have examined which provides “upon the transfer of an LLC interest and the admission of the transferee as a member, the transferee succeeds to that portion of the capital contributed by the transferor.” This LLC’s operating agreement, while written, is silent as to the point. Again, the LLC Act is silent as to how the point is to be resolved.

Clearly, the response to the ambiguities identified in either of these rather commonplace examples is to provide a workable default rule.

Conclusion

This Part I has (hopefully) identified some of the problems that exist under the various LLC Acts and the manner in which they provide default rules for the allocation among the members of economic and voting rights. Part II of this article will address the interface of the provisions addressing the allocation of economic rights vis-à-vis the rules for the maintenance of capital accounts.

Endnotes

1 See, e.g., Gilchrist v. Collopy, 82 S.W. 1018 (Ky. 1904) (addressing, in the absence of a statutory definition or a controlling provision in the articles or the bylaws, what would be a quorum of the shareholders permitted to elect directors).

2 See, e.g., UNIF. PART. ACT § 18(e), 6 (pt. II) U.L.A. 101 (2001); Ind. CODE § 24-4-1-18(e); and Ky. REV. STAT. ANN. § 362.235(5). This rule has been carried forward into the more modern partnership law. See, e.g., REV. UNIF. PART. ACT § 401(f), 6 (pt. II) U.L.A. 133 (2001); Ky. REV. STAT. ANN. § 362.1-401(b); Va. CODE ANN. § 50-73.99(6).

3 See, e.g., Del. CODE ANN. tit. 8, § 212(a); Ind. CODE § 23-1-30-2(a); and Ky. REV. STAT. ANN. § 271B.210-1(1).

4 See, e.g., Chollar Mining Co. v. Wilson, 5 P. 670 (Ca. 1895) (“majority of shareholders” defined as being a majority of the number of shareholders and not a majority of the shares held). See also THOMAS C. SPELLING, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS § 376 (1892) (“At common law, no member could cast more than one vote whether he held one share or a great many,”) (footnote omitted).

5 See UNIF. PART. ACT § 18(a), 6 (pt. II) U.L.A. 101 (2001); Ind. CODE § 24-4-1-18(a); and Ky. REV. STAT. ANN. § 362.235(1). This provision has been carried forward into RUPA. See REV. UNIF. PART. ACT § 401(b), 6 (pt. I) U.L.A. 133 (2001); Del. CODE ANN. tit. 6, § 15-401(b); Ky. REV. STAT. ANN. § 362.1-401(2); and Va. CODE ANN. § 50-73.99(8).

6 See, e.g., PROTOTYPE LIMITED LIABILITY COMPANY ACT § 403(A); and Ky. REV. STAT. ANN. § 275.175(1) (as enacted in 1994 Ky Acts, ch. 389, § 35).

7 See, e.g., 1998 Ky. ACTS, ch. 341, § 29 (voting rights); § 30 (allocations); and § 31 (distributions). No suggestion is intended that this was the only path utilized by the states; in fact even the opposite took place. The Michigan LLC Act, which originally allocated voting authority among the members in proportion to their respective shares of distributions, those being in proportion to contributions made, moved to a per capita default. See Mich. CODE § 450.4502(1).

8 Also, a few states provide no default rule. The various defaults utilized by the states for allocating voting rights among the members are catalogued in 1 LARRY E. RIBSTEIN AND ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES, Appendix 8-4 (Second Ed. June 2013). Examples of states that continue to employ the per-capita default rule for member votes are Arizona and South Dakota. See Ariz. REV. STAT. ANN. § 29-681.E; S.D. CODIFIED LAWS § 47-34A-404.1A(1). Ohio is an example of a no default rule state. See Ohio REV. CODE ANN. § 1705.26 (“The operating agreement of a
[LLC] may grant to all or a specified group of its members the right to vote on a per capita or other basis on any matter.

Both Indiana and Kentucky allocate voting power in accordance with capital contributed and not returned. See IND. CODE § 23-18-4-3(a); KY. REV. STAT. ANN. § 275.175(3); see also IND. CODE § 23-18-1-13 (definition of “majority in interest of the members”); KY. REV. STAT. ANN. § 275.015(14) (definition of “majority-in-interest of the members”).

While the Revised Uniform LLC Act directs that matters in the ordinary course will be decided by a majority of the members, how “majority” is ascertained (per capita, based upon contributions made or otherwise) is not addressed. See Revised Prototype LLC Act § 406(b)(1), 67 BUS. LAW. at 117, 159 (Nov. 2011). The Revised Uniform LLC Act utilizes a per capita default for allocating voting authority. See Rev. Unif. LLC Act § 407(b)(2), 68 U.L.A. 483 (2008).

Also, a few states provide a no default rule. An example of a state that continues to employ the per-capita default rule for distributions is Alaska. See Alaska Stat. § 10.50.290. Both the Revised Prototype LLC Act and the Revised Uniform LLC Act retain a default rule of per-capita distributions. See Revised Prototype LLC Act, § 404(a)(1), 67 BUS. LAW. at 156; Rev. Unif. LLC Act § 404(a); 68 U.L.A. 480 (2008). The various defaults for the allocation of profits, losses and distributions among the members are catalogued in RIBSTEIN AND KEATINGE, supra note 8 at Appendix 5-2.


Ind. Code § 23-18-5-3. The same allocation requires that any departure from the default rule on allocations of profits and losses be in writing. In contrast, neither the Delaware LLC Act nor the Revised Prototype LLC Act impose a statute of frauds requirement. See DEL. CODE ANN. tit. 6, § 18-101(7); REV. PROTOTYPE LLC ACT § 404(a)(1), 67 BUS. LAW. 156.

In Kentucky, until 2002, pursuant to a constitutional limitation, corporate shares could not be issued except for money paid in, property or services performed; shares issued for services to be provided in the future or an unsecured promissory note were invalid ab initio. In 2002, that provision of the Kentucky Constitution was deleted, and the corporate act was revised to permit the issuance of shares for both promissory notes and an agreement to provide services in the future. KY. REV. STAT. ANN. § 271B.6-210(3). But then there arose a new question: at what point are the shares fully paid and non-assessable? This led to the need for another statutory amendment, one providing that the shares are fully paid and non-assessable upon the corporation’s receipt of the note or the contract to provide services. See KY. REV. STAT. ANN. § 271B.6-210(4).

Exhibit 1. The car with the failing transmission is still at the shop. The voyage was quite pleasant. The Titanic did not claim a refund of only half of the fare on the basis that the first half of the voyage was quite pleasant.

ENDNOTES

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28 See, e.g., Ky. Rev. Stat. Ann. § 275.200(1); Ohio Rev. Code Ann. § 1705.29(B) ("A promise by a member to contribute to the [LLC] is not enforceable unless it is set forth in a writing signed by the member."). Under the Revised Prototype LLC Act, any commitment to contribute is enforceable only if set forth in writing. See Rev. Prototype LLC Act § 403(a), 67 Bus. Law. at 155.

29 See Ky. Rev. Stat. Ann. § 275.265(1). In 2010, the Kentucky LLC Act was amended to make it express 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 Ind. Code § 23-18-6-4.1(b) (requiring unanimous consent of the "other members," thereby excluding the assignor member, to admit assignee as a member). Under the Revised Prototype LLC Act, the unanimous consent of the members is required to admit an assignee as a member; there is no carve out to exclude from the vote the assigning member. Revised Prototype LLC Act § 401(b)(3), 67 Bus. Law. at 154. The same rule exists in the Revised Uniform LLC Act. See Rev. Unif. LLC Act § 401(d)(3), 68 U.L.A. 478 (2008).

30 See, e.g., Ky. Rev. Stat. Ann. § 275.255(1)(b) ("An assignment shall entitle the assignee to receive, to the extent assigned, only the distributions to which the assignor would be entitled"); Ind. Code § 23-18-6-3(b)(2); Rev. Prototype LLC Act § 502(b), 67. Bus. Law. at 163 (Nov. 2011) ("An assignee has the right to receive, in accordance with the assignment, distributions to which the assignor would otherwise be entitled."); Rev. Unif. LLC Act § 502(b), 68 U.L.A. 496 (2008).


32 See also Ind. Code § 23-18-6-4.1(b); 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).


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