

# State Law & State Taxation Corner

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As Amended from Time to Time

*By Thomas E. Rutledge*

Often read operating agreements that provide, *inter alia*, that the operation and management of the LLC will be governed by the operating agreement and, where the operating agreement is silent, by the LLC Act “as amended from time to time.” At least two questions follow, namely what are the implications of, in effect, incorporating by reference future changes in the law, and what would be the implications of adopting a contrary rule, in effect defining the “LLC Act” as that “in effect on the initial effective date of the Operating Agreement.”

## The LLC as a Creature of Contract

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It is axiomatic that LLCs are creatures of contract. Each LLC will be governed by an “operating agreement” or a “limited liability company agreement” that sets forth the agreement of the members as to how that particular LLC will operate and what are the benefits and burdens of its members and perhaps other persons, such as managers.<sup>1</sup> Typically, as to matters *inter se* the LLC, the LLC Act will provide default rules that are applicable only when no contrary rule has been set forth in that LLC’s particularized operating agreement. In contrast, the aspects of the LLC Act that impact upon the rights of third parties are typically not subject to modification in the operating agreement. We would not expect to be enforced a provision in an operating agreement that the LLC will not at all times maintain a registered office and an agent for service of process or exempting itself from the requirement to file an annual report with the Secretary of State. The operating agreement is a contract. As such, it is subject to the rules applicable to all other agreements.<sup>2</sup> For example, prior to a statutory amendment, the Delaware Supreme Court found that a provision for performance that could not be performed within a year was unenforceable consequent to the Statute of Frauds.<sup>3</sup> Subsequent to this decision, the Delaware LLC Act was amended to exclude Delaware LLC agreements from the reach of the Statute of Frauds.<sup>4</sup> We can expect (to date, it does not appear to have happened) that a lack or failure of consideration defense to the validity of an operating agreement will be made. The application of particular state laws as to the validity and enforcement of contracts will likewise be applied.<sup>5</sup>



**THOMAS E. RUTLEDGE** is a member of Stoll Keenon Ogden PLLC resident in the Louisville, Kentucky office.

## Dartmouth College

The iconic case of *Trustees of Dartmouth College v. Woodward*,<sup>6</sup> in addition to providing its description of the nature of a corporation, namely “an artificial body, invisible, intangible, and existing only in contemplation of laws,”<sup>7</sup> is a case on the Contracts Clause of the U.S. Constitution.<sup>8</sup> Therein, the state of New Hampshire sought to set aside a royal grant to Dartmouth College. The Supreme Court held that could not be done, as the grant was in the nature of a contract and the actions of the state could not impair the rights thereunder. Further, the Supreme Court held that a state may amend a statute and alter existing rights if, and only if, the state reserves that right to itself.

## So Is the New Rule Incorporated by Reference or Not?

For purposes of this discussion, I am largely going to focus on the law of my home jurisdiction of Kentucky, but the analytic path here employed should be applicable to any state that has not employed staggered effective dates for its sequential amendments to its LLC act. This analysis is likewise applicable, as several of the states, a notable example being Florida, replace their LLC Acts and impose the new act upon LLCs organized under the prior law.<sup>9</sup>

The Kentucky LLC Act has been repeatedly amended since its initial adoption, and none of those amendments has incorporated a “grandfather” clause to the effect that the revised provision is applicable only to LLCs formed after that date.<sup>10</sup> If the (presumably written) operating agreement was silent as to a particular issue, is it the old or the new rule that controls?<sup>11</sup>

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.<sup>12</sup> Second, it is provided that amendments to the LLC Act shall not impair the obligations of contracts existing when the amendments become effective.<sup>13</sup> Third, as a general rule, statutes do not have retroactive effect.<sup>14</sup> There is as well §3 of the Kentucky Constitution, it being a *Dartmouth College* provision reserving to the legislature the right to modify laws.<sup>15</sup> Last, there is the rule of contract law that an agreement incorporates the law as it exists at the time the contract is entered into.<sup>16</sup>

LLCs are creatures of contract, in this case the operating agreement. As a contract, the operating agreement incorporates the law as it exists at the time the contract

is entered into. Under most LLC Acts, to the extent that the operating agreement does not set forth a contrary rule, the terms of the LLC Act apply;<sup>17</sup> in effect, the LLC Act is the initial operating agreement of every LLC subject to modification by private ordering, qualified in certain instances by a statute of frauds requirement.<sup>18</sup>

There is reserved to the Kentucky General Assembly the ability to amend the LLC Act,<sup>19</sup> thereby avoiding the rule of *Dartmouth College*. Statutes are not applied retroactively absent the General Assembly’s express intent to do so.<sup>20</sup> 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.<sup>21</sup> 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) agreement unless its language clearly indicates such to have been ([the]—sic) intention of ([the]—sic) parties.<sup>22</sup>

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 agreement 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 at that time, any member could withdraw on 30 days’ prior written notice and receive a liquidating distribution of the “fair value” of his interest in the company.<sup>23</sup> In 1998, the statute was amended to eliminate the right to a liquidating distribution upon dissociation. Now, in 2016, a member decides to withdraw from the company and expects a distribution in the amount of the fair value of his interest therein.

In support of 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 LLC 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.<sup>24</sup> 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.

To provide another example, assume the LLC in question was organized in Kentucky in 1996. At that time, the members entered into a written operating agreement that was silent as to its amendment; at that time, the LLC Act required the unanimous approval of the members to amend an operating agreement.<sup>25</sup> 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.<sup>26</sup> Now, in 2016, it has been proposed that the operating agreement be amended. As to the proposed amendment, 40 percent of the members are opposed and 60 percent 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.

If the statute, as amended, is controlling, absent contrary private ordering, the agreement is subject to modification by subsequent legal changes.<sup>27</sup> This rule may drive a desire to provide greater specificity in the operating agreement, repeating statutory rules so that they become a matter of private agreement that is not subject to, in effect, legislative amendment.

These points seem, to date, to have been seldom litigated. In one case from Louisiana, the question arose as to whether a member retained the benefit of a statute allowing for voluntary resignation and a liquidating distribution, notwithstanding a subsequent amendment to the statute eliminating that right.<sup>28</sup> In that instance, the court upheld the right to resign and receive a liquidating distribution. Essentially, the LLC Act as incorporated into the operating agreement is the act as it existed at the time of organization. In *Levey v. Brownstone Asset Management, L.P.*, the Delaware Chancery Court avoided the question of whether the 2010 amendments to the Delaware LLC Act precluding the application of the Statute of Frauds<sup>29</sup> applied to agreements existing prior to its adoption.<sup>30</sup> In *Halley v. Barnabe*, the Kansas Supreme Court considered whether the adoption of the Kansas Revised LLC Act, it expressly providing for derivative actions, would apply to existing suits that had been dismissed on the basis that the prior LLC Act did not provide for derivative actions, and determined that it did.<sup>31</sup>

Now there may be a level of comfort in a rule incorporating the statute only as it exists at the time of formation, but that rule may have its own problems. Prior to the adoption of the Check-the-Box classification regulations,<sup>32</sup> many LLCs acts required that the LLC have two

members.<sup>33</sup> Today, all states permit single-member LLCs (SMLLCs).<sup>34</sup> Is it desired that an LLC formed when LLCs were required to have at least two members be required to wind-up and terminate its activities if it today loses one of its members, reducing it to a SMLLC? If the law in effect at the time of the LLC's formation (at least in certain states) is incorporated, notwithstanding subsequent amendment, that could well be the outcome.<sup>35</sup>

*[T]he aspects of the LLC Act that impact upon the rights of third parties are typically not subject to modification in the operating agreement.*

Appreciating the difficulty of anticipating statutory developments,<sup>36</sup> the question comes down to (as do most issues involving LLCs) good drafting in the operating agreement. An agreement, which defines the “Act” as “the LLC Act of the State of Nova as of the date the articles of organization were filed by the Nova Secretary of State,” clearly incorporates the law in effect at the time the operating agreement is entered into. Certainly that is a legitimate approach,<sup>37</sup> even as it imposes an obligation to compare the agreement to the law as it evolves and to update, as desired, the operating agreement to, by contract, adopt new laws provided for by statute.<sup>38</sup> If, continuing the above example, an LLC formed at the time an LLC was required to have two members desires the flexibility to have only a single member, it may elect that rule in its articles of organization or its operating agreement.<sup>39</sup>

Conversely, the operating agreement may incorporate the LLC Act “as amended from time to time.” If this formula is employed, then the LLC Act as it evolves over time is incorporated by reference, and the LLC evolves with that law. If the LLC Act newly affords or newly restricts a right, then absent it being written into the operating agreement the newly granted or restricted right governs the LLC and its members. If the LLC Act in effect provides, for example, a right to withdraw and receive a fair value liquidating distribution, and later that right is eliminated, the member has lost that opportunity.

So what is it to be? Valid arguments can be made for either formula. One or the other needs to be chosen—the point is to select one of the options with a full appreciation of the consequences thereof.

## ENDNOTES

- <sup>1</sup> See, e.g., Ky. Rev. Stat. Ann. §275.015(21) (defining an “operating agreement” as the agreement of the members “as to the conduct and affairs of a [LLC.]”); Rev. Prototype LLC Act §102914, 67 Bus. Law. 117, 125 (Nov. 2011).
- <sup>2</sup> See, e.g., Conn. Gen. Stat. Ann. §34-242(1) (“It is the policy of sections 34-100 to 34-242, inclusive, to give maximum effect to the principle of freedom of contract and to enforceability of limited liability company agreements.”).
- <sup>3</sup> *Olsen v. Halvorsen*, 986 A2d 1150 (Del. 2009). See also Thomas E. Rutledge, State Law & State Taxation Corner, *Statute of Frauds and Partnerships/Operating Agreements*, J. PASSTHROUGH ENTITIES, Nov.–Dec. 2008, at 33.
- <sup>4</sup> See Del. Code Ann. tit. 6, §18–101(7).
- <sup>5</sup> See, e.g., Ky. Rev. Stat. Ann. §371.065 (requirements for valid guaranty).
- <sup>6</sup> *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819).
- <sup>7</sup> *Trustees of Dartmouth College v. Woodward*, 17 U.S. at 636.
- <sup>8</sup> U.S. Const. Art. 1, §10, cl. 1 (“No state shall ... pass any ... law impairing the obligation of Contracts ...”).
- <sup>9</sup> Fla. Stat. Ann. §605.1108(2) (“On or after Jan. 1, 2015, this chapter governs all limited liability companies.”). *Contrast* Calif. Corp. Code §17713.04(b) (operating agreements of LLCs pre-existing the Jan. 1, 2014 effective date of the new LLC Act remain governed by the “prior law”).
- <sup>10</sup> *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 Jan. 1, 2012); Ind. Code §§23-18-3-1 and 23-18-3-11 (setting forth rules for, respectively, LLCs existing on or prior to June 30, 1999, and LLCs formed after June 30, 1999).
- <sup>11</sup> Another fact pattern that could give rise to this problem occurs when a state adopts, and applies to pre-existing LLCs, the Revised Uniform Limited Liability Company Act (RULLCA). Section 110 of RULLCA specifies certain actions that an operating agreement may not do. Presume the prior act did not have such a list of limits on the operating agreement. If the operating agreement of the old law LLC exceeds the permitted scope of the new law, what is the continuing effect, if any, of those now forbidden provisions?
- <sup>12</sup> See Ky. Rev. Stat. Ann. §275.003(6).
- <sup>13</sup> Ky. Rev. Stat. Ann. §275.003(1).
- <sup>14</sup> See Ky. Rev. Stat. Ann. §446.080(3).
- <sup>15</sup> See Ky. Const. §3.
- <sup>16</sup> See, e.g., *LJM Corp. v. Maysville Hotel Group, LLC*, No. 2004-CA-000120-MR (Ky. App. Apr. 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.* DC-KY, 18 FSupp2d 704, 705 (1998) (“Kentucky has embraced the general proposition that ‘constitutional and statutory provisions in ef-

fect 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 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 the form of action for enforcement.).

- <sup>17</sup> See, e.g., Ky. Rev. Stat. Ann. §275.003(8).

- <sup>18</sup> See, e.g., Ky. Rev. Stat. Ann. §275.170 (“Unless otherwise provided in a written operating agreement.”); Ind. Code §23-18-4-2(a) (“Unless otherwise provided in a written operating agreement”).

- <sup>19</sup> Ky. Const. §3 (“and every grant of a franchise, privilege or exemption, shall remain subject to revocation, alteration or amended.”). *Accord* Fla. Stat. Ann. §605.1105 (“The Legislature has the power to amend or repeal all or part of this chapter at any time, and all domestic and foreign [LLCs] subject to this Chapter shall be governed by the amendment or repeal.”). See also THOMAS M. COOLEY, A TREATISE ON THE CONSTITUTIONAL LIMITATIONS WHICH REST UPON THE LEGISLATION POWER OF THE STATES OF THE AMERICAN UNION 383 (5th ed. 1883) (“The citizen has no vested right in statutory privileges and exemptions.”)

- <sup>20</sup> See Ky. Rev. Stat. Ann. §446.080(3). *Accord* Alaska Stat. §01.10.090; Colo. Rev. Stat. §2-4-202; S.C. Code Ann. §2-7-10; S.D. Codified Laws §2-14-21.

- <sup>21</sup> 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). See also Ariz. Stat. §29-854(c); Conn. Gen. Stat. Ann. §34-242(d) (“Neither sections 34-100 to 34-242, inclusive, nor any amendment to said sections shall be construed to impair the obligations of any contract existing on, or affect any action or proceedings begun or right accrued before, Oct. 1, 1993, or the effective date of such amendment.”); *Accord* Ind. Const. §24 (“No ... law impairing the obligation of contracts, shall ever be passed.”); Wisc. Const., Art. I, §12 (“No ... laws impairing the obligation of contracts, shall ever be passed ...”). Be aware that the opposite statutory construct may be adopted. For example, under the Revised Prototype LLC Act, see REVISED PROTOTYPE LIMITED LIABILITY COMPANY ACT, 67 Bus. Law. 117 (Nov. 2011). All provisions of this Act may be altered from time to time or repealed and all rights of members and agents are subject to this reservation. Unless expressly stated to the contrary in this Act, all amendments of this Act shall apply to limited liability companies and members and agents whether or not existing as such at the time of the enactment of any such amendment. *Id.*, at 224 (§ 1205).

- <sup>22</sup> Williston on Contracts §30:23.

- <sup>23</sup> See Rutledge, *Chapman v. Regional Radiology Associates, PLLC: A Case Study in the Consequences of Resignation*, 100 KENTUCKY LAW JOURNAL ONLINE 15 (2011).

- <sup>24</sup> See, e.g., *KPERS v. Reimer A. Koger Assocs., Inc.*, 927 P2d 466 (Kan. 1896) (“[A] mere expectancy of future benefit, or a contingent interest in property founded on anticipated continuance of existing laws, does not constitute a vested right.”) See also *Parish of Jeffersons v. Gonzales*, 288 So.2d 65, 66–67 (La. App. 1974).

- <sup>25</sup> See Ky. Rev. Stat. Ann. §275.175(2)(a) as enacted by 1994 Ky. Acts, ch. 389 §35 and prior

to amendment by 1998 Ky. Acts, ch. 341, §29. Accord Prototype LLC Act §403(8)(1) (1992).

<sup>26</sup> See Ky. Rev. Stat. Ann. §275.175(2)(a).

<sup>27</sup> Accord Del. Code Ann. tit. 6, §18-1106.

<sup>28</sup> *Sage v. Radiology and Diagnostic Services, LLC*, 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 the time of the LLC's formation).

<sup>29</sup> Del. Code Ann. tit. 6, §101-7.

<sup>30</sup> C.A. No. 5714-VCL, 2014 WL 3811237 (Del. Ch. Aug. 1, 2014).

<sup>31</sup> *Halley v. Barnabe*, 24 P3d 140 (Kan. 2001). Of course, there are a multitude of decisions considering, outside the context of LLCs, the impact of statutory alterations upon existing contractual arrangements. See, e.g., *Kia Motors America, Inc. v. Glassman Oldsmobile*

*Saab Hyundai, Inc.*, CA-6, 706 F3d 733 (2013) (expansion of statutory exclusivity zone from six to nine miles not applied retroactively).

<sup>32</sup> Reg. §301.7701-1 *et seq.*

<sup>33</sup> See, e.g., Ky. Rev. Stat. Ann. §275.025 (prior to amendment by 1998 Ky. Acts, ch. 341, §23); LARRY E. RIBSTEIN AND ROBERT R. KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES §4:3 (2nd ed. Dec. 2015).

<sup>34</sup> See RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES §4:3 (2nd ed. Dec. 2015); *id.*, Appendix 4-4.

<sup>35</sup> See, e.g., *Peinado v. Barnett*, 2001 WL 1380441 (Cal. App. 1st Div. 2001) (veil of LLC pierced to hold sole member liable on company obligation on grounds including "First, the formation of Bridge Development as a California LLC did not follow the necessary legal formalities. Prior to January 1, 2000, an LLC was required to have

two or more members. Since Bridge has only one member, it was not legally constituted when it was created in 1997.").

<sup>36</sup> Who among us, in 1994, could have anticipated the Check-the-Box regulations and the demise of the *Kintner* Classification regulations?

<sup>37</sup> See also generally Dolly Wu, *Timing the Choice of Law by Contract*, 9 NORTHWESTERN J. OF TECH. AND INTELLECTUAL PROP. 401 (Spring 2011).

<sup>38</sup> Assuming of course that the members agree with the amendment. See also Thomas E. Rutledge & Phuc H. Lu, *No Good Deed Goes Unpunished: Pitfalls for Counsel to a Partnership About to be Governed by a New Law*, 45 BRANDEIS L. J. 755 (2007).

<sup>39</sup> Be aware that even with this formula, a court could hold that "procedural," as contrasted with "substantive," provisions in the amended LLC Act may be applied to pre-existing entities.

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