

State Law & State Taxation Corner

By Thomas E. Rutledge

In Delectus Personae and Organic Transactions



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In a prior column, I considered how proxies, given in the context of unincorporated business organizations, may defeat the otherwise applicable rules of *in delectus personae*.¹ A proxy is not, however, the sole mechanism by which *in delectus personae* may be subverted. Without suggesting that the field is thereby fully covered, it is necessary to consider how various organic transactions, (e.g., mergers, consolidations and conversions), may equally subvert otherwise applicable rules of *in delectus personae*. Whether, in a particular instance, these opportunities are a necessary flexibility or, in the alternative, an abusive “planning opportunity” is dependent upon the facts or the situation and a particular viewpoint. For that reason, an appreciation of the opportunities is always necessary.

In Delectus Personae—A Brief Review

The rule employed in most unincorporated business organizations is that the right to participate in the management of the venture is not freely transferable. Rather, while the right to participate in the economics of the venture may be freely conveyed,² that conveyance does not vest in the transferee the right to participate in management.³ The case law is abundant to the effect that the transferee has no voice in the venture, including no right to inspect records, is not the beneficiary of fiduciary duties and has no voice in the amendment of the agreement governing the venture.⁴ After the assignment of a participant’s economic rights in the venture, the assignor is either automatically disassociated or is subject to disas-



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sociation by the remaining participants, thereby precluding or at least limiting the formation of a class of person participating in management without having an economic interest in the venture.

Organic Transactions as an End-Around of *In Delectus Personae*

Consider a garden-variety LLC governed by the statutory default rules. The three equal members are A, B and C, each a business corporation. Each of A, B and C consider this division of voting rights to be an important protection to their individual positions—no one member has the capacity to impose their will on the venture.

After some period of time (and successful operations), B's owners decide it is time to retire, and they offer to sell out to C's owners. They accept the offer and eventually merge B into C. Consider now A's position in the LLC. B having merged into C, there was no "transfer" of B's interest in the LLC such that C, as to what was B's interest, is a mere assignee.⁵ B, by reason of merging with C, was not dissociated from the LLC.⁶ A, having entered into LLC on the basis that a triumvirate structure protected its position, now finds itself at C's mercy, it having the authority to make ordinary and in certain states even extraordinary decisions on behalf of the LLC.⁷

Admittedly, this situation, it may be argued, is not a true violation of *in delectus personae* in that A did initially agree to be in the LLC venture with C. While A may have relied upon the three-way equal division of control, at least it has not been forced to accept a complete stranger as a new member in the LLC. That, however, can easily happen.

Assume the same LLC with equal members A, B and C. Once again, B's shareholders have decided to retire, but this time C is not willing to acquire B. That is not, however, from the perspective of B's shareholders a significant problem, as D has expressed an interest in acquiring B. Pursuant to a reverse merger, B becomes a wholly owned subsidiary of D. B, now under the control of D, remains a member of the LLC. Then, as D desires to simplify its organizational structure, B is merged with and into D. D, on its own account, is now a member in the LLC.

A (as well as C) is now in business with not B, but rather D. Most important for our purposes, neither A nor C gave any consent to D's admission as a member⁸ even as D is a member. A and C likely now owe fiduciary obligations,⁹ as well as an obligation of good faith and fair dealing, to C¹⁰ and also information disclosure obligations.¹¹ D is now a party to the operating agreement and has a voice in its amendment¹² and may move for the LLC's judicial dissolution.¹³

The examples so far presented begin with the assumption that it is a business organization that was the initial member for whom another organization was substituted. It is not correct to assume that so long as the initial owners are individuals that a similar outcome is not possible.

Consider a general partnership XYZ organized under a state enactment of RUPA. XYZ has three equal partners, namely Tom, Dick and Harry.

Being comprised entirely of individuals, there is no possibility that, by means of a merger, a third party may be substituted for one of the current participants. Any effort by a participant to unilaterally transfer their interest in

the venture will result in an assignee who lacks voting and other rights¹⁴ and an assignor who is thereby subject to disassociation from the venture.¹⁵ It would appear, therefore, that in a venture comprised entirely of natural persons, organic transactions are not a mechanism by which the otherwise applicable rules of *in delectus personae* are applicable. Appearances can, however, be deceiving.

For example, under the laws of Maryland and Rhode Island,¹⁶ it is possible for a sole proprietorship to convert into an LLC. Utilizing this capability, any of Tom, Dick or Harry could cause an LLC to become, *vis-à-vis* the partnership, a partner. From there, by means of either selling 100 percent of the limited liability company interest in that LLC or by merging that LLC into another venture, someone different than either of Tom, Dick or Harry could indirectly become a partner in the partnership. But, you observe, you do not practice in Maryland or Rhode Island, and none of the members of the LLCs or partners in the partnerships that you advise are Maryland or Rhode Island residents, so this is not your concern. As already noted, appearances can be

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deceiving. Neither of these statutes requires that the sole proprietorship have been organized¹⁷ or operating in that jurisdiction in order to take advantage of the conversion mechanism.¹⁸ Ergo, any of Tom, Dick or Harry may take advantage of these statutes and become (as to the partnership) an LLC, a transaction that will not effect a dissociation from the partnership,¹⁹ and from there convey the right to participate in the partnership's affairs.

So What to Do?

LLCs and partnerships are creatures of contract for which, in the absence of a contrary agreement, the underlying statute provides certain default rules.²⁰ While they provide for the rule of *in delectus personae* and specify that a voluntary assignee may not participate in management, there are obvious mechanisms by which the rule may be circumvented. As is so often the case, whether these constitute legitimate planning opportunities or abusive violations of the clear intent of the statute depends upon one's perspective.

If there is a desire to eliminate these mechanisms, then the operating or partnership agreement needs to address these circumstances. For example, change

of control limitations upon the merger or consolidation of a member/partner who is a business entity may provide that the entity surviving the merger or consolidation is treated as an assignee absent (in effect) readmission by the other members/partners. Such a formula would permit the other members to make an informed decision as to the ability of the merged entity to participate in management, irrespective of whether the original member/partner is or is not the entity surviving the merger. Obviously, there are numerous permutations of such provisions such as they are not applicable if the merger in question involves a parent who engages in a short-form merger with a subsidiary. While the limitations and exceptions that may be appropriate for a particular deal will undoubtedly be different from the next deal, the important thing is to have considered and detailed what they may be.

Likewise, addressing the possibility of the reorganization of a natural person is something that needs to be considered. Keep in mind that there is no requirement that an individual be resident or doing business in Rhode Island or Maryland in order to take advantage of their conversion statutes. Even agreements among individuals need to consider these "planning opportunities."

ENDNOTES

¹ See Thomas E. Rutledge, *In Delectus Personae and Proxies*, J. PASSTHROUGH ENTITIES, July–Aug. 2011, at 43.

² See, e.g., UNIF. LTD. PART. ACT §503(a)(1), 6 (pt. 1) U.L.A. 156 (2001); UNIF. PART. ACT §27, 6 (pt. 2) U.L.A. 332 (2001); REV. UNIF. LTD. LIAB. CO. ACT §502(a)(1), 6B U.L.A. 496 (2008); Del. Code Ann. tit. 6, §503(a)(1) (Del. RUPA); *id.* §18-702(a) (Del. LLC Act); Ky. Rev. Stat. Ann. §362.1-503(1)(a) (KyRUPA); *id.* §362.280(1) (KyUPA); and *id.* §275.255(1)(a) (Ky LLC Act). See also REV. UNIF. PART. ACT §503(b)(1), 6 (pt.1) U.L.A. 157 (2001) (transferee to receive distributions that would have otherwise gone to the transferor); UNIF. PART. ACT §27, 6 (pt. 2) U.L.A. 332 (2001) (same); REV. UNIF. LTD. LIAB. CO. ACT §502(b), 6B U.L.A. 496 (2008) (same); Del. Code Ann. tit. 6, §503(b) (same); *id.* §18-702(b)(2) (same); Ky. Rev. Stat. Ann. §362.1-503(2)(a) (same); *id.* §362.280(1) (same); *id.* §275.255(1)(b) (same); and Pa. Code §33-44-502.

³ See, e.g., UNIF. PART. ACT §27(1), 6 (pt. 2) U.L.A. 332 (2001); REV. UNIF. PART. ACT §503(a)(3), 6 (pt. 1) U.L.A. 156 (2001); UNIF. LTD. LIAB. CO. ACT §502, 6B U.L.A. 602 (2008); REV. UNIF. LTD. LIAB. CO. ACT §502(a)(3), 6B U.L.A. 496 (2008); UNIF. LTD. PART.

ACT §702(a)(3), 6A U.L.A. 462 (2001); Del. Code Ann. tit. 6, §15-503(a)(3); Ky. Rev. Stat. Ann. §362.280(1); *id.* §362.1-503(1)(c); *id.* §362.2-702(1)(c); and *id.* §275.255(1)(c). Exceptions to this rule include statutory trusts organized under the Uniform Statutory Trust Entity Act which, while unincorporated, as a default rule permits free transferability of beneficial interests therein and permits the transferee to fully exercise any voting rights previously enjoyed by the transferor. See UNIF. STATUTORY TRUST ENTITY ACT, §601(a), 6B U.L.A. (2010 Supp.) 81. Transferability may be limited in the governing instrument. See *id.* §103(e)(2), 6B U.L.A. (2010 Supp.) 45.

⁴ 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); *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); and *Dame v. Williams*, 727 N.Y.S.2d

816, 818 (N.Y. App. Div. 2001) (estate of former general partner not entitled to participate in partnership's management or to inspect its records). See also Thomas E. Rutledge, Carter G. Bishop and Thomas Earl Geu, *No Cause For Alarm: Foreclosure and Dissolution Rights of a Member's Creditor*, 21 PROBATE & PROPERTY 35 at 40 (May–June 2007).

⁵ See, e.g., Del. Code Ann. tit. 8, §259(a); Ky. Rev. Stat. Ann. §271B.11-060(1)(b) (upon a merger all property "vests" in the surviving corporation). See also MOD. BUS. CORP. ACT §11.07, official comment ("A merger is not a conveyance, transfer or assignment.")

⁶ See, e.g., REV. UNIF. LTD. LIAB. CO. ACT §602, 6B U.L.A. 502 (2008) (listing bases for dissociation and not there listing merger of a member); Ky. Rev. Stat. Ann. §275.280 (same); S.C. Code §33-55-601 (same); and Tenn. Code §48-249-503(a)(same).

⁷ See, e.g., Ky. Rev. Stat. Ann. §275.350(1) (permitting majority-in-interest of the members to approve a merger).

⁸ See, e.g., REV. UNIF. LTD. LIAB. CO. ACT §401(d)(3), 6B U.L.A. 478 (2008) (requiring the consent of all of the incumbent members to the admission of a member's transferee as a member); Del. Code Ann. tit. 6, §18-704(a)

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- (1) (requiring consent of all members other than the assignor); and Ky. Rev. Stat. Ann. §275.265(1) (requiring consent of majority-in-interest of incumbent members other than the transferor to the admission of a member's transferee as a member).
- ⁹ See, e.g., REV. UNIF. LTD. LIAB. CO. ACT §409(c), 6B U.L.A. 488 (2008); Ky. Rev. Stat. Ann. §275.170(1).
- ¹⁰ See, e.g., Ky. Rev. Stat. Ann. §275.003(7).
- ¹¹ See, e.g., REV. UNIF. LTD. LIAB. CO. ACT §410(a) (3), 6B U.L.A. 493 (2008); Ky. Rev. Stat. Ann. §§275.185(2), (3).
- ¹² See, e.g., Ky. Rev. Stat. Ann. §275.175(2)(a) (operating agreement may be amended by majority-in-interest of the members); Ala. Code §10-12-24(c) (unanimous approval of the members required to amend operating agreement); Tenn. Code §48-29-401(f) (1) (unanimous consent to amendment of operating agreement).
- ¹³ See, e.g., Ky. Rev. Stat. Ann. §275.290(1); R.I. Gen. Laws §7-16-40; and Tenn. Code §48-249-616.
- ¹⁴ See *supra* notes 3–4 and accompanying text.
- ¹⁵ REV. UNIF. PART. ACT §601(4)(ii), 6 (pt. 1) U.L.A. 163 (2001); Ky. Rev. Stat. Ann. §362.1-601(4)(b).
- ¹⁶ Md. Corps. & Ass'n Code Ann. §4A-212; R.I. Gen. Laws §7-16-5-1. There may be other states with similar statutes. My thanks to Allan Donn (Willcox & Savage, P.C.) for direction to these statutes.
- ¹⁷ How does one determine the jurisdiction of "organization" of a sole proprietorship?
- ¹⁸ See, e.g., Md. Corp. & Ass'n Code Ann. §4A-212(a) ("An individual conducting business as a proprietorship may convert the proprietorship to a [LLC]").
- ¹⁹ See, e.g., REV. UNIF. PART. ACT §601, 6 (pt. 1) U.L.A. 163 (2001); Ky. Rev. Stat. Ann. §362.1-601.
- ²⁰ See, e.g., *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, [the LLC Act] contains default provisions that will govern the conduct of the entity's business and affairs.").

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