

State Law & State Taxation Corner

By Thomas E. Rutledge*

In Delectus Personae and Proxies



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Proxies are a well-understood phenomenon in the law of corporations, a realm in which the right to participate in the venture's management, absent contrary private ordering, is freely transferable. Proxies are less well understood in the law of unincorporated business organizations, a realm in which as a default rule the right to participate in management is not exercisable to one not admitted to participation by the incumbent participants.

The (Sometimes) Acceptance of Proxies

By means of a proxy, a corporate shareholder delegates to an agent the capacity to, in the shareholder's place, exercise the right to vote. In certain instances, the proxy holder is directed by the principal as to the manner in which the votes are to be cast, while in other instances the proxy holder has discretion as to how the shares will in a particular instance be voted. Corporate law has long recognized the existence of proxies, defining the required characteristics thereof in order for recognition by the corporation.¹ This broad acceptance of proxies needs, however, to be understood in context. Proxies are permitted for the shareholders; corporate directors, as a rule, may not vote by proxy.² Some organizational forms, an example being cooperatives under the uniform act, preclude proxy voting by even the members.³

In Delectus Personae

The rule employed in most unincorporated business organizations is that the right to participate in the



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management of the venture is not freely transferable. Rather, while the right to participate in the economics of the venture may be freely conveyed, that conveyance does not vest in the transferee the right to participate in management.⁴ The case law is abundant to the effect that the transferee has no voice in the venture, including no right to inspect records, to be the beneficiary of fiduciary duties or to have a voice in the amendment of the agreement governing the venture.⁵ After the assignment of a participant's economic rights in the venture, the assignor is either automatically dissociated or is subject to dissociation 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.

At the same time, certain acts provide that the capacity to participate in management may be delegated. For example, the Kentucky LLC Act provides:

Unless otherwise set forth in a written operating agreement, a member or manager of a limited liability company has the power and authority to delegate to one (1) or more other persons the member's or manager's powers to manage or control the business and affairs of the limited liability company, including without limitation the power to delegate to agents and employees of a member, manager, or limited liability company or to delegate by an agreement to other persons. This delegation by a member or manager of a limited liability company shall not cause the member or manager to cease to be a member or manager of the limited liability company.⁶

The exact intent of this provision is unclear—it has no predecessor in the Prototype LLC Act,⁷ upon which the original Kentucky LLC Act is based,⁸ or the ULLCA. At first blush, it would appear to allow a general delegation of the right to participate in the LLC's management. This reading conflicts, however, with the *in delectus personae* provisions otherwise set forth in the LLC Act.⁹ At a minimum, there is ambiguity. Other statutes are more direct, expressly permitting proxy voting.¹⁰

Even as the separation of voting and economic benefit may not be wealth maximizing,¹¹ the negative effects are minimized by the proxies' short-term nature and unilateral revocability by the principal.¹² Problems arise, however, when the proxy is irrevocable, permitting a potential separation of the interest of the owners and those of the potentially disloyal agent.

Proxies as an End-Around of *In Delectus Personae*?

In unincorporated organizations, the proxy represents a violation of *in delectus personae*, separating the right to participate in management from the determination that a particular person may be a member or partner enjoying the right to participate in management.¹³ Consider Bob, a member of XYZ, LLC. Under the applicable statute, he can convey to Scott his interest in XYZ, LLC, and Scott, as an assignee therein, will enjoy the economic fruits of the venture even as Bob continues to have the right as a member to participate in management.¹⁴ Bob now gives to Scott his proxy to exercise the voting rights that relate to the LLC interest that was conveyed. Assume that the proxy permits Scott to vote entirely as he sees fit and has no liability to Bob as to how any vote is exercised. For all intents and purposes, Scott has stepped into Bob's shoes *vis-à-vis* the LLC and is able to participate in its management notwithstanding the rule of *in delectus personae* embodied in the LLC Act.

In the alternative, assume the same proxy from Bob to Scott, but without a conveyance of the underlying interest. Scott has a naked right to participate in management. While consequent to the transfer of the economic interest in the venture, there is at least the possibility of dissociating Bob and thereby rendering the proxy a nullity (if Bob, as the principal, has no right to vote, Scott, his proxy, has no capacity to vote); the conveyance of a naked proxy gives rise to no such right unless so provided in the operating agreement. Scott may be acting on Bob's behalf and pursuant to Bob's instructions. Alternatively, Scott may be acting entirely in his own interests. Regardless, the rule that only members may participate in management has been violated.

But we are begging the question—in the context of an unincorporated business organization that utilizes the rule of *in delectus personae*, is the right to vote exercisable by proxy? As a general rule, one who may act as a principal may do so through an agent.¹⁵ However, if performance of an act is not delegable, performance through an agent does not constitute performance by the principal.¹⁶ As noted above, corporate directors are not permitted to vote by proxy, that being a rule of long acceptance.¹⁷ It needs to be recognized that permitting shareholders to vote by proxy is an innovation; at common law, even shareholders could not vote by proxy.¹⁸ Is

a member's (or partner's) right to participate in the venture's management of such a nature that it is not delegable and may be exercised only by the member or partner? Although not addressed in comments to the Restatement (Third) of Agency and in the absence (so it would appear) of case authority on the point, the rule of nontransferability of the right to participate in management would indicate that it is.¹⁹ Ergo, absent the operating/partnership agreement permitting a proxy vote, members and partners should not be permitted to vote by proxy.

Statutes Permitting Delegation

Assuming a normative rule that members/partners may not vote (*i.e.*, participate in management) through an agent, what is to be made of statutory provisions that enable delegation.²⁰ All else being equal, one could say that they permit unilateral delegation of the right to participate in the LLC's/partnership's management. Seldom are all things equal, and they certainly are not here. Both partnerships and LLCs impose limitations upon who may become a partner or member with the faculty to participate in management²¹ and provide expressly that while the economic rights in the venture are transferable, the transferee does not succeed to the right to participate in management.²² As such, the provisions need to be reconciled. While it may have been intended that provisions of this nature serve to enable a member or partner who is itself a business entity to act through its own agents,²³ and while such a reading would be consistent with *in delectus personae*, the language is not so limited as to restrict the delegation to partners and members who can act only through agents.

Irrevocable Proxies

An irrevocable proxy, as to the rule of *in delectus personae*, is a different animal from a traditional revocable proxy.²⁴

In the formula employed in the Restatement (Third) of Agency, an irrevocable proxy is "held for the benefit for the holder or third person" and is given "to protect a legal or equitable title or to secure the

performance of a duty."²⁵ An irrevocable proxy does not, as contrasted with a typical revocable proxy, create an agency relationship.²⁶ The most important distinguishing factors, for purposes of this discussion, are that the irrevocable proxy does not exist for the benefit of its creator, the holder thereof is not under the creator's control and the holder does not owe fiduciary duties to the creator.²⁷

In the context of an LLC or partnership, even where a revocable proxy is permitted, an irrevocable proxy needs to be understood as a unilateral divestiture of both the right to participate in management (even though that right is not typically alienable) and the economic interest in the venture. Consequently, depending upon the statutory formula in place, and assuming no contrary private ordering in the controlling agreement, the partner or member giving an irrevocable proxy is either automatically or is subject to dissociation.²⁸

So What to Do?

Starting from the easiest, practitioners and their clients need to fully appreciate the distinctions between a revocable and an irrevocable proxy. The latter is not simply the former on steroids, but rather a beast of a different nature. In the context of a partnership or LLC, an irrevocable proxy should be understood to be an alienation of the interest in the venture no different than an effort to unilaterally dispose of the interest in the partnership or LLC interest. Giving an irrevocable proxy affects the member's/partner's dissociation, either absolutely or conditionally based upon action by the other participants, from the venture, the member/partner who enjoyed the right to participate in management having now been removed from that position, the proxy holder has no right to do so.²⁹

Second, consideration needs to be given to statements in partnerships and operating agreements stating that members and partners may vote by proxy. Are they, in the context of the venture, appropriate? In a widely held limited partnership, perhaps they are. Conversely, in a closely held venture, in which the controlling document at length limits transferability with the clear objective of precluding third party

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involvement in management, a provision permitting proxy voting is likely out of place.

Third, assuming that a proxy does conflict with principles of *in delectus personae*, statutes should be clarified by provisions to the effect that proxy voting

is not permitted except as authorized by the governing partnership or operating agreement. At the same time, state statutes that appear to permit unrestricted delegation³⁰ should be reviewed and clarified to, as appropriate, restrict their application.

ENDNOTES

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¹ See, e.g., Del. Code Ann. tit. 8, §212; Ind. Code §23-1-30-3(a) ("A shareholder may vote the shareholder's shares in person or by proxy."); Ky. Rev. Stat. Ann. §271B.7-220.

² See, e.g., 2 William Meade Fletcher, FLETCHER'S CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS at §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. An exception to this general prohibition on director proxy voting is Louisiana, which permits them in particular corporations that so provide in the articles of incorporation. See La. Code 12 §81(E).

³ See Unif. Ltd. Coop. Ass'n Act §515(a), 6A U.L.A. 222 (2008); see also *id.*, comment.

⁴ 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); *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 permit free transferability of beneficial interests therein and permit 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.

⁵ See, e.g., *Bauer v. The Blomfield Co.*, 849 P2d 1365 (Alaska 1993) (assignee of

partnership interest not owed obligations of good faith and fair dealing); *Bayside Petroleum, Inc. v. Whitmar Exploration Co.*, DC-OK, 1997 WL 34690262 ("no fiduciary duty" is owed the assignee of a partner); *Haynes v. B&B Realty Group, LLC*, 633 SE2d 691 (N.C. 2006) (no fiduciary duties owed to transferee of LLC interest); *Landskroner v. Landskroner*, 797 NE2d 1002, 1014 (Ohio Ct. App. 2003) (fiduciary duties are not owed to former member of LLC); and *Dame v. Williams*, 727 NYS2d 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*, PROBATE & PROPERTY, May-Jun. 2007, at 40.

⁶ Ky. Rev. Stat. Ann. §275.165(3). A provision of similar import appears in the Tennessee adoption of RUPA. See T.C.A. §61-1-401(l). Tennessee has a similar provision in its LLC Act. See T.C.A. §48-249-401(c); *id.* §48-249-403(n). In the Tennessee LLC Act these provisions are in addition to provisions authorizing and limiting proxies. See T.C.A. §48-225-101. Those provisions in Tennessee were in turn based upon a provision in the Delaware adoption of RUPA. See Del. Code Ann. tit. 6 §15-401(l); see also *id.* §18-407 (equivalent provision of Delaware LLC Act); and *id.* §17-403(c) (equivalent provision of Delaware LP Act). For review of section 403(c) of the Delaware LP Act, see Martin I. Lubaroff and Paul M. Altman, LUBAROFF & ALTMAN ON DELAWARE LIMITED PARTNERSHIPS at §4.18.

⁷ The Prototype LLC Act was the product of a task force of the Committee on Partnerships and Unincorporated Business Organizations (since renamed the Committee on LLCs, Partnerships and Unincorporated Entities) of the ABA Section of Business Law. The Prototype is reprinted in 3 Larry E. Ribstein and Robert R. Keatinge, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES.

⁸ See Thomas E. Rutledge and Lady E. Booth, *The Limited Liability Company Act: Understanding Kentucky's New Organizational Option*, 83 Ky. L. J. 1, 9 (1994-95).

⁹ See Ky. Rev. Stat. Ann. §275.255(1)(c) (assignee of LLC interest not afforded the right to participate in LLC's management); *id.* §275.275(1)(a) (the vote of all incum-

bent members is required to admit a new member acquiring an interest directly from the LLC).

¹⁰ See, e.g., Del. Code Ann. tit. 6, §18-302(d) (members may vote by proxy unless the operating agreement provides to the contrary); Unif. Ltd. Liab. Co. Act §404(e), 6B U.L.A. 592 (2008) (permitting both members and managers to act through a proxy); and Rev. Unif. Ltd. Liab. Co. Act. §407(d), 6B U.L.A. 484 (2008) (permitting a member to act through a proxy or other agent).

¹¹ *Haft v. Haft*, 671 A2d 413, 421 (Del. Ch. 1995) ("it is appropriate to acknowledge that the corporate law has tended to distrust and discourage the separation of the shareholder claim as equity investor (*i.e.*, the right to enjoy distributions on stock if, as, and when declared) from the right to vote stock.... A powerful argument can be advanced that generally the congruence of the right to vote and the residual rights of ownership will tend towards efficient wealth production.")

¹² *Id.* See also RESTATEMENT (THIRD) OF AGENCY §3.06(5) (agency may be terminated by principal); *id.* §3.10(1) (same).

¹³ See also *Haft v. Haft*, *supra* note 11 (discussing issues that arise in separating voting rights through a proxy from the economics of ownership).

¹⁴ See, e.g., Ky. Rev. Stat. Ann. §275.280(1)(c)2 (so long as there is at least one other member, a member who has transferred entire interest in LLC remains a member until dissociated by a vote of a majority-in-interest of the other members). See also Ind. Code §23-18-6-5(a)(3)(B) (a member who transfers entire interest in LLC dissociated upon the vote of a majority of the other members; no separate provision for single member LLC). A similar rule is employed in RUPA. See Rev. Unif. Part. Act §601(4)(ii), 6 (pt. 1) U.L.A. 163 (2001). This rule is in contrast to that employed in certain LLC acts pursuant to which a member is automatically dissociated upon a transfer of all or substantially all economic interests in the LLC. See, e.g., Del. Code Ann. tit. 6, §18-702(b)(3); Mont. Code §35-8-803.

¹⁵ See *supra* note 2; see also RESTATEMENT (THIRD) OF AGENCY §3.04(1).

¹⁶ See RESTATEMENT (THIRD) OF AGENCY §3.04(3).

¹⁷ See, e.g., William W. Cook, COOK ON STOCK AND STOCKHOLDERS AND CORPORATION LAW at §592 (2d ed. 1889) ("Directors, of course, cannot act or vote by proxy") (citation omit-

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ted); II Arthur W. Machen, Jr., A TREATISE ON THE MODERN LAW OF CORPORATIONS at §1455 (1908) (“Directors cannot vote by proxy.”) (citations omitted); and *id.* §1458 (“At a Directors’ meeting, votes by proxy cannot be received or counted, and the Directors have no power by resolution to alter this rule.”) (citations omitted).

¹⁸ See *Machen*, *supra* note 17 at §1252 (“At common law each member of a corporation could vote in person only, and could not give a proxy or power of attorney for that purpose.”); Charles B. Elliott, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS at §472 (3rd ed. 1900) (“At common law all votes must be given in person. There is no right to vote by proxy unless it is conferred by statute, charter or by-law.”) (citations omitted); II William W. Cook, A TREATISE ON THE LAW OF CORPORATIONS HAVING A CAPITAL STOCK at §610 (4th ed. 1898) (“At common law a stockholder has no right to cast his vote by proxy.”) (citation omitted); Victor Morawetz, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS OTHER THAN CHARITABLE at §360 (1882) (there

is no right of a shareholder to vote by proxy unless authorized by the by-laws); and James Grant, A PRACTICAL TREATISE ON THE LAW OF CORPORATIONS IN GENERAL AS WELL AGGREGATE AS SOLE at [*256] n. (q) (1854) (“In general the personal presence of the voter is necessary; and it seems that a corporation not authorized so to do by charter or statute, could not establish a mode of voting by proxy.”) (citation omitted); see also Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VANDERBILT L. REV. 129, 160 (2009).

¹⁹ But see 1 Carter G. Bishop and Daniel S. Kleinberger, LIMITED LIABILITY COMPANIES at ¶7.03[3][c].

²⁰ See *supra* note 6 and accompanying text.

²¹ See, e.g., Rev. Unif. Ltd. Liab. Co. Act §401(d)(3), 6B U.L.A. 478 (2008) (admission of new members to LLC require, as default rule, approval of all incumbent members); Ky. Rev. Stat. Ann. §275.275(1)(a) (same); Rev. Unif. Part. Act § 401(i), 6 (pt. 1) U.L.A. 133 (2001) (admission of a partner requires the approval of all partners); Ky. Rev. Stat. Ann. §362.1-401(9) (same).

²² See *supra* note 4.

²³ See also RESTATEMENT (THIRD) OF AGENCY §3.04, comment d (“A person that is not an individual, such as a sovereign state or a corporation, cannot act in the physical world except through the actions of individual persons.”)

²⁴ On the point of animals of a different nature, we do have judicial confirmation of the existence of the jackalope. See *Whitely v. Moravec*, CA-7, 635 F3d 308, (2011).

²⁵ Restatement (Third) of Agency §3.12 (2006).

²⁶ See *id.*, comment b.

²⁷ See *id.* Contrast *id.* § 1.01 (agency as a fiduciary relationship under which the agent acts on the principal’s behalf and subject to the principal’s control).

²⁸ See *supra* note 14.

²⁹ Need it even be stated that the agent cannot have greater rights vis-à-vis a third party than does the principal?

³⁰ See, *supra* notes 6-9 and accompanying text.



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