

# State Law & State Taxation Corner

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## It's Not Me, It's You: Planning for Expulsion of Members from LLCs

By Thomas E. Rutledge

It is lamented that half of all marriages end in divorce. To this lament there is the only partially tongue-in-cheek response that “yes, but the other half end in death.” Business relationships are no different—at some point, either the reality of the actuarial tables or a disagreement as to how to proceed forward will necessitate a restructuring of the relationship.

Nobody, at the inception of a venture, wants to plan for the break-down in the interpersonal relationship that is often at the core of the business plan. Perhaps not wanting to “jinx” the new venture, participants avoid discussing the possibility of one day needing to expel one of the owners. That planning is, however, crucial, and counsel needs to consider and draft for that potentiality.<sup>1</sup>

### The Statutory Backdrop

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Different organizational forms provide different rules for the capacity to expel a participant and the consequences of the expulsion. Beginning with the general partnership, a partnership agreement may provide for the expulsion of a partner.<sup>2</sup> Even where the agreement is silent as to expulsion, by a unanimous vote the partners may expel a partner if it is unlawful to carry on the partnership's business with that person as a partner.<sup>3</sup> Only in the narrowest of circumstances will this unlawful threshold be applicable. At the other end of the spectrum has been the business corporation wherein, absent private ordering such as a buy-sell agreement, there is no right to effect a shareholder's expulsion from the venture. An exception to this rule is the professional service corporation wherein, if a shareholder ceases to hold the professional certification required *ab initio* to be a shareholder, shareholder status may be terminated and the shares redeemed.<sup>4</sup>

LLC statutes are seldom any better in setting forth mechanisms by which a member can be expelled from the company. Acts that expressly permit an operating agreement to provide an expulsion mechanism<sup>5</sup> provide no direction when the agreement of a particular LLC fails to utilize the opportunity. While certain LLC acts do carry forward the right to expel a member when it is otherwise



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illegal to continue forward with them as a member,<sup>6</sup> this language only continues a rule of narrow (and therefore rare) application.

Some acts provide for judicial expulsion. The Revised Prototype LLC Act provides:

- (a) on application by the limited liability company, the person is expelled as a member by judicial order because the person:
- (1) has engaged, or is engaging, in wrongful conduct that has adversely and materially affected, or will adversely and materially affect, the limited liability company's activities;
  - (2) has willfully or persistently committed, or is willfully and persistently committing, a material breach of the limited liability company agreement or the person's duty or obligation under this Act or another applicable law; or
  - (3) has engaged, or is engaging, in conduct relating to the limited liability company's activities that makes it not reasonably practicable to carry on the activities with the person as a member.<sup>7</sup>

Similar language appears in the Revised Uniform LLC Act.<sup>8</sup> Neither the Revised Prototype nor the Revised Uniform LLC Act limits the ability for an operating agreement to restrict these provisions.<sup>9</sup> While each provision is helpful in that both a capacity to effect and a standard for judicial expulsion are detailed, each requires judicial intervention, typically a process that is both slow and expensive. What is not clear is whether the operating agreement may expand the basis of judicial expulsion.

While other acts offer atypical formulae for when expulsion may be effected,<sup>10</sup> they are far from comprehensive. Absent a provision of either the controlling act or the applicable operating agreement creating a right of expulsion, that option will not be available.<sup>11</sup>

## Where You Stand Depends on Where You Sit

In considering expulsion provisions, attention must be paid to the particular circumstances of the client. While uncertainty as to whether a particular member will be the one expelled versus one who remains with the company may balance the competing pressures for a high-versus-low threshold for expulsion and high-versus-low payout upon expulsion, that is not the only dynamic at issue. There are as well questions involving: (a) the basis for expulsion; (b) the threshold to trigger expulsion; (c) the forum for effecting an expulsion; (d) the effect of expulsion; and (e) the question of judicial review (or arbitration) of the validity of the basis for expulsion.

## The Basis for Expulsion

Provisions addressing the expulsion of a member need to be customized to the particular venture. A classic example is a professional practice; even when state law does not limit membership to those holding the professional license required for the firm,<sup>12</sup> the LLC will need to have the right to expel the member who loses the license to practice law, medicine, architecture, *etc.*<sup>13</sup> Another circumstance in which a right of expulsion needs to be written into the operating agreement is an LLC that holds a liquor license. Focusing upon the wholesale/distribution and the retail sales levels, often state law will not allow a license to be held by a person with a felony conviction or with misdemeanor convictions involving alcohol; where the license is held by an entity, these limitations are applied as well at the owner's level.<sup>14</sup> An LLC in the entertainment industry will want to protect itself from loss of those licenses by defining violation of applicable liquor regulation law as a basis for expulsion. Similar limitations are appropriate in any industry in which licensing is dependent in whole or in part upon the character of the entities' owners and other constituents.

That said, this is not a point that may be ignored in ventures that are not subject to licensing limitations based upon constituent identities. Generic bad conduct such as vexatious lawsuits against the venture and the other owners may justify expulsion, as might the failure to keep confidential company information. If it is anticipated that a member will provide ongoing services for the LLC (*e.g.*, advertising, restaurant manager), failure to perform may justify expulsion. Another possibility is ongoing disagreement as to the management of the venture.<sup>15</sup> Each operating agreement is unique, and the basis for expulsion set forth in each needs to be customized to the venture at hand.

Special attention needs to be paid to LLCs, which themselves have entity owners. If an owner holds its interest through an SMLLC, to provide but one example, that SMLLC will never have a DUI conviction or lose its license to practice architecture. The basis for expulsion needs to apply not only to the member *qua* member but also to the member's constituents.

## The Threshold for Expulsion

What should be the mechanism by which a member may be expelled? In most instances this will be a vote of the members, although it is not inconceivable that it could be a determination of a manager.<sup>16</sup> Should this be a vote of a mere majority of the members, a super-majority or a unanimous vote of the members? It is assumed that this is a disinterested vote from which the vote of the member

whose removal is under consideration is excluded.<sup>17</sup> In defining the threshold, attention needs to be paid to carefully defining “disinterested.” If both a husband and wife are independently members of the LLC, may one vote on the other’s expulsion? What about parents and children? Keep in mind that “A foolish consistency is the hobgoblin of small minds.”<sup>18</sup> In the family business, it may be appropriate for the parents to vote on a child’s expulsion even though a child may not vote to expel a parent.

## The Forum for Expulsion

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How may an expulsion be effected? Must there be a meeting of the members at which the member whose expulsion is under consideration be afforded an opportunity to respond to the charges made against them? Alternatively, may the necessary threshold of the other members simply act by written consent?<sup>19</sup> While the first option may be seen as affording “due process” rights,<sup>20</sup> it increases transaction costs. The second option may *ex post* be seen as underhanded unless it is clear that proceeding in this manner is sanctioned by the operating agreement.

## The Effect of Expulsion

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What does it mean that a member has been expelled? There are a variety of possibilities. The expelled member may become an assignee of his own LLC interest,<sup>21</sup> in which interest he only has the rights of an assignee and continues to participate in the economic fruits of the venture.<sup>22</sup> Alternatively, it could be provided that upon expulsion the expelled member shall cease to have any ongoing connection with the LLC and will be bought out at a price based on an appraisal or a valuation procedure detailed in the operating agreement.<sup>23</sup> Acknowledging the many disputes that arise in valuation,<sup>24</sup> a buy-out serves to terminate the now expelled member’s rights as an assignee.<sup>25</sup> Conversely, where the agreement is clear as to both the right to effect an expulsion and the amount to be paid the expelled member, even in the face of challenges based on either good faith and fair dealing or intrinsic fairness, the contract should be enforced as written.<sup>26</sup> As middle grounds there is translation of the member into an assignee with either or both of put or call rights exercisable by the company or the former member.

## Judicial Review of the Basis of Expulsion

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Whether or not the basis for expulsion is subject to review is itself a fertile grounds for disagreement. Consider an

operating agreement that permits a member to be expelled “by a Majority of the other Members upon a determination that the Member has violated his fiduciary duty to the Company.” Should the determination by the required threshold of the members (a) of what are the fiduciary duties of a member and (b) that particular conduct violated that fiduciary duty be (i) binding or (ii) subject to judicial review on the basis that (1) there was no applicable fiduciary duty or (2) the complained of conduct did not violate the duty? It is not hard to imagine situations in which the members may incorrectly characterize certain obligations as fiduciary when in fact they are not. It is not hard to imagine that the member *qua* member may not be subject to fiduciary duties<sup>27</sup> but could be found to have “violated” them, thereby justifying expulsion.

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In a similar vein, the members may misinterpret the legal effect of certain terms, relying upon them to justify expulsion when in fact they do not. For example, in *Harker v. Guyther*,<sup>28</sup> there was a falling out between the two members of an LLC. The operating agreement in question allowed for the expulsion of a member upon the “substantial misappropriation” of company assets of more than \$1,000, and one member sought to expel the other on that basis. The Court held that summary judgment was not appropriate in that “misappropriation” required an element of wrongful intent; there was a colorable basis for the amounts taken as arguably they were appropriate in order to equalize distributions between the members.<sup>29</sup> In that “misappropriation” was not defined in the agreement, the generally accepted definition was determined by reference to various dictionaries. This reference introduced an element of subjective intent that may not have been intended by the drafter; had misappropriation been defined, that ambiguity could have been avoided.<sup>30</sup>

## My Planning Opportunity Is Your Abuse

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Assume an LLC in which one member is a “bad actor.” The LLC holds a liquor license under a state law that

provides for forfeiture of the license if any owner has two driving under the influence (DUI) convictions. Our bad actor has just received his second DUI. That same member may credibly be charged with having violated obligations he undertook in the operating agreement. However, that operating agreement is silent as to expulsion of a member. The only positive is that the operating agreement may be amended by a super-majority of the members. Is it possible for that super-majority to (i) amend the operating agreement to provide for expulsion on the basis of DUI convictions and violations of obligations undertaken in the operating agreement and then (ii) apply those new provisions to expel the bad actor member based upon pre-amendment conduct?

*Trusting that the statute fully and comprehensively protects the rights of the participants in each venture organized thereunder is unjustified.*

The expelled member will claim that even if the amendment to the operating agreement is valid, its application to *ex post* conduct constitutes the equivalent of an attainder, and that should not be allowed.<sup>31</sup> Further, he or she may claim that the amendment combined with the objective of applying it *vis-is* pre-amendment

conduct is a violation of the obligation of good faith and fair dealing. In contrast, it will first be observed that the limitations upon bills of attainder<sup>32</sup> limits the government, and no government action is here implicated. Second, just as a two-step process to create a mechanism for a merger and then the execution of that merger is effective, so is the process for putting in place and then utilizing an expulsion procedure.<sup>33</sup> Third, it is not a violation of good faith and fair dealing to amend the agreement in accordance with the rules governing amendment; each member has *ab initio* agreed to be bound by the agreement as amended.<sup>34</sup> Still, at least absent an evidentiary hearing, a court may be reluctant to endorse that approach.<sup>35</sup>

## And That Is Another Reason the Operating Agreement Needs to Be Clear

Trusting that the statute fully and comprehensively protects the rights of the participants in each venture organized thereunder is unjustified. The need to protect a venture's ongoing activities by expelling a participant therefrom is a simple case in point—the need for the capability is clear as the statutes are typically not up to the task. For that reason, the operating/partnership agreement needs to provide whatever capacity is appropriate for that particular venture.

### ENDNOTES

<sup>1</sup> See, e.g., *Page v. ADS Investments, LLC*, C.A. No. NM-2006-0334 (R.I. Superior Ct. Aug. 5, 2014) ("An LLC's ability to remove its members has been called a 'key management power,' and is often provided for in State statutes."), citing 1 THOMPSON, CLOSE CORP AND LLCs: LAW AND PRACTICE §5:13 (Rev. 3d ed.).

<sup>2</sup> See Act Sec. 601(2), (3) of the REV. UNIF. PART. ACT of 2001, 6 (pt. I) U.L.A. 163 ("A partner is dissociated from a partnership upon ... (2) an event agreed to in the partnership agreements as causing the partner's dissociation; (3) the partner's expulsion pursuant to the partnership agreement."). *Accord* Act Sec. 31(1)(d) of the UNIF. PART. ACT of 2001, 6 (pt. II) U.L.A. 370. See also Act Sec. 601(b)(2)(3) of the UNIF. LTD. PART. ACT of 2008, 6A U.L.A. 450.

<sup>3</sup> Act Sec. 601(4)(i) of the REV. UNIF. PART. ACT of 2001, 6 U.L.A. (pt. I) 163 ("A partner is dissociated from a partnership upon...the unanimous vote of the other partners if it is unlawful to carry on the partnership business with that partner.") See also Act Sec. 602(4)(A) of the REV. UNIF. LTD. PART. ACT of 2008, 6A U.L.A. 453.

<sup>4</sup> See, e.g., KY. REV. STAT. ANN. §274.095; IND. CODE §23-1.5-3-3(a).

<sup>5</sup> See, e.g., Act Sec. 602(3) of the REV. UNIF. LTD. LIAB. CO. ACT of 2008, 6B U.L.A. 502 (a member is dissociated from the LLC when "the person is expelled as a member pursuant to the operating agreement."); KY. REV. STAT. ANN. §275.280(1)(c)1 (member is removed "in accordance with a written operating agreement"); IND. CODE §23-18-6-5(a)(3)(A); Act Sec. 602(c) of the REV. PROTOTYPE LLC ACT of 2011, 67 BUS. LAW. 117, at 169.

<sup>6</sup> See, e.g., Act Sec. 602(d)(1) of the REV. PROTOTYPE LLC ACT, 67 BUS. LAW. 169; Act Sec. 602(4)(a) of the REV. UNIF. LTD. LIAB. CO. ACT of 2008, 6B U.L.A. 502.

<sup>7</sup> ACT SEC. 602(e) of the REV. PROTOTYPE LLC ACT, 67 BUS. LAW. 170.

<sup>8</sup> See Act Sec. 602(5) of the REV. UNIF. LTD. LIAB. CO. ACT of 2008, 6B U.L.A. 502. *Accord* Act Sec. 603(5) of the UNIF. LTD. PART. ACT of 2008, 6A U.L.A. 453.

<sup>9</sup> See Act Sec. 110(c) of the REV. PROTOTYPE LLC ACT, 67 BUS. LAW. at 136; Act Sec. 110(c) of the REV. UNIF. LTD. LIAB. CO. ACT of 2008, 6B U.L.A. 442.

<sup>10</sup> See, e.g., N.C. GEN. STAT. 57D-3-2 (providing for expulsion of a member "Abandoning all of the rights of his ownership interest except his

economic interest, or any portion thereof.").

<sup>11</sup> In the absence of either a statutory or contractual right to expel a member, there is no right to do so. See, e.g., *Page v. ADS Investments, LLC*, C.A. No. NM-2006-0334 (R.I. Superior Ct. Aug. 5, 2014) ("absent a provision in an operating agreement allowing for the involuntary removal of members, the parties seeking removal are left to the default rules [of the LLC Act]."); *Man Choi Chiu v. Chiu*, 896 NYS2d 131, 132 (Sup. Ct. App. Div. 2 2010) (provision of LLC Act addressing expulsion of a member only indicated that operating agreement could provide for expulsion; absent having done so there is no right to expel a member); *Brazil v. Rickerson*, DC-MO, 268 FSupp2d 1091, 1099 (2003).

<sup>12</sup> See generally Thomas E. Rutledge, *The Place (If Any) of the Special Purpose Professional Structure in Entity Rationalization*, 58 BUS. LAW. 1413 (Aug. 2003).

<sup>13</sup> See, e.g., MARYLAND CORP. & ASS'N CODE §5-101(g)(2).

<sup>14</sup> See, e.g., KY. REV. STAT. ANN. §243.100.

<sup>15</sup> See, e.g., *Martindale v. Hartman Harlow Bass Robinson and McDaniel PLLC*, 119 So3d 338 (Miss. Ct. App. 2012) (member of law firm

who repeatedly disagreed with allocation of resources to a particular contingency fee case expelled in accordance with operating agreement); *Young v. Ellis*, 172 Wash. App. 1014 (Wash. Ct. App. Div. 2 Dec. 7, 2012) (expulsion justified in dispute as to best business model).

<sup>16</sup> For example, in a large LLC with a professional manager and members who are subject to periodic capital calls, a manager could be empowered to expel a member after failing to perform on one or more calls.

<sup>17</sup> If a disinterested vote is not required, a majority member cannot be removed. *Young v. Ellis*, 172 Wash. App. 1014 (describing as “absurd” suggestion that an amendment of operating agreement required unanimous vote of the members, a member could be expelled only with their consent).

<sup>18</sup> RALPH WALDO EMERSON, SELF-RELIANCE.

<sup>19</sup> See, e.g., *Overhoff v. Scarp, Inc.*, 812 NYS2d 809 (N.Y. Sup. Ct. 2005) (where state allows members of LLC to act by majority written consent, requirement of attendance of all members at a meeting of the members in order to constitute a quorum is inapplicable); DEL. CODE ANN. tit. 6, §18-302(d); Act Sec. 406(d) of REV. PROTOTYPE LLC ACT, 67 BUS. LAW. 159.

<sup>20</sup> See also MBCA §808(d) (notice of special meeting of the shareholders for removal of a director required to set that forth as the purpose of the meeting); KY. REV. STAT. ANN. §271B.8-080(4) (same).

<sup>21</sup> This is the treatment of members under certain LLC Acts upon voluntary resignation from the company. See, e.g., Act Sec. 603(a)(3) REV. UNIF. LTD. LIAB. CO. ACT, 6B U.L.A. 504 (2008); KY. REV. STAT. ANN. §275.280(1)(c)2; see also Thomas E. Rutledge, *You Just Resigned—Now What? Different Paradigms for Withdrawing From a Venture*, J. PASSTHROUGH ENTITIES, Nov.–Dec. 2009, at 43.

<sup>22</sup> See, e.g., KY. REV. STAT. ANN. §275.280(5); Act Sec. 603(a) of REV. PROTOTYPE LLC ACT, 67 BUS.

Law. 171; *All Saints University of Medicine Aruba v. Chilana*, No. A-2628-09T1, slip op. at 33 (N.J. Super. Ct. Ch. Div. Dec. 24, 2012) (a dissociated member of an LLC “is enjoined from participating in the management of the LLC” but “retains [his] economic rights” since dissociation does not “automatically constitute[ ] a loss of economic rights in addition to a loss of managerial rights.”).

<sup>23</sup> Care needs to be taken in defining post-expulsion obligations. If a member is subject, for example, to an obligation to maintain in confidence company information, likely it is not intended that after expulsion the now former member is to be released from that obligation.

<sup>24</sup> See, e.g., *Shawnee Telecom Res., Inc., v. Brown*, 354 SW3d 542 (Ky. 2011) (distinction between fair value and fair market value).

<sup>25</sup> See, e.g., CALIF. CODE §17704.10 (transferee has right to inspect books and records).

<sup>26</sup> See, e.g., *Martindale*, *supra* note 15. Note that careful attention to the factual predicates for expulsion is necessary. See, e.g., *Alloush v. Physicians Cardiovascular Venture, Inc.*, No. 2011-T-0112 (Ohio Ct. App. 11th Dist. June 10, 2013).

<sup>27</sup> See, e.g., KY. REV. STAT. ANN. §275.170(4).

<sup>28</sup> *Harker v. Guyther*, 995 NYS2d 637, 2014 NY Slip Op 07403 (3rd Dept. Oct. 30, 2014).

<sup>29</sup> Peter Mahler, in his blog NEW YORK BUSINESS DIVORCE, has reviewed this decision, which review is available online at [www.nybusinessdivorce.com/2014/11/articles/uncategorized/court-construes-membership-termination-provision-in-llcs-operating-agreement/](http://www.nybusinessdivorce.com/2014/11/articles/uncategorized/court-construes-membership-termination-provision-in-llcs-operating-agreement/).

<sup>30</sup> See also *Brazil v. Rickerson*, 268 FSupp2d 1091, 1097–1098 (W.D. Mo. 2003) (where operating agreement provided for expulsion of a member by vote of majority of other owners based on misconduct “to such an extent as to render it impracticable for the then members to carry on the Company business together,” summary

judgment as to whether that standard had been met was denied).

<sup>31</sup> Wisc. CONST. Article I, §12 (“No bill of attainder, ex post facto law, nor any law impairing the obligation of contracts, shall ever be passed, and no conviction shall work corruption of blood or forfeiture of estate.”).

<sup>32</sup> See, e.g., *Arciero v. Hager*, 397 SW2d 50 (Ky. 1965) (the Kentucky constitutional provision as to attainder applied only to criminal penalties).

<sup>33</sup> See, e.g., *Twin Bridges Limited Partnership v. Draper*, C.A. No. 2351-VCP, 2007 Del. Ch. LEXIS 136 (Sept. 14, 2007) (dismissing that amendment of limited partnership agreement to permit partnership’s merger and subsequent merger of limited partnership into new partnership were invalid).

<sup>34</sup> See, e.g., *Kentucky Home Mutual Life Ins. Co. v. Leitner*, 196 SW2d 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 FSupp 424 (W.D. Ky. 1945); *Fox v. I-10 Partners*, 957 P2d 1018 (Colo. 1998) (limited partner bound by additional capital contribution added by majority approved amendment of partnership agreement).

<sup>35</sup> See, e.g., *Demam Data Systems, LLC v. Schessel*, Case No. 8:12-cv-2580-T-24 EAJ (M.D. Fla. Feb. 3, 2014) (denying motion to dismiss challenge to amendment of operating agreement by majority members pursuant to which minority member was later expelled and providing for reduction in liquidating distribution in the event expulsion was for cause to 50 percent of book value; statute provided default of fair value liquidating distribution).

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