THOMAS E. RUTLEDGE, Stoll Keenon Ogden PLLC, Louisville, Kentucky

State Law & State Taxation Corner

VanWinkle v. Walker*: Did the Members Intend to Waive Limited Liability?*

By Thomas E. Rutledge*

In *VanWinkle v. Walker*, a decision rendered last August, the Kentucky Court of Appeals affirmed a determination that, consequent to the wording of a particular operating agreement, the members in the LLC assumed and were personally liable to satisfy the LLC's debts and obligations. Whether that was the members' intent is open to reasoned dispute.

The Operating Agreement and the Decision

VanWinkle, Walker and Crawford formed TLC Developers, LLC in 2004, executing an operating agreement in connection therewith. That operating agreement provided in part:

> The profits and liabilities of the Company shall be divided as follows: Carl David Crawford = thirty-three and one third (33 1/3%), Lyle A. Walker = thirty-three and one third (33 1/3%) percent and Troy Van Winkle [sic] thirty-three and one third (33 1/3%).[1]

When the company fell upon hard times, Walker and Crawford contributed additional amounts in order that the company could meet its business expenses. As recited by the court, "in their view, in the event TLC did not have the cash on hand to pay the liabilities itself, the operating agreement mandated that the three members would pay the liabilities of TLC equally."[2] VanWinkle did not make those contributions, apparently of the belief that the operating agreement did not require him to do so.[3] He did, however, on two occasions contribute one-third of the amount necessary to satisfy TLC's property taxes.[4]

Ultimately, Walker and Crawford filed a complaint seeking a declaration of rights with respect to the obligation to satisfy TLC's liabilities and the interpretation of the operating agreement. After a bench trial, the circuit court held that "the operating agreement unambiguously stated that the three members agreed to split the liabilities of the company in thirds," and ultimately ordered VanWinkle to pay $87,300 as his share of those liabilities.[5] This appeal followed.

VanWinkle had essentially two arguments. First, the operating agreement, and the LLC Act, protected him from liability for the LLC's debts and obligations.

TABLE 1.

Division of Profits and Liabilities Provision	KRS §275.205
The profits and **liabilities** of the Company shall be **divided** as follows: Carl David Crawford = thirty-three and one third (33 1/3%), Lyle A. Walker = thirty-three and one third (33 1/3%) percent and Troy Van Winkle [sic] thirty-three and one third (33 1/3%).	Profits and **losses** of a limited liability company shall be **allocated** among the members and among classes of members in the manner provided in the operating agreement. If a written operating agreement does not otherwise provide, profits and losses shall be allocated on the basis of the agreed value, as stated in the records of the limited liability company as required by KRS 275.185, of the contributions made by each member to the extent they have been received by the limited liability company and have not been returned.[1]

[1] Essentially the same language is employed in the Delaware LLC Act. *See* DEL. CODE ANN. tit. 6, §18-503.

Second, he would argue that personal liability for the LLC's debts and obligations is antithetical to the very notion of an LLC and for that reason could not be enforced. Both arguments would fail.

While the operating agreement recited that the members enjoyed limited liability from the debts and obligations of the LLC, essentially repeating the language of KRS §275.150(1),[6] the court went on to note, however, that while not recited in the operating agreement, the LLC Act continues with KRS §275.150(2), which provides:

> Notwithstanding the provisions of subsection (1) of this section, under a written operating agreement or under another written agreement, a member or manager may agree to be obligated personally for any of the debts, obligations, and liabilities of the limited liability company.[7]

Applying this language, the court found that "that is exactly what TLC's members did when they agreed to split the liabilities of the company in the 'Division of Profits and Liabilities' provision." of the operating agreement.[8]

As for the argument that imposition of liability for company obligations is antithetical to the very notion of an LLC, the court noted as well KRS §275.003(1), it providing that it is the public policy of Kentucky to give maximum effect to principles of freedom of contract and the enforcement of operating agreements.[9] As to this point, the court wrote:

> While holding the members personally liable for the TLC's liabilities may seem contrary to the very point of establishing an LLC, it adheres to the intent of the General Assembly: namely, to allow business partners the freedom to contract and establish an LLC that fits the needs of the respective members. Here, following a meeting of the minds, TLC's three members each decided to split the liabilities of the company in equal shares.

Not referenced by the Court of Appeals was a provision of the operating agreement affording the members a right of first refusal ("ROFR") upon a member's desire to effect a sale of his interest therein.[10] It provided that if the ROFR was exercised "The remaining Member's shall then assume all remaining debt owed by the Company." It is curious that this provision was not addressed by the Court of Appeals in that it buttresses the conclusion that the members agreed to accept personal liability for the LLC's debts and obligations. Still, there would need to be resolved whether "liabilities" and "debt" are intended to be synonymous.

Additional Analysis

It is entirely possible that the attorney who drafted the TLC Developers operating agreement, in drafting the Division of Profits and Liabilities provision, thought that he or she was doing nothing more than repeating KRS §275.205[11] as applied to the facts of this particular LLC. A comparison of the two provisions (emphasis added) demonstrates how small changes in the wording utilized in the operating agreement thwarted that (assumed) intent (*see* Table 1).

Why, when "profits" was carried over to the operating agreement, was "losses" dropped and "liabilities" substituted? The words are not synonymous, and the LLC Act does not address the allocation of "liabilities." The briefs filed with the Court of Appeals offer no explanation as to why the substitution was made. Neither do they offer a justification for treating the terms as synonymous. As I have elsewhere observed as to paraphrasing, there as to repeating the rule of member limited liability:

> Some operating agreements recite that the members, and possibly others, enjoy limited liability from the LLC's debts and obligations. It is questionable whether a provision of this nature is a good practice. If the entirety of the statutory provision (KRS §275.150(1)) is recited, then nothing new is known. If in contrast the provision is paraphrased, distinctions

> between the statutory language and the paraphrase could be argued to be a waiver of the statutory provision and an acceptance of liability for certain creditor's claims (surprisingly including those of the plaintiff). The operating agreement cannot grant limited liability broader than is provided for by statute.[12]

The same admonition applies here. If the attorney was seeking to simply paraphrase KRS §275.205, why the alterations in the language of the statute as employed in the operating agreement? The change in wording is what opened the members to personal responsibility for LLC obligations.

That said, while member limited liability may be waived,[13] in this instance the operating agreement, almost verbatim, repeated the language of the statutory grant of limited liability.[14] The court did not address the conflict between contractually reciting the rule of limited liability while, via the Division of Profit and Liabilities provision, waiving that limited liability.

In the course of this decision, the Court of Appeals discussed and distinguished the holding in *Racing Investment Fund 2000 v. Clay Ward Agency*,[15] wherein the Kentucky Supreme Court held that an additional capital contribution obligation set forth in the LLC's operating agreement could not be enforced so as to raise funds to satisfy the claims of a third-party creditor, the Clay Ward Agency. Rather, it was held that the provision of that operating agreement for additional capital contributions was "designed to provide on-going capital infusion as necessary, at the Manager's discretion."[16] That provision read:

> The Investor Members … shall be obligated to contribute to the capital of the Company, on a *prorata* basis in accordance with their respective Capital Interests, such amounts as may be reasonably deemed advisable by the Manager from time to time in order to pay operating, administrative, or the business expenses of the Company which have been incurred, or which the Manager reasonably anticipates will be incurred, by the Company.[17]

The *VanWinkle* court would characterize the distinction as:

> Using this provision, a creditor of the LLC at issue successfully convinced the circuit court to order the members to make additional Contributions to satisfy the LLC's debt.
>
> Put another way, the creditor used that provision to render the members of the LLC personally liable for the LLC's debts. The Kentucky Supreme Court eventually reversed this order and stated the provision at issue "is not a post-judgment collection device by which any legitimate business debts of the LLC can be transferred to individual members by a court-ordered capital call."[18] In so holding, the Court stated the above capital call provision did not beat the unequivocal language standard for the LLC's members to assume personal liability.
>
> On the other hand, the language in TLC's operating agreement is indeed unequivocal, especially when compared to the provision at issue in *Racing Fund*. In *Racing Fund* the provision referenced capital calls, which were to be ordered by the manager. This was hardly unequivocal language of liability assumption. In the case at bar, the provision mandates that the "liabilities of the Company shall be divided" evenly between the three members. This was unambiguously stated on page 4 of the operating agreement, which VanWinkle signed, and leaves no doubt that it was the members' intent to be personally liable for the debts of TLC.[19]

But was it? Certainly the drafter opened the door to that conclusion by utilizing "liabilities" rather than "losses" in the Division of Profit and Liabilities provision. Noting was gained by repeating that language if all that was intended was to repeat the rule of KRS §275.205. But the Court of Appeals ignored the repetition in the operating agreement of the rule of limited liability,[20] and in so doing did not give effect to each provision of the agreement. Further, the very purpose of forming an LLC is to gain for the participants the benefit of limited liability.[21] Under Kentucky law, "the entire context of the agreement" must be taken into account in determining the party's intent.[22]

Also noteworthy is that the operating agreement[23] did not address the mechanism for determining the amount of additional capital required, the timeline for contribution, and the remedies available[24] in the event of default.[25] The presence of provisions of this nature would manifest a clear intent to expose the members to additional capital contribution obligations. While the absence of provisions of this nature is not necessarily fatal to such a determination, that absence does raise the question of whether there was a fully-formed agreement to bear personal responsibility for company liabilities.

Ultimately, it is hard to see how there was an "unequivocal" waiver of limited liability in an agreement that went to the trouble of repeating the language of the statutory

grant of limited liability. The Court of Appeals was able to read past that language. Whether another court will be willing to do the same will be known only with the passage of time.

Subject to certain important limitations,[26] LLCs are substantially creatures of contract pursuant to which, by a private agreement, nearly all of the inter-se rules set forth in the LLC act may be modified or even eliminated.[27] Kentucky generally applies a statute of frauds to these departures from the default rules, requiring that they be in the articles of organization or in a written operating agreement. A broader consideration of what is necessary in order to affect the language "except as otherwise provided in the operating agreement" will have to await another day. In the meantime, the *VanWinkle* decision here reviewed highlights how easy it may be to waive the rule of limited liability otherwise enjoyed by an LLC's members and other constituents.

ENDNOTES

* Thomas E. Rutledge is a member of Stoll Keenon Ogden PLLC resident in the Louisville office. A frequent speaker and writer on business organization law, he has published in journals including The Business Lawyer, the Delaware Journal of Corporate Law, the American Business Law Journal and the Journal of Taxation, and is an elected member of the American Law Institute. He blogs at *Kentuckybusinessentitylaw.blogspot.com*.

1 2018 WL 443388, *2. The Court of Appeals would refer to this provision as the "Division of Profit and Liabilities provisions."

2 2018 WL 443388, *1.

3 The opinion did not address how these payments by VanWinkle had been treated, possibilities including both a contribution to capital or a loan. According to the Appellee's Brief, when advised that additional capital was needed "VanWinkle refused to pay, indicating that he did not have the money available to contribute." *See* Brief for Appellee dated February 9, 2017 at 1. Obviously this is different than an assertion of no liability.

4 *Id*. The opinion did not address how these payments by Van Winkle had been treated, possibilities including a contribution to capital or a loan. Appellee's Brief to the Court of Appeals asserted that VanWinkle also made contributions for paying insurance premiums. *See* Brief for Appellees dated February 9, 2017 at 1; *see also id*. at 2.

5 Not addressed in the opinion or in the briefs filed with the Court of Appeals was whether the members, inter-se, could bring an action to enforce the capital contribution obligation versus a requirement that the claim be brought as a derivative action. *See also infra* note 25.

6 The Kentucky LLC Act, at KRS §275.150(1), recites the rule that members, as well as managers, employees and agents, of an LLC are not liable for the LLC's debts and obligations. It provides:

> (1) Except as provided in subsection (2) of this section or as otherwise specifically set forth in other sections in this chapter, no member, manager, employee, or agent of a limited liability company, including a professional limited liability company, shall be personally liable by reason of being a member, manager, employee, or agent of the limited liability company, under a judgment, decree, or order of a court, agency, or tribunal of any type, or in any other manner, in this or any other state, or on any other basis, for a debt, obligation, or liability of the limited liability company, whether arising in contract, tort, or otherwise. The status of a person as a member, manager, employee, or agent of a limited liability company, including a professional limited liability company, shall not subject the person to personal liability for the acts or omissions, including any negligence, wrongful act, or actionable misconduct, of any other member, manager, agent, or employee of the limited liability company. That a limited liability company has a single member or a single manager is not a basis for setting aside the rule otherwise recited in this subsection.

7 Subsection (2) of KRS §275.150 did not appear in the original (1994) Kentucky LLC Act. Rather, it was added in 1998. *See* 1998 Ky Acts, Ch. 341, §26. As this adoption post-dated the effective date of the Check-the-Box entity classification regulations, this addition was not created to facilitate classification of a particular LLC as a partnership under the previously applicable Kintner classification regulations. Rather, the intent of this provision was to expressly allow the members to, ab initio, with respect to some or all company obligations, waive the otherwise applicable limited liability. Such an advance waiver is advantageous in certain commercial transactions as the member, qua member, becomes a party to, and liable for the performance on, a particular agreement, a status different from that of a guarantor. It may as well be applied with respect to those provisions of the Internal Revenue Code, an example being Code Sec. 469, which draw distinctions as to whether or not a limited liability shield exists.

8 2018 WL 443388, *2.

9 KRS §275.003(1) provides:

> (1) It shall be the policy of the General Assembly through this chapter to give maximum effect to the principles of freedom of contract and the enforceability of operating agreements. Unless displaced by particular provisions of this chapter, the principles of law and equity shall supplement this chapter. Although this chapter is in derogation of common law, the rules of construction that require strict construction of statutes which are in derogation of common law shall not apply to its provisions. This chapter shall not be construed to impair the obligations of any contract existing when this chapter, or any amendment of it, becomes effective, nor to affect any action or proceeding begun or right accrued before the chapter or amendment takes effect.

10 *See* Brief of Appellees dated February 9, 2017, 10.

11 KRS §275.205, unlike most of the provisions of Kentucky's original (1994) LLC Act, was not based upon the Prototype Limited Liability Company Act (1992). Rather, it was largely based upon the Revised Uniform Limited Partnership Act (1985) §503. However, in that adoption, the RULPA default rule of distributions in proportion to capital contributions was changed in the LLC Act to be on a per capita basis. *See also* Thomas E. Rutledge and Lady E. Booth, *The Limited Liability Company Act: Understanding Kentucky's New Organizational Option*, 83 Ky. L. J. 1, 26 (1994–95). A change from per capita to per capital contributions was made in 1998.

12 Mark A. Sargent and Walter D. Schwidetzky, Limited Liability Company Handbook (2017–2018 ed.) at App. Ky-7-18, note 59.

13 *See* KRS §275.150(2).

14 *See* 2018 WL 4043388, *2. The departure in the operating agreement from the statute is that "manager" was not carried over. As TLC was a member-managed LLC and lacked a manager, that differential is understandable.

15 320 S.W.3d 654 (Ky. 2010). As a point of disclosure, the author's firm was counsel to The Clay Ward Agency in that dispute.

[16] 2018 WL 4043388, *3, quoting 320 S.W.3d at 659.

[17] *Id*., quoting 320 S.W.3d at 658.

[18] Not argued in that case was that as Racing Investment Fund 2000 was insolvent (*i.e*., its liabilities exceeded the value of its assets), the manager's fiduciary duty shifted to protecting the interests of the unsecured creditors, a class including the Clay Ward Agency. Any argument of this nature would have been based upon reference to foreign law (*see*, *e.g*., including *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp*., 1991 WL 277613 (Del. Ch. Dec. 30, 1991) as subsequently limited by *North American Catholic Educational Programming Foundation v. Gheewalla*, 930 A.2d 92 (Del. 2007). *See also Quadrant Structural Products Co. v. Vertin*, 102 A.3d 155, 176 (Del. Ch. 2014)) as Kentucky law has not to date addressed the shifting of fiduciary duties in an LLC to the creditors upon insolvency.

[19] 2018 WL 4043388, *3 (citations to *Racing Investment Fund* deleted).

[20] *See supra* note 7.

[21] *See* 2018 WL 443388, *3, quoting *Racing Investment Fund*, 320 S.W.3d at 659 ("[a]ny such assumption of personal liability, which is contrary to the very business advantage reflected in the name 'limited liability company', must be stated clearly in *unequivocal language* which leaves no room for doubt about the parties' intent.").

[22] *See*, *e.g*., *Veech v. Deposit Bank of Shelbyville*, 128 S.W.2d 907, 911 (Ky. 1939). *See also Mitchell v. S. Ry. Co*., 74 S.W. 216 at 217 (Ky. 1903) ("It is not proper, in construing a contract, for a court to seize upon some expression in it, and allow that to control, in disregard of other provisions of it."); *City of Louisa v. Newland*, 705 S.W.2d 916 at 919 (Ky. 1986) ("Any contract or agreement must be construed as a whole, giving effect to all parts and every word in it if possible.")

[23] The entirety of TLC's operating agreement was reproduced in the appendix to the Appellant's (VanWinkle's) brief filed with the Court of Appeals.

[24] *See also* KRS §275.003(2).

[25] *See also* Bradley T. Borden and Thomas E. Rutledge, *Interest Dilution and Damages as Contribution-Default Remedies in Failing LLCs and Partnerships*, Business Law Today (Nov. 27, 2018).

[26] *See* Mohsen Manesh, *Creatures of Contract: A Half-Truth about LLCs*, 42 Del. J. Corp. L. 391 (2018).

[27] *See*, *e.g*., KRS §275.003(1); Del. Code Ann. tit. 6, §1101(b).