

State Law & State Taxation Corner

By Thomas E. Rutledge

You Just Resigned—Now What? Different Paradigms for Withdrawing From a Venture

"You can check out any time you like, but you can never leave."¹

Different forms of business organization afford the participants therein different degrees of opportunity to withdraw from the venture, differentiations that vary as well between state statutes governing similar forms of organizations. Understanding those differences is crucial to avoiding gaps in agreement and surprises as to rights and obligations.

Resignation Through the Fiduciary Lens

Directors and officers of a corporation are fiduciaries to the corporation.² Absent truly extraordinary circumstances, they have a unilateral power to resign from those positions and thereby terminate their ongoing fiduciary obligations.³ General partners in a general or a limited partnership are fiduciaries⁴ (as well as mutual agents) of the partnership and the other partners; they enjoy a unilateral power to resign as general partners and thereby terminate their ongoing fiduciary obligations.⁵ Shareholders, *qua* shareholders, are not fiduciaries either to the corporation or to the other shareholders⁶ and have no right to resign. Absent extraordinary circumstances, limited partners in a limited partnership are not fiduciaries. While certain statutes have afforded them the power to resign,⁷ this power is based upon economics and not fiduciary law. Therefore, the general rule is that fiduciaries have the power to unilaterally withdraw from the office giving rise to the fiduciary obligations and thereby, prospectively, terminate those obligations.



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The situation in at least some LLCs is different. Members in a member-managed LLC owe fiduciary obligations to either the LLC and the other members, or at least to the LLC.⁸ While in a manager-managed LLC, the members, *qua* members, do not *ab initio* have fiduciary obligations to either the LLC or the other members,⁹ such obligations can arise by private ordering. What is atypical vis-à-vis other forms of organization is that members, *qua* members and as fiduciaries, do not have the unilateral power to terminate the position giving rise to those fiduciary obligations *unless* so provided in a written operating agreement. Absent a provision addressing the power to resign in a written operating agreement, a member desiring to resign from the LLC is at the mercy of the other members in order to be able to do so. Consider the case of a member in a plumbing repair company organized as an LLC. That member would like to resign and set up his own plumbing company (where, as we know, he will make far more money than he would as an attorney). As a member, he owes a fiduciary duty of loyalty to the LLC,¹⁰ and is therefore precluded from competing with the LLC. The subject operating agreement is silent as to resignation. Therefore, that member is at the mercy of all the other members in the current LLC consenting (or not) to his departure and opening a competing business. If the member, not released as such by the other members, opens the competing venture, then (a) there is a manifest breach of the duty of loyalty and (b) the member is bound to turn over to the LLC all profits and benefits derived from the new venture.¹¹ From the perspective of that member desiring to open his own business, this is not a very tenable situation.

Different Models for Member Resignations

As adopted in 1994, the Kentucky LLC Act gave members the right, on 30 days prior written notice, to withdraw from the LLC and to receive the "fair value" of their limited liability company interests.¹² At that time, LLCs had, as a default rule, minimal "capital lock-in."¹³ This rule was merely a default, and could be modified in the written operating agreement. In 1998, the provision allowing a member to unilaterally withdraw from an LLC was deleted from the Kentucky LLC Act, and replaced by the following provision:

Unless otherwise provided in a written operating agreement, a member has no right to withdraw

from [an LLC]. If the written operating agreement does not specify a time a member may withdraw, a member shall not withdraw without the consent of all other members remaining at the time.¹⁴

After 1998, a member does not have the right to withdraw from a Kentucky LLC *unless* such a right is set forth in a written operating agreement or, at the time resignation is desired, all of the other members consent.¹⁵

As adopted in 1992, the Delaware LLC Act afforded a member the unilateral right to withdraw upon six months prior written notice, whereupon the former member is/was to receive the fair value of their interest in the company.¹⁶ Although not retroactive to LLCs formed prior to the 1996 amendments,¹⁷ from July 31, 1996, a member of a Delaware LLC does not have a right to resign unless so provided in the operating agreement.¹⁸ If resignation is permitted, absent private ordering to the contrary, the member has a right to be redeemed by the company for fair value.¹⁹

The Revised Uniform Limited Liability Company Act²⁰ provides a default rule that a member may withdraw from the LLC.²¹ A dissociation by resignation will be rightful or wrongful,²² and if wrongful, the disassociated member is liable to the company and in certain instances the other members for the damages caused thereby.²³ Upon resignation, the resigning member is a transferee of its own transferable interest,²⁴ and on a prospective basis fiduciary duties as a member²⁵ and the right to participate in the LLC's management are terminated.²⁶

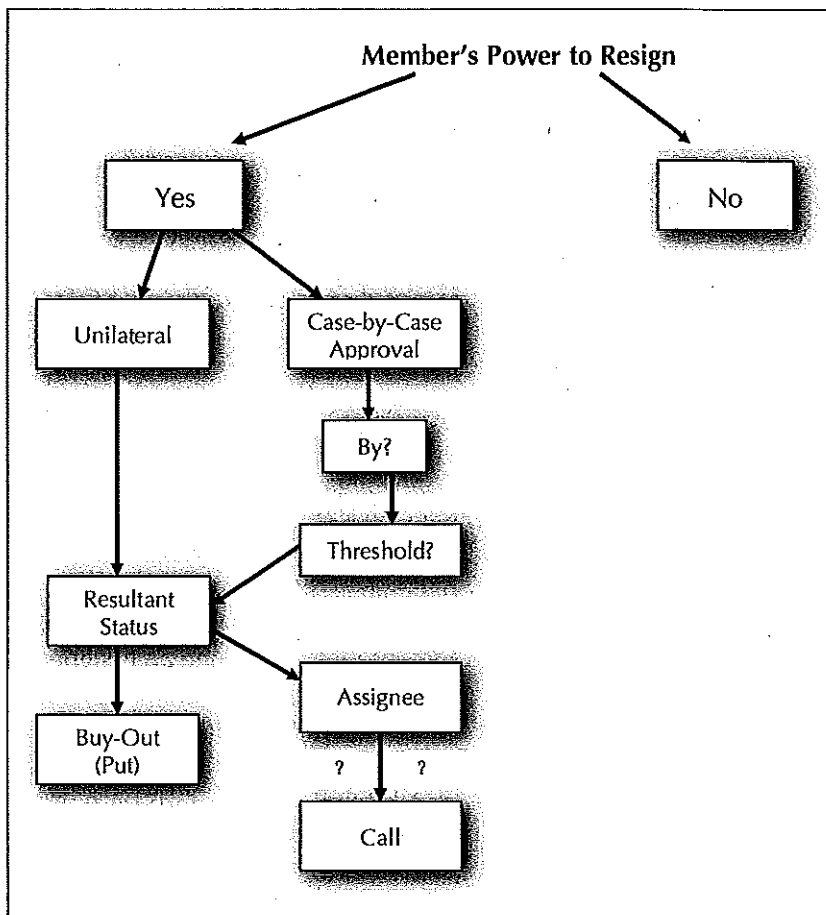
The Private Ordering of Resignation

The initial question is whether the operating agreement does or does not afford the member the power to resign. The next question is the mechanism of resignation, and the final question to be addressed is the status of the resigning member. See Chart 1.

Option I—No Power to Resign

If the members have no power to resign from the LLC, simply for purposes of clarity, that rule should be set forth in the operating agreement. For example:

§ No Power of Resignation. Prior to the completion of the liquidation and winding-up



of the affairs of the Company, no Member may resign from the Company.

To the extent that the operating agreement provides for its amendment by fewer than all of the members, an individual member could be released from this obligation by whatever vote is necessary for the amendment of the operating agreement.

Option II–A Unilateral Power to Resign

The operating agreement may afford any member the power to unilaterally withdraw from the LLC. To accomplish this, the operating agreement could provide:

§__ Member Power to Resign. Any Member may, by delivery of written notice to the Company, resign as a Member in the Company.

Alternatively, it may be desired that there be a minimum period of notice and/or that the resignation be effective only as of the end of an accounting period. For example:

§__ Member Power to Resign. Any Member, by delivery of written notice to the Company, may resign as a Member in the Company, which resignation shall be effective at the end of the calendar month that includes the 30th day after receipt by the Company of said written notice.

Option III–A Conditional Right to Withdraw

The operating agreement may contain a conditional right of resignation; that is, there is a case-by-case approval (or not) of the desire to resign. There should be a mechanism for (a) the member desiring to withdraw to give notice of its intent to do so; (b) a determination as to who (managers, other members) determines whether the approval will be granted and, within that group, the necessary voting threshold; and (c) a determination as to what will be the default rule

if the group charged with the approval (or not) of a proposed resignation does not act within the defined time frame. For example:

§__ Member Resignation. A Member desiring to resign as such from the Company shall provide to the Company written notice of the desire to resign. The resignation is subject to the approval of [all of the managers] [a majority of the managers] [all other members] [a super-majority of the other members] [a majority of the other members], who are charged to either approve or disapprove the proposed resignation within [30] days of receipt by the Company of the notice of desire to resign. If no action is taken with respect to the desire to resign, the proposed resignation shall be [approved] [disapproved].

Status After Resignation

Once there has been agreement that a particular member may resign from the LLC, there remains the question of the status of the now resigned member. There are at least two possibilities. Under the first pos-

sibility, a member, having resigned from the company, will be an assignee thereof, and as an assignee will have an ongoing (albeit minimal) relationship with the company.²⁷ Such a provision would read:

§ Status of a Member Having Resigned. From the effective date of a Member's resignation as such, the former Member shall be an assignee.

Upon resignation a member becomes, in effect, the assignee of its own limited liability company interest. From there, the rights of an assignee are defined in the applicable LLC act. Under the Kentucky LLC Act, the affirmative rights of an assignee are that the assignee is entitled:

"to receive, to the extent assigned, only the distributions to which the assignor would be entitled."²⁸

Another important provision states that an assignee shall not be:

"entitle[d] to participate in the management and affairs of the limited liability company or to become or exercise any rights of a member other than the right to receive distributions pursuant to subsection (1)(b) of this section."²⁹

Alternatively, it could be provided that upon resignation, a member will have put its limited liability company interest to the LLC, thereby converting its rights from property³⁰ into contract and entitling it to a buy-out on whatever terms are specified in the operating agreement. Without here attempting to delve into the morass that is defining how values will be determined in a buy-out context, such a provision could provide:

§ Effect of Resignation. Upon the effective date of a Member's resignation from the Company, (i) the Member's limited liability company interest shall be deemed to be put to the Company for a value to be determined in accordance with Section ___ of this Agreement, and (ii) the former Member's relationship with the Company shall be converted from one of property to one of contract. The Company's consequent obligation to the former Member shall be satisfied as provided in Section ___ of this Agreement.

Mixing the two concepts, it could be provided that, from the effective date of resignation, the former

member will be an assignee of its limited liability company interest, and thereafter the company would have the right to call that assignee interest, converting same into a contract right to be valued and paid for as otherwise dictated in the operating agreement.

A Few Other Things to Consider that Could Go Wrong

Capital Contribution Obligations

First, with respect to a resigning member, attention must be paid to the operating agreement and any ongoing capital contribution obligations that were assumed. Although the conclusion is somewhat counterintuitive, a member who has resigned from the company and who will therefore be an assignee may still be responsible for capital contribution obligations undertaken in the operating agreement even though an assignee is not considered, as such, to be a party to the operating agreement. For example, under Kentucky law:

The assignor of a limited liability company interest shall not be released from liability as a member solely as a result of the assignment.³¹

Therefore, if one represents a minority member in an LLC that has ongoing capital contribution obligations, in negotiating any resignation, there should be an express cut-off of the future contribution obligations.³² In addition, there needs to be provided indemnification by the company and the other members to the extent that, notwithstanding the company's waiver of those additional contribution obligations, they are enforced by a creditor who relied thereon.³³

Indemnification and Advancement

Other points to consider with respect to resigning members are indemnification and advancement provisions. Any right to indemnification or right to advancement of expenses from an LLC is typically a matter of contract; as a default rule, such rights do not exist.³⁴ A member, having resigned and become either an assignee or the holder of only a contract right of redemption from the LLC, is not a party to the operating agreement. All else being equal, the member is not in a position to insist upon rights of either indemnification or advancement that were set forth in the operating agreement and from which it benefited during the period that it was a member. When

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representing a minority member who is leaving an LLC in which the operating agreement provides for indemnification and/or advancement, it is important that the documents relating to the resignation provide for the continuation of those rights. Conversely, when representing the LLC vis-à-vis a resigning member, there may be significant reluctance to continue to provide rights of either indemnification or advancement.

ENDNOTES

- ¹ The Eagles, *Hotel California*.
- ² See, e.g., MODEL BUS. CORP. ACT §§8.30(a), 8.42(a)(3); KY. REV. STAT. ANN. §271B.8-300(1)(c), 271B.8-420(1)(c).
- ³ See, e.g., FLETCHER CYCLOPEA OF THE LAW OF PRIVATE CORPORATIONS §345.
- ⁴ See, e.g., UPA §21, 6 U.L.A. 194 (2001); KY. REV. STAT. ANN. §362.250; RUPA §404, 6 U.L.A. 143 (2001); KY. REV. STAT. ANN. §362.1-404; DEL. CODE ANN. tit. 6, §§15-404(b), (c); ULPA §408, 6A U.L.A. 439 (2008); and KY. REV. STAT. ANN. §362.2-408.
- ⁵ See, e.g., UPA §31(1)(b), 6 U.L.A. 370 (2001); KY. REV. STAT. ANN. §362.300(1)(b); RUPA §601(a), 6 U.L.A. 163 (2001); KY. REV. STAT. ANN. §362.1-601(1); DEL. CODE ANN. tit. 6, §15-601(i); INO. CODE §23-16-7-2.
- ⁶ The inter-shareholder fiduciary obligation principles of cases following from *Donahue v. Rodd Electrotype Co.*, are exceptional, aberrational and analytically flawed, but that is a discussion for another day.
- ⁷ See, e.g., RULPA §603, 6B U.L.A. 286 (2008); INO. CODE §23-16-7-3.
- ⁸ See, e.g., KY. REV. STAT. ANN. §275.170(1) (Duty of care obligations in an LLC are owed by members, absent private ordering to the contrary to both the LLC and the other members); KY. REV. STAT. ANN. §275.170(2) (Duty of loyalty obligations of members in an LLC, absent private ordering to the contrary, are owed to the LLC and not to the other members); RULLCA §409(b), 6B U.L.A. 488 (2008) (member's duty of loyalty); RULLCA §409(c), 6B U.L.A. 489 (2008) (member's duty of loyalty).
- ⁹ See, e.g., KY. REV. STAT. ANN. §275.170(4); RULLCA §409(g)(1), 6B U.L.A. 489 (2008). See also, *Mitchell v. Smith*, 2009 WL 891908 (D. Utah Mar. 31, 2009).

- ¹⁰ See, e.g., KY. REV. STAT. ANN. §275.170(2).
- ¹¹ *Id.*
- ¹² This provision was based upon §802(c) of the ABA PROTOTYPE LIMITED LIABILITY COMPANY ACT.
- ¹³ This lack of capital lock-in arose not from the *Kintner* tax classification regulations that otherwise had such an impact upon the manner in which LLC acts of that era were drafted, but was, rather, a carry over from the rules applicable to general and limited partnerships that served as the model for many, if not most, of the substantive aspects of LLC law.
- ¹⁴ KY. REV. STAT. ANN. §275.280(3).
- ¹⁵ A written operating agreement may provide a threshold other than all of the members to approve, on a case by case basis, a resignation.
- ¹⁶ DEL. CODE ANN. tit. 6, §§18-603, 18-604 (both as prior to 1996 amendments).
- ¹⁷ DEL. CODE ANN. tit. 6, §18-603. Presumably the operating agreement of a 1992 through July 31, 1996, organized LLC could eliminate or condition that right.
- ¹⁸ *Id.* Under the Virginia formula, a member has only such right of resignation as is set forth in writing in the operating agreement or the articles of organization. See VA. CODE §13.1-1032. See also VA. CODE §13.1-1040.1(1) (defining resignation as an event of dissociation); VA. CODE §13.1-1042.2 (defining the effect of a dissociation).
- ¹⁹ DEL. CODE ANN. tit. 6, §18-604.
- ²⁰ Hereinafter RULLCA.
- ²¹ See RULLCA §602(1), 6B U.L.A. 502 (2008). See also RULLCA §601(a), 6B U.L.A. 502 (2008). Not being referred in RULLCA §110, these provisions may be freely modified by private ordering.
- ²² A wrongful dissolution is defined in RULLCA §601(b), 6B U.L.A. 502 (2008).
- ²³ See RULLCA §601(c), 6B U.L.A. 502 (2008). *Accord* RUPA §602(c), 6 U.L.A. 169 (2001).
- ²⁴ See RULLCA §603(a)(3), 6B U.L.A. 504 (2008).
- ²⁵ See RULLCA §603(a)(2), 6B U.L.A. 504 (2008).
- ²⁶ See RULLCA §603(a)(1), 6B U.L.A. 504 (2008).
- ²⁷ Although the analysis is somewhat involved, this is the effect of a resignation under the existing Kentucky LLC Act. KY. REV. STAT. ANN. §275.015(8) defines an "event of dissociation" as "an event that causes a person to cease to be a member as provided in Ky. REV. STAT. ANN. §275.280." See also KY. REV. STAT. ANN. §275.280(1)(a) (upon resignation a member shall "disassociate" and "cease to be a member" of an LLC). KY. REV. STAT. ANN. §275.280(3) provides that a member may, with the approval of the other members, resign from an LLC. Therefore, resignation is an event of dissociation and upon resignation a member ceases to be a member.

There is, however, no right of redemption of a member's limited liability company interest upon resignation. Assuming that the 1998 General Assembly did not intend that, absent private ordering to the contrary; upon resignation a member's economic interest in the LLC is forfeit, the former member's economic rights are an assignee interest. See also *Ptasynski v. CO2 Claims Coalition, LLC*, DC Colo., 2007 U.S. Dist. LEXIS 32776 (in *dicta* stating that under the Colorado LLC Act, a resigned member continues to have the same economic rights vis-à-vis the LLC as if resignation had not taken place). The Ohio LLC Act is quite express on this point, stating that "the withdrawing member shall be treated as if the member were an assignee of all the member's membership interest as of the date of withdrawal." OHIO REV. CODE ANN. §1705.12; see also *id.* §1705.18.

- ²⁸ KY. REV. STAT. ANN. §275.255(1)(b). See also DEL. CODE ANN. tit. 6, §18-702(b)(2) ("An assignment of a [LLC] interest entitles the assignee to share in such profits and losses, to receive such distribution or distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled, to the extent assigned"); OHIO REV. CODE ANN. §1705.18 (assignee not entitled to exercise any rights of a member).
- ²⁹ KY. REV. STAT. ANN. §275.255(1)(c). See also DEL. CODE ANN. tit. 6, §18-702(b)(1) ("An assignment of a [LLC] interest does not entitle the assignee to become or to exercise any rights or powers of a member"). See also *Bauer v. Blomfield Company/Holden Joint Venture*, Ala. SCt, 849 P.2d 1365 (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. Aug. 13, 1997) ("no fiduciary duty" is owed the assignee of a partner); *Haynes v. B & B Realty Group, LLC*, N.C. App., 179 N.C. App. 104, 633 S.E.2d 691 (2006) (no fiduciary duties owed to transferee of LLC interest); *Landskroner v. Landskroner*, 797 N.E.2d 1002, 1014 (Ohio App. 2003) (fiduciary duties were not owed to former member of LLC); Daniel S. Kleinberger, *A User's Guide to the New Uniform Limited Partnership Act*, 37 SUFFOLK U.L. REV. 583, 661 (2004):
The position of a "mere transferee" may be exploited by "An amendment to the partnership agreement which advantages partners to the prejudice of bare transferees, a breach of the duty of loyalty that benefits the partners, a merger or conversion of the partnership that 'shuffles the equity' of the partnership to the prejudice of the transferees."
- ³⁰ See, e.g., RULLCA §501, 6B U.L.A. 496 (2008) ("A transferable interest is personal property"); DEL. CODE ANN. tit. 6, §18-701

("A [LLC] interest is personal property."); Ky. REV. STAT. ANN. §275.250.

³¹ Ky. REV. STAT. ANN. §275.255(1)(f). *Accord* RULLCA §603(b), 6B U.L.A. 505 (2008) ("A person's dissociation as a member of a [LLC] does not of itself discharge the person from any debt, obligation, or other liability to the company or the other members which the person incurred while a member").

³² See also Ky. REV. STAT. ANN. §275.200(4).

³³ See, e.g., PROTOTYPE LLC ACT §502(E) (set forth as an alternative provision in the commentary); IND. CODE §23-18-5-2(b); DEL. CODE ANN. tit. 6, §18-502(b); Ky. REV. STAT. ANN. §275.200(5):

Notwithstanding any compromise approved pursuant to subsection (4) of this section, a creditor of a [LLC] who extends credit or otherwise acts in reliance on an obligation after the member executes a writing which reflects that obligation and before any such compromise

is reached, may enforce the original obligation.

³⁴ See, e.g., Ky. REV. STAT. ANN. §275.180(2); DEL. CODE ANN. tit. 6, §18-108; IND. CODE §23-18-2-2(14). See also *Bernstein v. Tract-manager, Inc.*, 953 A.2d 1003, 2007 Del. Ch. LEXIS 172 (Del. Ch., Nov. 20, 2007).

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⁷ See generally Porter, *supra*.

⁸ *Id.*

⁹ *E.M. Dailey Est.*, 82 TCM 710, Dec. 54,506(M), TC Memo. 2001-263.

¹⁰ *E.J. Church*, DC Tex., 2000-1 USTC ¶60,369. *Aff'd*, CA-5, 2001-2 USTC ¶60,415, 268 F3d 1063.

¹¹ *R.L. Keller*, DC Tex., 2009-2 USTC ¶60,579 (Aug. 20, 2009).

¹² It appears that the general partner was a corporation, although the court refers to it

as a limited liability company as well.

¹³ Although as described below, a partnership or LLC having multiple owners might still be a disregarded entity.

¹⁴ See Reg. §301.7701-1 *et seq.* These are the so-called "check-the-box" regulations.

¹⁵ *S.J. Pierre*, 132 TC No. 2, Dec. 57,910 (Aug. 24, 2009).

¹⁶ Compare Rev. Rul. 99-5, IRB 1999-6, 8, 1999-1 CB 434 (sale of interest in a single-member LLC treated as a sale of undivided interest in LLC's assets). *But see* Reg. §1.752-2(k) (disregarded entity not disregarded in determining how partnership debt is allocated).

¹⁷ This conclusion was predicted in Molz & Owen, *Creative Tax Planning Using Disregarded Entities*, 64 NYU Inst Fed Tax, Chapter 10, §10.07 [2] [b] (2006).

¹⁸ In *Pierre*, it appears that the trusts were grantor trusts, where the taxpayer was treated as the 100% owner for income tax purposes.