

# State Law & State Taxation Corner

## Interest Assignments Among Members

By Thomas E. Rutledge

The rule of *in delectus personae* is well rooted in the law of LLCs; no person can by acquisition of an interest in the venture exercise management functions unless and until some threshold of the incumbent members consents to the assignee doing so.<sup>1</sup> The various LLC Acts are abundantly clear as to this protocol. What is less clear, and is typically ignored in the various acts, is the effect of an assignment among the members. Does, in that instance, the assignee succeed to the right to participate in management appurtenant to the assigned interest, or rather are they an assignee with respect thereto?

### The Usual Rule as to Assignments

The rule employed in most unincorporated business organizations<sup>2</sup> is that the right to participate in the management of the venture is not freely assigned.<sup>3</sup> Rather, while the right to participate in the economics of the venture may be freely conveyed,<sup>4</sup> that conveyance does not vest in the assignee the right to participate in management.<sup>5</sup> The case law is abundant to the effect that the assignee has no voice in the venture including no right to inspect records,<sup>6</sup> is not the beneficiary of fiduciary duties or the obligation of good faith and fair dealing<sup>7</sup> and has no voice in the amendment of the agreement governing the venture.<sup>8</sup> After the assignment of a participant's economic rights in the venture, the assignor is either automatically disassociated<sup>9</sup> or is subject to disassociation by the remaining participants,<sup>10</sup> thereby precluding or at least limiting the formation of a class of person participating in management without having an economic interest in the venture.



**THOMAS E. RUTLEDGE** is a member of Stoll Keenon Ogden PLLC resident in the Louisville, Kentucky 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.

### Why the Treatment of Inter-Partner/Member Assignments Matters

Assume an LLC with three members, Scott, Bob and Steve. Each holds an equal one-third interest (economics and management) in the company. The operating agreement does nothing more as to interest assignments than to repeat the default statutory rules. All management decisions may be made by a majority of

the voting units. As such, each member bears the risk of being ousted, but only by the unanimous agreement of both of the other members.

Steve, in anticipation of his well-earned retirement, desires to depart from the LLC. There being no put right in the operating agreement or underlying LLC act by which Steve can compel the LLC to make a market for his interest, Steve offers to sell his interest to Scott. The offered price being fair, Scott buys Steve's interest in the LLC.

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At the next meeting of the members, are there two members with (a) Scott holding two votes and Bob only one, or is the situation (b) Bob and Scott each hold a single vote? Obviously, the resolution of this question may be put off if Bob and Scott are in agreement as to how to proceed. But assume they are not in agreement. The resolution of the question determines whether (a) Bob may be outvoted by Scott's unilateral decision, or (b) no continuing member is subject to being outvoted by any other member.<sup>11</sup>

## Assignments Among Members— Statutory Provisions

The various LLC acts are unanimous in repeating the rule that the assignee of a member does not by reason of the assignment succeed to any right to participate in the management and affairs of the venture.<sup>12</sup> They are also apparently unanimous in failing to provide a clear rule as to whether or not this rule applies *vis-à-vis* an assignee who was already a member or partner.

There are two paradigms for considering the problem. Under the first, the member/partner may be treated as a member/partner as to that portion of the limited liability company interests/partnership interests for which the member/partner has been admitted as a member/partner, holding any balance as an assignee. Alternatively, the person may be treated as a member/partner as to any limited liability company interest/partnership interest held by that person.

The first option has the benefit of better preserving any agreement among the members as to vesting control. By way of example, in the above-described LLC with three equal members Scott, Bob and Steve, each member was capable of being outvoted, but only by an agreement of the two other members. If, however, Steve is able to unilaterally transfer to Scott his entire interest in the LLC and thereby vest Scott with two-thirds of all management rights, Bob will be outvoted by Scott acting unilaterally.

Under the second option, there is increased complexity, namely, the necessity of tracking interests for which the holder has been admitted as a member and those for which the holder is a mere assignee. Also, it is questionable whether the status of "member" should relate at all to a particular interest versus another interest, especially as it is possible to be a member without holding an interest in the LLC.<sup>13</sup>

The crucial point is to appreciate that the statutes are silent as to the question. The Revised Prototype LLC Act provides that the assignment of an LLC interest "does not entitle the assignee" to participate in the LLC's management or inspect its books and records.<sup>14</sup> But if the assignee already holds those rights, why the need for and what is the effect of this limitation? The Revised Uniform Limited Liability Company Act, which in its text makes no distinction between an assignment among members versus a transfer to a third party, provides in a comment that the limitations upon the effect of a transfer apply equally to an assignment *inter-se* the members as they do to a transfer to a third-party.<sup>15</sup> This statement is of course only a comment and its guidance is open to debate.

There may as well be an important differential between the various acts based upon the effect of an assignment upon the assignor. Certain acts provide that the assignment of all or substantially all of the interest in the venture only sets the condition precedent for the other members to by a vote cause the assignor's disassociation.<sup>16</sup> Other acts provide that the assignment of all or substantially all of the interests in the venture effects the assignor's disassociation.<sup>17</sup> While the second class of statutes does not present a problem, the first does. If assignment of the interest does not of itself terminate the assignor's position as a member, but an assignment to an incumbent member/partner vests in the assignee all rights including management rights with respect thereto, then the membership interest is being called upon to afford management rights to two persons simultaneously. Certainly that cannot be the intent, and it would be entirely unworkable to have both the assignor and the assignee vested with the right to exercise management rights based upon the same interest

in the LLC. The statutes that provide for disassociation automatically consequent to assignment do not present this anomaly. Where disassociation consequent to an assignment requires as well a second step of action by the other members, likely the analysis should be that an assignment to an incumbent member does not vest in the assignee the management rights related thereto in that to treat an inter-member assignment as effecting the assignor's disassociation would be to add to the statute a rule not set forth therein.

## The Limited Case Law

Surprisingly, there have been few litigated disputes, at least disputes that led to available opinions, considering this issue. In a decision from the Delaware Chancery Court, the court interpreted a particular operating agreement to the effect that one of the three members could unilaterally assign the management rights to another member, the court finding in a provision of the agreement to the effect that an assignee would not be admitted as a member without the consent of the other members was inapplicable where the assignee was already a member.<sup>18</sup> It is important to note that in the subject operating agreement, the standard Delaware definition of a limited liability company interest, that being exclusively the economic rights in the venture,<sup>19</sup> had been redefined to include the right to participate in management of the venture. In that, *inter alia*, the operating agent allowed assignments of LLC interests among members, and as the agreement defined the LLC interest as including the management rights, then:

Because Achaian was already a Member at the time of the Purchase Agreement and nothing in the LLC Agreement requires that it be readmitted as a Member with respect to each additional interest it acquired in Omniglow, it was entitled to receive the “entire ownership interest” owned by Holland, including the interest’s corresponding voting rights.<sup>20</sup>

This decision is more in the nature of a confirmation that the private agreement of the parties with respect to the effect of an *inter se* assignment will be enforced notwithstanding the default rule of the Delaware LLC Act<sup>21</sup> rather than espousing a rule of application of the statute itself.

The only other detailed assessment of the question appears to be a decision from the North Carolina Business Court rendered in *Blythe v. Bell*.<sup>22</sup> A particular benefit of this decision is that with essentially only one exception it interprets the underlying law unsullied by an operating agreement that modified that law.

Drymax, LLC, organized in North Carolina in 2007, was originally owned by Blythe (40 percent), Hickory Brands, Inc. (“HBI”) (owned by Rob Bell and Virginia Bell) (30 percent), Joseph (president of HBI) (20 percent), Rob Bell (five percent) and Virginia Bell (five percent). The ownership was not changed until 2007 when HBI assigned its interest equally between Rob and Virginia Bell. In early 2008, Joseph resigned from HBI and transferred his interest in Drymax to HBI (see Table 1).

TABLE 1					
2003		2007		2008	
Blythe	40%	Blythe	40%	Blythe	40%
HBI	30%	Joseph	20%	HBI	+20%
Joseph	20%	Rob	5% + 15%	Rob	5% + 15%
Rob	5%	Virginia	5% + 15%	Virginia	5% + 15%
Virginia	5%				

None of the various assignments were approved by a vote of the members or by a written agreement. When disputes over the LLC’s governance and management arose, the question turned upon who was a member and what respective management rights did they each have. If the assignments were not effective to convey management rights, then the 30-percent interest transferred by HBI to Rob and Virginia Bell and the 20-percent interest transferred by Joseph to HBI would not be included in determining management rights, leaving for consideration only the interests allocated to Blythe (40 percent), Rob (five percent) and Virginia (five percent) in 2003, they yielding management rights of 80 percent to Blythe, 10 percent to Rob and 10 percent to Virginia.

*Obviously, the way to address the ambiguity on how assignments among members should be treated is to do so in the operating agreement.*

The applicable North Carolina LLC Act provided for automatic dissolution of a member upon assignment of all of their interest in the LLC.<sup>23</sup> Admission of a replacement member requires the unanimous consent of the other members or a written, signed and dated agreement to that effect.<sup>24</sup> Further, the LLC Act contained a prohibition on voluntary withdrawal from the LLC absent authority to do so in the articles (*sic*—the opinion refers to “articles of incorporation”) or the operating agreement.<sup>25</sup>

Blythe, not surprisingly, argued that none of the assignments was effective to convey management rights. The defendants, in contrast, argued that assignments to incumbent members were effective to convey management rights. Further, the defendants argued that an assignor of the economic rights in an LLC retains the management rights until the assignee's admission as a member.

The Court determined that upon an assignment of all of an interest from one incumbent member to another: (i) the management rights are fully conveyed; (ii) the assignee may exercise the management rights related to the assigned interest; and (iii) the assignor is thereby disassociated from the LLC. Curiously, the Court found that this interpretation did not do violence to the "no voluntary resignation" limitation of the LLC Act.<sup>26</sup> In contrast, the Court found that upon an assignment to a nonmember, absent the assignor's admission as a member by the incumbent members, the assignor remains a member with the management rights in the LLC.<sup>27</sup> By treating the assignor as continuing to hold the management rights, the Court preserved the rule that a member may not voluntarily resign.<sup>28</sup>

In application:

- in that Rob and Virginia were members at the time of HBI's 2007 transfer to them: (a) HBI ceased to be a

member, and (b) Rob and Virginia succeeded to the management rights in the transferred interests; and

- in that HBI was not a member at the time of Joseph's 2008 transfer to it: (a) HBI succeeded only to a 20-percent economic interest, and (b) Joseph retained a 20-percent management stake in the LLC.

In the end, as summarized by the Blythe Court<sup>29</sup> (see Table 2):

## Addressing the Issue by Private Ordering

Obviously, the way to address the ambiguity on how assignments among members should be treated is to do so in the operating agreement. If inter-member assignments are to result in the assignor's disassociation and the treatment of the assignee as a member with respect to the assigned interests, then say so.<sup>30</sup> Alternatively, the agreement could provide that an assignment to an incumbent member is to be treated no differently than an assignment to a stranger to the LLC. Typically, that will involve the assignor being either disassociated or being subject to disassociation and the assignee, as to the assigned interest, not succeeding to any management rights. Even in those states that provide that assignment of the economic interests in the venture only sets the stage for disassociation by the other members, the operating agreement may provide for automatic disassociation without the requirement of further action by the other members.<sup>31</sup> What is important is to pick the desired result and provide for it in the agreement. By doing so, the ambiguity is addressed and the expectations of the parties can be realized.

TABLE 2		
	Economic Interest	Voting
Blythe	40%	40%
HBI	20%	0%
Joseph	0%	20%
Rob Bell	20%	20%
Virginia Bell	20%	20%

## ENDNOTES

<sup>1</sup> The various partnership acts as well embody these rules. For ease of expression, this discussion is in the nomenclature of the LLC.

<sup>2</sup> Exceptions to this rule include statutory trusts organized under the Uniform Statutory Trust Entity Act which, while unincorporated, as a default rule permits free assignability of beneficial interests therein and permits the assignee to fully exercise any voting rights previously enjoyed by the assignor. See Unif. Statutory Trust Entity Act, §601(a), 6B ULA (2010 Supp.) 8; see also Ky. Rev. Stat. Ann. §386A.6-010(3). Assignability may be limited in the governing instrument. See Unif. Statutory Trust Entity Act §103(e)(2), 6B ULA (2010 Supp.) 45.

<sup>3</sup> Different statutes utilize "assign/assignment" while others use "transfer." See, e.g., Rev. Prototype Limited Liability Company Act §102(1), 67 Bus. Law. 117, 127 (Nov. 2011) ("assign"); Ky. Rev. Stat. Ann. §275.255 ("assign"); Rev. Unif. Part.

Act §101(14), 6 (pt.1) ULA 61 (2001) ("transfer"). The terms are herein used interchangeably.

<sup>4</sup> See, e.g., Unif. Ltd. Part. Act §503(a)(1), 6 (pt. 1) ULA 156 (2001); Unif. Part. Act §27, 6 (pt. 2) ULA 332 (2001); Rev. Unif. Ltd. Liab. Co. Act §502(a)(1), 6B ULA 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) (Ky. RUPA); *id.* Ky. Rev. Stat. Ann. §362.280(1) (Ky. UPA); and §275.255(1)(a) (Ky. LLC Act). See also Rev. Unif. Part. Act §503(b)(1), 6 (pt.1) ULA 157 (2001) (transferee to receive distributions that would have otherwise gone to the transferor); Unif. Part. Act §27, 6 (pt. 2) ULA 332 (2001) (same); Rev. Unif. Ltd. Liab. Co. Act §502(b), 6B ULA 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); Pa. Code §33-44-502 (same).

<sup>5</sup> See, e.g., Unif. Part. Act §27(1), 6 (pt. 2) ULA 332 (2001); Rev. Unif. Part. Act §503(a)(3), 6 (pt. 1) ULA 156 (2001); Unif. Ltd. Liab. Co. Act §502, 6B ULA 602 (2008); Rev. Unif. Ltd. Liab. Co. Act §502(a)(3), 6B ULA 496 (2008); Unif. Ltd. Part. Act §702(a)(3), 6A ULA 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).

<sup>6</sup> See, e.g., *Dame v. Williams*, 727 NYS2d 816, 818 (N.Y. App. Div. 2001) (estate of former general partner is not entitled to participate in partnership's management or to inspect its records); *Kinkle v. R.D.C., LLC*, 889 So2d 405 (La. Ct. App. 3rd Cir. 2004) (assignee of deceased member not entitled to inspect LLC records).

<sup>7</sup> See, e.g., *Bauer v. The Blomfield Co.*, 849 P2d 1365 (Alaska 1993) (assignee of partnership interest is not owed obligation 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 SE2d 691 (N.C. 2006) (no fiduciary duties are 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).

<sup>8</sup> See, e.g., *Thomas v. Bozick*, 93 A3d 614 (M.D. App. May 28, 2014). See also Thomas E. Rutledge, Carter G. Bishop & Thomas Earl Geu, *No Cause For Alarm: Foreclosure and Dissolution Rights of a Member’s Creditor*, 21 *Probate & Property* 40 (May–June 2007).

<sup>9</sup> See, e.g., Del. Code Ann. tit. 6, §18-702(b)(3) (member disassociated upon transfer of all economic interest in LLC); Mont. Code §35-8-803 (member disassociated upon a transfer of all or substantially all economic interests in LLC).

<sup>10</sup> 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 disassociated by a vote of a majority-in-interest of the other members); Ind. Code §23-18-6-5(a)(3) (B) (a member who transfers entire interest in LLC disassociated upon the vote of a majority of the other members; no separate provision for single-member LLC); Arkansas (Ark. Code §4-32-802(a)(3) (B) (same)); Connecticut (Conn. Code §34-180(a)(3)(B)) (same); New Mexico (N. Mex. Code §53-19-38(A)(3)(b)) (same). Similar rules are employed in RUPA and in the Revised Prototype Limited Liability Company Act. See Rev. Unif. Part. Act §601(4)(ii), 6 (pt. 1) ULA 163 (2001); Revised Prototype Limited Liability Company Act, §603(a), 67 Bus. Law. 117, 171 (Nov. 2011).

<sup>11</sup> There is no question that, going forward, Scott

is entitled to two-third of the economic fruits of the LLC while Bob retains the one-third share he has always had. See *supra* note 4.

<sup>12</sup> See *supra* note 5.

<sup>13</sup> See, e.g., Del. Code Ann. tit. 6, §18-301(d); Ky. Rev. Stat. Ann. §275.195(3); Rev. Prototype Limited Liability Company Act §401(c), 67 Bus. Law. 117, 154 (Nov. 2011).

<sup>14</sup> Rev. Prototype Limited Liability Company Act §502, 67 Bus. Law. 117, 163 (Nov. 2011). The same rule was set forth in §704(A)(3) of the 1992 Prototype LLC Act. The 1992 Prototype LLC Act, 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, is reprinted in 3 Larry E. Ribstein and Robert R. Keatinge, Ribstein & Keatinge on Limited Liability Companies.

<sup>15</sup> See Rev. Unif. Ltd. Liab. Co. Act §602(4)(B), comment, 6B ULA 503 (2008):

However, consistent with current law, a member may transfer governance rights to another member without obtaining consent from the other members. Thus, this Act does not itself protect members from control shifts that result from transfers among members (as distinguished from transfers to non-members who seek thereby to become members).” This explanation exists notwithstanding the rule under RULLCA that the transfer by a member of all of their transferable “economic interests” merely sets the stage for dissociation from the LLC, that dissociation otherwise requiring the consent of all of the other members.

<sup>16</sup> See *supra* note 10.

<sup>17</sup> See *supra* note 9.

<sup>18</sup> *Achaian, Inc. v. Leemon Family LLC*, 25 A3d 800 (Del. Ch. 2011). See also J. William Callison, *Achaian and interest transfers among existing partners and members*, Research Handbook on Partnerships, LLCs and Alternative Forms of Business Organizations (Edward Elgar Publishing, 2015).

<sup>19</sup> See Del. Code Ann. tit. 6 §18-101(8).

<sup>20</sup> 25 A2d at 808–809.

<sup>21</sup> See also Del. Code Ann. tit. 6 §18-101(8); *id.* §18-704(a)(2).

<sup>22</sup> 2012 NCDC 60, 2012 WL 6163118 (N.C. Super. Dec. 10, 2012).

<sup>23</sup> N.C. Code §57C-5-02.

<sup>24</sup> N.C. Code §57C-5-4(a).

<sup>25</sup> N.C. Code §57C-5-06.

<sup>26</sup> See *Blythe*, 2012 WL 6163118, \*8 (The LLC Act allows “members, absent a contrary agreement, to transfer both their economic and control membership interests to existing members without unanimous member consent.”).

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* (“The court cannot find a fair reading of the Act, reconciling all its provisions, that reflects a legislative purpose that allow a member to cease being a member leaving his prior control interest inchoate.”).

<sup>29</sup> *Id.*, at \*9.

<sup>30</sup> See also Thomas E. Rutledge, *Allocating Voting and Economic Rights in LLCs: An Invitation to Confusion (Part II)*, J. Passthrough Entities, Mar./Apr. 2014, at 61 (addressing the need to address the deemed transfer of credit for the capital contribution of the transferor to the transferee).

<sup>31</sup> See, e.g., Ky. Rev. Stat. Ann. §275.280(1)(c)2 (“Unless otherwise provided in a written operating agreement.”).

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