

CONTROVERSIES & CONUNDRAS: CONVERTING A PARTNERSHIP INTO AN LLC

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I. THE PROBLEM

A new client comes into your office with an issue that needs to be addressed.² A few years back, the client and three other partners formed Idacus Enterprises (“Idacus”), a Tennessee partnership. About a year ago, the four partners converted Idacus into a member-managed limited liability company (“LLC”) in accordance with Tennessee Code Annotated section 48-204-101. While the partners—now members—followed proper conversion procedure, they failed to approve and execute an operating agreement for Idacus, LLC in connection with the conversion. The four members did agree, however, to the articles of conversion. The articles of conversion, like the standard provisions discussed below, did not contain any provisions regarding the required vote to adopt or amend an operating agreement. Additionally, the articles required that voting power be based on membership interest and that only a simple majority be necessary to amend the articles.

Currently, three of the members, including your client, want an operating agreement, but the fourth member does not want to sign it—or anything else for that matter. This is problematic because, absent an operating agreement, the three fear that they will be unable to preserve and enforce their agreed-upon rules regarding the management and conduct of their business, the governance structure of Idacus, and the rights and responsibilities of the members.³

Ideally, members simultaneously approve an operating agreement and conversion to prevent the current controversy from arising. While it is important that an attorney advise clients contemplating a partnership-LLC conversion to approve an operating agreement at the same time as the conversion, this article discusses some potential solutions to the client’s problem, ranked in order from

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² This hypothetical problem is partially based on a problem that arose in connection with the author’s work on a matter as a clerk at a law firm.

³ See TENN. CODE ANN. § 48-206-101(a) (2002).

“most desirable” to “least desirable.” First, however, this article briefly discusses the LLC business form and the process of conversion from a partnership to an LLC.

II. THE LIMITED LIABILITY COMPANY

The LLC originated in 1977 when Wyoming adopted an LLC statute based on a European business organization concept.⁴ It is one of the most recent forms of business organization. The key advantages of the LLC over traditional business forms—the C-corporation, the S-corporation, the general partnership, and the limited partnership—are limited owner liability, the availability of partnership tax status, ownership control, and managerial flexibility.⁵ Since the Internal Revenue Service approved partnership tax status for the LLC in 1988, every state has adopted an LLC statute.⁶ While seen as superior to traditional forms of business, the LLC has become “less extraordinary” with the recent developments of the limited liability partnership and the limited liability limited partnership.⁷

Like other entity law statutes, the Tennessee Limited Liability Company Act⁸ (the “LLC Act”) provides rules for formation, maintenance, internal governance, personal liability to third parties, dissolution, and merger. While some of these rules are immutable, many merely serve as a default that can be modified by the members through either the articles of organization or conversion or an operating agreement.⁹

III. THE CONVERSION

The conversion of a partnership to an LLC was expressly contemplated by the Tennessee legislature in its drafting of the LLC Act. Three sections of the Act

⁴ J. DENNIS HYNES, AGENCY, PARTNERSHIP AND THE LLC: IN A NUTSHELL 217 (West Publishing 1997).

⁵ *Id.*

⁶ *Id.*

⁷ *Id.* at 218.

⁸ TENN. CODE ANN. § 48-201-101 *et seq.* (2002).

⁹ E. Mattias Jannerbo, *An Introduction to Limited Liability Companies*, in LIMITED LIABILITY COMPANIES IN TENNESSEE 5 (2001). This is especially notable considering many provisions “contain the statement ‘Unless otherwise provided in the articles or the operating agreement. . . [.]’” *Id.*

reference the process.¹⁰ For a general partnership, all the partners, or a number specified in the partnership agreement, must approve the conversion.¹¹ The same is true for a limited partnership.¹² After the conversion is approved, the partnership must file articles of conversion with the Tennessee Secretary of State.¹³ These articles are similar to the articles of organization used to form an LLC outside the conversion context, except that they require additional information about the predecessor partnership and the conversion.¹⁴

Consequently, the resulting LLC is deemed to be a continuation of the same entity that was in existence before the conversion, albeit in a different organizational form.¹⁵ The post-conversion LLC members enjoy all of the benefits of LLC status upon conversion, but the LLC members remain liable for any pre-LLC, partnership liabilities and obligations for which they were liable before the conversion.¹⁶

IV. THE OPERATING AGREEMENT

An operating agreement is not required in Tennessee for a member-managed LLC.¹⁷ Only board-managed LLCs require an operating agreement.¹⁸ At some point in the organization and maintenance of an LLC (preferably in the beginning), the members of an LLC may want to approve an operating agreement to control the way

¹⁰ See TENN. CODE ANN. §§ 48-204-101 to -103.

¹¹ *Id.* § 48-204-101(b).

¹² *Id.*

¹³ *Id.* § 48-204-101(c).

¹⁴ *Id.* Specifically, in addition to meeting the requirements of section 48-205-101, the articles of conversion must include: (1) a statement that the partnership was converted into a limited liability company; (2) the name and principal address of the partnership; (3) the names of the partners of a general partnership or the names of the limited partners of a limited partnership; (4) a statement that the conversion was approved by the appropriate percentage of partners; and (5) the number of members of the new limited liability company at the date of conversion (usually the filing date of the articles). *Id.*

¹⁵ TENN. CODE ANN. § 48-204-102(a).

¹⁶ *Id.* § 48-204-101(e).

¹⁷ *Id.* § 48-206-101(a).

¹⁸ *Id.*

business is conducted by the LLC and between or among its members. If the members choose to adopt an operating agreement in Tennessee, it must contain the following:

- (1) the names and membership interests of all the members;
- (2) the amount of cash and the agreed value of other property or services contributed for each membership interest;
- (3) the amount and value of any contributions under a contribution agreement and the times and/or events that cause those contributions to be made;
- (4) any rights regarding distributions; and
- (5) times and/or events that will cause the LLC to dissolve.¹⁹

In addition, the operating agreement may contain “any provisions [that] the members wish to state in the operating agreement,”²⁰ particularly those that involve “the management of the business of the LLC, . . . the conduct of its business, and the rights and privileges of members . . . to the extent that such provisions are not inconsistent with the laws of this state or the articles.”²¹

V. THE SOLUTIONS

Recall, however, that your client’s LLC currently has no operating agreement and that three out of the four members of the LLC, including your client, desire to provide for an operating agreement. Fortunately, a review of the LLC Act reveals several ways by which your client and the two consenting fellow members can achieve their desired objective. A description of each solution follows.

A. Amend Articles to Require a Lesser Standard for Approving an Operating Agreement

While the idea that the members of an LLC need not unanimously approve the operating agreement may seem counter-intuitive (even to seasoned business

¹⁹ *See id.*

²⁰ *Id.* § 48-206-101(a)(7).

²¹ *Id.* § 48-206-101(a).

lawyers), the structure and content of the LLC Act implies that the drafters contemplated a valid and binding agreement made by fewer than all of the members.

Tennessee Code Annotated section 48-206-102(a) states that “[e]xcept as otherwise provided in the articles, an operating agreement must initially be agreed to by all members or the organizer(s).”²² Accordingly, if the articles provide that only a majority of members must approve the operating agreement, then the agreement of the majority is sufficient to bind all of the members to its terms.²³ The statutory language is quite plain and unambiguous on this matter, and the Tennessee legislature provided for great flexibility in the formation and operation of LLCs through the adoption of this provision.

Tennessee Code Annotated section 48-206-102 is a departure from similar statutory provisions in surrounding states.²⁴ Other states, such as Mississippi, North Carolina, Virginia, Alabama, and Georgia, explicitly require that *all* members must initially approve the operating agreement of an LLC.²⁵ Even the Uniform Limited Liability Company Act (“ULLCA”) provides that “all members of a[n] [LLC] may enter into an operating agreement . . .”²⁶ Although the ULLCA was drafted later, the Tennessee legislature had available to it in its statutory deliberations the LLC statutes of each of the above-mentioned states. If the Tennessee legislature had intended to require all members to approve an initial LLC operating agreement, it would have followed the language of those and other similarly situated states. The language used in Tennessee Code Annotated section 48-206-101(c) indicates that the Tennessee legislature intended to allow less than a unanimous vote to adopt an operating agreement if the members of the LLC so desire.

An operating agreement signed by less than all the members is binding on all the members pursuant to Tennessee Code Annotated section 48-206-101(c), which

²² *Id.* § 48-206-102(a) (emphasis added).

²³ *Id.* § 48-206-101(c).

²⁴ *See id.* § 48-206-102.

²⁵ *See, e.g.*, MISS. CODE ANN. § 79-29-306(2)(a) (2001) (operating agreement “must initially be agreed to by all of the members”); N.C. GEN. STAT. § 57C-3-05 (2001) (“member shall be bound by any operating agreement . . . to which the member . . . expressly assented”); VA. CODE ANN. § 13.1-1023(B)(1) (1999) (“operating agreement must initially be agreed to be all of the members”). None of these statutes contain the “unless otherwise specified” language contained in Tennessee Code Annotated section 48-206-101(c).

²⁶ UNIF. LTD. LIAB. CO. ACT § 103, 6A U.L.A. 434 (1995).

states that “[u]nless otherwise provided in the articles *or* in an operating agreement that has been adopted or agreed to by the *required vote of the members* . . . [such operating agreement] shall be binding on the LLC and its members.”²⁷ Because the statute does not say “adopted or agreed to by *all* the members,” the Tennessee legislature has unequivocally expressed its intent that an agreement approved by a portion of the LLC membership can bind the whole, if the articles so provide.

Because the consent of only a majority of members is required to amend the LLC articles under the default rules in the LLC Act,²⁸ the three members, in this example, interested in having an operating agreement could vote to amend the Articles of Conversion to require only seventy-five percent (75%) or a lesser percentage of the members to adopt an operating agreement. This provision would then allow the three consenting members to draft and adopt an operating agreement that would bind each of them and the non-conforming fourth member. It is important to note that, under the LLC Act, voting occurs on a “per capita” basis.²⁹ That is, each member gets an equal vote. If there are four members, each has voting power equal to 25%. If the members wish to have their voting power equal their membership interest, the articles must expressly provide so. The difference between the two formats becomes significant below under solutions C and D.

The only concern with this action is that the fourth member may have and could exercise dissenter’s rights. Under Tennessee Code Annotated section 48-231-201, a member is entitled to dissent and, if successful, obtain payment for the fair value of the interest in the LLC in the event that:

- (1) a plan of merger involving the LLC is consummated;
- (2) a sale, lease, or transfer of all or substantially all of the LLC’s property or assets is consummated;
or
- (3) amendments to the articles or operating agreement are approved that materially and

²⁷ TENN. CODE ANN. § 48-206-101(c) (emphasis added).

²⁸ *Id.* §§ 48-209-103(f), 48-240-101. Be sure to check a client’s articles to see if the required vote for amendment is higher, as allowed by section 48-209-103(f).

²⁹*Id.* § 48-224-101.

adversely affect the rights or preferences of that member's membership interest in the LLC.³⁰

Amending the articles in the way suggested herein could be seen as adversely affecting the rights or preferences of the fourth member's interest in Idacus in that, after approval and filing of the amended articles in accordance with Tennessee Code Annotated section 48-209-101, the fourth member's approval would no longer be required for a binding operating agreement. Specifically, excluding or limiting the fourth member's right to vote on a matter—the operating agreement—could be interpreted as violating Tennessee Code Annotated section 48-231-201(a)(3)(C). However, because the fourth member would retain voting rights, although approval would no longer be required, it could be argued that the member does not have dissenter's rights.³¹

If the fourth member is successful in asserting dissenter's rights,³² the matter ends up in court.³³ If this happens, your client may wish to argue that the fourth member violated the obligation of good faith as a member by unreasonably withholding consent to an operating agreement that would allow the business of the LLC to more smoothly and amicably proceed.³⁴

B. Amend Articles to Add Agreement Provisions Directly to the Articles

Tennessee Code Annotated section 48-205-101 states that the articles “may contain provisions not inconsistent with the law relating to the management of the

³⁰ *Id.* § 48-231-201(a) (not all events are listed).

³¹ It should again be noted that in order to avoid such a situation, all the partners should approve an operating agreement, at least a skeleton agreement that can be amended by a majority later, at the same time as the conversion is approved.

³² There are numerous procedural requirements for perfection of dissenter's rights included in Tennessee Code Annotated sections 48-231-202 through –209.

³³ *See* TENN. CODE ANN. §§ 48-231-301, 302 (2002). Under these sections, if the parties cannot agree on how much to pay the dissenter(s), the LLC is required to petition a court to determine the fair market value of the dissenter's membership interest. *Id.* § 48-231-301(a). If suit is not filed by the LLC within two months of a dissenter's payment demand, then the LLC is required to pay the amount demanded. *Id.* The court also may assess costs and attorney's fees to the LLC or, in the alternative, to the dissenter if it finds, in equity, that the dissenter acted “arbitrarily, vexatiously, or not in good faith in demanding payment.” *Id.* § 48-231-302(a).

³⁴ *See id.* § 48-240-102(b).

business or the regulation of the affairs of the LLC.”³⁵ Thus, a majority of members³⁶ can vote to amend the articles to include provisions that would otherwise be put into the operating agreement. This may be somewhat unorthodox and could cause privacy problems because the articles are public record. However, it is probably the easiest option available because it requires only the amendment of one document, rather than the amendment of one and the creation of another.

The ULLCA also expressly contemplates including provisions commonly reserved for the operating agreement in the articles. In addition to listing what the articles *must* set forth, the ULLCA provides that an LLC *may* set forth in its articles: (1) “provisions permitted to be set forth in an operating agreement” or (2) “other matters not inconsistent with law.”³⁷ Since the ULLCA was drafted after Tennessee adopted its statutes, the absence of the language in ULLCA § 203(b) from the Tennessee Code Annotated does not mean that the Tennessee legislature expressly rejected that language. The language in the Tennessee statute is broad enough to permit inclusion in the articles of any provision usually set forth in an operating agreement.

Through inclusion of this and other similar provisions in the LLC Act, the Tennessee legislature has provided the members of an LLC great flexibility. Throughout the LLC Act, insertion of provisions into either the articles or the operating agreement is allowed.³⁸ While the Tennessee legislature probably did not have this hypothetical client’s specific situation in mind, the statutory provisions it adopted allows the law to adapt to a number of situations, whether contemplated or unforeseen.

C. Create a “Members’ Agreement”

Shareholders of corporations may (under certain legally permitted circumstances) execute agreements among themselves to control how they govern the corporation.³⁹ A similar contractual device could be used by and among the three Idacus members who want an operating agreement. Because they collectively

³⁵*Id.* § 48-205-101(12).

³⁶ *See supra* note 27 and accompanying text.

³⁷ UNIF. LTD. LIAB. CO. ACT § 203(b), 6A U.L.A. 444 (1995).

³⁸ *See, e.g.*, TENN. CODE ANN. §§ 48-206-102, 48-216-101, 48-218-102.

³⁹ *See id.* § 48-17-302.

have a supermajority voting position in Idacus, the three members would not require the fourth member to conduct business. This solution is more limited in that it would not be considered the LLC's operating agreement and would not therefore bind the fourth member. This option may be supplemented with solution B by amending the articles to add language that will keep the fourth member in check in terms of assignment of interest, etc.⁴⁰ The "Members' Agreement" would do the rest of the work without concern for the fourth member.

Tennessee Code Annotated expressly authorizes agreements among members in section 48-226-101, but they are subject to the corporate rule on shareholders' agreements.⁴¹ Some limitations exist in terms of assignees of financial rights, but nothing in the LLC statute otherwise limits these agreements in substance or in form.⁴² Additionally, as mentioned in solution A, the articles may require amendment so that voting is by membership interest and not the default "per capita" rule.⁴³ This ensures that the three agreeing members can control voting in Idacus, LLC.

D. Create a New LLC That Governs Interest in Idacus, LLC

As an alternative to solution C, the three members could form another LLC to govern their share of membership interests in Idacus, LLC. With this new LLC, which shall be called Vegas Holding Company ("Vegas"), the three agreeing members can control Idacus as a supermajority as long as voting power is based on membership interest.⁴⁴ Since the members can simultaneously adopt both the

⁴⁰ While solution C requires more effort in terms of drafting and filing, it can supplement solution B where the core majority members can agree on some, but not all, of the terms. The "Members' Agreement" can then govern how the three resolve their differences.

⁴¹ TENN. CODE ANN. § 48-226-101(a). These shareholder rules are contained in section 48-17-302. The agreement between the shareholders controls how the covered shares are voted. *Id.* § 48-17-302(a). The agreement shall not be invalid as an attempt to restrict the discretion of the board of directors in its management of business. *Id.* § 48-17-302(b). The transferee of shares covered in a shareholders' agreement is bound by that agreement if the transferee takes those shares with notice of such agreement. *Id.* § 48-17-302(c). Liability may be transferred from the directors to the shareholders who assent to the action taken pursuant to the shareholders' agreement. *Id.* § 48-17-302(d).

⁴² *See id.* § 48-226-101.

⁴³ *See id.* § 48-224-101.

⁴⁴ The articles must explicitly reject the default "per capita" voting rule and adopt a membership-interest based voting rule.

articles and the operating agreement, Vegas can instantly become the functional equivalent of a 75% corporate shareholder in a corporation. The three common members of both LLCs could run Idacus through Vegas and simultaneously be subject to an operating agreement among themselves. Again, this solution could be used along with one or more of the above solutions to ensure that the fourth member does not try to disrupt the management of Idacus, LLC.⁴⁵

A problem exists, however, if the new LLC is seen as only one member, sharing control of Idacus, LLC with the fourth member.⁴⁶ To avoid this problem, the articles of Idacus must state that voting power is based on membership interest instead of a “per capita” vote.⁴⁷ This alternative is somewhat costly, time consuming, and probably less practical because of the extra paperwork and fees. Nonetheless, it is an alternative that merits mentioning.

E. Assignment

Another possible solution is to completely replace the fourth member with someone who is more amenable to an operating agreement. This individual, selected by the three members, could purchase the fourth member’s interest in Idacus, LLC. As long as the assignment is not prohibited in the articles,⁴⁸ the fourth member could transfer his interest to this other person for consideration equal to the value of that interest.⁴⁹ If such an assignment is prohibited, then the consenting members can amend the articles to allow for the assignment to proceed.⁵⁰

This solution’s advantage is that the stubborn fourth member is replaced with someone more cooperative. However, the disadvantages include certain tax liabilities associated with the assignment and difficulty in replacing the unique

⁴⁵ The previous solutions are preferred, but solution D is listed as a possibility in the event the others fail.

⁴⁶ See TENN. CODE ANN. § 48-224-101. Again, this would only occur if the default-voting rule is in place.

⁴⁷ See *id.* § 48-224-101(c)(1).

⁴⁸ See *id.* § 48-218-101.

⁴⁹ See *id.* § 48-218-102 (member may assign full membership interest).

⁵⁰ This assumes that they have the requisite voting power.

services that the fourth member provided to the LLC. Therefore, each situation is different and must be evaluated separately.

F. Dissolution

The final possible solution, which is offered as a last resort, is for the members to cause dissolution of Idacus, LLC, either by themselves⁵¹ or through the courts,⁵² with the LLC continuing after terminating the fourth member's interest.⁵³ Obviously, the intent of this action would be to remove the fourth member but continue the business. As a part of this action, your client and the other two members would pay the fair market value of the membership interest to the fourth member and continue without that member. As a result, the three remaining members would have a greater amount of interest and total control of Idacus.⁵⁴

⁵¹ TENN. CODE ANN. § 48-245-202. Section 48-245-202(a) states that the members may dissolve the LLC:

- (1) Upon any event of dissolution set forth in the articles, operating agreement, or the Tennessee Limited Liability Company Act . . . ;
- (2) By any procedures set forth in the articles or operating agreement; or
- (3) By the members when authorized in the manner set forth in this section.

Dissolution must be submitted for approval by the members after they have received written notice. *Id.* § 48-245-202(b). If the dissolution is approved by majority vote (or as provided in the articles or operating agreement), the LLC must be dissolved and notice of such dissolution shall be filed with the Tennessee Secretary of State. *Id.* § 48-245-202(c).

⁵² *Id.* § 48-245-901 to 904. A court may decree dissolution, upon application “by the attorney general or reporter or by or for a member,” when it is not reasonably practicable to carry on the business of the LLC “in conformity with the articles or the operating agreement.” *Id.* § 48-245-902(a). The members need not be made parties to the action “unless relief is sought against them individually.” *Id.* § 48-245-903(b). The court can issue injunctions, appoint a receiver or custodian, or carry on the business until a full hearing can be held. *Id.* § 48-245-903(c). If a member petitions the court for dissolution, that member must file a bond to cover the defendant's probable costs. *Id.* § 48-245-903(d). In addition to dissolution, the court may grant equitable relief “it considers just and reasonable in the circumstances.” *Id.* § 48-245-901.

⁵³ *See id.* § 48-245-101(b). (noting that a LLC is not dissolved as long as there is one remaining member and that the “existence and business of the LLC are continued by consent of a majority vote of the remaining members”).

⁵⁴ *See id.* § 48-245-101(b).

Again, the stubborn fourth member is advantageously removed from the business. The disadvantages are, however, threefold. First, the fourth member may not wish to leave, which may result in the termination and winding up of the LLC. Second, the three members will be required to raise a large sum of cash to buy off the interest, depending on its value. Third, tax liabilities may arise from the dissolution making it impractical and not worth the effort. The relevance of these concerns determines the effectiveness of the dissolution solution.

VI. CONCLUSION

Unfortunately, little case law exists regarding this hypothetical client's issue. If the client is sued, this issue could be a case of first impression for the court. However, the plain meaning of the LLC Act favors the client for most, if not all, of the above-mentioned solutions. Because the LLC is such a new form of business organization, few issues have been fully litigated. However, it may not be long before litigation that tests the terms and provisions of the LLC Act develops.

As for this client, at least one, or a combination of some, of the above solutions can resolve the issue. The appropriateness of any solution may be best assessed after obtaining more information from the client and involvement of the agreeing members in the decision-making process. Moreover, awareness of the risk of proceeding without an agreed-upon operating agreement leads to competent planning advise for other clients who are contemplating such a conversion.