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Commonwealth of Kentucky

Court of Appeals

NO. 2010-CA-000131-MR

DR. CYRUS C. CHAPMAN — APPELLANT

v.

APPEAL FROM MCCRACKEN CIRCUIT COURT
HONORABLE CRAIG Z. CLYMER, JUDGE
ACTION NO. 06-CI-01159

REGIONAL RADIOLOGY ASSOCIATES, PLLC — APPELLEE

OPINION
AFFIRMING

** ** ** ** **

BEFORE: ACREE, CAPERTON, AND CLAYTON, JUDGES.

CLAYTON, JUDGE: Dr. Cyrus C. Chapman appeals several decisions of the McCracken Circuit Court. First, he appeals from the court's September 10, 2009 order granting partial summary judgment to Regional Radiology Associates, PLLC (hereinafter "RRA"), and granting the portion of his summary judgment as to the valuation of accounts receivable but denying his cross-motion for summary

judgment. Additionally, he appeals from the November 4, 2009 order denying his motion to alter, amend or vacate, denying as moot RRA's motion to dismiss his Kentucky Rules of Civil Procedures (CR) 59.05 motion, and granting RRA's motion for final judgment on all remaining issues. Finally, he appeals the court's December 16, 2009 order denying his motion to alter, amend or vacate. In the various orders the court determined, pursuant to Kentucky Revised Statutes (KRS) Chapter 275, that Dr. Chapman was a member of RRA, a professional limited liability company, but also decided that because no written operating agreement had been executed, Dr. Chapman was not entitled to any additional compensation upon his withdrawal from RRA. We will elucidate further issues as we convey our decision. For the following reasons, we affirm.

FACTUAL AND PROCEDURAL BACKGROUND

RRA is a radiology medical practice organized by Dr. Rosemary Shiben in 2000, and located in the Paducah, Kentucky. In October 2000, RRA was organized as a limited liability company under KRS Chapter 275. Dr. Rosemary Shiben was its sole "manager" and "member" until January 1, 2003.

In 2001, RRA employed Dr. Chapman. It executed a Physician's Employment Agreement with him, under which he received annual compensation of $240,000. The agreement was effective until December 31, 2002. Section 8 of the agreement stated that RRA might offer him an opportunity to become an equity member of the PLLC on or about January 1, 2003.

In mid to late 2002, Dr. Shiben discussed with Dr. Chapman the possibility of his becoming a 40% ownership member of RRA. Their discussion included whether Dr. Chapman would enter into an agreement entitled "Assignment of Membership Interest," as well as a physician employment agreement. Neither document, however, was signed. As part of the negotiations, they discussed Dr. Chapman's making a capital contribution of $10,000. In fact, Dr. Chapman tendered a check to Dr. Shiben through Jim Wring, the office manager, in the amount of $10,000. But the check was never cashed and, eventually, returned to Dr. Chapman. Apparently, because of the lack of a written agreement, RRA did not accept the capital contribution. To date, the sum of $10,000 has not been paid. Significantly, RRA had no written operating agreement nor did it have any other written contracts concerning the methodology to be used in computing payments to Dr. Chapman after January 1, 2003.

Nevertheless, on January 1, 2003, RRA began treating Dr. Chapman as a member of RRA under KRS Chapter 275, and as a partner of RRA for tax purposes. Additionally, on January 1, 2003, RRA elected to be taxed as a partnership. This date was the first time that RRA had more than one member. At the culmination of 2003, the parties' K-1 forms indicated that Dr. Shiben's partnership percentage was 60%, and Dr. Chapman's partnership percentage was 40%. And, an annual report for RRA, which was filed with the Kentucky Secretary of State and signed by Dr. Shiben, showed a new member of the company, that is, Dr. Chapman. For the tax years 2004 and 2005, the same

partnership percentages were listed on the tax forms. Further, the 2004 and 2005 annual reports filed with the Secretary of State for RRA listed Drs. Shiben and Chapman as members.

Once Dr. Chapman was treated as a partner for tax purposes, his guaranteed annual payment was changed from $240,000 to $195,000. Plus, RRA no longer paid the employer's share of the income tax payments on the guaranteed annual payment. Besides the guaranteed income, Dr. Chapman also received a 40% share of the ordinary income (after expenses) of RRA. These additional distributions were based on the profits earned by RRA.

Since the parties had no written operating agreement, cash distributions were made under a system devised by Dr. Shiben. She also was responsible for determining when RRA would make a cash distribution. During his membership in RRA, Dr. Chapman accepted the cash distributions and expressed no objection to the methodology used to determine them.

In January 2006, Dr. Chapman gave notice that he intended to work elsewhere starting in April 2006. After giving notice, he worked intermittently for RRA through April 14, 2006. Following this date, he performed no services for RRA and was not associated with it. From January 1, 2006, through April 14, 2006, Dr. Chapman was paid guaranteed income payments of $63,000 but he received no other profit/income distributions from RRA. From January 1, 2006, until April 14, 2006, Dr. Chapman took time off from RRA for a cruise, additional vacation time for spring break, and worked some hours for his future employer.

Upon his departure from RRA, he did not request additional compensation of any type. Dr. Chapman received no compensation for the accounts receivable earned by RRA between January 1, 2006, and April 14, 2006, although later it was ascertained from his tax forms that he was credited with an additional $51,826, which, in essence, was a cash distribution. RRA's documentation shows the accounts receivable for this period of time were $362,116.46.

Despite the lack of any written or oral agreement between the members, upon his departure from RRA, however, Dr. Chapman did ask for an additional cash distribution based on his status as a former member. After negotiations failed to resolve the issue, RRA filed a declaratory judgment act in McCracken Circuit Court on December 3, 2006, asking the court to declare the rights, duties, and obligations of the parties arising from their previous business relationship. Dr. Chapman answered and counterclaimed, seeking an unspecified sum of money from RRA's undistributed net income and accounts receivable.

On September 10, 2009, a hearing was held in McCracken Circuit Court about the parties' cross-motions for summary judgment. At the hearing, the parties agreed that no genuine issues of material fact were in dispute. The court entered an order partially granting RRA's motion for summary judgment. The only issue remaining after the grant of partial summary judgment motion was the amount of the deductions that RRA may take from the $51,826. RRA concedes that this amount is owed to Dr. Chapman.

During discovery the parties and the court learned that, in addition to the $63,000 paid to Dr. Chapman, RRA had allocated an additional $51,826 in taxable income to him. Specifically, Dr. Chapman's 2006 income tax withholding form and his partnership K-1 form indicated that his share of ordinary business income from RRA was $51,826. Moreover, Dr. Chapman incurred tax liability for this sum even though he never received it. Further analysis regarding the business transaction between the parties confirmed that RRA had also allocated $14,255 in tax deductions to Dr. Chapman, which offset his taxable income. And RRA paid $6,862 in state taxes on Dr. Chapman's behalf. Notably, these taxes were incurred by Dr. Chapman and RRA did not owe them.

Finally, as far as Dr. Chapman's cross-motion for summary judgment, the court determined that valuation for the accounts receivable in question was $362,116.46. But the court denied the portion of the cross-motion that asserted that RRA had a legal obligation to pay Dr. Chapman a portion of the accounts receivable after his withdrawal from RRA.

Thereafter, Dr. Chapman filed a motion to alter, amend or vacate the September 10, 2009 order. The court denied the motion on November 4, 2009. Besides the court's denial of the motion, it resolved the amount owed by RRA to Dr. Chapman based on the additional $51,826 in reported income. Accordingly, the court, after considering the various monetary factors, decided that RRA must pay Dr. Chapman $20,709. The court computed it as follows:

Taxable income allocated to Chapman $ 51,826

Capital payment never made by Chapman	$(10,000)
State taxes paid by RRA owed by Chapman	$ (6,862)
Deductions allocated to Dr. Chapman	$(14,255)
Amount due to Chapman	$ 20,709

RRA does not dispute this amount.

Subsequently, Dr. Chapman appealed from the September 10, 2009 order, the November 4, 2009, and a December 16, 2009 order, which denied another motion to alter, amend, or vacate. In his appeal, Dr. Chapman asks the Court for a judgment that he is entitled to receive 40% of the value of RRA as of April 14, 2006. Dr. Chapman believes that the amount due to him as of this date is 40% of the $362,116.46 accounts receivable, less the $10,000 capital contribution, for a total of $134,846.58. Or, in the alternative, Dr. Chapman asks the Court to remand this case to the McCracken Circuit Court for a determination of the value of RRA as of April 14, 2006, and, thereafter, require that RRA pay Dr. Chapman 40% of the ascertained value of RRA, less the $10,000 capital contribution.

ISSUE

The issue to be considered is whether a former member of a manager-managed professional limited liability company is due an additional cash distribution after he voluntarily resigns from the professional limited liability company when no written operating agreement or oral agreement exists that establishes an entitlement to such remuneration. Dr. Chapman maintains that he was a member of RRA, his percentage of ownership was 40%, and, therefore, he is entitled to a 40% payment for the value of the company on the date of withdrawal.

On the other hand, RRA maintains that the circuit court was correct in its determination under KRS Chapter 275 that RRA should pay Dr. Chapman $20,709 after his voluntary withdrawal and no more.

STANDARD OF REVIEW

The standard of review for summary judgments is whether the trial court correctly determined that there were no genuine issues of material fact and that the moving party was entitled to judgment as a matter of law. *Steelvest, Inc. v. Scansteel Service Center, Inc.*, 807 S.W.2d 476, 480 (Ky. 1991). Without any material disputes concerning the facts, the question is one "of law and may be reviewed de novo." *Bob Hook Chevrolet Isuzu, Inc. v. Com. Transp. Cabinet*, 983 S.W.2d 488, 490 (Ky. 1998). With this standard in mind, we review the case.

ANALYSIS

KRS Chapter 275 governs the creation and direction of limited liability companies and the rights of its members. In essence, a limited liability company is a hybrid business entity that offers its members limited liability, as if they were shareholders of a corporation, but treats the entity and its members as a partnership for tax purposes. Using this framework, our analysis will focus on three issues. First, we will address whether Dr. Chapman was a member of the professional limited liability company, RRA. Next, we will consider the issue of whether he should receive any additional financial remuneration for his ownership interest following his voluntary withdrawal from the company. And finally, we will decide what impact, if any, *Patmon v. Hobbs*, 280 S.W.3d 589 (Ky. App.

2009), has on this case. As an aside, this case is one of first impression involving the construction of certain statutes in KRS Chapter 275.

KRS 275.275 governs admission to membership in a limited liability company. That statute provides:

> (1) Subject to subsection (2) of this section, a person may become a member in a limited liability company:
>
> > (a) In the case of the person acquiring a limited liability company interest directly from a limited liability company, upon compliance with an operating agreement or, if an operating agreement does not so provide in writing, upon the written consent of all members; and
> >
> > (b) In the case of an assignee of the limited liability company interest, as provided in KRS 275.255 and 275.265.
>
> (2) The effective time of admission of a member to a limited liability company shall be the later of:
>
> > (a) The date the limited liability company is formed; or
> >
> > (b) The time provided in the operating agreement or, if no time is provided, when the person's admission is reflected in the records of the limited liability company.

Thus, pursuant to KRS 275.275(1)(a), a person becomes a member of a Kentucky limited liability as described in the limited liability company's "operating agreement or, if an operating agreement does not so provide in writing, upon the written consent of all members." Here, neither party contests that Dr. Chapman was a member of RRA for the time period from January 1, 2003, until April 14,

2006, notwithstanding the lack of a written operating agreement or any written documentation. Certainly, after January 1, 2003, RRA began treating Dr. Chapman as a member of RRA under KRS Chapter 275, and as a partner of RRA for tax purposes. Therefore, it has been agreed that Dr. Chapman was a member of RRA, and it is appropriate that the issues herein are to be determined under KRS Chapter 275.

Next, we will consider whether under KRS Chapter 275 Dr. Chapman was entitled to any additional payment upon his voluntary withdrawal from RRA. Initially, we note that no dispute exists as to the following facts: RRA was always a "manager-managed" company; Dr. Shiben was always the manager of RRA; and, no written or oral agreement has been provided or claimed that shows RRA had any provision regarding payments to withdrawing members. Since no written operating agreement or verbal agreement existed as to compensation upon resignation of membership, it is necessary, as the parties and the circuit court established, to review KRS Chapter 275.

The first applicable factor is found in KRS 275.210, which explicates the distribution of cash or other assets to members of a limited liability company:

> If the operating agreement does not so provide in writing, each member shall share in any distribution 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. A member shall be entitled to receive distributions described in this section from a limited liability company to the extent and at the times or

> upon the happenings of the events specified in an operating agreement or at the times determined by the members or managers pursuant to KRS 275.175.

At RRA, Dr. Shiben was the sole manager and, as such, given the absence of a written operating agreement or an oral agreement, had the right to determine both the timing and amount of the cash distributions.

Next, we now scrutinize the statutory direction in KRS Chapter 275 concerning allocation of profits and losses among members of a limited liability corporation. This information in KRS 275.205 states in pertinent part:

> 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.

As previously stated, no written operating agreement exists, so we turn to the default portions of KRS Chapter 275. According to the statutory language, it is necessary, before allocating any profits (or losses), to ascertain the agreed value, as stated in the records of RRA, of the contributions made by each member to the extent that they have been received and not returned. This section has been explained as follows:

> LLC profits and losses are allocated among the members as provided in the operating agreement. If the articles or a written operating agreement do not provide for

> allocations, profits and losses are allocated in proportion to capital contributions.

See J. William Callison and Maureen A. Sullivan, *Limited Liability Companies: A State-by-State Guide to Law and Practice, Ltd. Liability Co.* § 14:27 (2010). Dr. Chapman has made no capital contributions and, therefore, under this provision, he was not entitled to any allocation of profit or loss.

The statutes in effect at the time of the case also provided that an interest in an LLC may be issued in exchange for consideration of cash, property, or services, or, the obligation to make a contribution.

> A limited liability company interest may be issued in exchange for consideration consisting of cash, property, services rendered, or a promissory note or other obligation to contribute cash or property or to perform services.

KRS 275.195 effective 1994. Thus, it seems that the Kentucky statutes in effect in 2003 did not mandate an initial cash contribution for a person to acquire an interest in a limited liability company. Similarly, notwithstanding Dr. Chapman's lack of a cash capital contribution, the facts show that he proffered a $10,000 contribution, which was returned to him because of the parties' failure to agree and execute certain documents. And, as of January 1, 2003, Dr. Chapman was treated as a member of the professional limited liability company.

The facts show that he received an annual guaranteed payment from RRA of $195,000, and that he paid income taxes on it. RRA made cash distributions to Dr. Chapman from the profits of RRA. Dr. Shiben's pro rata share

was 60%, and Dr. Chapman's pro rata share was 40%. Both members received K-1 tax forms showing income from RRA. And, finally, the 2003 annual report submitted to the Kentucky Secretary of State and signed by Dr. Shiben included the name of a new member, Dr. Chapman. His name was also listed on the 2004 and 2005 annual reports. So, despite the statutory language regarding the allocation of profit and losses found in KRS 275.205, the normal course of dealing for RRA from 2003 until 2005 was to treat Dr. Chapman as a member, and provide him with a 40% cash distribution from the profits. Yet, it must be emphasized that all distributions were solely determined, both as to time and amount, by the manager-member. Furthermore, Dr. Chapman made no objection to the process or to the amount of the distributions.

In short, having determined that from 2003 until April 2006, Dr. Chapman was a member and received a pro rata distribution of profits, we now look to the applicable law to ascertain whether Dr. Chapman was entitled to any additional compensation upon his withdrawal from RRA. Significantly, it is important to note that the statutes pertaining to the allocation of profits and losses are not applied or cross-referenced to a member's disassociation from a limited liability company, but only address profit distribution for members.

Cessation of membership is provided for in KRS 275.280. The pertinent portion of the statute as it was in effect at the time of Dr. Chapman's withdrawal says:

> (1) A person shall disassociate from the limited liability company and cease to be a member of a limited liability company upon the occurrence of one (1) or more of the following events:
>
> > (a) Subject to the provisions of subsection (3) of this section, the member withdraws by voluntary act from the limited liability company[.]

The statute, however, gives no instruction as to compensation for the withdrawing member. Since no guidance is provided in the statute about cessation of membership, we look elsewhere in KRS Chapter 275. In doing so, we note KRS 275.165(2), which states that if a Kentucky limited liability company's articles of organization vest management in one or more managers, then, except to the extent otherwise provided in the articles of organization, the operating agreement, or KRS Chapter 275, "the manager or managers shall have exclusive power to manage the business and affairs of the limited liability company." Here, RRA's Articles of Organization vested power in Dr. Shiben, who was the sole manager at all times relevant to this proceeding. Consequently, Dr. Shiben had "exclusive power to manage the business and affairs" of RRA under KRS 275.165(2), except as might otherwise be stated in KRS Chapter 275.

Hence, with no written operating agreement and no direct statutory direction, any decision regarding compensation rested with Dr. Shiben. Moreover, any reliance on KRS 275.205 is misplaced, since it pertains only to the allocation of profit and losses among members of a Kentucky limited liability company, and

does not specifically mandate any required compensation upon a member's voluntary withdrawal from a limited liability company.

To summarize, Dr. Chapman has provided no statutory support for his contention that he is owed 40% of the accounts receivable as of April 14, 2006. Indisputably, no operating agreement was entered into between the members that delineated the actions upon a member's withdrawal. The only perceptible statutory guidance is found in KRS 275.165(2), which says "the manager or managers shall have exclusive power to manage the business and affairs of the limited liability company." Dr. Shiben was the sole manager of RRA with exclusive power to manage the business, and she allowed for RRA to give Dr. Chapman $63,000 and $51,826 as he left RRA.

Moreover, we are not persuaded by Dr. Chapman's argument that the 60/40 pro rata allocation of profits establishes an agreed value for his interest in RRA, and entitles him to 40% of the accounts receivable, less the $10,000 capital cash contribution, upon his withdrawal. Again, he provides no statutory language or caselaw or agreement between the parties to support this interpretation. While a written operating agreement or an oral agreement may have provided such compensation, one did not exist.

And, as previously intimated, Dr. Chapman's reliance on KRS 275.205 as establishing his entitlement to 40% of the accounts receivable is also misplaced. This statute merely pertains to the allocation of profits and losses. It makes no reference to a member's share of a company's assets when a member

leaves. A company's distribution of cash or other assets to its members is found in KRS 275.210, wherein is found the following applicable language:

> A member shall be entitled to receive distributions described in this section from a limited liability company to the extent and at the times or upon the happenings of the events specified in an operating agreement or at the times determined by the members or managers pursuant to KRS 275.175.

At all times, RRA's distributions of cash were solely determined by Dr. Shiben, and it had no written operating agreement.

In sum, Dr. Chapman has failed to establish that RRA had a legal obligation to pay him a portion of the accounts receivable upon his voluntary resignation from RRA. No written operating agreement ever governed Dr. Chapman's membership. Neither does any statutory language allow for his receipt of a portion of the accounts receivable, nor does equity so demand. Contrary to Dr. Chapman's assertion that, based on the course of dealings between the parties, equity required that he receive 40% of the accounts receivable upon his departure from RRA. The practices of RRA were dependant on his membership and had no bearing on his ultimate decision to leave RRA.

Finally, Dr. Chapman cites *Patmon v. Hobbs*, 280 S.W.3d 589 (Ky. App. 2009), as supporting his proposition that, as an owner of a limited liability company, he is entitled to 40% of its value upon his withdrawal. In *Patmon,* the managing member of the company formed a competing business and diverted some of the assets of another limited liability company, for which he was the

managing member, to his new business. The court held that, in diverting an opportunity from this limited liability company to another company, he breached his fiduciary duty of loyalty to the original company. Curiously, Dr. Chapman's only explanation for *Patmon's* applicability is that he was owed a duty of good faith and to be treated fairly. The facts of this case do not indicate otherwise. Besides, we conclude that *Patmon* is inapposite because it addressed the relationship between fiduciary duty and misappropriation of corporate opportunity.

For the foregoing reasons, the summary judgment of the McCracken Circuit Court is affirmed. Additionally, we add that we concur with the trial court's well-reasoned approach to the remaining financial issues devolving from Dr. Chapman's resignation, and conclude that RRA's payment of $20,709 to him is appropriate.

ALL CONCUR.

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