

DELAWARE LLCs

The Wave of the Future and Advising Your Clients About What to Expect

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In less than two decades, Delaware limited liability companies (LLC) have gone from *nouveau* “alternative” entity to the “go-to” entity. Since 2001, new LLC formations have outpaced all other business entity formations in Delaware, including corporations. The rapid deployment of LLCs by the business community has naturally led to an uptick in LLC litigation. That litigation has resulted in steady development of the case law surrounding and construing the Delaware Limited Liability Company Act (the DLLCA or the Act). Previously, Delaware courts frequently looked to the well-developed body of corporate jurisprudence for guidance in resolving LLC disputes. As a result, Delaware’s LLC law has paralleled the state’s corporate law in many key respects. That dynamic appears to be changing, however.

Over the last few years, the common law and statutory law relating to LLCs have experienced fairly dramatic

changes. For example, as discussed more fully herein, members can eliminate traditional fiduciary duties, provide broad exculpatory rights, waive the right to judicial dissolution, and waive the right to have a receiver appointed. Additionally, though members may structure their relationship through an oral or implied operating agreement, they need to consider the applicability of the statute of frauds. These, and other, changes in the statutory and common law of LLCs in Delaware reflect an acknowledgment of the inherent differences between unincorporated entities and corporations. As Delaware’s LLC law continues to mature, we likely will see greater divergence between the state’s LLC law and its corporate law.

This is not to say that Delaware courts will not look to Delaware’s well-developed body of corporate law for guidance on occasion. Indeed, they will, and they should. However, the Delaware LLC is an animal of a different stripe, given its contractual lineage. Many of the recent judicial decisions, some of which are discussed below, acknowledge this fact and reflect a concerted effort by Delaware’s courts, legislators, and practitioners to develop a body of law for LLCs with the depth, breadth, and stability that are hallmarks of the state’s corporate law.

Operating Agreements

As business law practitioners know, limited liability companies are creatures of contract. Delaware’s statutory scheme

affords members virtually unlimited discretion to define the terms of their relationship in the operating agreement. Indeed, the Act contains a host of fundamental provisions that are subject to modification by the members. Such unfettered contractual freedom can be problematic, however. As the Delaware experience would suggest, all too often operating agreements contain contradictory, inconsistent, ambiguous, and, sometimes, just plain indecipherable language. When a dispute arises over the meaning of a provision in the operating agreement, Delaware courts employ an objective theory of contract interpretation. Extrinsic evidence is excluded when the meaning of the disputed term is obvious from a plain reading of the contract. The challenge, then, is to draft with precision because unambiguous operating agreements are enforced as written in Delaware.

Indeed, it was on this basis that the court of chancery recently ordered judicial dissolution of an LLC despite one member’s claim that the operating agreement failed to reflect the intent of the parties. In *Spellman v. Katz*, C.A. No. 1838 (Del. Ch. Feb. 6, 2009), the operating agreement required dissolution upon the occurrence of a series of events set forth in the agreement. The enumerated events occurred, but neither member moved to dissolve the company for several years. The respondent argued that the dissolution provision was unknown to the members at the time they signed the operating

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agreement and asserted that the members' true—but unwritten—intent was to operate the company until certain tax and mortgage-related benefits expired, as evidenced by their course of conduct. The court declined to consider the parol evidence, finding the language of the operating agreement unambiguous.

Less than two months later, the court granted dissolution in another LLC action, concluding that the relevant terms of the operating agreement were only susceptible to one reasonable interpretation. In *In re Nextmedia Investors, LLC*, C.A. No. 4067-VCS (Del. Ch. May 6, 2009), the operating agreement specified a date for dissolution and required that all members adversely affected by the amendment approve any extension of the dissolution date. The managers amended the dissolution date even though they were unable to obtain the requisite consent. On a motion for summary judgment, the defendant company argued that the relevant provisions were susceptible to different interpretations and, thus, were ambiguous. The court found that the interpretation asserted by the company conflicted with the plain language of the operating agreement and refused to engage in a tortured reading of the agreement to create an ambiguity. As the foregoing decisions demonstrate, precise drafting ensures that the operating agreement accurately reflects the members' business intentions; clear drafting also enables courts to resolve interpretational disputes early in litigation, thereby reducing litigation costs.

Oral Operating Agreements

Oral and implied operating agreements present a much thornier issue for courts. In Delaware, members may structure their business relationship through a written, implied, or oral operating agreement. The flexibility afforded by section 18-101(7) of the DLLCA is not without risk, however. When members, whether by design, inadvertence, or simple neglect, do not execute a written operating agreement, they face substantial uncertainty if their relationship deteriorates to the point of

litigation because oral contracts must be proven by clear and convincing evidence in Delaware. If that evidentiary burden is not satisfied, the court of chancery may look to the DLLCA to supply the terms of the members' operating agreement. Thus, the very real possibility exists that the court-imposed operating agreement will differ dramatically from the oral agreement originally envisioned by the members.

The uncertainty associated with oral operating agreements took on a new twist with the court of chancery's decision in *Olson v. Halvorsen*, C.A. No. 1884-VCL (Del. Ch. Oct. 22, 2008).

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There, the court considered whether the statute of frauds applied to an oral operating agreement. Generally speaking, the statute of frauds requires that certain types of contracts (e.g., for the sale of land, for the sale of goods in excess of \$500, and those that cannot be performed in one year) must be in writing and signed by the party against whom performance is sought for the contract to be enforceable in a court of law.

Prior to *Olson*, no Delaware court had been asked to consider whether the statute of frauds applied to an oral operating agreement. To many, the question seemed something of an academic one. Indeed, if asked, many Delaware practitioners would have answered the question in the negative. A leading Delaware treatise on limited liability company law expressed that very opinion. The authors reasoned that the application of the statute of frauds would run counter to the policy of the Act, i.e., to give maximum effect to the enforceability of operating agreements.

To the chagrin of some, the court of chancery in *Olson* arrived at the opposite conclusion. Though noting the

split of scholarly opinion on the applicability of the statute of frauds to an oral operating agreement, the court applied the doctrine to the agreement and held that those provisions that cannot possibly be performed within one year, i.e., a multiyear earn-out provision and other substantive obligations and restrictions extending beyond one year, were unenforceable. The court explained that its decision was "in line with the policy for the enactment of the statute of frauds—to protect defendants against unfounded or fraudulent claims that would require performance over an extended period of time." The court acknowledged the policy of the DLLCA "to give maximum effect . . . to the enforceability of limited liability companies" but reasoned that the narrow application of the statute of frauds did not run counter to that policy. *Olson* adds yet another layer of uncertainty to oral operating agreements. Thus, practitioners should advise their clients of the risks involved with oral and implied operating agreements and encourage them to reduce their agreement to a clear, precise writing.

Fiduciary Duties and Liabilities

By now, it is well understood that, as a result of the amendments to section 18-1101 of the DLLCA in 2004, members may limit or eliminate both traditional fiduciary duties and liabilities arising out of a breach of those duties. Caution is in order, however. Delaware courts typically imply the existence of traditional fiduciary duties as a default mechanism in the absence of an express, unambiguous provision in the operating agreement eliminating those duties. Thus, precise drafting is paramount, as the recent decision in *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, C.A. No. 3658 (Del. Ch. Apr. 20, 2009), illustrates.

In *Bay Center*, the plaintiff (Bay Center Apartments Owner, LLC) sued the managing member (Emery Bay PKI, LLC) of a Delaware LLC (Emery Bay Member, LLC) and the individual owner of PKI (Alfred Nevis) over a failed condominium development project. Plaintiff asserted claims of breach

of fiduciary duty against PKI and Nevis (defendants), which they moved to dismiss. Unfortunately for defendants, the operating agreement contained arguably conflicting provisions concerning fiduciary duties. Defendants pointed to a provision of the agreement stating, “[e]xcept for any duties imposed by this Agreement . . . each Member shall owe no duty of any kind towards the Company or the other members in performing its duties and exercising its rights hereunder or otherwise.” But plaintiff pointed to an immediately preceding section of the agreement that stated, “[t]he Members shall have the same duties and obligations to each other that members of a limited liability company formed under the Delaware Act have to each other.” That meant, in the Court’s view, the members of Emery Bay owe each other default fiduciary duties. Given the conflicting provisions, the court of chancery had no choice but to deny the motion to dismiss. Had the drafters of the Emery Bay agreement made clear their intention with respect to fiduciary duties, this unhappy circumstance (at least for defendants) could have been avoided.

The good news is that when parties make clear that fiduciary duties are eliminated, Delaware courts will readily honor their intent. For example, in *Fisk Ventures, LLC v. Segal*, C.A. No. 3017-CC (Del. Ch. May 7, 2008), the court of chancery held that, “by flatly stating that members have no duties other than those expressly articulated in the Agreement,” the parties had eliminated fiduciary duties because the agreement did not otherwise articulate any such duties. Delaware courts similarly will honor the parties’ efforts to limit liability for a breach of duty where their intent is unambiguously expressed in the operating agreement. In *Wood v. Baum*, 953 A.2d 136 (Del. 2008), the operating agreement exculpated managers from liability except for claims based on fraudulent, illegal, or bad faith conduct. The Delaware Supreme Court affirmed the court of chancery’s dismissal of the action because the plaintiff failed to plead “particularized

facts [in the complaint] that demonstrate that the [managers] acted with scienter, i.e., that the [managers] had actual or constructive knowledge that their conduct was legally improper.” Thus, whether it is eliminating fiduciary duties or expanding exculpatory rights, practitioners would do well to state the parties’ intentions in clear, unambiguous terms.

A further note of caution is in order. Though section 18-1101(c) of the Act prohibits elimination of the implied covenant of good faith and fair dealing, as a practical matter, claims asserting breach of the implied covenant are difficult to sustain in Delaware because the doctrine is construed narrowly. Thus, practitioners should consider advising clients to incorporate some standard of liability in the operating agreement. It is perfectly acceptable, for example, to eliminate manager liability except in cases of fraudulent or illegal conduct, as was the case in *Wood v. Baum*. One can go even further and attempt to define the precise circumstances in which liability may be imposed.

Judicial Dissolution

The story is an all-too-familiar one. A once successful business falters for any number of reasons and one or more of the members seek to exit the business. Though perhaps not thought of as such, the statutory right of judicial dissolution embodied in section 18-802 of the DLLCA is a valuable right because it can provide members with an exit mechanism in certain instances. To obtain judicial dissolution, a member must establish that “it is not reasonably practicable to carry on” the company’s business in conformity with its operating agreement. The decision to grant judicial dissolution rests with the sound discretion of the court of chancery, but section 18-802 does not identify the factors the court should consider. As such, the task of developing an appropriate test has fallen to the Delaware courts.

Recently, in *Fisk Ventures, LLC v. Segal*, C.A. No. 3017-CC (Del. Ch. Jan. 13, 2009), the court of chancery identified three factual circumstances that the

court should consider in evaluating the reasonably practicable standard: (i) the existence of a board deadlock; (ii) the absence of a mechanism in the operating agreement to circumvent the deadlock; and (iii) the inability of the company to operate, given its financial condition. The court granted dissolution in *Fisk*, finding that all of the factors had been satisfied. There is, however, no

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requirement that all of these factors be met to obtain a decree of judicial dissolution. Nor are the factors individually dispositive.

Arguably, a fourth factor should be added to the *Fisk* factors: whether the company is operating within the scope of the business purpose clause in its operating agreement. It was on this basis that the court of chancery declined to grant judicial dissolution in *In re Seneca Investments LLC*, 970 A.2d 259 (Del. Ch. 2008). Though Seneca Investments LLC had dramatically reduced its operations, it continued to act as a passive investment vehicle and was pursuing legal claims against one of the members. These activities were within the company’s broad business purpose clause, which permitted it to “engage in any lawful act or activity for which corporations may be organized.” The court relied on the absence of a board deadlock and the company’s compliance with its business purpose to deny dissolution.

More recently, the petitioner in *In re Arrow Investment Advisors, LLC*, C.A. No. 4091-VCS (Del. Ch. Apr. 23, 2009), made a novel, though ultimately unavailing, argument, perhaps in an effort to circumvent the holding in *Seneca*. Arrow Investment Advisors, LLC had a business plan setting forth financial projections for the company’s first

The Delaware Limited Liability Company Act

The Delaware Limited Liability Company Act (the Act) is reviewed annually and amended periodically to keep it current and to maintain its preeminence. Effective August 1, 2009, the Act was amended to

- Clarify that the court of chancery has subject matter jurisdiction to interpret, apply, or enforce any provision of the Act or any instrument, document, agreement or certificate contemplated by any provision of the Act (Del. Code tit. 6, § 18-111);
- Provide that a certificate of merger or consolidation filed by a surviving or resulting or other business entity must be executed by any person authorized to execute such certificate of such other business entity (Del. Code tit. 6, § 18-204);
- Allow a change of the registered agent or registered office to be included in a certificate of merger that is filed by a surviving domestic limited liability company (Del. Code tit. 6, § 18-209(c)(4));
- Confirm that a limited liability company may amend, or adopt anew, a limited liability company agreement in conjunction with a merger or consolidation under Del. Code tit. 6, § 18-209, unless the agreement expressly prohibits such amendment or adoption of a new agreement in connection with a merger or consolidation (Del. Code tit. 6, §§ 18-209(f) and 18-302(e)). As a result of this amendment, the amendment or adoption of a new limited liability agreement in connection with a merger or consolidation can be accomplished, notwithstanding a provision in the existing limited liability company agreement placing limitations or restrictions on amendments, e.g., special voting or consent requirements such as supermajority approval; and
- Codify that the doctrine of independent legal significance may apply with respect to actions taken under provisions of the Act (Del. Code tit. 6, § 18-1101). The doctrine of independent legal significance provides that an action taken pursuant to one provision of the Act is legally independent and will not be deemed invalid solely because it is identical to or similar in substance to an action that could have been taken pursuant to another provision of the Act, but fails to satisfy the requirements of that other provision. In other words, each action has independent legal significance.

few years. The economic downturn left the company unable to meet those projections. The managers chose to pursue other strategies not set forth in the business plan, but that were within the scope of the broad business purpose clause in the operating agreement. The petitioner argued that it was no longer reasonably practicable to carry on the business of the company because the company could not meet the projections in the business plan and was pursuing strategies outside the plan. The court found the petitioner's argument unpersuasive, reasoning that the business purpose clause in the agreement, not the business plan, was controlling.

As the foregoing cases demonstrate, Delaware courts are chary about granting judicial dissolution except in the most extreme circumstances.

Accordingly, practitioners should advise their clients concerning the potential consequences of board deadlocks, broad (or narrow) business purpose clauses, and the failure to include reasonable buy-out provisions for disgruntled members. Following the decision in *R&R Capital, LLC v. Buck & Doe Run Valley Farms, LLC*, C.A. No. 3803-CC (Del. Ch. Aug. 19, 2008), practitioners also should address the advisability of waiving the statutory right of judicial dissolution.

R&R Capital, LLC presents one of the more controversial court of chancery decisions concerning alternative entities in 2008. In that case, the court held that members could waive their statutory right to judicial dissolution, appointment of a receiver, and winding up. Generally speaking, the decision has

two key parts. The court first addressed an "apparent tension" between two provisions in the operating agreement. Section 10.1 of the operating agreement recited that entry of a decree of judicial dissolution pursuant to section 18-802 of the DLLCA would result in dissolution. By contrast, in section 13.1, titled *Waiver of Dissolution Rights*, the members agreed that "irreparable damage would occur if any member should bring an action for judicial dissolution," and waived their "right to seek a court decree of dissolution or to seek the appointment by a court of a liquidator for the Company." Relying on the language of section 18-802, which states that a "decree of judicial dissolution" may be entered upon an "application *by or for* a member or manager," the court reasoned that a member could waive his or her right to seek judicial dissolution, but could not waive another's right to seek judicial dissolution on behalf of the member. This portion of the *Fisk* decision leaves two interesting questions unanswered: first, who would have the power and authority to act "for" a member—a trustee or a guardian, perhaps? Second, if the member knowingly waives a statutory right, how does a trustee or guardian stepping into the shoes of the member, so to speak, succeed to rights greater than those possessed by the member?

The court next addressed waiver of the statutory rights embodied in sections 18-802, 18-803, and 18-805. The court concluded that these statutory rights are permissive, not mandatory, and thus could be waived. This conclusion was premised on three points. First, these sections do not expressly prohibit waiver, whereas other sections of the DLLCA, such as 18-1101(c) and (e), contain express language prohibiting waiver. Second, the court cited the use of permissive, rather than mandatory, language (i.e., "may") in sections 18-802 and 18-805 as evidence that the drafters of the DLLCA intended that these sections could be modified by the members in their agreement. Finally, the court reasoned that these statutory rights were not intended to protect third parties and, therefore, waiver of these rights would not harm the interests of third parties. The court also cited

public policy reasons to further buttress its conclusion that these statutory rights could be waived.

Prior to *R&R Capital*, many, if not most, Delaware practitioners were of the opinion that the statutory right to judicial dissolution was mandatory, like its corporate counterpart, and thus could not be waived. Some practitioners remain of the opinion that the right should not be waivable because it affords members an exit mechanism in the face of oppression or other business-related misconduct. Though the court in *R&R Capital* stated that the implied covenant of good faith and fair dealing would provide sufficient protection to members, that doctrine is applied narrowly in Delaware and, therefore, a question remains whether the doctrine truly can provide adequate protection. That said, *R&R Capital* is the law in Delaware presently. Therefore, practitioners would be wise to consider

whether this statutory right should be among the panoply of rights and protections incorporated into the members' operating agreement.

Document Inspection Rights

Finally, practitioners should understand and be prepared to define member inspection rights carefully. In the corporate world, stockholders possess a qualified right to inspect the books and records of a corporation in which they have invested, and Delaware courts have been careful to protect and encourage the use of that inspection right. By contrast, section 18-305 of the DLLCA affords members a right of access only to those documents and other information enumerated in that section, subject to such "reasonable standards" as may be set forth in the operating agreement. This right of access is statutorily qualified by the requirement that the demand for access be "for any purpose reasonably related

to the member's interest as a member of the limited liability company."

Inspection rights are yet another example of where the law of limited liability companies departs from corporate law in Delaware. Member inspection rights may be broadened or narrowly restricted in the operating agreement. Since inspection rights may serve as an important check on management, care should be taken in drafting these provisions. Practitioners representing nonmanagement members may wish to broaden and fortify a member's right of access in the operating agreement, while those representing member-managers may wish to impose significant but reasonable limitations. As is often the case in much of the law, circumstances drive the decision. However, circumstances change over time, which is why practitioners should advise their clients to be even-handed, careful, and forward-looking when deciding on the terms of the operating agreement.