RECENT CASE LAW DEVELOPMENTS RELATING TO DELAWARE'S ALTERNATIVE ENTITIES

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The Delaware courts have addressed a number of significant issues over the past year relating to alternative entities formed under the Delaware Revised Uniform Limited Partnership Act (the "LP Act")[1] and the Delaware Limited Liability Company Act (the "LLC Act"). Some of the areas addressed by the courts include fiduciary duties, the inspection of books and records, the applicability of the statute of frauds, indemnification, judicial dissolution, and various procedural issues. This article discusses these cases and their practical effects on the use of Delaware alternative entities.

I. FIDUCIARY DUTIES

A. Contractually Assumed Fiduciary Duties

In *In re Cencom Cable Income Partners, L.P. Litigation,*[2] the Delaware Court of Chancery analyzed a plaintiff's right to enforce a voluntarily assumed duty. This case added to a series of decisions stemming from ongoing litigation by class representatives of limited partners against a limited partnership, its general partner, and the general partner's executive officers. In this case, the general partner, pursuant to authority conferred by the LP agreement, agreed to sell certain partnership assets to various affiliates. The general partner invoked the appraisal process set forth in the LP agreement and, although not required pursuant to the LP agreement, retained a law firm to act as special outside counsel on behalf of the limited partners in connection with such sale. In disclosure material, the general partner noted that the role of the law firm was to "assure that the Appraisal Process and the Sale Transaction would be fair to the Limited Partners and to protect the rights of the Limited Partners in connection therewith."[3] The law firm was to deliver an opinion that the appraisal process, the general partner's solicitation of consent, and the sale transaction were each in compliance with the LP agreement.[4]

In prior litigation, the court had held that the general partner had voluntarily assumed a duty that the law firm would fulfill its obligations. In this part of the litigation, the defendants, including the general partner, were seeking summary judgment based upon an argument that the plaintiffs had no right to enforce the voluntarily created duty, regardless of its scope, because the plaintiff had not actually bargained for the created duty and had not given the general partner any consideration to support its assumption of such duty. As a result, in the defendants' view, the only theory of recovery

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1. *See*, respectively, DEL. CODE ANN. tit. 6, §§ 17-101, *et seq*., and §§ 18-101, *et seq*.

2. C.A. No. 14634, 2008 WL 5050624 (Del. Ch. Nov. 26, 2008).

3. *Id.* at *2.

4. *Id.*

available to the plaintiffs was promissory estoppel. Since the limited partners had not read the disclosure statement and had not relied upon the disclosure, the elements of promissory estoppel could not be met. The court disagreed with the defendants' use of the contractual-based promissory estoppel theory and reasoned that the duty at issue '"arose not out of contract, but out of the common law"' and therefore the promissory estoppel argument was unavailing.[5] As the general partner had voluntarily undertaken to deliver the opinion and had "imported common law fiduciary duties into the relationship," the court denied the defendants' motion for summary judgment on this issue.[6]

B. Modification of Fiduciary Duties

As a general matter, the default rule under the LP Act and the LLC Act is that traditional corporate fiduciary duties apply in the limited liability company and limited partnership context. As both limited liability companies and limited partnerships are creatures of contract, the LP Act and the LLC Act allow modification within the applicable LP agreement or LLC agreement, including the waiver or elimination of duties (including fiduciary duties), except for the implied contractual covenant of good faith and fair dealing.[7] The risk associated with any contract is the presence of unclear or ambiguous language left for a court to interpret upon a dispute among the parties involved. In *Kahn v. Portnoy,*[8] Chancellor Chandler analyzed an LLC agreement that attempted to modify traditional fiduciary duties but did so in an ambiguous manner.

The *Kahn* case involved a derivative complaint brought by a shareholder (i.e., member) of an LLC against various directors and beneficial owners of the LLC. The plaintiff alleged that the defendant directors had breached their fiduciary duties when they approved a lease transaction between the LLC and an affiliated company of the LLC, which transaction the plaintiff contended was designed to benefit the defendant directors at the expense of the LLC. In response to this claim, the defendant directors filed a motion to dismiss for failure to state a claim.

The LLC agreement at issue provided that the fiduciary duties of the board of directors would be identical to those of a board of directors of a Delaware corporation under the Delaware General Corporation Law (the "DGCL"), unless otherwise specifically provided within the LLC agreement. Section 7.5(a) of the LLC agreement first modified fiduciary duties by specifically permitting or approving the board of directors' actions in respect of certain types of conflicts of interest if specified conditions were met. Section 7.5(a) also set forth a presumption that the board of directors acted properly even in interested transactions, with such presumption only capable of being overcome by clear and convincing evidence. The defendant directors argued that this section of the LLC agreement altered the pleading standard and created a presumption that they acted within their duties, notwithstanding the fact that their approval of the lease transaction had been interested. The court disagreed with the defendants and found that the application of section 7.5(a) of the LLC agreement to the current situation was susceptible to more than one reasonable interpretation, and, as a result, the court would not choose between the interpretations during the motion to dismiss stage of the case proceedings. Further, the court noted that the evidentiary standard set forth in section 7.5(a) of the LLC agreement was not in any event applicable in the motion to dismiss stage of the proceedings.

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5. *Id.* at *4.

6. *Id.*

7. LP Act § 17-1101; LLC Act § 18-1101.

8. C.A. No. 3515-CC, 2008 WL 5197164 (Del. Ch. Dec. 11, 2008).

In addressing plaintiff's fiduciary duty claims, the defendants also argued that the challenged transaction had been disclosed and therefore accepted by the shareholders when the LLC had been formed. In rejecting that assertion, the court recognized that the LLC agreement specifically addressed fiduciary duties "and thus negate[d] any other implied approval of conflicted board decisions."[9] As a result, the court was of the view that, in this context, "other disclosures [did] not impliedly override the express provisions of [the LLC's] primary governing document."[10]

The court then examined whether the defendants could be held personally liable for violating their duties under the exculpation section of the LLC agreement. After attempting to reconcile two arguably conflicting provisions exculpating the directors, the court determined that neither provision protected directors from liability if they acted in bad faith. As part of its analysis of the motion to dismiss, the court included an interesting discussion of good faith. Noting that good faith is not "an independent fiduciary duty" but rather a part of the duty of loyalty, the court made clear that a breach of the duty of loyalty need not involve a conflict of interest between a director and the company. "A director does not act in good faith, even if there is not a direct conflict of interest as to that director, unless the director 'acts in the good faith belief that her actions are in the corporation's best interest.'"[11] The court described the failure to so act as "'classic, quintessential bad faith.'"[12]

The court explained that bad faith also "includes conduct that can be defined as 'a conscious disregard for one's responsibilities' or 'intentionally fail[ing] to act in the face of a known duty to act,'"[13] and the court denied the defendants' motion to dismiss, finding that the plaintiff had sufficiently alleged a quintessential element of bad faith to survive such a motion. In so doing, the court focused on allegations regarding one director's divided loyalties to the LLC and regarding the other directors' being beholden to such director to the detriment of the LLC.

In *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC,*[14] the Delaware Court of Chancery further examined the concept of the modification of fiduciary duties in an LLC agreement. The plaintiff and defendant were each LLCs that together formed another LLC ("Emery Bay") to own a condominium project and in which the defendant LLC acted as the managing member. An individual defendant ("Nevis") was the manager of the defendant LLC. The defendant LLC was given considerable power and authority under the LLC agreement of Emery Bay, although most of its management responsibilities were set forth in a separate agreement signed by one of its affiliates and to which it was only a counterparty.

The project encountered many problems. Emery Bay defaulted under a third-party loan that Nevis had personally guaranteed. The plaintiff claimed that upon the default, the defendants held secret negotiations that resulted in the creation of a separate note to divert cash flow from Emery Bay and that were designed to avoid triggering both the personal guarantee by Nevis under the third-party loan and capital calls on the defendant LLC to make contributions to Emery Bay.

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9. *Id.* at *5. n.22.

10. *Id.*

11. *Id.* at *7.

12. *Id.*

13. *Id.*

14. C.A. No. 3658-VCS, 2009 WL 1124451 (Del. Ch. Apr. 20, 2009).

Once the project had completely failed, the plaintiff brought action against the defendant LLC, Nevis, and others for monetary damages under several theories of liability, including breach of fiduciary duties. The defendants filed a motion to dismiss on all claims other than the plaintiff's contract claims. The court denied the motion to dismiss in its entirety.

The court addressed whether the LLC agreement had modified the traditional fiduciary duties of loyalty and care owed to the members of Emery Bay. The defendants argued that the LLC agreement had completely eliminated all fiduciary duties, while the plaintiff argued that the LLC agreement had specifically preserved the traditional fiduciary duties. In its review of the LLC agreement, the court referenced two sections of the LLC agreement, one that seemed to provide that the members owed each other default fiduciary duties and the other that seemed to provide that the members owed each other no duty of any kind not imposed under the LLC agreement. The court favored the plaintiff's interpretation based in part on the view that modifications of fiduciary duties must be clearly stated: "And, the interpretive scales also tip in favor of preserving fiduciary duties under the rule that the drafters of chartering documents must make their intent to eliminate fiduciary duties plain and unambiguous."[15]

With respect to the defendant LLC, who had been accused of various breaches of fiduciary duties, the court did not dismiss such claims because it had already concluded that the LLC agreement had not modified the defendant LLC's fiduciary duties. More interestingly, the court then examined the fiduciary duty claims against Nevis, who was not a direct member, manager, or officer of Emery Bay. In this analysis, the court relied upon *In re USACafes, L.P. Litigation,*[16] which provides that "'those affiliates of a general partner who exercise control over the partnership's property may find themselves owing fiduciary duties to both the partnership and its limited partners.'"[17] The court noted that the duty is limited to circumstances where the affiliate exerts control over the assets of the entity. The court found that the plaintiff had sufficiently pled facts that Nevis had exerted direct control over Emery Bay's property. The duty of an affiliate is also limited to circumstances where the affiliate has used its control to benefit itself at the expense of the entity. Here, the court also found that the plaintiff had sufficiently pled facts to show that Nevis had benefitted himself at the expense of Emery Bay by renegotiating a loan to avoid triggering his personal guarantee. Thus, the court denied the motion to dismiss the claims relating to the fiduciary duties owed by Nevis.

In *Brinckherhoff v. Texas Eastern Products Pipeline Company, LLC,*[18] the Delaware Court of Chancery had been asked to approve a settlement of two actions. The first action included a count alleging breaches of fiduciary duties in connection with a master limited partnership's engaging in a joint venture transaction and an asset sale. There was significant ownership and control overlap between the master limited partnership and the joint venture partner and buyer. The second action arose out of a challenge by the plaintiffs to a merger of two entities controlled by the defendant, which the plaintiffs claimed was effectuated by the defendant solely to extinguish the plaintiffs' standing to maintain the first action. As *Brinckherhoff* was a decision to approve a settlement agreement, the court did not render any final decisions regarding the plaintiffs' fiduciary duty claims, but rather discussed the strength of potential arguments made by each side in determining the appropriateness of the settlement agreement.

In evaluating the settlement, the court noted the strength of the plaintiffs' underlying claims of breaches of fiduciary duties. As part of their case, the plaintiffs relied on a provision of the applicable LP agreement that specifically provided

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15. *Id.* at *9.

16. 600 A.2d 43 (Del. Ch. 1991).

17. *Bay Center*, 2009 WL 1124451, at *9 (quoting Bigelow/Diversified Secondary P'ship Fund 1990 v. Damson/Birtcher Partners, C.A. No. 16630-NC, 2001 WL 1641239, at *8 (Del. Ch. Dec. 4, 2001)).

18. 986 A.2d 370 (Del. Ch. 2010).

that transactions between affiliates under the LP agreement be "fair and reasonable" and on terms "no less favorable to [the partnership] than those generally being provided to or available from unrelated third parties."[19] The defendants argued that provisions of the LP agreement providing the general partner with general managerial authority and defining "sole discretion" protected the defendants' actions. The court was not persuaded by the defendants' interpretation, finding that the provision specifically addressing affiliated transactions controlled the issue because, from a contractual interpretation standpoint, the more specific provision controls over a general provision. The court noted that the restriction on transactions with affiliates did not involve discretionary action by the general partner but instead set forth a standard ("fair and reasonable") that the transaction must satisfy. In applying the more specific provision to the facts, the court stated:

> Whether the terms of the Pioneer Sale and the Jonah Joint Venture met the contractual standard established by Section 6.6(e) is a hotly disputed issue. At this stage of the case, I believe the plaintiffs have made a strong showing that the terms of the transactions dramatically undervalued Teppco's assets, were structured by conflicted fiduciaries who had powerful economic and personal reasons to favor Enterprise, were less favorable to Teppco than a third party transaction, and were unlikely to meet the "fair and reasonable" test. I thus believe that there is a strong case to be made that Section 6.6(e) was breached.[20]

While the court felt that the plaintiff had strong arguments as to why the affiliated transaction provision had been breached, it did not feel that claims styled as common law breach of fiduciary duty claims would succeed. The court acknowledged that the LP Act permits parties to limit or eliminate fiduciary duties. As a result, the court believed that the affiliate transaction provision replaced common law fiduciary duties. In evaluating the second action, however, the court recognized that under the LP Act, parties may not eliminate the implied covenant of good faith and fair dealing.

C. Application of Entire Fairness Standard

In evaluating a breach of fiduciary duty claim in certain self-interested transactions, courts may apply the more stringent entire fairness standard of review rather than the deferential business judgment rule. The Delaware Court of Chancery applied the entire fairness standard of review in the limited partnership context in *Venhill Limited Partnership v. Hillman*.[21] In *Venhill*, various family trusts formed and funded a limited partnership (the "Partnership"), of which the defendant was the sole general partner. The Partnership owned a significant stake in Auto-Trol Technology Corporation ("Auto-Trol"), and the defendant was the chairman, chief executive officer, and president of Auto-Trol. Auto-Trol had initially been successful, but, through the years, its revenues rapidly declined until it was insolvent. Through the use of his sole discretion to control the funds of the Partnership, the defendant, as general partner, repeatedly caused the Partnership to lend funds to Auto-Trol, draining cash from the Partnership. The terms of the loans were set completely by the defendant and were much more favorable to Auto-Trol than what would have been received by Auto-Trol in an arm's-length transaction. Over the years, despite calls from his family member trustees to stop the loans, the defendant caused the Partnership to loan millions of dollars to Auto-Trol. After years of seeing no returns from money the Partnership had invested in Auto-Trol, the limited partners opted to remove the defendant as the general partner of the Partnership. Sensing his imminent removal as general partner, the defendant transferred, for no consideration, the majority equity interest of

19. *Id.* at 387.

20. *Id.* at 388.

21. C.A. No. 1866-VCS, 2008 WL 2270488 (Del. Ch. June 3, 2008).

Auto-Trol from the Partnership to a new entity owned by the Partnership that he personally managed. He also funneled another $2 million from the Partnership into Auto-Trol. The Partnership and two family trust limited partners, as the plaintiffs in *Venhill*, brought action against the defendant for alleged breaches of his fiduciary duties of care and loyalty.

The plaintiffs and the defendant in *Venhill* agreed that the entire fairness standard applied to the investment decisions made by the defendant, as he was both the general partner of the Partnership and the chairman, chief executive officer, and president of Auto-Trol. Initially, the defendant argued that the plaintiffs were barred from contending that the loans breached any fiduciary duties because they had stood by and not used their voting powers earlier to remove him as the general partner of the Partnership and had therefore ratified or acquiesced to his actions. The court, however, disagreed and found that it would not be a "productive innovation" to adopt a rule that would "impose on stockholders a duty to remove a fiduciary who was bent on pursuing what the stockholders believed to be an imprudent strategy because if they do not do that, the fiduciary's actions will be immunized from the ordinary scrutiny of equity."[22] The court stated that any such policy would create a "crudely overbroad immunity from liability" for a fiduciary.[23] Further, based on the facts in this case, and particularly that the defendant had engaged in several transactions without any notice to the trustees, the traditional corporate doctrines of acquiescence or ratification were not applicable.[24]

The court "concluded that [the defendant] breached his duty of loyalty by undertaking action on behalf of [the Partnership] for the bad faith reason that it advanced his personal interests and knowing that the action was unfair to [the Partnership]."[25] The defendant nonetheless argued that he was exonerated by the exculpation section of the Partnership's LP agreement, which stated that the general partner would not be liable to the Partnership or the limited partners for any acts or omissions, "so long as the General Partner *acts in good faith and is not found to be guilty of gross negligence or willful or wanton misconduct with respect thereto.*"[26] The court noted that this section of the LP agreement appeared to provide that the defendant would not be liable for dealings that, while unfair to the Partnership, were "well-motivated and undertaken without gross negligence."[27] The court also found that the defendant could still be liable to the plaintiffs for acts in bad faith and with gross negligence and acts shown to be willful misconduct.

In assessing the defendant's liability under the exculpation standard, the court noted that it would be helpful to use the entire fairness standard to evaluate the conduct of the defendant in the loan transactions. In applying the entire fairness standard, the court first considered the process used to implement the transactions in order to determine the fairness of the transaction. The court found an absence of fair process in that (1) the defendant never attempted any type of market check by either considering other alternative investments or by considering what loan terms similarly situated lenders would have provided to Auto-Trol; (2) the defendant failed to seek the advice of any professional who could provide objective advice on the future for Auto-Trol or on the prudence of the Partnership investment in Auto-Trol; and (3) the defendant lacked any kind of analytical process for the investments in Auto-Trol made by the Partnership. Further,

22. *Id.* at *20.

23. *Id.* at *21.

24. The doctrines of acquiescence or ratification typically apply in scenarios where a "stockholder is informed of all the material facts regarding a transaction and then, by act or deed, either acquiesces in the transaction or gives it affirmative approval." *Id.* (quoting *In re* Wheelabrator Techs., Inc., S'holders Litig., 663 A.2d 1194, 1201 n.4 (Del. Ch. 1995)).

25. *Id.* at *33.

26. *Id.* at *22.

27. *Id.* at *24.

the court found that the transactions, based in part on the grossly unfair loan terms and lack of investment rationale for the loans made, lacked substantial fairness to the Partnership. Relying upon this analysis, the court concluded that the exoneration clause in the LP agreement did not insulate the defendant from liability because he did not act in the good faith pursuit of the Partnership's best interests. Instead, the defendant acted in bad faith and with willful misconduct, as he knew he was making investments in an "imprudent and irrational manner."[28] He was also found to have acted in a grossly negligent manner, as his decisions "did not involve any rational consideration of relevant factors."[29] As a result, the court held that the defendant would be liable for monetary damages.

D. Breach of Contract, Implied Covenant of Good Faith and Fair Dealing, and Fiduciary Duties

In *Fisk Ventures, LLC v. Segal,*[30] the Delaware Court of Chancery considered a dispute involving a counterclaim for a breach of contract, a breach of the implied covenant of good faith and fair dealing, and breach of fiduciary duties. An LLC had been set up with two classes of members who had the power to place representatives on a board of managers. A supermajority vote of the board was required for all essential decisions relating to the LLC. The LLC had persistent problems raising enough money to continue its operations. The class A and class B members could not agree on a course of action for financing the LLC's operations, and the board was deadlocked. After various proposals had been rejected, one of the class B members, Fisk Ventures, LLC, brought an action for judicial dissolution of the LLC under sections 18-801 and 18-802 of the LLC Act. In response, one of the class A members, Dr. Andrew Segal, brought counterclaims against Fisk Ventures, LLC and other class B members alleging a breach of contract, a breach of the implied covenant of good faith and fair dealing, and a breach of fiduciary duties.

For the contract claim, Segal argued that section 9.1 of the LLC agreement created a standard of conduct for its members that had been breached by the class B members' rejection of Segal's plans for research, financing, and other issues. Section 9.1 read as follows:

> No [m]ember shall have any duty to any [m]ember of the [LLC] except as expressly set forth herein or in other written agreements. No [m]ember, [r]epresentative, or [o]fficer of the [LLC] shall be liable to the [LLC] or to any [m]ember for any loss or damage sustained by the [LLC] or to any [m]ember, unless the loss or damage shall have been the result of gross negligence, fraud or intentional misconduct by the [m]ember, [r]epresentative, or [o]fficer in question ….[31]

The court found that this language in the LLC agreement did not create a code of conduct and therefore refused to "turn an expressly exculpatory provision into an all encompassing and seemingly boundless standard of conduct."[32] Further, even if section 9.1 did create a code of conduct, no facts were alleged that were sufficient to show that the class B members had

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28. *Id.* at *30.

29. *Id.*

30. C.A. No. 3017-CC, 2008 WL 1961156 (Del. Ch. May 7, 2008).

31. *Id.* at *9.

32. *Id.*

acted with "gross negligence, willful misconduct, in bad faith, or by knowingly violating the law."[33] The court granted the motion to dismiss the contract claim.

Segal also had argued that the class B members had breached the implied covenant of good faith and fair dealing by blocking various financing opportunities proposed by Segal for the LLC. "Every contract contains an implied covenant of good faith and fair dealing that 'requires a "party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits" of the bargain.'"[34] The court rejected this argument and noted that as the implied covenant is in fact implied, it is in place to "protect[] the *spirit* of the agreement" and "it cannot be invoked where the contract itself expressly covers the subject at issue."[35] Segal argued that the implied covenant had been breached by the class B members impeding the financing alternatives that Segal wanted. The court noted that Segal did not have the contractual right to decide how to finance the LLC and instead found that the LLC agreement expressly dealt with the subject of financing by requiring board approval with respect to financing. Segal could not bring a claim to grant him a substantive right for which he had not negotiated.

The court also rejected Segal's arguments relating to his breach of fiduciary duty claims against the class B members. The court found that, in accordance with section 18-1101(c) of the LLC Act, the LLC agreement had eliminated fiduciary duties to the maximum extent permitted by law by expressly stating that "members have no duties other than those expressly articulated in the [LLC agreement]."[36] Thus, in the court's view, since the LLC agreement did not expressly articulate any fiduciary obligations, the LLC agreement had in fact eliminated them. Further, even if there were fiduciary duties set forth in the LLC agreement to not act in bad faith or with gross negligence, the court held that Segal had failed to allege any facts sufficient to show a breach of any such duty.

II. PROCEDURAL ISSUES

A. Demand Futility

In order to bring a derivative action on behalf of an LLC, a member or assignee, as applicable, must either make a demand on the managers or members with authority to do so to bring the suit and such managers or members must have refused to do so, or demonstrate demand futility in that "an effort to cause those managers or members to bring the action is not likely to succeed."[37] In the previously discussed *Kahn* case,[38] the court evaluated a derivative action claim based

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33. *Id.* at *10.

34. *Id.* (quoting Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 442 (Del. 2005), quoting Wilgus v. Salt Pond Inv. Co., 498 A.2d 151, 159 (Del. Ch. 1985)).

35. *Id.*

36. *Id.* at *11.

37. LLC Act § 18-1001; *see also* LP Act § 17-1001 (providing comparable standards for limited partners or assignees to bring derivative actions).

38. *Kahn*, 2008 WL 5197164, at *9-13 (as the plaintiff did not make a demand on the board of directors, the plaintiff had to properly allege demand futility).

on demand futility. In assessing the futility of the demand, the court applied the corporate law *Aronson* test.[39] The court found that the plaintiff had adequately pled facts in the complaint to create reasonable doubt as to the disinterestedness or independence of a majority of the LLC's board of directors and therefore demand on the board of directors was futile.

In this case, the court focused on the first prong of the *Aronson* test; namely, whether there were particularized factual allegations that a majority of the directors were either interested or not independent. "A director is interested in a transaction when the director receives a personal benefit (or detriment) from a transaction that is not shared by the other shareholders of the corporation and the benefit is of subjective material significance to the director" and "where the director stands on both sides of the transaction."[40] In contrast, independence focuses on whether a "director's decision was impartial and based on the merits of the subject to be decided."[41] It does not require an allegation of a benefit or detriment from the transaction. Applying these standards, the court found that the allegations were sufficient to demonstrate that two of the directors were "interested" in the transaction due to conflicts that existed among various entities. The other three directors were deemed to be not "independent" under Aronson due to various relationships that they had with various interested parties.

The court also analyzed whether the LLC agreement altered the pleading requirements of section 18-1001 of the LLC Act. Interestingly, in analyzing the facts of the case, the court noted that the LLC agreement "certainly *could* have altered the demand futility and *Aronson* requirements."[42] Nonetheless, the court concluded that no such alteration had occurred.

The Supreme Court of Delaware also applied the *Aronson* test to a limited liability company derivative action case in *Wood v. Baum,*[43] where the Delaware Court of Chancery had previously dismissed a complaint for failure of the plaintiff to show that demand on the board would have been futile. The plaintiff had originally filed a derivative action alleging various breaches of fiduciary duties by the board of the LLC. Having failed to make a pre-suit demand upon the board of directors of the LLC, the plaintiff was required to establish that demand on the board would have been futile.

Before analyzing the facts of the case, the court first noted that there are two tests that should be construed in determining demand futility. First, in cases where there are claims that involve a "contested transaction," the previously discussed *Aronson* test applies.[44] Second, in cases where there are allegations regarding a board of directors' oversight duties, the *Rales* test applies, which requires the plaintiff to "allege particularized facts establishing a reason to doubt that 'the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.'"[45]

The plaintiff, having conceded that the first prong of the *Aronson* test was not applicable as the majority of the LLC's board was generally independent and disinterested, attempted to create a reasonable doubt that the board would have

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39. *Id.* at *9 (noting that the *Aronson* test requires a plaintiff to create reasonable doubt that either "(1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment") (quoting Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984)).

40. *Id.*

41. *Id.* at *10.

42. *Id.* at *11.

43. 953 A.2d 136 (Del. 2008).

44. *See supra* note 39.

45. *Baum*, 953 A.2d at 140 (quoting Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993)).

properly exercised its business judgment as the board was disabled due to a "substantial risk of liability."[46] For this reason, the court examined the exculpation provision in the LLC agreement, which provided that the directors were exempted from all liability except in cases of '"fraudulent or illegal conduct.'"[47] The court further noted that under section 18-1101(e) of the LLC Act, except for an act or omission that "constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing," an LLC agreement may limit or eliminate any liability for a breach of duties (including fiduciary duties) of a person who is a party to or is otherwise bound by the LLC agreement.[48] Under the LLC agreement and the LLC Act, the directors had limited exposure to any liability. For this reason, in the court's view, the complaint must have alleged particularized facts that would prove that a majority of the board "knowingly engaged in 'fraudulent' or 'illegal' conduct or breached 'in bad faith' the covenant of good faith and fair dealing."[49]

The court found that the plaintiff had failed to plead the specific facts required to show fraud, had failed to allege facts that showed the defendants "knowingly" engaged in illegal conduct, and, finally, had not alleged a bad faith violation of the covenant of good faith and fair dealing. As part of its opinion, the court stated that "board approval of a transaction, even one that later proves to be improper, without more, is an insufficient basis to infer culpable knowledge or bad faith on the part of individual directors" and that membership on an audit committee is not sufficient to infer scienter.[50] Overall, based on the standard set by the LLC agreement's exculpation provision, the plaintiff had failed to establish that pre-suit demand was futile, and the decision of the Court of Chancery was affirmed.

The court also provided constructive advice to the plaintiff. Because particularized allegations are needed in demand futility cases, it would have been wise for the plaintiff to have instituted a books and records request. In cases where allegations need to be pled with specificity, "the failure to allege particularized facts is frequently compounded by a failure to make a statutory 'books and records' request concerning the matters alleged and the Board's consideration of such matters. Here, plaintiff could have, but chose not to, make a books and records request pursuant to [the LLC Act]."[51]

B. Personal Jurisdiction

The Delaware Court of Chancery considered personal jurisdiction issues in connection with the previously discussed *Fisk Ventures* case.[52] In *Fisk Ventures,* one of the third-party respondents, H. Fisk Johnson, who was a class B member of the LLC and a former member of the board of managers, moved to dismiss Segal's claims of breach of fiduciary duties on the theory that the court had no personal jurisdiction over him. In response, Segal argued that service of process was proper under Del. Code Ann. tit.10, § 3104 or section 18-109 of the LLC Act. Segal reasoned that because Johnson had sat on the board of the LLC and now controlled and directed the actions of his appointed representatives on

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46. *Id.* at 141.

47. *Id.*

48. *Id.* (quoting LLC Act § 18-1101(e)).

49. *Id.*

50. *Id.* at 142.

51. *Id.* at 143-44.

52. *Fisk Ventures*, 2008 WL 1961156, at *6-8.

the board, and because Johnson had caused the LLC to move its domicile to Delaware when he initially invested in the LLC, he should therefore be subject to jurisdiction in Delaware.

"[S]ection 3104 provides for personal jurisdiction over a nonresident where (1) the nonresident transacted some sort of business in the state, and (2) the claim being asserted arose out of that specific transaction."[53] The court concluded that service of process on Johnson under Del. Code Ann. tit. 10, § 3104 was improper because although Johnson had limited contacts with Delaware, such contacts did not have any nexus with the actual claims in the case.

Section 18-109 of the LLC Act provides that service of process is proper as to managers of limited liability companies or those who "participate[] materially in the management of the limited liability company."[54] Segal conceded that Johnson was not a manager, and the court noted that "the mere power to appoint a manager does not force a member of an LLC to impliedly consent to service of process under section 18-109."[55]

Thus, instead of focusing on Johnson as a manager, Segal argued that Johnson had participated materially in the management of the LLC by controlling the actions of his appointed representatives on the board or, in the alternative, that he should be viewed as a *de facto* manager due to the broad rights that the LLC agreement provided him. The court disagreed with both of these arguments. First, the fact that members of the board "occasionally conferred" with Johnson was not enough to support the notion that Johnson had "consented to personal jurisdiction in Delaware."[56] Further, as the LLC agreement specifically provided that *"all management power… shall be exclusively vested in the board,"* the court found that as Johnson was not sitting on the board at the time of the events in question, and even though his representatives were on the board, he could not be viewed as a *de facto* manager.[57] As a result, service of process under section 18-109 was improper since Johnson had not consented to the court's in personam jurisdiction. As service of process was not valid under either section 3104 or section 18-109, the court granted Johnson's motion to dismiss for lack of personal jurisdiction.

In *Total Holdings USA, Inc. v. Curran Composites, Inc.,*[58] Vice Chancellor Strine addressed the issue of personal jurisdiction as it related to a nonresident general partner of a Delaware general partnership. The defendant was a Missouri corporation with no Delaware-related activities that held an interest in a Delaware general partnership (the "General Partnership") that it had formed with the plaintiff. While the General Partnership also did not do business in Delaware, the joint venture agreement establishing the General Partnership contained a provision stating that the General Partnership was being formed by the partners "in accordance with the laws of the State of Delaware," and the joint venture agreement contained a Delaware choice of law provision. There was no forum selection provision in the joint venture agreement. The court concluded that the General Partnership was governed by the Delaware Revised Uniform Partnership Act ("DRUPA").[59]

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53. *Id.* at *7.

54. LLC Act § 18-109(a).

55. *Fisk Ventures*, 2008 WL 1961156, at *7.

56. *Id.*

57. *Id.* at *8.

58. C.A. No. 4494-VCS, 2009 WL 3238186 (Del. Ch. Oct. 9, 2009).

59. Del. Code Ann. tit. 6, §§ 15-101, *et seq.* The court found that despite the fact that the General Partnership had been formed when the Delaware Uniform Partnership Act was in effect, when the Delaware General Assembly enacted DRUPA, it specifically provided that it shall govern "*all*" partnerships after a two-year grace period had expired and therefore DRUPA governed the General Partnership.

The plaintiff and defendant later amended the joint venture agreement; such amendment contained identical Delaware law provisions and also added a new "put" provision. Upon the exercise of the "put" provision, disputes arose over the value of the defendant's interest in the General Partnership, and litigation ensued. The defendant then brought a motion to dismiss claiming a lack of personal jurisdiction in the State of Delaware.

The defendant attempted to argue that the General Partnership should not be governed by Delaware law. The court found this to be unpersuasive, finding that based on the explicit language of, and choice of law provision in, the joint venture agreement, the General Partnership was a Delaware entity governed by DRUPA.

Having determined that the General Partnership was governed by DRUPA, the court next addressed whether the defendant was subject to personal jurisdiction in Delaware. The court turned to the consent provision found in section 15-114 of DRUPA, which provides, in relevant part:

> A partner … of a partnership which is formed under the laws of the State of Delaware or doing business in the State of Delaware may be served with process in the manner prescribed in this section in all civil actions or proceedings brought in the State of Delaware involving or relating to the business of the partnership or a violation by a partner … of a duty to the partnership or any partner of the partnership.[60]

The defendant argued that section 15-114 was not satisfied because the current dispute did not relate to the core business of the General Partnership (i.e., selling composites). The court disagreed with the defendant's argument and held that a dispute where the defendant allegedly owed money to another partner by being overpaid under the put provision in the joint venture agreement was clearly a dispute relating to a "violation by a partner of a duty to any partner of the partnership" as provided in section 15-114. Further, a dispute over the meaning of the joint venture agreement was clearly "involving or relating to the business of the partnership" as provided in DRUPA. "Therefore, the key principle emerging from the cases interpreting § 3114 and similar statutes is that consent to jurisdiction provisions may be used to subject a fiduciary to the jurisdiction of the Delaware courts for disputes over the meaning of and compliance with a Delaware entity's governing documents."[61] Exercising jurisdiction over the defendant under section 15-114 did not offend any of the defendant's due process rights because the dispute concerned the internal affairs of a Delaware partnership in which the defendant had become a partner. Finding that the defendant was subject to personal jurisdiction in the State of Delaware, the court denied its motion to dismiss.

C. Status Quo Order Under Section 18-110

In *Pharmalytica Services, LLC v. Agno Pharmaceuticals, LLC,*[62] the Delaware Court of Chancery imposed a status quo order to prevent irreparable harm to an LLC. The governing board of the LLC had removed the defendant as the president and chief executive officer of the LLC because it had discovered that the defendant had created a separate entity that was competing against the LLC. The LLC later learned that, after such removal, the defendant had been acting on behalf of the LLC by seeking to appoint designees to the board of a company located in and established under the laws of the People's Republic of China. The plaintiff LLC initiated this action seeking a preliminary injunction to prevent the defendant from taking action on behalf of the LLC or representing himself as a representative of the LLC.

60. *Total Holdings*, 2009 WL 3238186, at *10 (quoting Del. Code Ann. tit. 6, §15-114(a)).

61. *Id.* at *10.

62. C.A. No. 3343-VCN, 2008 WL 2721742 (Del. Ch. July 9, 2008).

Although the plaintiff brought an action seeking preliminary injunction against the defendant to prevent him from taking action on behalf of the LLC or holding himself out as representative of the LLC, the court noted that the relief sought by the plaintiff was in the nature of the relief granted under section 18-110 of the LLC Act, which allows for "continued operation of the venture, with a goal of minimal disruption, while the identity of those properly holding corporate power can be established."[63] Since section 18-110 is similar to section 225 of the DGCL, the court followed precedent from actions brought under section 225. The court issued the status quo order in favor of the LLC. In preserving the status quo and providing certainty in the management of the LLC, the court precluded the defendant from representing the interests of the LLC.

III. INTERPRETATION OF GOVERNING AGREEMENTS

A. Distributions Upon Withdrawal

The Delaware Court of Chancery in *Schuss v. Penfield Partners*[64] considered the rights of withdrawing limited partners of a hedge fund to certain distributions under an LP agreement. In Schuss, limited partners of a hedge fund brought suit against the hedge fund itself, the general partner, and the general partner of the general partner for breach of contract, breach of fiduciary duty, and an accounting. The plaintiffs had withdrawn from the hedge fund and had expected to receive an in kind and ratable distribution amounting to their liquidating share as of the time they withdrew. The distributions were made to the plaintiffs in kind but were not ratable, and, as a result of a decrease in the value of the designated securities at the time of the distributions, the distributions had values that were materially less than the plaintiffs' capital accounts at the time of their withdrawal. The defendants filed a motion to dismiss for failure to state a claim, which ultimately was granted in part and denied in part.

On the breach of contract claim, the defendants first argued that the hedge fund itself was an improper party to the suit, as it was not a party to the LP agreement and therefore could not have breached the LP agreement. The court disagreed with this argument, finding that section 17-606(a) of the LP Act specifically provides that once a partner withdraws from a partnership, he or she has the status of a creditor, as the partnership owes a distribution to the partner. Aside from this initial issue, there were two key issues in the case:

> (1) [W]as the general partner required to make any in kind distribution on a pro rata basis; and (2) were the withdrawing partners entitled to the securities the general partner specified at the time of retirement, even if they had declined in value at the time of distribution, or to assets whose aggregated value equaled the withdrawing partners' share of the fund as of the date of their retirement?[65]

On the issue of the defendants' authorization to provide in kind and nonratable distributions, the plaintiffs argued that section 17-605 of the LP Act applied and that they could not be compelled to take any more than their pro rata share of any security as an in kind distribution.[66] In contrast, the defendants argued that the LP agreement had in fact

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63. *Id.* at *3.

64. C.A. No. 3132-VCP, 2008 WL 2433842 (Del. Ch. June 13, 2008).

65. *Id.* at *1.

66. Section 17-605 of the LP Act provides:

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overridden the LP Act. The court agreed with the defendants and found that the LP agreement overrode the default rule of section 17-605 by specifically providing that the general partner in its "sole discretion" could "make a distribution in cash, securities, or a combination, as determined and selected by the [g]eneral [p]artner."[67] The court further held that, as a matter of law, the LP agreement did not require that the distribution be ratable, and therefore the plaintiffs' claim that the general partner was required to make in kind and ratable distributions was dismissed.

On the second issue, there were disagreements between the parties over the application of a section of the LP agreement that provided that payment should be made to fully withdrawing limited partners '"[w]ithin 30 days after the date of retirement of a Partner'" in cash, securities, or a combination of the two '"equal in value to not less than 90% of the estimated amount of the Liquidating Share.'"[68] The arguments stemmed from when the amount due was to be determined, either at the time of withdrawal or the time of distribution. The plaintiffs believed that the amount owed to them was calculated at the time of withdrawal and securities distributed in kind to them at a later point needed to be based upon that value. The defendants, on the other hand, believed that the assets could be segregated based upon the value for distribution within 30 days in accordance with the LP agreement. Thus, in the defendants' view, if the value of such securities should fall within that interim period, the risk was on the plaintiffs. This was important because the value of the assets at the time of distribution had materially decreased. The court denied the defendants' motion to dismiss because it found that there was a possibility that the plaintiffs' interpretation of the LP agreement section was correct.

B. Ability to Retain Counsel

The Delaware Court of Chancery analyzed the ability of a member of an LLC to retain counsel for an LLC in *Maitland v. International Registries, LLC.*[69] The case, which involved an LLC that was held and managed by two equal members, started with an action filed for the inspection of the books and records of the LLC. In connection with the books and records action, one of the members, as the plaintiff, filed a motion seeking an order striking the answer of the LLC, as the defendant, and disqualifying the LLC's counsel. The plaintiff argued that since the LLC had two members who each held 50 percent interests, the answer filed by the LLC and retained counsel was in violation of the LLC agreement, which required action by a majority of the members. The other member argued that the LLC agreement actually gave each member management rights.

The court started its analysis with a review of the management section of the LLC agreement, which provided:

> Management of the [LLC] shall vest solely in the Members, and the decision of the Members holding a majority of all LLC Interests as to all such matters shall be controlling. The Initial Members are hereby granted all rights, powers, authorities, and authorizations necessary, appropriate, and advisable and/or convenient to manage the [LLC] and to determine and carry out its affairs.[70]

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> Except as provided in the partnership agreement, a partner may not be compelled to accept a distribution of any asset in kind from a limited partnership to the extent that the percentage of the asset distributed exceeds a percentage of that asset which is equal to the percentage in which the partner shares in distributions from the limited partnership.

67. *Id.* at *6.

68. *Id.* at *8.

69. C.A. No. 3669-CC, 2008 WL 2440521 (Del. Ch. June 6, 2008).

70. *Id.* at *1.

Based on this language, the court acknowledged that each member may be empowered to manage the LLC when the co-owner was silent; however, the court noted that the LLC agreement did "not contemplate and cannot allow one owner's management wishes to trump the other's where they differ."[71] Therefore, so long as the LLC had two members, neither member was vested with the power to control unilaterally the LLC; where there was a disagreement among the members, the LLC would be deadlocked. The court further noted that a deadlocked LLC could not validly retain counsel or file an answer, so the plaintiff's motion to strike the LLC's answer and disqualify its counsel was granted. The court did, however, analogize the facts of the case to a corporate case, *Engstrum v. Paul Engstrum Associates,*[72] where two shareholders each held a 50 percent interest in a corporation and the court concluded that one stockholder should be permitted to intervene as a party defendant with the authority to defend on behalf of the corporation against the other stockholder as the plaintiff. The court held that the *Engstrum* ruling should be applicable to the *Maitland* facts; therefore, the other member was permitted to intervene as a party defendant with the authority to defend on behalf of the LLC against the plaintiff.

C. Withdrawal Provisions

On a motion to dismiss, the Delaware Court of Chancery analyzed a withdrawal right pursuant to a provision in a supplementary agreement between a limited partner and a general partner in *BASF Corporation v. POSM II Properties Partnership, L.P.*[73] The partnership had been formed with the purpose of owning, and then leasing to an affiliate, a chemical plant in Texas. As a result, the partnership "was indirectly controlled by the operator of the [p]lant."[74]

The contributions toward the plant's construction made by the limited partners of the partnership were set forth in supplementary agreements entered into by each limited partner with the general partner. The supplementary agreement with one initial limited partner contained a provision providing that should the general partner become aware that its general partner or its affiliates were no longer operating the plant, it was required to notify the limited partner. Upon the receipt of such notification, the limited partner was then provided with 90 days to notify the partnership that it wished to withdraw as a limited partner of the partnership and have its interest purchased.

The general partner of the general partner ("Lyondell"), which had been a publicly held company and was the operator of the plant, was eventually acquired by a privately held company. Thus, while Lyondell, as the operator of the plant, remained the same entity, Lyondell's ownership structure had changed. The plaintiff viewed this purchase of stock in Lyondell as a triggering event under the withdrawal provision of its supplementary agreement.

The general partner disagreed about the triggering of the withdrawal right, and consequently, the plaintiff brought an action against the general partner and the partnership seeking a declaration of the occurrence of a change in operation as described in the plaintiff's supplementary agreement. The plaintiff put forth the arguments that (1) there had been a change of Lyondell as the operator as contemplated by the supplementary agreement due to the change in control of the operator of the plant, and (2) the plant was now operated by the new parent entity and not Lyondell. The defendants filed a motion to dismiss and argued that (1) a change of control of Lyondell did not give the plaintiff any rights pursuant to the supplementary agreement because Lyondell was still the operator, and (2) the plaintiff had failed to allege any actual facts to support its argument that Lyondell, as a separate legal entity, no longer operated the Texas plant.

71. *Id.*

72. 124 A.2d 722 (Del. Ch. 1956).

73. C.A. No. 3608-VCS, 2009 WL 522721 (Del. Ch. Mar. 3, 2009).

74. *Id.* at *2.

The court started its analysis of whether the withdrawal provision of the supplementary agreement was triggered by a change of control of Lyondell by noting that this was a straightforward contract interpretation question and a question of law.[75] Noting that Lyondell was still the operator of the plant regardless of Lyondell's change in ownership structure, the court found that the withdrawal provision was not a change of control provision and was not ambiguous. "Delaware law does not invest judicial officers with the power to creatively rewrite unambiguous contracts in this manner."[76] Furthermore, the court commented that the parties could have included a change of control provision in their agreement and specified the parameters of its application to various factual possibilities. The court stated that the plant was still currently being operated by Lyondell despite the change in control of its equity and therefore the withdrawal provision in the supplementary agreement was not triggered.

Finally, the court discussed the plaintiff's alternative argument that the withdrawal provision was triggered because Lyondell's new parent was actually operating the plant instead of Lyondell. The court agreed with the defendants and concluded that the plaintiff had failed to plead any facts about how there had been a change in the plant's operation. In making its argument, the plaintiff cited the parent's management reports and consolidated financial statements, which contained statements about its operation of the plant. The court was uninfluenced by these reports of consolidated operations and instead viewed them as merely evidence that the parent entity was actually a corporate holding company, which would naturally have operating subsidiaries (such as Lyondell) hold and operate its assets. "A holding corporation like LyondellBasell must present reports of their affairs on a consolidated basis."[77] The court concluded that Lyondell was still operating the plant and therefore the withdrawal provision in the supplementary agreement was not triggered. The court dismissed the plaintiff's complaint.

D. Covenant v. Condition

In *Travelcenters of America LLC v. Brog,*[78] the Delaware Court of Chancery examined the difference between noncompliance with a condition as opposed to a covenant in a contract. In the case, the plaintiff was an LLC and the defendants were shareholders (i.e., members) of the LLC. The defendants had previously submitted notice to the LLC purporting to nominate two directors to the board of directors of the LLC. The LLC brought an action in the Court of Chancery and obtained a declaration that the notice by the defendants had not complied with the LLC agreement. The LLC then commenced an action seeking indemnification of its costs and fees associated with obtaining the declaration.

The LLC sought indemnification based on a section of its LLC agreement that provided that the shareholder defendants would "indemnify [the LLC] from and against all costs and expenses, including reasonable attorneys' and other professional fees, arising from such shareholder's breach of any provision of the LLC [a]greement."[79] The LLC argued that the defendants had breached the LLC agreement because their notice did not comply with the LLC agreement requirements. The issue before the court was whether the failure to comply with the notice requirements constituted a breach of the LLC agreement by the defendants.

75. *Id.* at *4

76. *Id.* at *6.

77. *Id.* at *8.

78. C.A. No. 3751-CC, 2008 WL 5272861 (Del. Ch. Dec. 5, 2008).

79. *Id.* at *2.

The court first explained that there is a distinction between promises and conditions, as "[p]romises give rise to a duty to perform, and conditions are events that must occur before a party is obligated to perform."[80] Furthermore, the court stated that "[w]hile the non-performance of a promise or covenant can result in a breach of a contract, the non-occurrence of a condition is not considered a breach unless the party promised that the condition would occur."[81] In considering the notice requirements under the LLC agreement, the court concluded that such requirements were merely conditions to the LLC's performance and not promises by the shareholders. The notice provisions simply establish the conditions for a shareholder to nominate a person for election to the board of directors. As the defendants' conduct constituted only a nonoccurrence of a condition and not a breach of contract, the LLC was not entitled to indemnification and the court granted the defendants' motion for judgment on the pleadings.

E. Oral Modification of LLC Agreement

In *Tunney v. Hilliard,*[82] the Delaware Court of Chancery addressed whether a provision of an LLC agreement could be orally modified. The plaintiff and defendant in Tunney had entered into a business venture where they owned and operated a restaurant and marina. Pursuant to this venture, they formed a corporation to serve as the operating entity and an LLC to be a real estate holding entity. The business venture was successful, and eventually the parties sold the business for a sizable profit. The governing documents of the LLC provided for a 50-50 division of profits. The plaintiff claimed, however, that due to the defendant's decision to reduce his time spent on the venture, the parties had orally agreed to a modification of the profit allocation whereby the plaintiff would be entitled to a 20 percent commission on the sales proceeds and the remainder would then be divided equally among the parties. The defendant denied any such oral modification.

Based on the evidence presented, the court determined that the plaintiff had failed to prove adequately an oral modification of the LLC agreement. The court stated that although oral modifications of written contracts are allowed under Delaware law, they are not favored; therefore, a heightened evidentiary burden is placed on the party seeking to prove an oral modification. This heightened burden requires proof of an "intended change to the written agreement with sufficient 'specificity and directness as to leave no doubt of the intention of the parties to change what they previously solemnized by formal document.'"[83] With a lack of any contemporaneous written evidence or any credible witness testimony, the plaintiff had failed to prove adequately an oral modification of the agreed-upon allocations, and therefore the court held that the written allocations would remain unaltered.

F. Actual v. Apparent Authority

In *Jack J. Morris Associates v. Mispillion Street Partners, LLC,*[84] the Superior Court of Delaware denied a motion for summary judgment in a suit relating to an alleged breach of contract. In Morris, an individual who had originally

80. *Id.* at *3.

81. *Id.*

82. C.A. No. 1317-VCN, 2008 WL 3975620 (Del. Ch. Aug. 20, 2008).

83. *Id.* at *5 (quoting Reeder v. Sanford Sch., Inc., 397 A.2d 139, 141 (Del. Super. 1979)).

84. C.A. No. 07C-04-023-RFS, 2008 WL 3906755 (Del. Super. 2008).

been removed as a general manager of the defendant LLC entered into a letter agreement with the plaintiff for the plaintiff to provide promotional, marketing, and advertising services to the LLC. The plaintiff provided services to the LLC and received assurance of payment from the former general manager, but the LLC did not pay for services provided by the plaintiff. This suit ensued.

The LLC argued that the former general manager was not authorized to sign the letter agreement. The various members of the LLC and the former general manager provided inconsistent statements concerning the former general manager's authority to act for the LLC and the LLC's knowledge of the existence of the letter agreement. The court set forth the relevant law on agency as follows:

> In the ordinary course of business dealings, an agent may be cloaked with three types of authority: express, implied and apparent authority. Express authority may be conveyed to an agent, either orally or in writing. Implied authority may be evidenced by conduct of the principal. Apparent authority may be evidenced by the conduct of the agent who holds himself out as possessing authority with the apparent consent or knowledge of the principal. In these circumstances, the principal cannot deny the agent's authority.[85]

Since whether an agency relationship exists is typically a question of fact and since there was a dispute on that basis, the court denied the plaintiff's motion for summary judgment, leaving it for a finder of fact to decide.

The Delaware Court of Chancery also explored the concepts of actual and apparent authority in *B.A.S.S. Group, LLC, v. Coastal Supply Co., Inc.*[86] An employee of a corporation embezzled funds from the corporation. The employee then formed an LLC with a friend and used the embezzled funds to purchase property on behalf of the LLC. When the corporation discovered the embezzlement, the employee was fired and a restitution agreement was reached whereby the employee transferred the property from the LLC to the corporation. The friend of the employee, as the other member of the LLC, commenced this individual and derivative action to void the transfer of the property from the LLC. The corporation counterclaimed for unjust enrichment and conversion. Both sides filed motions for partial summary judgment.

The plaintiff's first contention was that the employee had no authority, actual or apparent, to transfer the property from the LLC. "Actual authority" exists when "a principal expressly or implicitly grants [such authority] to an agent."[87] The plaintiff argued that the employee had no actual authority because the LLC agreement required the consent of both members to transfer the property. The plaintiff's argument was based upon a section of the LLC agreement that required the consent of a majority of the members to take certain actions, which he argued included the transfer of the property. As he had not consented, the plaintiff asserted that the employee did not have actual authority to transfer the property.

The LLC agreement also contained a power of attorney provision whereby the employee was designated as an authorized person who arguably had authority to transfer the property. The plaintiff argued that the power of attorney section was not applicable because the employee had not acted in good faith, which was a requirement of the power of attorney provision. The court determined that there were disputed issues of fact and it could not make a determination of whether the employee had acted in good faith; therefore, summary judgment on the issue of actual authority was not appropriate.

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85. *Id.* at *3.

86. C.A. No. 3743-VCP, 2009 WL 1743730 (Del. Ch. June 19, 2009).

87. *Id.* at *5 (quoting Albert v. Alex. Brown Mgmt. Servs., Inc., C.A. Nos. 762-N, 763-N, 2005 WL 2130607, at *10 (Del. Ch. Aug. 26, 2005)).

In analyzing whether the employee had "apparent authority" in transferring the LLC property to the corporation, the court stated that "'[a]pparent authority is that authority which, though not actually granted, the principal knowingly or negligently permits an agent to exercise, or which he holds him out as possessing.'"[88] A party asserting apparent authority must demonstrate reasonable reliance on the indicia of authority that was originated by the principal. If the third party, based on the surrounding circumstances, relies in good faith upon the agent's apparent authority, then the principal will be bound "'to the same extent as if actual authority had existed.'"[89] The court found that factual disputes existed that precluded a determination of whether apparent authority existed and refused to grant summary judgment.

The corporation raised a counterclaim of unjust enrichment and sought as a remedy the imposition of a constructive trust or damages. Unjust enrichment requires a showing of: "(1) an enrichment; (2) an impoverishment; (3) a relation between the enrichment and the impoverishment; (4) the absence of justification; and (5) the absence of a remedy provided by law."[90] The court found that when the employee used the embezzled funds to purchase the property, all of the elements for unjust enrichment clearly existed. The plaintiff argued that he and the LLC were innocent parties and should not be penalized for the acts of the employee/co-member. The court disagreed and specifically found that the knowledge of the employee, as an officer, director, or manager of the LLC, could be imputed to the LLC. The court also stated that "'[r]estitution is permitted even when the [party] retaining the benefit is not the wrongdoer.'"[91] As a remedy for the unjust enrichment (and also for the corporation's conversion counterclaim), the court ordered the imposition of a constructive trust over the funds and property involved.

G. Breach of Contract and Implied Covenant

On a motion to dismiss, the Delaware Court of Chancery examined claims for, *inter alia,* breach of contract of an LLC agreement and breach of the implied covenant of good faith and fair dealing. In *Kuroda v. SPJS Holdings, L.L.C.,*[92] the plaintiff was a non-managing member of an LLC that was a general partner of a limited partnership that made investments in Japanese corporations. The plaintiff also was an owner of an investment advisor to the partnership.

Over time, tensions developed between the defendant managing members of the LLC and the non-managing member plaintiff concerning the approach being taken with respect to the partnership's activities in Japan. The plaintiff wanted to cease his work as an investment advisor and stated his desire to withdraw as a non-managing member of the LLC. The parties were not, however, able to reach an agreement on the terms of his separation. The plaintiff initiated suit against the managing members making various claims, including that they had breached the terms of the LLC agreement by failing to pay him incentive allocations and other payments that were contractually owed to him, and had breached the implied covenant of good faith and fair dealing by reason of the defendants' improper conduct. The defendant managing members responded with a motion to dismiss.

One of the plaintiff's breach of contract claims alleged that the defendants had breached the LLC agreement by refusing to pay the plaintiff incentive allocations and the balance in his investment capital account, and by issuing to him

88. *Id.* (quoting *Alex. Brown*, 2005 WL 2130607, at *10).

89. *Id.* (quoting Old Guard Ins. Co. v. Kimmy's Grille, Inc., 860 A.2d 811, 2004 WL 2154286, at *3 (Del. Sept. 21, 2004) (ORDER)).

90. *Id.* at *6.

91. *Id.* at *7 (quoting Nash v. Schock, 732 A.2d 217, 232 (Del. 1999)).

92. 971 A.2d 872 (Del. Ch. 2009).

an incorrect Schedule K-1. The defendants argued that such obligations, if owed, were obligations of the LLC for which they, as members, were not liable. The plaintiff was not, however, arguing that the defendant members were liable because they were members, but rather because they were responsible for managing the LLC and "they took affirmative steps in contravention of their own obligations under a contract to which they are signatories-the LLC [a]greement."[93] While the court acknowledged that members, as members, are not generally liable for the obligations of an LLC, it also noted that members may be liable to other members for breach of contract. In this case, the court referred to the LLC agreement's exculpation provision in specifying a member's liability exposure. Because it was ambiguous whether the particular provisions of the LLC agreement imposed a contractual duty upon the defendant members, the court did not dismiss these breach of contract claims. Resolution of that issue would have to wait until trial.

The court also continued Delaware's policy to construe narrowly the implied covenant of good faith and fair dealing. The plaintiff alleged that the defendants had breached the implied covenant of good faith and fair dealing by engaging in

> arbitrary, unreasonable, and/or deceitful conduct, including (1) failing to pay [the plaintiff] monies that they know he is due, (2) using threats of litigation to coerce [the plaintiff] and to retaliate against him, (3) sabotaging negotiations in an effort to reduce the amounts due to [the plaintiff], and (4) disparaging [the plaintiff] in connection with his work with defendants.[94]

The court stated that the implied covenant has a "narrow purpose" and the plaintiff was required to "allege a specific implied contractual obligation and allege how the violation of that obligation denied the plaintiff the fruits of the contract."[95] The implied covenant "cannot be invoked to override express provisions of a contract."[96] Importantly, the court noted that the LLC agreement itself controlled on a claim that the defendants failed to pay money due to the plaintiff under the LLC agreement. Further, the plaintiff had failed to draw a sufficient connection between the alleged violations by the defendants of the implied covenant and specific implied obligations under the LLC agreement. Since the plaintiff's allegations of injury were governed by the expressed contractual terms of the LLC agreement, the court dismissed his claim against the defendants for a breach of the implied covenant of good faith and fair dealing.

The Delaware Court of Chancery also examined a claim for a breach of the implied covenant of good faith and fair dealing in the previously discussed *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*.[97] Based on the previously discussed facts, the plaintiff LLC brought a claim for a breach of the implied covenant against the defendant LLC responsible for managing Emery Bay. The plaintiff's claim was premised on the argument that under Emery Bay's LLC agreement, the defendant LLC had a duty to manage Emery Bay and, in that context, had the power and authority to cause the performance of supporting agreements relating to the management of the project, and failed to do so. The defendant LLC disagreed and argued that the LLC agreement merely provided it with the power to act if it so decided. The court

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93. *Id.* at 881.

94. *Id.* at 887.

95. *Id.* at 888.

96. *Id.*

97. C.A. No. 3658-VCS, 2009 WL 1124451 (Del. Ch. Apr. 20, 2009).

framed the question presented to it as whether an obligation to cause the performance of the supporting agreements by the defendant LLC could be implied in the LLC agreement.

Initially, the court recognized that the implied covenant of good faith and fair dealing should be used infrequently. "Delaware courts rightly employ the implied covenant sparingly when parties have crafted detailed, complex agreements, lest parties be struck by judicial error with duties they never voluntarily accepted. Nevertheless, Delaware courts have 'recognized the occasional necessity of implying contract terms to ensure the parties' reasonable expectations are fulfilled.'"[98] The court found that the defendant LLC had an obligation to manage Emery Bay and to cause the supporting agreements to be carried out in good faith, and it could not prevent the plaintiff from "'receiving the fruits of the bargain.'"[99] The court further found that the plaintiff had alleged sufficient facts to infer reasonably that the defendant LLC's failure to cause the performance of the supporting agreements was not in good faith. The court denied the defendants' motion to dismiss the plaintiff's claim of breach of the implied covenant of good faith and fair dealing.

H. Amendments to Operating Agreements

On a motion for summary judgment, the Delaware Court of Chancery examined the meaning of an amendment provision of an LLC agreement in a petition for judicial dissolution in *In re Nextmedia Investors, LLC*.[100] The claim stemmed from an amendment made to an LLC agreement to extend the term of the LLC, where the consent to amend was not obtained from the petitioners who were members of the LLC. The LLC agreement provided that specific sections of the LLC agreement could not be amended "[w]ithout the consent of each Member to be adversely affected."[101]

When the petitioners had initially invested in the LLC and were admitted as members of the LLC, the LLC agreement provided a clear, eight-year investment horizon for the LLC and the LLC was to dissolve after this period. When the dissolution date was approaching, the LLC attempted to market its assets but, due to an economic downturn, the market conditions at the time were not favorable. The board of managers desired to extend the duration of the LLC with hopes that the economy would improve. To effectuate this extension, the board proposed an amendment to the LLC agreement to extend the term. This amendment was to a section of the LLC agreement that required the consent of each member that would be adversely affected by such amendment, and the petitioners had not consented to the amendment. Attempting to persuade the petitioners to consent, the chief financial officer of the LLC sent the petitioners a letter asserting that dissolution of the LLC would not be in the petitioners' best interests because of the current economic conditions. The letter also suggested that the LLC would assert that the consent of the petitioners was unnecessary since they would not be adversely affected by the amendment.

The LLC informed the petitioners that it viewed the amendment as properly adopted and that the LLC had not been dissolved. In response, the petitioners filed a motion seeking an order for judicial dissolution of the LLC. The petitioners argued that based on the amendment provision in the LLC agreement, the amendment was not properly adopted without their consent. In examining the petitioners' claim, the court noted that the ability to withdraw from an investment is important: "It is not uncommon for organizational documents to require a unanimous vote to avoid dissolution,

98. *Id.* at *7 (quoting Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 443 (Del. 2005)).

99. *Id.* (quoting *Dunlap*, 878 A.2d at 442).

100. C.A. No. 4067-VCS, 2009 WL 1228665 (Del. Ch. May 6, 2009).

101. *Id.* at *2.

in recognition of the importance investors place on the ability to withdraw."[102] In this case, there was a specific date for dissolution provided in the LLC agreement, and the court concluded that a reasonable investor would regard this date as a guaranteed investment end point that would require such investor's consent to change. Such provision was a material economic term of the LLC agreement. In addition, the fact that the LLC had originally sought the consent of the petitioners for the amendment reflected the LLC's view that such consent was necessary for the amendment, despite the arguments made in response to the petitioners' motion. The court concluded that the petitioners had adequately shown a reasonable interpretation of the LLC agreement and that the unanimous consent of the LLC's members was required to adopt the amendment extending the term of the LLC.

The LLC also attempted to argue that dissolution of the LLC was not appropriate because the petitioners should be required to demonstrate that they were actually adversely affected by the amendment to the LLC agreement. The court disagreed with this argument, stating that the only thing the petitioners were required to show was that their consent was required for the amendment and it was not obtained. "Whether they were to be adversely affected … is necessarily a before-the-fact question—a company cannot determine who is entitled to vote on an action by first carrying out the action and then seeing who is adversely affected."[103] The determination of whether an amendment triggers an approval requirement is based on whether the proposed contractual amendment would "alter an economically meaningful term."[104] The court concluded that the amendment to extend the term was clearly an amendment that required the consent of the petitioners and therefore granted the petitioners' motion for summary judgment to judicially dissolve the LLC.

I. Removal of Manager

In *R & R Capital, LLC v. Merritt,*[105] the Delaware Court of Chancery analyzed manager removal provisions in various LLC agreements to determine whether a manager had been validly removed as manager and member of nine LLCs. The defendant had been a manager of various LLCs and a member of some of those LLCs. As to two of the LLCs involved, the plaintiffs attempted to remove the defendant as the manager of the LLCs based on claims that the defendant had: (1) failed to pay taxes relating to the LLCs; (2) conducted activities that led to outstanding judgments and/or liens against the entities; (3) caused many of the LLCs to have their certificates of formation cancelled for failure to pay taxes and failure to maintain a registered agent; (4) failed to make distributions from the sale of property owned by the LLCs; (5) transferred property owned by one of the LLCs to satisfy personal obligations and later sold additional properties of that LLC for below market value; (6) used resources from one group of the LLCs for her personal use without prior authorization; (7) caused government action against one LLC for causing its property to fall into serious disrepair; and (8) failed to dissolve an LLC as required by its operating agreement when she sold all of its property. In response, the defendant argued that her ability to manage the entities was hindered by the fact that the owner of one of the plaintiffs had a felony conviction, which prevented her from obtaining certain licenses, and that the plaintiffs had interfered with her operation of the entities.

Due to their dissatisfaction with the defendant's management, the plaintiffs sent her a notice of removal for "cause" under a section of each of the entities' operating agreements, which provided that a manager could be removed for

102. *Id.* at *4.

103. *Id.* at *7.

104. *Id.*

105. C.A. No. 3989-CC, 2009 WL 2937101 (Del. Ch. Sept. 3, 2009).

"cause" upon written demand setting forth specific facts giving rise to such "cause," including that the manager had: "(a) engaged in fraud or embezzlement, (b) committed an act of dishonesty, gross negligence, willful misconduct, or malfeasance that has a material adverse effect on the Company or any other Member, or (c) been convicted of a felony."[106] The removal notice sent by the plaintiffs was based on an action brought between the parties in Pennsylvania, where the judge had found in favor of the plaintiffs and stated that the defendant had engaged in fraud in connection with a transaction between the plaintiffs and the defendant for the purchase of "pinhooking" horses. The plaintiffs then initiated suit to obtain a declaration that the defendant had been validly removed as a manager.

The defendant argued that since the issue had already been litigated and decided, the plaintiffs were estopped from bringing their removal claim based on the doctrine of res judicata. A res judicata claim must demonstrate that:

> (1) the court making the prior adjudication had jurisdiction; (2) the parties to the present action are either the same parties or in privity with the parties from the prior adjudication; (3) the prior adjudication was final; (4) the causes of action were the same in both cases or the issues decided in the prior action were the same as those raised in the present case; and (5) the issues in the prior action were decided adversely to the party's contention in the instant case.[107]

The court found that the third element needed for a *res judicata* argument was missing from the defendant's claim. While the pinhooking horse transaction had been raised by the plaintiffs in a complaint in New York, the judge hearing that claim had not made a final adjudication on the transaction as it related to the defendant's removal as a manager. Therefore, the court concluded that the plaintiffs were not barred from bringing their action based on the doctrine of *res judicata*. For the same reason that there had not been a final adjudication on the issue involved, the court also rejected the defendant's defenses of collateral estoppel and judicial estoppel.

The defendant also argued that the plaintiffs misinterpreted the removal section of the operating agreements of the LLCs, arguing that even if she had perpetrated a fraud against the plaintiffs, she could not be removed as a manager unless the LLCs had suffered a "material adverse effect" caused by her fraudulent behavior. The court disagreed with the defendant's interpretation of the removal provision and found that the qualification of suffering a "material adverse effect" applied to other provisions in the LLC agreements and there was no such qualification for removal when the manager had committed fraud. The court found the provision to be susceptible to only one meaning and was therefore unambiguous. Further, the court noted that even if there was a contractual requirement to demonstrate a "material adverse effect," the defendant's actions had had such an adverse effect on the members so that she still could be removed for cause. Having found that the removal notice was both proper and effective, the court declared that the defendant had been validly removed as a manager of the LLCs.

J. Arbitrability of Claims

In *Julian v. Julian,*[108] the Delaware Court of Chancery analyzed an arbitration provision in an LLC agreement and addressed the issue of who should decide whether parties to an LLC agreement must submit their particular dispute to arbitration. *Julian* arose from disputes among three brothers who had formed various family-owned LLCs. Due to disputes

106. *Id.* at *2.

107. *Id.* at *3 (quoting Julian v. E. States Constr. Serv., Inc., 2009 WL 1211642, at *5 (Del. Ch. May 5, 2009)).

108. C.A. No. 4137-VCP, 2009 WL 2937121 (Del. Ch. Sept. 9, 2009).

among the members, the plaintiff brother had resigned from some of the LLCs and sought a judicial determination of the fair value of the LLCs from which he had resigned. The defendant brothers responded by arguing that the plaintiff's claims should be dismissed because there was an adequate remedy at law in the form of arbitration, which was set forth in the operating agreements of some of the applicable LLCs.

The court found that the issue presented was one of substantive arbitrability, which the court defined as "whether the parties decided in the contract to submit a particular dispute to arbitration."[109] The court noted that Delaware courts generally favor arbitration when parties bargained for arbitration in their contract. "Delaware's public policy strongly favors arbitration, but arbitration is consensual, so the parties must have agreed to it."[110] Before determining substantive arbitrability, the court stated that an initial issue was who should decide if the parties to the contract chose to submit the dispute to arbitration or to a court. "'[T]he question of whether the parties agreed to arbitrate is generally one for the courts to decide and not for arbitrators.' Consequently, courts should presume the parties did not agree to arbitrate arbitrability, unless there is 'clear and unmistakable evidence that they did so.'"[111]

To make this determination, the court used a two-prong method articulated by the Delaware Supreme Court in *Willie Gary* to determine "whether an arbitration clause constituted 'clear and convincing evidence' of the parties' intent to arbitrate arbitrability."[112] That standard would be met if the arbitration clause "(1) generally refers all disputes to arbitration and (2) references a set of arbitral rules that empowers arbitrators to decide arbitrability."[113] It was undisputed in this case that the arbitration provision at issue generally referred all disputes to arbitration; therefore, the first prong of the standard was met. The arbitration provision also referred matters to the American Arbitration Association rules, which the court found to empower arbitrators to decide arbitrability. The second prong of the standard was also met.

Despite the fact that both prongs of the *Willie Gary* test had been met, the plaintiff still contended that his claims did not arise out of or relate to the LLC agreements, since his claims related to a valuation of his interest upon resignation under section 18-604 of the LLC Act. As a result, he asserted that "a court, and not the arbitrator, should determine that they fall outside the broad scope of the applicable arbitral provision."[114] Further, he had also made fiduciary duty claims, which he argued did not relate to or arise out of the LLC agreements.

The court found the plaintiff's arguments unpersuasive. LLCs are creatures of contract and are required under the LLC Act to have a limited liability company agreement; consequently, the plaintiff's request for the fair value of his interest in an LLC relates to some extent to the terms of the applicable LLC agreement. Having found that the *Willie Gary* test had been met and there was a basis for finding that the disputes related to the relevant LLC agreements, the court determined that an arbitrator should be left to decide whether the disputes should be before an arbitrator.

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109. *Id.* at *4 (quoting James & Jackson, LLC v. Willie Gary, LLC, 906 A.2d 76, 79 (Del. 2006)).

110. *Id.* at *3.

111. *Id.* at *5 (quoting DMS Properties-First, Inc. v. P.W. Scott Assoc., Inc., 748 A.2d 389, 391-92 (Del. 2000); *Willie Gary*, 906 A.2d at 79 (quoting First Options of Chicago, Inc. v. Kaplan, 514 U.S. 938, 944 (1995))).

112. *Id.*

113. *Id.*

114. *Id.* at *6.

IV. INSPECTION OF BOOKS AND RECORDS

A. Scope of the Right to Compel Access to Books and Records

In *Madison Real Estate Immobilien-Anlagegesellschaft Beschrankt Haftende KG v. KanAm USA XIX Limited Partnership,*[115] the Delaware Court of Chancery examined the scope of a limited partner's right to gain access to the books and records of a limited partnership under an LP agreement and the LP Act. The plaintiff in *Madison* was a German entity that was formed as an "acquisition vehicle" to make initial small investments in partnerships. If it determined that the partnership involved was an attractive investment, it then would make a tender offer for the purchase of additional interests.

The limited partnership targeted by the plaintiff in *Madison* was a fund that owned joint venture interests in shopping centers. The plaintiff viewed the fund as a potential tender offer candidate due to some financial problems the fund was having, thereby indicating that the limited partners in the fund might be willing to sell their interests at a discount. To initiate its tender offer plan, the plaintiff purchased a small amount of limited partner interests in the fund and then completely analyzed the partnership and produced various models that priced a potential tender offer. With the purpose of developing its tender offer, the plaintiff made several written books and records inspection demands to the fund's general partner, which included demands for detailed financial and operations information about the fund. Eventually the general partner responded and rejected the demand by citing that the information requested was "proprietary, confidential, and in the nature of trade secrets."[116] After a revised demand was also rejected by the general partner, the plaintiff commenced action to gain access to the information. The plaintiff alleged that the failure of the general partner and the fund to provide such information was a breach of the LP agreement and the LP Act, and such failure had resulted in monetary damages to the plaintiff.

The court first analyzed the plaintiff's claim under section 17-305 of the LP Act. Section 17-305 provides that "a limited partner may obtain access to books and records of a limited partnership upon a reasonable demand for any purpose reasonably related to the limited partner's interest as a limited partner."[117] The plaintiff argued that it had two proper purposes for requesting access to the books and records: (1) valuing the fund as a whole for the purpose of commencing a tender offer, and (2) valuing its existing interests in the fund. In its analysis, the court noted that the "*primary* purpose must be proper," that "any *secondary* purpose, whether proper or not, is irrelevant," and that the plaintiff has the burden of demonstrating a proper purpose.[118]

In analyzing the plaintiff's purpose, the court examined the standards set by case precedent in two cases, *Madison Avenue Investment Partners, LLC v. American First Real Estate Investment Partners, L.P.*[119] ("*Madison I*") and *BBC Acquisition Corp. v. Durr-Fillauer Medical, Inc.*[120] The plaintiff analogized the current facts to *Madison I*, where access to books and records was allowed for the proper purpose of valuing one's investment when there was an objective of acquiring additional

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115. C.A. No. 2863-VCP, 2008 WL 1913237 (Del. Ch. May 1, 2008).

116. *Id.* at *3.

117. *Id.* at *2.

118. *Id.* at *5 (quoting BBC Acquisition Corp. v. Durr-Fillauer Med., Inc., 623 A.2d 85, 88 (Del. Ch. 1992)).

119. 806 A.2d 165 (Del. Ch. 2002).

120. 623 A.2d 85 (Del. Ch. 1992).

units. The court rejected the plaintiff's assertion and instead distinguished the *Madison I* facts from the current facts because in *Madison I,* no decision had been made to launch a tender offer. The court here agreed with the general partner that the current facts were more analogous to the corporate law *BBC Acquisition* case, where the court determined that a primary purpose of valuing an interest to consider whether to increase an offering price in a tender offer situation was not reasonably related to an interest as a stockholder and therefore was not a proper purpose within the meaning of Del. Code Ann. tit. 8, § 220. Under the current Madison facts, including the concession by the plaintiff, the court found that the primary purpose of the plaintiff in seeking the books and records of the fund was to make a tender offer. The court concluded that the plaintiff's primary purpose was not reasonably related to its interest in the fund and therefore was not a "proper purpose" within the meaning of section 17-305 of the LP Act.

The court also addressed two alternative and independent grounds under section 17-305(b) of the LP Act that would have allowed the general partner and the fund to deny the plaintiff access to the books and records. First, the court found that the general partner had demonstrated that it could keep the requested information confidential pursuant to section 17-305(b) because it reasonably believed that the requested information was in the nature of trade secrets. Further, the court found that the general partner had adequately shown that the fund was required to keep the requested information confidential pursuant to various written and oral third-party agreements.

The court then analyzed the plaintiff's claim that it was entitled, pursuant to the LP agreement of the fund, to inspect the books and records. The LP agreement referred to a right to inspect the "books of account" of the fund, as opposed to the more commonly used term "books and records." The plaintiff argued that the term used in the LP agreement was ambiguous and therefore, based on the doctrine of *contra proferentem*, which resolves ambiguities against the drafter, should be construed in its favor to include the requested information. The general partner disagreed with the plaintiff and felt that the language in the LP agreement was unambiguous and did not encompass the information requested by the plaintiff. Relying on a definition provided by the general partner from *Black's Law Dictionary*, as well as the second sentence of the relevant section of the LP agreement, which stated that the "books of account shall be closed at the end of each year," the court determined that the term "books of account" was limited to documents that the fund had created, controlled, or closed out at the end of each year. Based on this conclusion, the court found that the LP agreement was not ambiguous and, further, the information requested by the plaintiff fell outside the scope of the "books of account" referred to in the LP agreement. The court denied the plaintiff's request to inspect the books and records of the fund.

B. Use of Commission to Request Documents

In *Maitland v. International Registries, LLC, et al.,*[121] the Delaware Court of Chancery ruled on a motion by the plaintiff for a commission requesting documents and deposition testimony where the ultimate case involved an action for the inspection of the books and records of two LLCs under section 18-305 of the LLC Act. The court in *Maitland* first noted that "[b]ecause the issues in a books and records case are narrow, discovery is necessarily narrow as well."[122] The court found that the request for discovery by the plaintiff was not narrow and would effectively grant the plaintiff his final relief of access to the books and records. The court stated that the plaintiff could not "use the discovery process in a books and records case to gain access to the books and records ultimately at issue,"[123] as this would allow the plaintiff to have a way around the LLC agreement and the LLC Act. The court denied the plaintiff's motion for commission.

121. C.A. No. 3669-CC, 2008 WL 2440521 (Del. Ch. June 6, 2008).

122. *Id.* at *2.

123. *Id.*

C. Entitlement to Review Books and Records

The Delaware Court of Chancery examined the entitlement of an individual to review the books and records of an LLC, based upon such individual's relationship to the LLC, in *Mickman v. American International Processing*.[124] In *Mickman*, the defendant LLC moved for summary judgment in a case brought by the plaintiff, Elaine Mickman, for the inspection of the books and records of the LLC. The LLC argued that the plaintiff was not a member or manager of the LLC and consequently was not entitled to inspection rights under section 18-305 of the LLC Act.

The court first quoted section 18-305 of the LLC Act, which explicitly provides certain books and records inspection rights to members and managers of an LLC. The LLC argued that the plaintiff was not listed on the list of members in the LLC agreement, and therefore she was not a member entitled to rights under section 18-305. The plaintiff argued that although she was not listed in the LLC agreement as a member, she was listed by the other two members on various tax forms as a member and should be entitled to the rights of a member. In its analysis, the court noted that LLCs by their nature are "flexible and less formal" than corporations and, accordingly, "it is reasonable to consider evidence [of membership] beyond the four corners of the operating agreement."[125] In this case, the court was willing to examine the evidence that the plaintiff had presented suggesting that, notwithstanding the LLC agreement, the parties to that agreement had intended to admit and thought they had admitted the plaintiff as a member of the LLC. As the court was willing to examine evidence showing that the plaintiff was a member of the LLC and thus entitled to inspection rights under section 18-305 of the LLC Act, the court denied the defendant LLC's summary judgment motion.

Subsequent to that decision, the Delaware Court of Chancery examined in the same case whether the plaintiff was entitled to photocopy the general ledgers of two LLC defendants.[126] The plaintiff first argued that she was entitled to photocopy the general ledgers because the LLCs had waived any objection to her obtaining that information when they granted her counsel the opportunity to review the ledgers. A waiver is the "'intentional relinquishment of a known right, either expressly or by conduct, which clearly indicates an intention to renounce a known privilege or power.'"[127] The court found that, based on their conduct, the LLCs had not waived their objections to the plaintiff's photocopying the ledgers as they had taken affirmative steps to deny the plaintiff that right, which indicated their intent to preserve their objections to the plaintiff's making photocopies.

The plaintiff's second argument was that she was entitled to photocopy the general ledgers under both operating agreements of the LLCs and section 18-305 of the LLC Act. Each of the LLC agreements expressly granted members inspection rights, and the court noted that "LLC agreements can grant members inspection rights that exceed the rights provided in the statute."[128] Each LLC agreement specifically provided that members shall have "access to all books and records" of the applicable LLC, but it did not define exactly what "access" entailed. The parties disagreed as to the interpretation, so the court referred to corporate precedent in interpreting the provision. The court found the language in the LLC agreements to be broad and to include the general ledgers that had been requested. Relying on corporate precedent,

124. C.A. No. 3869-VCP, 2009 WL 891807 (Del. Ch. Apr. 1, 2009).

125. *Id.* at *2.

126. Mickman v. Am. Int'l Processing, L.L.C., C.A. No. 3869-VCP, 2009 WL 2244608 (Del. Ch. July 28, 2009).

127. *Id.* at *1 (quoting Moore v. Travelers Indem. Ins. Co., 408 A.2d 298, 302 (Del. Super. 1979)).

128. *Id.*

the court interpreted "access" to include making photocopies of the books and records. Since the court found that the plaintiff was contractually entitled to photocopy the general ledgers under the LLC agreements, it did not address the plaintiff's statutory right of access under section 18-305 of the LLC Act.

D. Proper Purpose

In *JAKKS PACIFIC, Inc. v. THQ/JAKKS PACIFIC, LLC,*[129] the Delaware Court of Chancery examined section 18-305 of the LLC Act's proper purpose test in connection with a books and records request. The plaintiff was a non-operating member of an LLC, and the defendant was a second member who was responsible for the day-to-day operations of the LLC and for the books and records of the LLC. The LLC was formed to market and sell videogames pursuant to a license held by the LLC. The company that issued the LLC its license was currently litigating a contract dispute with the LLC, making the future extension of the license extremely speculative. The plaintiff had no capital invested in the LLC and did not have any residual equity interest in the LLC. It was only entitled to a preferred return from the sales revenue of the LLC. The plaintiff's "economic interest in the joint venture, though it is technically a member of the LLC, is less that of an equity owner and more akin to a licensor with rights to royalties based on sales."[130]

The plaintiff sent the defendant a letter demanding a "broad spectrum of financial documents" relating to the LLC. The defendant responded by supplying over 110,000 pages of material to the plaintiff. The plaintiff made multiple follow-up requests for additional LLC information. Subsequently, the plaintiff made an additional books and records demand on the defendant, which demand included an extensive list of items. The plaintiff also provided a list of reasons for this request. The defendant responded that the request was overbroad and failed to state a proper purpose. The plaintiff then initiated a lawsuit to enforce its rights under section 18-305.

The plaintiff cited the following purposes in its demand for documents: "(1) to aid it in negotiating the Preferred Return for the next distribution period, (2) to value its interest in the LLC, and (3) to investigate alleged mismanagement and wrongdoing by [the defendant] in managing the affairs of the joint venture."[131] The court stated that the plaintiff had to establish by a preponderance of the evidence that there was proper purpose for inspection of the books and records.

Since the extension by the LLC of its license agreement was so speculative, the court found the first purpose for the demand by the plaintiff (i.e., to negotiate the preferred return) to be not reasonably related to the plaintiff's interest in the LLC. Further, although the court noted that in most circumstances, a demand to value an interest in an LLC (i.e., the plaintiff's second purpose) is generally a valid purpose for a demand, the plaintiff had no residual equity interest in the LLC and was only entitled to a preferred return and that return was currently being determined through an arbitration. Finally, to support an allegation of mismanagement in a books and records demand (i.e., the plaintiff's third purpose), the plaintiff "must offer a credible basis to suspect mismanagement or wrongdoing."[132] The plaintiff did not offer any credible basis. As the court found that the plaintiff had failed to meet its burden of proof that it had a proper purpose under section 18-305, judgment was entered for the defendant.

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129. C.A. No. 4295-VCL, 2009 WL 1228706 (Del. Ch. May 6, 2009).

130. *Id.* at *2.

131. *Id.* at *4.

132. *Id.* at *5.

V. STATUTE OF FRAUDS

In *Olson v. Halvorsen*,[133] the Delaware Court of Chancery, as a matter of first impression, addressed whether the Delaware statute of frauds applies to LLC agreements. The Delaware statute of frauds states that "an agreement 'that is not to be performed within the space of one year from the making thereof' must be reduced to writing and signed by the party against which the agreement is to be enforced."[134] Prior to the *Olson* case, there had been disagreement among commentators on the statute of fraud's application, as it is not specifically addressed in the LLC Act and there was no case law directly on point.

In *Olson*, a hedge fund had been founded by a number of individuals. One of the individuals was subsequently removed and argued that he was entitled to certain payout terms specified in an unsigned operating agreement. The defendants who as founders had removed the individual plaintiff answered the plaintiff's complaint by asserting that the statute of frauds was applicable to the unsigned operating agreement and the earnout provisions were therefore unenforceable since they could not be performed within one year.

In determining the primary issue of whether the statute of frauds is applicable to LLC agreements, the court first noted that the LLC Act expressly allows oral operating agreements; however, the LLC Act does not specifically address whether the statute of frauds would be applicable to such oral agreements.[135] The court recognized that some commentators believe that without express statutory language overriding the statute of frauds, the principle is still applicable, as compared to other commentators who feel that the authorization of oral agreements along with the general principle under the LLC Act of giving maximum effect to the enforceability of LLC agreements creates an inference that the legislature intended to override the statute of frauds. The court found that the statute of frauds applies to LLC agreements that have terms that cannot be performed within a year. In so finding, the court held that "if an LLC agreement contains a provision or multiple provisions which cannot possibly be performed within one year, such provision or provisions are unenforceable."[136] In following the Delaware legislature's intent, the court also held that "provisions of an oral LLC operating agreement that could possibly be performed within one year will not fall within the statute of frauds and will remain enforceable."[137]

In determining the applicability of the statute of frauds to the *Olson* facts, the court noted that in addition to the payment of money to the plaintiff, the defendants also had certain other obligations that required them to take certain actions and prevented them from taking other actions, all for a period of time that extended beyond a year. Also, the payments that the plaintiff was requesting could not be calculated until more than one year after the date of the purported operating agreement. Based on these facts, the court determined that the statute of frauds was applicable.

The plaintiff asserted that even if the statute of frauds applied, certain exceptions were applicable. First, he argued that the multiple writings exception applied, which allows multiple writings to satisfy the statute of frauds where one of the writings is signed by the parties against whom the documents are to be enforced and the writings "'(a) reasonably identify

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133. C.A. No. 1884-VCL, 2008 WL 4661831 (Del. Ch. Oct. 22, 2008). The Court of Chancery's decision after trial may be found at *Olson v. Halvorsen*, C.A. No. 1884-VCL, 2009 WL 1317148 (Del. Ch. May 13, 2009).

134. *Id.* at *3 (quoting Del. Code Ann. tit. 6, § 2714(a)).

135. *See* LLC Act § 18-101(7) (providing that "a limited liability company agreement means any agreement … written, *oral*, or implied") (emphasis added).

136. *Olson*, 2008 WL 4661831, at *3.

137. *Id.*

the subject matter of the contract, (b) indicate that a contract has been made between the parties or an offer extended by the signing party and (c) state with reasonable certainty the essential terms of the unperformed promises in the contract.'"[138] The court rejected the plaintiff's arguments because the signed documents did not clearly identify the unsigned operating agreement and, in particular, the earnout provision contained therein that the plaintiff wanted the court to enforce. The court also noted that the signed documents failed to set forth any of the essential terms of the unsigned operating agreement, that are required to satisfy the multiple writings exception to the statute of frauds.

The plaintiff also argued that the part performance exception to the statute of frauds should apply. The court disagreed. Following the rule that multiple other jurisdictions have applied, it held that the part performance exception to the statute of frauds is only applicable to contracts for the sale of land, which would not apply to the facts in this case. As no exception was available to the plaintiff, the statute of frauds applied and the court granted summary judgment in favor of the defendants.

On December 15, 2009, the Delaware Supreme Court affirmed the Delaware Chancery Court's conclusion that the statute of frauds applies to LLC agreements.[139] The court applied principles of statutory construction and ruled that the LLC Act did not repeal the application of the statute of frauds to LLC agreements. The court explained that "[t]he LLC Act's explicit recognition of oral and implied LLC agreements does not preclude the statute of frauds."[140]

VI. INDEMNIFICATION

In *Donohue v. Corning*,[141] Vice Chancellor Strine addressed whether a removed managing member of an LLC was entitled to advancement of attorneys' fees. The plaintiff in *Donohue* had been a managing member of the LLC and was purportedly removed by special board approval of the LLC for "cause" in accordance with the LLC agreement. Prior to his removal, the defendant nonmanaging members had offered the plaintiff a reduced role in the LLC as opposed to removal; however, the plaintiff rejected this option and instead threatened to institute adversarial proceedings if he were removed. The defendants never responded with threats of initiating any type of action or suit against the plaintiff. Upon his removal, the plaintiff brought suit disputing the validity of the removal under the LLC agreement, and this decision addressed the plaintiff's motion for partial summary judgment to have his litigation costs advanced.

The plaintiff sought advancement pursuant to the section of the LLC agreement that provided:

> To the fullest extent permitted by law, the [LLC] shall indemnify and hold harmless … the Covered Persons from and against all liabilities and expenses (including, without limitation, judgments, fines, penalties, amounts paid in settlement, attorneys' fees, and costs of investigation) incurred in connection with the *defense* or *disposition* of any claim, action, suit, or proceeding, whether civil, criminal, administrative, or investigative, in which the Covered Person is involved, as a party or otherwise, or with which the Covered Person may be *threatened*, either during the Covered Person's incumbency or thereafter, by reason of having been, or by reason of any action taken by, the Covered Person. The

138. *Id.* at *5 (quoting ROI, Inc., v. E.I. du Pont de Nemours & Co., Inc., 1989 WL 135717, at *5 (Del. Oct. 19, 1989) (citing Restatement (Second) Of Contracts § 131)).

139. 986 A.2d 1150 (Del. 2009).

140. *Id.* at 1161.

141. 949 A.2d 574 (Del. Ch. 2008).

> [LLC] shall advance such expenses to the Covered Person upon receipt of an undertaking from such Covered Person to repay the advanced amount if it is ultimately determined that such Covered Person was not entitled to indemnification.[142]

Based on the indemnification and advancement provision, the plaintiff stated that: (1) he was a "Covered Person" under the definition provided in the LLC agreement,[143] (2) the defendants had threatened to remove him for cause for breaching his duties to the LLC and for acting with malfeasance, and (3) in bringing the suit, he was "disposing" of the threatened action by the defendants. The defendants instead asserted that no action had been threatened against the plaintiff and therefore the plaintiff's action did not fit within the advancement provision of the LLC agreement. Further, the defendants argued that regardless of whether the plaintiff's request for advancement was covered by the LLC agreement, he should not be entitled to advancement because the action was brought by him in furtherance of his own monetary interest and not as a fiduciary to the LLC.

The court acknowledged that although the plaintiff "may have both corporate and personal motivations for bringing [the] action," his decision to bring the action was "consistent with the policy behind allowing companies to advance funds to and indemnify their directors and officers."[144] The court explained that the policy of the Delaware legislature regarding indemnification is to encourage corporate officials to resist what they consider to be frivolous claims against them, secure in their knowledge that if they are vindicated, their reasonable expenses will be paid. Further, the principle purpose of indemnification is to "encourage capable men to serve as corporate directors, secure in the knowledge that expenses incurred by them in upholding their honesty and integrity … will be borne by the corporation they serve."[145]

Despite the favorable public policy of allowing indemnification, the court found that the LLC had contractual discretion in determining whether to grant advancement and the plaintiff was required to prove his entitlement to advancement under the LLC agreement. In trying to make his case, the plaintiff seemed to accept that the LLC agreement's advancement provision required conduct that was responsive or defensive in nature to give rise to an advancement right. The court found that the plaintiff could not identify the threatened suit that he was defending or disposing of by bringing suit. In particular, the court noted that the plaintiff had never been threatened by the defendants, who, to the contrary, had repeatedly told him they were not threatening him with any type of action. The court found that a for-cause removal was not a proceeding contemplated by the advancement provision of the LLC agreement, and the court denied the plaintiff's motion for partial summary judgment and dismissed the count in the plaintiff's complaint seeking entitlement to advancement.

In *Stockman v. Heartland Industrial Partners, L.P.,*[146] the Delaware Court of Chancery examined rights to advancement and indemnification under the terms of an LP agreement. Two officers of a portfolio company owned by a Delaware limited partnership were subject to various criminal proceedings brought against them in connection with their roles at the company. These criminal proceedings were eventually dismissed without prejudice. The former officers then

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142. *Id.* at 576 (emphasis added).

143. The LLC agreement defined "Covered Persons" to include managing members.

144. *Id.* at 577.

145. *Id.*

146. C.A. Nos. 4227-VCS, 4427-VCS, 2009 WL 2096213 (Del. Ch. July 14, 2009).

sought indemnification and advancement of legal fees from the company's parent (i.e., the defendant limited partnership). The partnership refused the requests and the officers responded by initiating legal action seeking advancement and indemnification under the LP agreement.

It was undisputed that the officers were "Indemnitees" under the LP agreement. The officers' claims were based upon their views that the advancement section of the LP agreement was mandatory, as it provided that expenses incurred "*shall* be advanced by the Partnership."[147] The partnership disagreed and argued that advancement under the LP agreement was not mandatory and instead required the written approval of the general partner of the Partnership, as the LP agreement also provided that "[n]o advances shall be made by the Partnership … without the prior written approval of the General Partner."[148]

In interpreting the LP agreement, the court referred to the general principle of contra proferentum, which construes ambiguous terms in an agreement against the drafter under certain circumstances:

> When an agreement like the [LP agreement] makes promises to parties who did not participate in negotiating the agreement, Delaware courts apply the general principle of *contra proferentum*, which holds that ambiguous terms should be construed against the drafter. The *contra proferentum* approach protects the reasonable expectations of people who join a partnership or other entity after it was formed and must rely on the fact of the operating agreement to understand their rights and obligations when making the decision to join … That is, in the case of an entity with ongoing operations, key constituents, including directors, officers and employees, look to the governing instrument's words, and not some obscure archive of parol evidence. As a result, any ambiguities in the [LP agreement] should be resolved in favor of the reasonable expectations of [the partnership's] Indemnitees regarding their indemnification and advancement rights.[149]

In this case, the court construed the ambiguities of the LP agreement in favor of the indemnitees, which included the officers.

In interpreting the advancement provision of the LP agreement, the court found that the officers' interpretation was the only reasonable one and the partnership's interpretation strained the plain meaning of the advancement provision when read in context. Further, the LP Agreement expressly set forth the meaning of "discretion," "sole discretion," and "sole and absolute discretion" in a manner that materially limited the general partner's liability exposure. The court found it to be meaningful that such terms were not used to modify the general partner's consent right in the advancement provision. "It would be very poor drafting indeed for [the partnership] to leave out a contractually important, liability-limiting term like 'sole and absolute discretion,' or at least 'discretion,' where [the partnership] intended to immunize the General Partner from a claim regarding advancement."[150] According to the court, it would have been easy for the drafter to provide specifically that the decision for advancement was at the discretion of the general partner. Since the court felt the general partner's approval role was merely to police the preconditions for advancement rather than to exercise discretion regarding advancement, and in light of the doctrine of *contra proferentum*, the court granted summary judgment to the officers on their claim for advancement of their legal expenses.

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147. *Id.* at *6.

148. *Id.* at *5.

149. *Id.*

150. *Id.* at *6.

On the issue of whether the officers were entitled to indemnification under the LP agreement, the court initially recognized that the LP Act gives parties greater contractual flexibility in drafting indemnification provisions than does the DGCL. Nonetheless, the indemnification provision in the LP agreement contained language similar, although not identical, to that provided under section 145 of the DGCL, which addresses indemnification in the corporate context. The LP agreement's indemnification provision selectively used language from section 145, which created confusion in interpreting it:

> In a nutshell, the Indemnification Provision adopts § 145's standard for good faith and lawful conduct, but is silent about the effect of a disposition of the underlying proceeding in favor of the Indemnitee, which is a key consideration when determining whether a corporate official is entitled to indemnification under § 145.[151]

The issue therefore was whether the plaintiffs had to plead and prove that they acted in accordance with the specific requirements of the indemnification provision so that they could be indemnified with respect to a prior criminal proceeding against them that had already been dismissed in their favor.

To aid its interpretation, the court examined precedent based on section 145. The court noted that section 145 purports to limit indemnifiable conduct to ensure that corporate officials "do not evade the consequences of their own misconduct in such a way that they are rewarded for or encouraged to violate applicable laws and to breach their fiduciary duties to the corporation."[152] When there is no conviction, fine, settlement payment, or other punishment to avoid, the corporation is not allowed under section 145 to inquire into the good faith or lawfulness of its indemnitees; instead, such indemnitees are entitled to indemnification where they were successful on the merits in the underlying proceeding. Applying section 145 to the facts of the case, the court concluded that since the officers' criminal proceedings were dismissed, they would have been entitled to indemnification under section 145.

After the court concluded its section 145 analysis, it proceeded to interpret the indemnification provision in the LP agreement. While the indemnification provision was very similar to section 145, it did not address the indemnification rights of those that had been successful in proceedings initiated against them. The partnership argued that the officers were not entitled to indemnification because the LP agreement required them to prove that their conduct giving rise to the dismissed criminal action "(A) was in or was not opposed to the best interests of the Partnership, (B) in the case of a criminal action or proceeding, the [officers] had no reasonable cause to believe that [their] conduct was unlawful, or (C) did not constitute fraud, bad faith, willful conduct, gross negligence…."[153] The officers argued that they were entitled to mandatory indemnification and the burden was on the partnership to demonstrate that they had acted in a manner that should cause them to be denied indemnification.

The court found the officers' argument to be persuasive, particularly as their criminal proceeding had been dismissed without any adverse finding. In addition, the court rejected the argument by the partnership that an indemnitee must litigate the issue of his conduct to determine if he is entitled to indemnification, as this would be inefficient, costly, and counterproductive to Delaware's public policy of encouraging indemnification. "[I]n a situation where the outcome of the underlying proceeding is favorable to the Indemnitee and provides no rational basis to infer that a breach of duty

151. *Id.* at *8.

152. *Id.* at *10.

153. *Id.* at *1.

occurred, the Indemnitee is not required to litigate over the substance of her conduct and her state of mind."[154] Finally, the court concluded that, based on the doctrine of *contra proferentum*, any ambiguity in the LP agreement surrounding whether the officers were entitled to indemnification should be resolved in favor of the officers.

VII. DISSOLUTION

A. Waiver of Judicial Dissolution

Prior to *R&R Capital, LLC v. Buck & Doe Run Valley Farms, LLC,*[155] the Delaware courts had never analyzed the effect of a waiver of judicial dissolution contained in an LLC agreement. In *R&R Capital*, the petitioners had financed nine Delaware LLCs. The sole and exclusive control of these LLCs was in one appointed manager, and the relationship between the petitioners and the manager had deteriorated over the years. The petitioners initiated suit against the Delaware LLCs seeking the dissolution of the nine LLCs or, in the alternative, the appointment of a receiver. The petitioners argued that (1) many of the LLCs had their certificates of formation cancelled due to statutory issues, and the manager's attempts to revive them were ineffective; (2) the manager had failed to provide an accounting of the cancelled LLCs; and (3) the manager and her boyfriend had defrauded the LLCs and engaged in self dealing.

The court immediately dismissed the claims of the petitioners against two of the LLCs for lack of standing. For those two LLCs, the petitioners were not themselves members of the LLCs, but instead were members of the members. Section 18-802 of the LLC Act provides that only a member or manager may petition the court for judicial dissolution, and this does not include a member of a member. The court did, however, allow the claims against the two LLCs to proceed for the appointment of a receiver under section 18-805 of the LLC Act, as such section allows an application to be brought by any "'person who shows good cause.'"[156]

The petitioners were members of the remaining seven LLCs, so they had statutory standing to seek judicial dissolution of those entities. The seven respondent LLCs argued that the petitioners could not seek judicial dissolution or seek the appointment of a liquidator because the petitioners had waived those rights under a common section of all of the various LLC agreements. The LLC agreements provided that one cause for dissolution would be a decree of judicial dissolution under section 18-802 of the LLC Act. The LLC agreements also contained a provision pursuant to which the members explicitly waived and renounced their right to seek a court decree of dissolution or appointment of a liquidator. In addressing the tension between the two sections of the LLC agreements, the court concluded that a decree of judicial dissolution may be entered by the court upon an application *by or for* a member or manager, so the members were only waiving the right to seek dissolution by them, not the rights of others to petition for them.

In analyzing whether such waivers to seek judicial dissolution were enforceable, the court first emphasized the general view that LLCs are creatures of contract that are designed to afford the maximum amount of freedom of contract, including the enforceability of LLC agreements. The court rejected the statutory arguments the petitioners had raised regarding the waiver and instead found nothing to indicate that waiving judicial dissolution violated the LLC Act.[157] The

154. *Id.* at *17.

155. C.A. No. 3803-CC, 2008 WL 3846318 (Del. Ch. Aug. 19, 2008).

156. *Id.* at *2 (quoting LLC Act § 18-805).

157. The petitioners had first pointed to section 18-109(d) of the LLC Act for the argument that nonmanaging members may not waive their rights to legal action absent an agreement to arbitrate. The court rejected this argument and found that section

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court also concluded that such waiver did not violate public policy, as there is a strong public policy in favor of freedom of contract. "Generally, the mandatory provisions of the [LLC] Act are 'those intended to protect third parties, not necessarily the contracting members.'"[158]

In the court's view, the petitioners were not left unprotected, as the LLC Act preserves the implied covenant of good faith and fair dealing, which protects members against others acting unfairly and in bad faith. As the petitioners were found to have "knowingly, voluntarily, and unambiguously waived their rights to petition [the] Court for dissolution or the appointment of a receiver under the LLC Act"[159] and such waiver is permissible and enforceable, the court granted the respondents' motion to dismiss.

B. Standard for Judicial Dissolution

Section 18-802 of the LLC Act provides that the Delaware Court of Chancery "may decree dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement."[160] The Court of Chancery provided further insight into this standard in *Fisk Ventures, LLC v. Segal*[161]. In *Fisk Ventures,* the plaintiff and defendant were each investors and members in an LLC. The LLC was managed by a five-person board with members appointed by the plaintiff and defendant. The LLC agreement provided that the board could only act upon the approval of 75 percent of its members. Neither party had enough votes individually to meet the 75 percent standard, which allocated for deadlocks. In fact, the parties had an ongoing five-year track record of perpetual deadlock, even having deadlocked over issues such as whether to hold board meetings. The LLC agreement required a 75 percent vote of the members to dissolve the LLC.

The plaintiff wanted the LLC to be dissolved and the defendant disagreed. Since the LLC agreement required a 75 percent vote of the members to dissolve the LLC, there was a deadlock on the issue of dissolution. The plaintiff filed a petition seeking judicial dissolution of the LLC under section 18-802 of the LLC Act.

In addressing the standard set forth in section 18-802, the court looked by analogy to section 17-802 of the LP Act and found the standard to be whether it is "reasonably practicable" to carry on business as opposed to whether it is impossible. The court found that case law had established various factual circumstances for the evaluation of the "reasonably practicable" standard, including: "(1) the members' vote is deadlocked at the Board level; (2) the operating agreement gives no means of navigating around the deadlock; and (3) due to the financial condition of the company, there is effectively no business to operate."[162] No one factor is dispositive, and not all factors must exist for a court to find that it is no longer reasonably practicable to carry on a business.

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18-109(d) of the LLC Act is not applicable and only governs service of process and venue. The petitioners then argued that certain provisions of the LLC Act, including judicial dissolution, were mandatory and nonwaivable. The court also disagreed with this proposition, pointing to discretionary language in the statute such as "may," and further stated that a lack of a phrase such as "unless otherwise provided" does not mean that a provision is nonwaivable. *Id.* at *4-5.

158. *Id.* at *5 (quoting Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 292 (Del. 1999)).

159. *Id.* at *8.

160. LLC Act § 18-802.

161. C.A. No. 3017-CC, 2009 WL 73957 (Del. Ch. Jan. 13, 2009).

162. *Id.* at *4.

The court found sufficient evidence to dissolve the LLC based on "the futility of [the LLC's] deadlocked board, the LLC [a]greement's failure to prescribe a solution to a potentially deadlocked board, and [the LLC's] dire financial straits."[163] Notwithstanding these factors supporting judicial dissolution, the defendant argued that the LLC agreement provided a method of resolving the deadlock because the plaintiff had a right to put its interests to the LLC for a specified price, which allowed the plaintiff to have an exit strategy from the LLC. The court, however, disagreed that the put right should be viewed as an alternative to judicial dissolution, as "it would be inequitable for [the] Court to force a party to exercise its option when that party deems it in its best interests not to do so."[164] The court granted the plaintiff's motion for judicial dissolution.

In *Estate of Eric Burke v. Eric S. Burke Home Improvement,*[165] another LLC case involving a deadlock, the Court of Chancery denied a motion for summary judgment and stated that the "reasonably practicable" test is a mixed question of both law and fact, and a trial was necessary to resolve all of the facts involved. The court did, however, note that based on case precedent, in situations involving a deadlock it is "exceedingly likely" that the court would ultimately order dissolution of the LLC.[166]

In contrast to *Fisk Ventures and Eric Burke*, the Court of Chancery denied a petition for dissolution in *Seneca Investments LLC v. Tierney.*[167] The petitioner, who was the former chief executive officer of the LLC, sought judicial dissolution of the LLC, claiming that for years the LLC had not: "(1) had a business plan; (2) made an investment; (3) sought or received additional capital; (4) sought to sell any shares; (5) had a shareholders' meeting; (6) had a meeting of the board of directors; or (7) sought to hire an employee or manager who could conduct any business on behalf of the corporation."[168] The LLC had in fact held three assets passively for a number of years.

The charter in *Seneca* had been set up to be governed by the DGCL, subject to certain express exceptions. In fact, the purpose of the LLC under its charter was "to engage in any lawful act or activity for which corporations may be organized under the [DGCL]."[169] The petitioner's petition for dissolution was therefore argued under both section 18-802 of the LLC Act and section 226(a)(3) of the DGCL.

In the court's section 18-802 analysis, it first noted that judicial dissolution has been granted "where there was a 'deadlock' that prevented the corporation from operating"[170] and where the defined purpose of the entity was fulfilled or impossible to carry out. In *Seneca*, there was no claim of a deadlock, so the court's focus was on whether it was impracticable for the LLC to fulfill its purpose as it was stated in its charter. The petitioner had shown no facts to meet the "reasonably practicable" standard under section 18-802; the petitioner had only alleged that the LLC was a functioning

163. *Id.*

164. *Id.* at *5.

165. C.A. No. 3322-CC, 2009 WL 1130388 (Del. Ch. Apr. 14, 2009).

166. The court referred to Haley v. Talcott, 864 A.2d 86 (Del. Ch. 2004), which involved a deadlocked LLC, and the court ultimately ordered dissolution of the entity.

167. C.A. No. 3624-CC, 2008 WL 4329230 (Del. Ch. Sept. 23, 2008).

168. *Id.* at *2.

169. *Id.* at *1.

170. *Id.* at *2.

passive instrumentality holding title to assets, which the court noted was "both lawful and common."[171] The petitioner had also attempted to argue that dissolution was proper under section 18-802 because the LLC had failed to comply with certain provisions of its LLC agreement, including making certain distributions and providing certain reports. The court felt that this approach was misplaced and noted that the "role of [the] Court in ordering dissolution under § 18-802 is limited, and the Court of Chancery will not attempt to police violations of operating agreements by dissolving LLCs."[172] Under these circumstances, the court found that granting judicial dissolution under section 18-802 was not warranted.

Because of the LLC agreement's incorporation of corporate principles, the court then turned to section 226(a)(3) of the DGCL to decide whether to appoint a custodian or receiver for the LLC due to abandonment of the LLC's business and a subsequent failure to dissolve.[173] The court concluded that the reference to the corporation's "business" under section 226(a)(3) meant the business of the LLC set forth in the purpose clause of its charter. It is lawful for a corporation to function as a passive holding company, which was consistent with the purpose set forth in the LLC's charter. In addition to serving as a passive holding company, the LLC was in the process of pursuing various legal claims, which was another "acceptable, and common, corporate function."[174] The court stated that it would be possible for a corporation facing a petition for dissolution to file nonmeritorious counterclaims to avoid judicial dissolution; however, that scenario was not present. Furthermore, the court found that a failure to have a business plan or to make new investments was not enough to show that the LLC had abandoned its business, as its stated purpose was to function as a passive holding company. As sufficient facts were not shown by the petitioner, the court dismissed the petition for dissolution of the LLC.

In *In re Arrow Investment Advisors, LLC,*[175] the Delaware Court of Chancery reviewed another set of facts and granted a motion to dismiss a petition for judicial dissolution. The petitioner seeking judicial dissolution of an LLC was a co-founder of the LLC who had previously been removed from its management by the other two co-founders. The purpose of the LLC as stated in its LLC agreement was to act as "an investment adviser to certain investment funds a*nd for such other lawful business as the Management Committee chooses to pursue.*"[176] The petitioner had been removed from the management committee of the LLC after disputes arose among the members of the committee over the management and strategic direction of the LLC.

Due to financial difficulties for the LLC in 2008, the LLC had sent a report to its members showing that the LLC was operating at a loss and notifying the members that the management committee had decided to explore new investment strategies for the LLC. After receiving this notification, the petitioner filed the petition seeking judicial dissolution of the LLC. The basis for the petition was that the management committee had poorly managed the LLC and had therefore impeded the LLC's business plan, goals, and objectives. The petition was very short and was viewed by the court as not containing a lot of support. The LLC sought to dismiss the petition, asserting that no facts had been set forth

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171. *Id.* at *3.

172. *Id.*

173. Section 226(a)(3) of the DGCL provides for the appointment of a custodian or receiver when "[t]he corporation has abandoned its business and has failed within a reasonable time to take steps to dissolve, liquidate or distribute its assets." DGCL § 226(a)(3).

174. *Seneca*, 2008 WL 4329230, at *5.

175. C.A. No. 4091-VCS, 2009 WL 1101682 (Del. Ch. Apr. 23, 2009).

176. *Id.* at *1 (emphasis added by court).

to infer that it was not reasonably practicable to carry on the business of the LLC as contemplated by section 18-802 of the LLC Act.

In analyzing whether judicial dissolution was appropriate, the court noted the extraordinary nature of judicial dissolution as a remedy. Judicial dissolution is not an appropriate remedy merely when profitability has not been as expected, as this is common in a capitalistic system that encourages risk-taking activity. Instead, judicial dissolution is to be used only in situations where an LLC's management has "become so dysfunctional or its business purpose so thwarted that it is no longer practicable to operate the business, such as in the case of a voting deadlock or where the defined purpose of the entity has become impossible to fulfill."[177]

In addressing the petitioner's arguments, the court first noted that an allegation that the LLC is not meeting its business plan is not the same as an allegation that it is no longer reasonably practical to carry on the business of the LLC in accordance with its LLC agreement. The court also disagreed with the petitioner's argument that the purpose set forth in the LLC agreement should be read narrowly, as this was clearly not the intent in light of the broad language in the LLC agreement allowing the LLC to pursue any lawful business chosen by the management committee. The petitioner argued that broad purpose clauses needed to be read narrowly to avoid section 18-802 from becoming superfluous; however, the court did not find this argument persuasive. The court acknowledged that there could be circumstances where judicial dissolution would be appropriate even when an entity had a broad purpose, if the facts supporting dissolution were persuasive.[178] Such a situation could arise "upon a strong showing that a confluence of situationally specific adverse financial, market, product, managerial, or corporate governance circumstances [exist making] it nihilistic for the entity to continue."[179]

The petitioner also argued that due to breaches of fiduciary duties by the current members of the management committee, judicial dissolution was appropriate. The court rejected this argument on two specific grounds. First, the court found that the petitioner had failed to allege any specific facts demonstrating a reasonable inference that fiduciary duties had been breached. Second, because many fiduciary duty claims are derivative claims, such claims must comply with the procedural requirements for derivative claims. In this case, none of those requirements had been met, including that the petitioner first make a demand on the management committee to address the alleged wrongs. "The purpose of demand is, in part, to give corporate managers an opportunity to address alleged wrongs without subjecting the entity to costly litigation."[180] The demand rule had an important function that should not be bypassed with a judicial dissolution petition.

In order for a petitioner to successfully bring a judicial dissolution petition based on breaches of fiduciary duties, she must show that "(1) she has proven the fiduciary breaches in a plenary action; and (2) there remains a rational basis for a dissolution remedy notwithstanding the remedy granted in the plenary action."[181] The LLC agreement required disputes to be handled first through arbitration. Since Delaware policy favors alternative dispute resolution, the petitioner was required to first attempt to handle his fiduciary duty concerns through the LLC agreement's dispute mechanisms.

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177. *Id.* at *2.

178. In fact, even with a broad purpose provision in an LLC agreement, the Delaware Court of Chancery granted a petition for judicial dissolution. *See* Harris v. RHH Partners, LP, C.A. No. 1198-VCN, 2010 WL 322993 (Del. Ch. Jan. 27, 2010).

179. *Arrow*, 2009 WL 1101682, at *3.

180. *Id.* at *4.

181. *Id.* at *5.

In summary, "[d]issolution is an extreme remedy to be applied only when it is [no] longer reasonably practicable for the company to operate in accordance with its founding documents, not as a response to fiduciary or contractual violations for which more appropriate and proportional relief is available."[182] Finding no basis for judicial dissolution, the court dismissed the petitioner's motion.

On a motion to dismiss, the Delaware Court of Chancery again discussed the standard for judicial dissolution under section 18-802 of the LLC Act in *Lola Cars International Limited v. Krohn Racing, LLC*.[183] In *Lola Cars*, the plaintiff and defendant had formed a Delaware LLC. Despite the fact that the plaintiff held a majority equity interest in the LLC, the members agreed to an equal representation on the board of the LLC of one director each. The defendant's director was also the chief executive officer of the LLC.

The relationship between the plaintiff and the defendant soured, and, among the multitude of claims made by the plaintiff, the plaintiff brought a claim seeking judicial dissolution of the LLC based on an allegation that the LLC could no longer realize its stated business purpose. The defendant moved to dismiss the plaintiff's petition for judicial dissolution, arguing that insolvency alone does not support judicial dissolution and that the plaintiff's alleged facts do not support the conclusion that the LLC cannot attain its business purpose.

The court relied upon the reasoning in *Fisk*[184] to determine if the reasonable practicability standard of section 18-802 had been met: "1) whether the members' vote is deadlocked at the Board level; 2) whether there exists a mechanism within the operating agreement to resolve this deadlock; and 3) whether there is still a business to operate based on the company's financial condition."[185] While noting that no one factor is dispositive and that not all *Fisk* factors must be present, the court found that all three of such factors existed. First, the court found a deadlock among the parties on whether to replace the chief executive officer. There was a potentially irreconcilable conflict between the parties, which would likely render the LLC unable to pursue the business objectives set forth in the LLC agreement. Second, the court concluded that there was not a mechanism for resolving the deadlock. The court arrived at this conclusion notwithstanding that the LLC agreement set forth a buy-out mechanism in the event of a dispute because such mechanism was voluntary. Third, the court expressed doubt as to whether the LLC could continue to operate based on its financial condition. The relevant inquiry was whether it is reasonably practicable to continue the business of the LLC and "not whether the company cannot possibly continue its business in [accordance] with its Operating Agreement."[186] In addition to the *Fisk* factors, the court also was persuaded by allegations of mismanagement, disloyalty, and poor performance.

The defendant also argued that the LLC agreement provided specific circumstances where the LLC could be terminated and since judicial dissolution was not specifically listed, it therefore was a contractually unavailable remedy. The court found the terms of the LLC agreement did not contain the exclusive means by which the LLC could be terminated and therefore judicial dissolution had not been contractually eliminated. The court denied the defendant's motion to dismiss the action for judicial dissolution. The court did not address whether a member's or manager's statutory right to petition for judicial dissolution could be contractually eliminated.

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182. *Id.* at *1.

183. C.A. Nos. 4479-VCN, 4886-VCN, 2009 WL 4052681 (Del. Ch. Nov. 12, 2009).

184. Fisk Ventures, LLC v. Segal, C.A. No. 3017-CC, 2009 WL 73957 (Del. Ch. Jan. 13, 2009).

185. *Lola Cars*, 2009 WL 405281, at *5 (quoting *Fisk Ventures*, 2009 WL 73957, at *4).

186. *Id.* at *6.

C. Winding Up Upon Cause Shown

Section 18-803(a) of the LLC Act provides that "upon cause shown," the Court of Chancery "may wind up [a] limited liability company's affairs" and "in connection therewith, may appoint a liquidating trustee."[187] In *Spellman v. Katz (In re KSA, L.L.C.),*[188] the Court of Chancery examined the circumstances that constitute "cause shown" to authorize the court to appoint a liquidating trustee to wind up the affairs of an LLC under the LLC Act. The plaintiff and defendant in the case were each doctors who had formed the LLC to construct a medical office building. The relationship between the plaintiff and defendant deteriorated. The plaintiff eventually initiated suit to either have the LLC dissolved pursuant to section 18-802 of the LLC Act or, in the alternative, have an order issued under section 18-803(a) to appoint a liquidating trustee for the LLC. The plaintiff argued that the LLC had already been dissolved pursuant to its LLC agreement, which provided for the LLC to be dissolved and wound up as soon as the construction of the medical building was completed and a certificate of occupancy was issued with respect to each condominium unit therein.

Although neither party denied that the express preconditions for dissolution set forth in the LLC agreement had been met, the defendant argued that dissolution and winding up of the LLC was not proper because the LLC agreement did not accurately reflect the intent of the parties. The defendant argued that neither party had intended for the LLC to be dissolved upon completion of the medical building. The court found the defendant's arguments to be unpersuasive, as it found the LLC agreement to be unambiguous and thus would not overlook the plain meaning of the provision by considering parol evidence in its interpretation. Based on the plain meaning of the LLC agreement and the lack of dispute among the parties as to the facts involved, the court found that the LLC had been dissolved by the express will of the members and it was then necessary to wind up the LLC's affairs. The court granted the plaintiff's motion for summary judgment on the issue of dissolution.

The court then turned to the plaintiff's section 18-803(a) argument for the appointment of a liquidating trustee. On dissolution, the LLC agreement required the parties to select jointly a person to wind up the LLC's affairs. Because of the animosity between the two members, it seemed very unlikely that they could agree on such an appointment. Due to this inability, the court concluded that "cause" existed to support its appointment of a liquidating trustee pursuant to section 18-803 of the LLC Act.

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187. LLC Act §18-803(a).

188. C.A. No. 1838-VCN, 2009 WL 418302 (Del. Ch. Feb. 6, 2009).