Materials

Lessons from the Trenches for Transactional Lawyers
Committee on Limited Liability Companies, Partnerships, and Unincorporated Business Entities (LLCPUE)
Business Law Section Spring Meeting, March 28, 2019

These materials have three parts:

- detailed outline of topics (first 12 pages)
- appendix to the outline (next 98 pages)
- Limited Liability Company Issues Arising Under Delaware Law (the final 29 pages)
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This outline, prepared by Professor Kleinberger with the assistance of the other panelists, was the tool the panel used to identify topics of interest and within their respective expertise and experience. Thus, the outline makes no attempt to be comprehensive and, barring total quietude from attendants (unprecedented in LLCPUE Committee presentations), the discussion will not encompass every topic in the outline.

I. Back to the beginning – the basic concepts
   A. objective theory
      1. Learned Hand and the 20 bishops

      A contract has, strictly speaking, nothing to do with the personal, or individual, intent of the parties. A contract is an obligation attached by the mere force of law to certain acts of the parties, usually words, which ordinarily accompany and represent a known intent. If, however, it were proved by twenty bishops that either party, when he used the words, intended something else than the usual meaning which the law imposes upon them, he would still be held, unless there were some mutual mistake, or something else of the sort. Of course, if it appear by other words, or acts, of the parties, that they attribute a peculiar meaning to such words as they use in the contract, that meaning will prevail, but only by virtue of the other words, and not because of their unexpressed intent.


      2. Williston
         a. “meeting of the minds” – a fallacy
         b. “As a general principle, the inquiry will focus not on the question of whether the subjective minds of the parties have met, but on

¹ For a copy of the decision, see the Appendix.
whether their outward expression of assent is sufficient to form a contract.” 1 Williston on Contracts § 4:1 (4th ed.) (WL)

3. Differing interpretations do not compel a finding of ambiguity
   a. “The mere fact that the parties may have different opinions regarding the interpretation of the contract does not itself create an ambiguity in the contract.” Ad Two, Inc. v. City & Cty. of Denver ex rel. Manager of Aviation, 9 P.3d 373, 377 (Colo. 2000).
   b. the litigator’s favorite – unambiguous although not all the appellate panel agrees – Savela v. City of Duluth, 806 N.W.2d 793, 800 (Minn. 2011) (P. Anderson, J., dissenting (“I disagree with the majority's conclusion that the language in the approximately 60 collective bargaining agreements (CBAs) between the City of Duluth and its employees is unambiguous. There is more than one reasonable interpretation of the CBAs at issue.”)
   c. even more entertaining – majority and dissent agreement that contract is unambiguous while offering conflicting interpretations

4. “I know you think you understand what you thought I said but I'm not sure you realize that what you heard is not what I meant.”

5. construction versus interpretation

6. functional basics
   a. have in mind the function(s)
      i. developing, creating, reflected the deal as understood by the participants
      ii. comfort letters as a lens
         • a mechanism for inducing/compelling due diligence in discussions with client
         • a point of comparison for how lawyers typically vet the rest of the agreement with client
            • “We thought we had only 500 antiquated widgets, for which they agreed to pay $500. It’s too late now to reopen this point, even though a mid-manager has discovered 6,000.”
      iii. regulatory approval
      iv. lender approval
      v. operating manual (discussed below)

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2 For an ancient but still useful discussion, see, in the Appendix, Kleinberger, Contracts and Disputes: Winning the War or Waging the Peace, 44 BENCH AND BAR OF MINNESOTA 15 (October 1987).
b. have in mind the audience
   i. other lawyers
   ii. clients and other part(ies)
   iii. judges and jurors
   iv. how to determine appropriate length, complexity, and specificity
      • the parable of the 20-page explanatory memo
      • the parable of the vice chancellor’s headache
   v. choice of language in cross border transactions
      • if English – consider specifying U.S. vs. British³
        ▪ Stump the Chump
          ≈ why no billionaires in Britain (back then)
          ≈ “In British English, a billion used to be equivalent to a million million (i.e. 1,000,000,000,000), while in American English it has always equated to a thousand million (i.e. 1,000,000,000). British English has now adopted the American figure, though, so that a billion equals a thousand million in both varieties of English.”
          https://en.oxforddictionaries.com/explore/how-many-is-a-billion/, last visited 2/18/19
        ▪ Chinese Department of Defense and “will versus shall”
          ≈ Determination or duty: … “Returning to our fairy godmother, her statement to Cinderella neatly illustrates the other main use of shall and will: to express a strong feeling that something must definitely happen, or that someone must do something as a duty. In a complete turnaround, traditional grammar dictates that I and we should be accompanied by will in such situations, whereas shall is used with you, he, she, it, and they…..”

c. consider the importance of plain English (to the extent possible), including short sentences
   
i. Cardozo is incomprehensible to most law students (let alone jurors)
   
i. law students rarely face the task of interpreting statutes such as follows:

Whereupon the enacting clause provides: “That it shall and may be lawful for the churchwardens or overseers of the poor of such parish or place where any such wife, or child, or children, shall be so left, upon application to, and by warrant or order from any two justices of the peace, to take and seize so much of the goods and chattels, and receive so much of the annual rents and profits of the lands and tenements of such husband, father, or mother, as such two justices of the peace as aforesaid shall order and direct, for or towards the discharge of the parish or place where such wife, child, or children are left, for the bringing up and providing for such wife, child, or children; which warrant or order being confirmed at the next quarter sessions, it shall be lawful for the justices of such quarter sessions to make an order for the churchwardens or overseers for the poor of such parish or place to dispose of such goods and chattels by sale, or otherwise, or so much of them, for the purposes aforesaid, as the court shall think fit, and to receive the rents and profits, or so much of them, as shall be ordered by the sessions, as aforesaid of his or her lands and tenements, for the purposes aforesaid.’ See, also, 22 Halsbury, Laws of England, § 1209."


ii. Humpty Dumpty definitions

   • Lewis Carroll, Through the Looking Glass, Ch. 6, https://ebooks.adelaide.edu.au/c/carroll/lewis/looking/chapter6.html, last viewed, 2/18/19

   ‘I don’t know what you mean by “glory,”’ Alice said.

   Humpty Dumpty smiled contemptuously. ‘Of course you don’t — till
I tell you. I meant “there’s a nice knock-down argument for you!”

‘But “glory” doesn’t mean “a nice knock-down argument,”’ Alice objected.

‘When I use a word,’ Humpty Dumpty said in rather a scornful tone, ‘it means just what I choose it to mean — neither more nor less.’

‘The question is,’ said Alice, ‘whether you can make words mean so many different things.’

‘The question is,’ said Humpty Dumpty, ‘which is to be master — that’s all.’

- Zschernig v. Miller, 389 U.S. 429, 435, 88 S. Ct. 664, 668, 19 L. Ed. 2d 683 n. 6 (1968) (“The court concluded that a leading Soviet jurist’s construction of article 8 of the law enacting the R.S.F.S.R. Civil Code seemed modeled after Humpty Dumpty, who said, ‘When I use a word * * *, it means just what I choose it to mean—neither more nor less.’” (citing Note, 55 Calif.L.Rev. 592, 594—595, n. 10 (1967); ellipsis in original).

iii. diagramming sentences

- if you don’t know how, you should
- if you have to diagram a sentence to be certain of its meaning, redraft

d. consider the importance of coherent organization

i. there’s a reason your 3rd grade teacher taught us to outline

- the importance of a coherent architecture from the outset; Aristotle: “[A]ny one is capable of carrying on and articulating what has once been well outlined.” Nicomachean Ethics (Chap. 1.7)

- the misleading ease of rearranging via cutting and pasting

- how to respond to a poorly organized document

ii. excessive cross references as a symptom

- however, sometimes best way to slice the apple

- key criterion – the reader’s ease rather than the writer’s

B. The overlay of securities law – beyond our scope

II. Complexity and length redux

A. Dealing with inevitable complexity
1. run the numbers – really worth the risk of confusion/contention later on?
2. examples
   a. especially useful when using a very complicated formula
   b. familiar tool in uniform business entity acts, but for a different purpose – to give an official interpretation by showing an example (typically clearly) within or outside the provision exemplified

An operating agreement can override Section 404(a)’s equal treatment requirement [pertaining to interim distributions] without specifically mentioning redemptions.

**EXAMPLE:** Ryan, LLC is a manager-managed limited liability company whose operating agreement: (i) includes a list (the “protected list”) of decisions or actions that may be taken only with the consent of all members; and (ii) provides that all other decisions and acts may be taken as the manager determines. The protected list does not include redemptions. The operating agreement overrides the Section 404(a)’s equal treatment requirement.

3. the role *vel non* of recitals – *People v. Forsyth*
   a. *People v. Forsyth,* 292 P.3d 1248, 125 8n. 95 (Colo. O.P.D.J. 2012) (“Principles of contract law instruct that recitals “should be reconciled with the operative clauses of the contract and given effect as far as possible.”
      i. *Stowers v. Cmty. Med. Ctr., Inc.*, 340 Mont. 116, 172 P.3d 1252, 1255 (2007); see also 17A C.J.S. Contracts § 403 (“although ‘whereas’ clauses do not control over the express provisions of a contract, they may be read in conjunction with the contract’s operative portions to ascertain the parties' intention, where the operative clauses are ambiguous”) (citations omitted).
      ii. “[T]here is case law holding that recitals in a contract are not binding upon the parties.”

*95* *See, e.g.*, Int'l Trust Co. v. Palisade Light, Heat & Power Co., 60 Colo. 397, 401, 153 P. 1002, 1003 (1916) (“Recitals which are general, and not contractual, merely descriptive, are not binding.”); Dornemann v. Dornemann, 48 Conn.Sup. 502, 850 A.2d 273, 281 (Conn.Sup.Ct.2004) (“Recitals in a contract, such as 'whereas' clauses, are merely explanations of the circumstances surrounding the execution of the contract, and are not binding.”

*97*
obligations unless referred to in the operative
provisions of the contract ....”) (quotation omitted).”

App. 406, 418 (1898):

The recital in the special contract is that the rate charged
was less than the regular tariff rate when such contract did
not apply. This in itself, we think, has the effect of stating
that there was a regular tariff rate for shipments not covered
by special contracts, and that the rate charged was less than
such higher rate and therefore the recitals in the contract
were prima facie evidence of the fact that there was a
higher legal rate than that charged, and that the latter was a
reduced rate and hence a sufficient consideration for the
exemption from liability for the loss of each jack shipped
beyond the $100. In our opinion ample
proof of the
existence of the greater rate than that charged is to be found
in the recital of the contract itself.

c. the special circumstance of “[f]alse recital of nominal
consideration”

A recital in a written agreement that a stated consideration
has been given is evidence of that fact as against a party to
the agreement, but such a recital may ordinarily be
contradicted by evidence that no such consideration was
given or expected.” Restatement (Second) of Contracts §
87 cmt c (1981).

d. considered at least an admission by each signatory?

B. Length – how long is the LLPUE Committee’s checklist for forming an LLC
(sans tax consideration)?

C. The limits of specificity

1. How many times does “reasonable” appear in:
   a. UCC, Article 2, proposed revision Draft (Interim--11/1999)– 115
   b. UBC - > 100 (some in comments)

2. Intentional vagueness?

D. Beta testing – the parable of a ULC drafting committee session

III. Who is the client? (mostly beyond our scope)

A. Special complexities when employee is about to become co-owner – especially if
employee has previously interacted with lawyer on entity’s behalf

IV. To restate the law or not

A. Dangers of not re-stating default rules

1. what if the statutory language changes?

   2. what is the applicable statute has glitched – e.g., is death a “withdrawal”
      under the Delaware statute?

B. Dangers of restating statutory language in contract
1. have you picked up all the interconnections in the statute?
   a. including definitions?

2. unless you’re sure that:
   a. you don’t want particular ones; and
   b. the engine will still function

3. will courts interpret your language per the statute?

4. what if the statute changes – implications for the originally intended meaning?

C. Going against the grain
   1. affecting fundamental concepts – e.g., eliminate the requirement to bring cases derivatively
   2. have you corralled all the concepts, including consequences?
      a. eliminate fiduciary duties and substitute contractual expression
      b. can a contract create desired fiduciary duties, or merely omit to eliminate those intended to remain – that is, are “fiduciary” remedies available?

V. Particular problems with phrases, words, terms of art
   A. Remote antecedents
   B. Assuming that the distributive principle of mathematics applies
      1. \([A(B+C) = AB + BC]\) – i.e., does a modifier apply only to the most proximate concept or all in the list
      2. don’t depend on commas
   C. Which is the narrower provision?¹
      1. subject to/except as provided in
         a. be consistent – the parable of schedules that duel with the agreement
         b. be leery of imbedded levels of subordination
      2. never “except as otherwise provided in this agreement” – if you can’t figure it out, what makes you think the opposing litigators will agree or that the court will figure it out?
   D. Make sure you understand the “terms of art” from other disciplines
      1. e.g., valuations – the parable of EBITA w/o reference to accrual or cash accounting
      2. e.g., the devil’s in the details – i.e., the specs
      3. vet with a practitioner in the discipline
   E. Timing problems with reciprocal obligations
   F. Conditions versus promises and the need for extreme clarity
   G. Numerals versus words stating number


² See the Appendix for the example of SDC University Circle Developer, L.L.C. v. Estate of Whitlow, 2019 WL 92791 (Court of Appeals of Ohio, Eighth District, Cuyahoga County).
H. “Including”
   I. Presumption against surplusage and “for avoidance of doubt”

VI. Forms
   A. Dangers and usefulness (must go beyond cut & paste)
   B. The special case of exhibits that control subsets – e.g., classes of interests, protected series

VII. Keeping the reality and the documents in synch
   A. Dangers to the client
      1. oppression claims (reasonable expectations) – Delaware devotees do not worry about this one
      2. modification
         a. oral
         b. implied in fact
      3. waiver
      4. evidence of ambiguity
   B. Dangers to the transactional attorney
      1. subsequent litigation against the lawyers who were the drafters
         a. malpractice: your corporate client could end up being controlled by your adversary
         b. breach of fiduciary duty
      2. the lawyers who were the drafters continue to represent the client in litigation – beware of conflicts & disqualification]
      3. Indemnity Litigation
   C. Defensive (proactive) measures
      1. encourage client to consider the document the operating manual
         a. plain English again
         b. the parable of the Monopoly rules
      2. deploy the arsenal\textsuperscript{7} the weapons
         i. NOM (misnomer) provisions
         ii. non-waiver provisions
         iii. non-reliance provisions
         iv. keeping the “implied covenant” in check\textsuperscript{8}

\textsuperscript{66} For copies of these and related cases, see the Appendix.
\textsuperscript{7} For a succinct discussion of the weaponry, in the Appendix see Daniel S. Kleinberger, “Protecting the Sacred Writing: The Operating Agreement,” \textit{Business Law Today}, February 14, 2018.
b. state of formation issues re enforceability
   i. Corbin v. Williston (PER)
   ii. NOM
3. provide a “maintenance plan” (periodic review)
4. with potential litigation in mind:
   a. Meticulously transcribe notes on meetings regarding disputed provisions
   b. The Highlander Rule: There Can Be Only One (controlling provision)
   c. With LLC membership disputes, consider obtaining waiver before agreeing to attempt to negotiate contract reformation or re-negotiate operating agreements

VIII. Documenting the deal after the fact
A. Operating/partnership agreements inevitably exist ab initio
   1. effect on preexisting informal/oral/implied-in-fact agreements
      a. obviously none if all agree and the agreement and its superseding character are well documented
      b. the difficulties of getting to agreement post hoc
   2. retroactive effect and “due formation” issues
   3. query Delaware “anytime” provision – Del. Code Ann. tit. 6, § 18-201(d) (“A limited liability company agreement shall be entered into or otherwise existing either before, after or at the time of the filing of a certificate of formation and, whether entered into or otherwise existing before, after or at the time of such filing, may be made effective as of the effective time of such filing or at such other time or date as provided in or reflected by the limited liability company agreement.”)
B. Restating the agreement
   1. pro forma or substantive (latter raises “who is the client” issues)
   2. special complexities when new investor entering
C. Consider conflict issues which:
   1. may not have existed ab initio; or
   2. were waived ab initio but not for subsequent work
IX. Definitions
A. Definitions as a subroutine
   1. test each out in every iteration
   2. why do uniform law commission drafting committees typically review definitions last?
   3. Humpty Dumpty – discussed above
   4. Lawyer’s Cha-Cha
   5. Deviation from the definitions in the applicable statute
   6. Ambiguity as to economic and governance rights
      a. to unit, or not to unit
      b. consistency with:
         i. tax terminology
ii. distributions provisions (especially complicated provisions)

B. Capitalization (writing, not finance)
   1. some object to as distracting (what do they know?)
   2. Initial Caps versus ALL CAPS
   3. Dangers
      a. incorporation from other documents – without adequate cross checking
      b. using a defined term in lower case
         i. if different meaning intended, confusing
         ii. what about inadvertent typos

X. Transfer restrictions and permitted transfers
   A. Coordination with defined terms
   B. Clarity as to what is prohibited
      1. e.g. “no transfer except as provided in Article ….”
      2. overrides the statutory default that permits transfers of economic rights?
   C. Death of the founder
      1. knowing the default rule re: power of estate (vary significantly)
      2. coordination with the estate planning (or lack thereof)
   D. Change of control provisions

XI. Admission of new members/partners – without signing the agreement

XII. Issues with management structure and power
   A. Boards?
   B. Corporate appearance
   C. Super-majorities
      1. end runs via merger
      2. unanimous consent provisions mean what they say – deadlock dangers
   D. Always include a call right?
      1. the equivalent of a corporate squeeze out merger
      2. Cf. UCC 2-719(2)
         a. remedy that fails of its essential purpose
         b. drafters avoid by including return of payment as an alternative remedy

XIII. Delineating/eliminating fiduciary duties
   A. duty limits versus liability protection
      1. distinction
      2. liability protection does not preclude equitable relief

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9 For an example of the difficulties in another context, in the Appendix see Sally Beauty Co. v. Nexxus Prod. Co., 801 F.2d 1001 (7th Cir. 1986). Do not neglect Judge Posner’s dissent.

3. does including both create ambiguity?

B. restating fiduciary duties versus recognizing them as not affected
   1. “contractual fiduciary duties” is an oxymoron except in Delaware
   2. even in Delaware – questions remain re: remedies
      a. disgorgement?
      b. entire fairness?
      c. punitive damages?

XIV. Choice of law and forum
   A. Arbitration
      1. are the real parties in interest bound?
         a. entity itself
         b. controlling owners of members/partners
      2. is the scope clear and sufficiently broad?
         b. “With the contractual freedom granted by the LLC Act comes the duty to scriven with precision. Regrettably for J & J [the party seeking to compel arbitration], the drafters of the MBC LLC Agreement crafted an unwieldy dispute resolution scheme that gives parties alleging claims for compulsory relief the right to litigate, rather than arbitrate, their claims.” Id.11

XV. Wrote the document – keep the client?
   A. Ethics issues12
   B. Testimony issues

XVI. Beta Testing agreements – a methodology

12 For an example of a disclosure/client-consent document, see in the Appendix “Prior Work Conflict Consent.”
Lessons from the Trenches for Transactional Lawyers

Appendix to the Outline

Cases appear first, followed by treatise excerpt and then articles.

200 F. 287
District Court, S.D. New York.

HOTCHKISS
v.
NATIONAL CITY BANK OF NEW YORK.

December 30, 1911.

Pursuant to the custom of stockbrokers in New York, securities are deliverable on the day following their sale. The transactions are of such magnitude that it would not be possible to conduct the business with the capital of the broker, who is obliged to obtain temporary credit to pay for securities deliverable to him, while he is receiving the proceeds of the securities which he is delivering to his purchasers. He is also required to carry large accounts of securities on margin for customers, to do which he obtains ordinary demand loans covered by securities, which are constantly changing by reason of sale or otherwise, so that, in addition to a temporary loan to make clearances, the broker must have accommodation to enable him to shift his collateral and receive securities, which are included in his ordinary demand loans. The clearance loans are loans for the day, which extend an accommodation credit in the morning for the specific purpose of enabling the broker to pay for securities delivered and to be returned from the proceeds of the same securities when delivered to his customer; it being understood that no portion of the proceeds of such loans should be used for any other purpose whatever to clear securities. No interest is charged on these loans, they being solely for the temporary accommodation of the depositor while he is meeting his engagements for the day. Though the loans are nominally made payable on demand, they are paid during the day as a matter of course without demand; the broker beginning to make deposits begins to make deliveries, and that was the course of dealing between the bankrupts and the bank, which had been carried on daily for many years.

At the opening of business on January 19, 1910, the bankrupts were solvent and obtained a clearance loan from defendant bank of $500,000, evidenced by two demand notes, providing that the bank should have a lien on all property of the bankrupts then or thereafter in its possession or under its control, with the right at any time to demand additional security. Against such credit the bankrupts drew four checks to pay off outstanding secured loans to certain banks and trust companies, which checks were certified by the bank, and on payment of the loans the securities deposited as collateral therefor were delivered to the bankrupts. This clearance loan had been paid off in the usual course of business during the forenoon of the day it was made, with the exception of about $117,000, when the suspension of the bankrupts was announced on the Stock Exchange at about noon, resulting from a violent break in the stock market affecting all securities, but chiefly the stock of the Columbus & Hocking Coal & Iron Company, in which the bankrupts were largely interested, and in which a pool existed. At about noon defendant’s vice president and assistant cashier, who had charge of making clearance loans, went to the office of defendant and asked for payment, or for securities to make good the clearance loan made that day, and after waiting an hour or two, during which the bankrupts conferred with their counsel, received securities not later than 2:30 p.m. When the bank received the securities, it knew that the bankrupts had suspended on the Stock Exchange, but did not know that it was insolvent. Substantially all the securities thus received were paid for or liberated from loans by the use of the proceeds of the clearance loan during the morning.

The special master found that when the securities were delivered the firm was insolvent, and that the representatives of the bank had reasonable cause to believe that it was intended to give defendant a preference whereby it would obtain a greater percentage of its debt than other creditors of the same class, and advised a decree for complainant, to which defendant
I do not think it necessary to add anything to the referee’s report, except upon two questions: First, the need of proving that the defendant knew that the bankrupts intended a preference; second, the defense of an equitable lien.

Upon the first point Alexander v. Redmond, 180 Fed. 92, 103 C.C.A. 446, is conclusive. It is idle to say that the opinion is obiter. I tried the case below, and, being of different opinion, decided it expressly, because the element of an intent to prefer was lacking. The reversal was therefore expressly upon that point, and the case settles the law in this circuit.

The second point is without doubt difficult, and requires careful analysis into the difference of intention between an obligation and a property right, which closely approach each other under these circumstances. I shall assume two things, which are at least not conceded. First, I assume that the written contracts may be varied by proof of a custom; second, that the custom would be valid, if it existed and actually gave a lien upon the assets. What, then, is the defendant’s position? It is this: Under the custom of banks and brokers, first, the certified checks, when withdrawn from the bank, remain in equity still the bank’s property, call the right a trust or whatever you will; second, the broker may use them only to relieve securities, either pledged or purchased, from liens upon them for money lent, or for purchase price due; third, the securities, when the broker receives them, are subject to an equitable lien equal in amount to the bank’s advances upon them, and that lien remains, not only upon them, but upon any money or other property which the broker may get by pledging or by selling them, so that if the broker, having sold the released securities, reinvests the moneys, the lien would remain upon the new securities so purchased. In other words, the actual intention of the parties here effects, the defendant says, what the law would itself impose, if the funds were at any time in the hands of the broker affected with an equitable lien or an implied or constructive trust. Now, this is a perfectly intelligible position, whether or not it be a sound one, and I must concede to the defendant that it does not seem to me to be an answer merely to show that the broker is free to pledge or sell the securities pledged with the bank’s money, because *291 if the custom contemplated his doing so, and also contemplated that the proceeds of such a sale or pledge should themselves be subject to the same lien, then it would not be an objection to show that the broker could in fact sell the securities.

On the other hand, all that actually takes place is consistent with the absence of any lien whatever, and with merely a restriction upon the use of the checks to the release of securities, and a strict requirement that the loan be paid at the close of the day. Nothing which the brokers do indicates that they regard the property in their hands as subject to any lien, because it is not enough that they are restricted in the use of the funds. For example, A. may lend B. money only on condition that B. put it in his business. A. would have no lien. Even if B. were to promise A. to pay him out of the funds in his business, A. would have no lien. Dillon v. Barnard, 21 Wall. 430, 22 L.Ed. 673; Franklin v. Browning, 117 Fed. 226, 54 C.C.A. 258; Barrington v. Evans, 3 Y. and C. 384. Justice Clifford says in Dillon v. Barnard, on page 439 of 21 Wall. (22 L.Ed. 673), that there must be—

‘some act of appropration on the part of the employer’ (the promisor) ‘depriving himself of the control of the funds, and conferring upon the contractor’ (the promisee) ‘the right to have them applied to his payment when the services are rendered or the materials are furnished. There must be a relinquishment by the employer of his right of dominion over the funds, so that without his aid or consent the contractor can enforce their application to his payment when his contract is completed. Nothing in the practice of the parties justifies any such inference as that indicated.’

A lien means that the lienor is to have the right to take his debt out of some specified res, which may, it is true, be a changing fund, but nevertheless must be ascertainable since it is a property right. To take out one’s debt from a res is a very much more stringent right than to restrict the borrower’s rights in the money you lend him, or even to promise to pay him from a fund. It seems hardly necessary to elaborate so obvious a distinction. Walker v. Brown, 165 U.S. 654, 17 Sup.Ct. 453, 41 L.Ed. 865. Again, the necessity of paying back the loan by 3 o’clock does not indicate that the bank meanwhile has any lien upon the funds, especially as the sources of payment are, naturally enough, indifferent to the bank itself. Nor is it significant that the bank should be interested in the kind of security in which the broker deals, because the loan represents so large a part of the broker’s indebtedness that its proceeds will for the time being be the greater part of his assets. Further, the need of beginning to pay back the loan by 12 o’clock
shows nothing, though the evidence really shows that the brokers have till 3 to begin to pay, because a creditor is under such circumstances naturally prone to suspicion if the debtor remains longer than necessary with so large a load of indebtedness. Indeed, the belief of a lien upon the broker’s assets would rather tend to less close scrutiny of the time of his repayments.

While, therefore, the use of funds by the broker does not necessarily preclude the existence of a lien, there is nothing in the practice of business which at all requires it to be interpreted in such terms. It is quite true that these ‘clearance’ loans are merely to enable brokers to shift about securities; but, while they are shifting them, they may hold them free and clear, or they may hold them subject to liens for the price. No one can a priori say which is more likely, and in the absence of some express provision covering the case the only interpretation which can be safely made is from the practice. Furthermore, the only occasion in practice which would throw any light would be when the question arose as to the bank’s rights between the time when the checks were certified and the loan paid. Such an occasion never arises, and so the custom does not help. If there had been instances in which the bank exercised a right as lienor during that period, and the broker assented, they would be material, but there are none. Even the single case which Alexander remembers in which the broker gave security overnight proves nothing, because the necessity would have been the same, whether or not the ‘clearance’ loan had been secured by a lien, because the ‘clearance’ loan was due in any case, and the broker must pay it by taking out a call loan with collateral somewhere, whether or not it had been secured itself theretofore.

All the evidence of custom, therefore, seems to me not to help the defendant in the least; on the other hand, some of it seems to injure its cause. For instance, if the brokers kept the ‘clearance’ loan securities separate, or in any way distinguished the bank’s supposed property from their own, there might be color for the claim of a lien; but, unfortunately for the bank, they mix everything indiscriminately. Now it is still possible that the lien is to be regarded as existing, even when for motives of convenience it is not kept defined; but upon the balance of probabilities the absence of any distinction must weigh. It would also be some evidence of intent if the ‘clearance’ funds were not mingled with other funds in one deposit confessedly within the broker’s power to use as he wishes; but they are so mingled.

Again, a strong evidence of the intention of the bank is that they so expressly, and with exuberant verbiage, reserve liens upon all securities in their possession. ‘Expressio unius exclusio alterius.’ Contrast the note used by the Bank of Commerce, which reserved a lien upon all the securities while in the hands of the brokers which were purchased out of the proceeds of loan. Of course, neither of these notes is conclusive, but each indicates that when the banks intended such an agreement they knew how to express it, and that in the case at bar the defendant expressed quite clearly a lien depending upon possession. The most reasonable understanding of the relation between the parties is that the bank relied upon the good faith of the broker to pay his loan and not to use his funds improperly, but that it had occurred to no one to consider what was the position of the bank, if the brokers should fail before the loan was paid. If that occurred, it seems to me incredible that, with no practice to go by, they should have left the matter without definition. The forms of the relation are all those of debtor and creditor. The practice under it sheds no light, as I have said; for obviously the banks could not exercise the rights of a lienor until there was some occasion to assert a preference. It seems pretty clear to me that the present assertion is no more than a favorable interpretation, which has no foundation in usage or expression. The bank itself, when asserting the lien, made no attempt to get only such securities as its funds had released, but gathered up all that came handy; among them stocks which had never been released by its funds, or by the substitution of securities released by such funds. It is impossible to see how, from any point of view, such securities were subject to a lien. The point is important only as showing that in practice the bank simply laid its hands on what it could get, like any other creditor seeking an illegal preference, and that its supposed lien must have been at the time ambulatory over the whole assets of the bankrupt estate. Such a practical construction of the bank’s rights is of substantial importance, when the question is of the interpretation of a practice or custom.

The testimony of Carse goes a little further than the actual practice of the brokers and the bank. He in one place characterizes the relations between the two, and states what they understood the legal status to be. Thus he says on his direct examination:

‘It has developed a form of trust, and the clear understanding implied between the broker and the bank is that whatever the broker obtains by the proceeds of the loan given to him is held in trust for the account of the bank.’

If a broker pays for stocks or bonds, it is the understanding of the bank that they belong to them as collateral to their
loan, and the broker simply retains possession of them long enough to make delivery and get payment,’ etc.

Now, if this witness’ interpretation of the legal effect of the custom is to stand for the court’s, of course the master’s decision as to the meaning of the custom is wrong; for then it is an out and out trust, disappearing into an equitable lien, upon payment of the certified checks to another bank and receipt of securities in exchange. But such an interpretation is not competent evidence at all, since it in effect usurps the court’s function which is to decide what was the ‘clear understanding.’

Moreover, it is of no consequence for another and deeper reason: A contract has, strictly speaking, nothing to do with the personal, or individual, intent of the parties. A contract is an obligation attached by the mere force of law to certain acts of the parties, usually words, which ordinarily accompany and represent a known intent. If, however, it were proved by twenty bishops that either party, when he used the words, intended something else than the usual meaning which the law imposes upon them, he would still be held, unless there were some mutual mistake, or something else of the sort. Of course, if it appear by other words, or acts, of the parties, that they attribute a peculiar meaning to such words as they use in the contract, that meaning will prevail, but only by virtue of the other words, and not because of their unexpressed intent.

Now, in the case at bar, whatever was the understanding in fact of the banks, and of the brokers, too, for that matter, of the legal effect of this practice between them, it is of not the slightest consequence, unless it took form in some acts or words, which, being *294 reasonably interpreted, would have such meaning to ordinary men. Of course, it will be likely that, if they both do understand their acts in the same way, usual men would have done so, too. Yet the question always remains for the court to interpret the reasonable meaning to the acts of the parties, by word or deed, and no characterization of its effect by either party thereafter, however truthful, is material. The rights and obligations depend upon the law alone.

When, therefore, Carse says what is the clear understanding of the legal effect of the practice, it is of no consequence, since that understanding was expressed only in acts, the natural meaning of which does not imply any trust relation, as he, and perhaps they, may have supposed. Had they said that they meant to create a trust, such a trust would arise; but when they merely adopted a course of conduct, the supposed results of that conduct are immaterial. I have therefore wholly disregarded this portion of Carse’s testimony.

The question of subrogation is easily disposed of. There is no subrogation, unless the money used to pay the claim kept alive by subrogation was money on which the party subrogated had in equity some claim, charge, or lien. I think there are no cases in which the payment of money in discharge of a claim allows of subrogation when the money was in all senses that of the man who paid the obligation. In other words, if the bank had some kind of equitable lien on the checks in the hands of the broker, it would certainly be entitled to be subrogated, but not if those funds were the funds of the broker in every sense. It is, of course, true that in Hurley v. Atchison, Topeka & Santa Fe Railroad, 213 U.S. 126, 29 Sup.Ct. 466, 53 L.Ed. 729, the court went a long way to sustain the equity of a claimant in bankruptcy, but I think it quite clear that the reason was this: The money which the road paid in advance for coal was the purchase price of an agreed quantity of coal, actually in existence. It was meant to give the road the right to demand from the seller a certain amount of coal actually in its possession, which, though not yet set apart from the bulk, was still definable in quantity. That was a specific interest in a res which survived bankruptcy. It hardly seems worth while to consider Sexton v. Kessler, 172 Fed. 535, 97 C.C.A. 161, in which there was a specific agreement.

[9] This case was heard in a somewhat anomalous way, as it was referred to take the testimony and report. The master has reported, and this is, therefore, in the nature of a final hearing on the testimony. The learned master allowed himself to be persuaded to incorporate certain refusals of requests to find—a practice which has, as far as I can learn, no place in equity practice, and the very beginnings of which I hope will always be resisted by the federal courts, which may otherwise find themselves in the unhappy predicament in that respect of the state courts under the New York Code. I have wholly disregarded these findings and refusals to find. I have treated the testimony as though submitted on final hearings.

This suit is in equity to recover the actual securities in specie. That is the prayer, and that was what was intended. It is quite likely that the trustee may have had the right to sue at law after rescinding *295 the transfer and making a demand, because the refusal would have been a conversion. However, he did nothing of the kind, but proceeded in equity to reclaim the securities, and he cannot now blow hot and cold. The decree will be for the delivery
of the securities, with any dividends received upon them. If the complainant wishes, he may take a reference on an accounting as to the responsibility for the depreciation in value. I cannot decide such a matter upon affidavits, though from the letters it looks as though the parties had substantially agreed that the bank should exercise its good judgment as to the sale of the securities. If so, the bank would under no circumstances be responsible for depreciation. If the trustee did not so consent, the question would arise whether or not the bank was a trustee ex maleficio, and, if so, whether it was responsible for any loss by depreciation, regardless of whether it used due care. Those questions I will not consider until it appears whether the trustee did not assent to the bank’s course.

The trustee will, of course, recover costs. Should a reference be had, I should be glad to have Judge Brown again act as master, if he is willing.
II. BACKGROUND

Boston Private acquired Gibraltar in October 2005, and, thereafter, Gibraltar, a banking entity, operated as a wholly-owned subsidiary of Boston Private. On September 17, 2009, Boston Private sold all of its shares of Gibraltar to a group of buyers pursuant to the Stock Purchase Agreement. In the Stock Purchase Agreement, Boston Private also undertook to make a payment to Gibraltar if it received certain tax benefits accruing from the business of Gibraltar (the “Tax Payment”). Before Gibraltar’s sale, its income tax liability or benefit was included as part of Boston Private’s consolidated income tax return.

Section 5.5(d) of the Stock Purchase Agreement describes each party’s obligations with regard to the Tax Payment and its calculation. Section 5.5(d) contemplates a Tax Payment for both the 2008 tax year and the short 2009 tax year ending on the date the stock sale closed; only the 2009 Tax Payment is at issue here. Under Section 5.5(d), Gibraltar first calculates its income tax liability or benefit for the 2008 and short 2009 tax years as though it filed separate returns for those years. To the extent that Gibraltar would have owed taxes on a standalone basis, it would be obligated to pay the entire amount of this hypothetical tax liability to Boston Private 15 days before the applicable tax payment is due from Boston Private to the taxing authority. The pending motions, however, address the calculation of the Tax Payment when Gibraltar’s standalone tax return yields negative taxable income.

The relevant portion of Section 5.5(d) states:

*To the extent that the separate return taxable income of [Gibraltar] and its Subsidiaries for any such taxable year is negative and generates a[sic] income Tax Benefit to [Boston Private] and [Boston Private’s] other Subsidiaries either as a result of being able to offset such loss against taxable income of [Boston Private] and its other Subsidiaries or as a result of being able to carry back such loss against prior years’ taxable income, [Boston Private] shall pay to [Gibraltar] the amount of such Tax Benefit when and if realized by [Boston Private] or, if sooner, within 15 days after the applicable Tax Return would be due if and to the extent [Gibraltar] and its Subsidiaries would be entitled to a refund of income Tax if they had filed a separate income Tax Return historically; provided, however, that in the case of the short 2009 taxable year any gain recognized for federal income tax purposes by [Boston Private] on the sale of the Shares hereunder shall first be taken into account to offset on a dollar-for-dollar basis any negative taxable income of [Gibraltar] and its Subsidiaries, and only the net amount, if any, remaining after such offset shall be taken into account for purposes of calculating any loss or Tax Benefit for the short 2009 taxable year under this Section 5.5(d). To the extent [Boston Private] cannot currently use all of its available losses, for purposes of the preceding sentence, [Boston Private] will use a pro-rata portion of each category of losses, including the losses from [Gibraltar] and its Subsidiaries, with the remainder being carried back and then forward, as may be applicable.*

Although as defined in the Stock Purchase Agreement, the term “Tax Benefit” can refer to a benefit received by either Boston Private or Gibraltar, as used in this Memorandum Opinion, the term “Tax Benefit” will refer more specifically to the benefit received by Boston Private as a result of Gibraltar’s losses; otherwise, the definition used here is the same as the one quoted above.

*2 Section 5.5(d) goes on to define the term “Tax Benefit” as “the positive difference, if any, between (i) Taxes that would have been payable by the relevant party for such year without taking into account any such adjustment and (ii) Taxes actually payable by the party for such year” (emphasis in the original).*2

It is undisputed that, as a result of Gibraltar’s losses, Boston Private received a Tax Benefit of approximately $15 million for the short 2009 tax year. Gibraltar contends that it is owed this $15 million under the terms of Section 5.5(d). Boston Private argues that it owes and has offered to pay Gibraltar a much smaller sum of $2,371,247, which is the amount of the refund to which Gibraltar would have been entitled for the short 2009 tax year if it had filed separately historically (the “Hypothetical Refund”).
III. THE CONTENTIONS

In support of their respective motions, both Boston Private and Gibraltar argue that Section 5.5(d) is unambiguous and that their respective interpretation is the only reasonable interpretation. Both parties claim that their respective reading of the provision comports with its plain meaning. Gibraltar further contends that its reading is supported by the last antecedent rule and confirmed by extrinsic evidence.

In opposition to the other party’s motion, both Boston Private and Gibraltar contend that the opposing party’s reading of Section 5.5(d) is unreasonable, does not comport with the plain meaning of the contractual language, and is not the only reasonable interpretation. Additionally, Boston Private challenges Gibraltar’s use of extrinsic evidence and the last antecedent rule.

IV. ANALYSIS

A. Applicable Standard

The Court must accept the non-moving party’s well-pledged facts as true and view those facts in the light most favorable to the non-moving party when considering a Rule 12(c) motion. The motion will only be granted if the Court finds that no material issue of fact exists and the movant is entitled to judgment as a matter of law. At the heart of this dispute is the interpretation of a portion of Section 5.5(d). When ruling on dueling Rule 12(c) motions that turn on an issue of contract construction, the Court must deny both motions if each has “advanced reasonable but conflicting readings of the Agreement,” or, in other words, if the contract provision in question is ambiguous. Delaware adheres to the “objective” theory of contracts under which a contract is construed as it would be understood by an objective, reasonable third party.


Id.
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*Id.* The Stock Purchase Agreement, at Section 6.8(a), recites that it is to be construed in accordance with the laws of Delaware.

Ambiguity exists “when the provisions in controversy are reasonably or fairly susceptible [to] different interpretations or may have two or more different meanings.” Rhone–Poulenc Basic Chems. Co. v. Am. Motorists Ins. Co., 616 A.2d 1192, 1196 (Del.1992). Whether a contract is ambiguous, addressed in the context of contract interpretation, is a question of law. O’Brien v. Progressive N. Ins. Co., 785 A.2d 281, 286 (Del.2006).


B. Boston Private’s Interpretation of Section 5.5(d)

The portion of Section 5.5(d) central to this dispute states: “... [Boston Private] shall pay to [Gibraltar] the amount of such Tax Benefit when and if realized by [Boston Private] or, if sooner, within 15 days after the applicable Tax Return would be due if and to the extent [Gibraltar] and its Subsidiaries would be entitled to a refund of income Tax if they had filed a separate income Tax Return historically ...” (emphasis added). Boston Private contends that the clause “if and to the extent [Gibraltar] and its Subsidiaries would be entitled to a refund of income Tax” (the “limiting clause”) is a limitation on its obligation and applies to the Tax Payment regardless of when it is paid. According to Boston Private’s interpretation, regardless of whether the Tax Payment is paid “when and if the [Tax Benefit is] realized by [Boston Private]” (the “first timing provision”) or “within 15 days after the applicable Tax Return is due” (the “second timing provision”), Boston Private’s Tax Payment obligation equals the value of the Tax Benefit limited to the amount of the Hypothetical Refund. Grammatically, Boston Private argues that the limiting clause acts as an adverb to modify “pay,” as in: “[Boston Private] shall pay ... if and to the extent [Gibraltar] and its Subsidiaries would be entitled to [the Hypothetical Refund]....”

*3 Under this reading, Gibraltar would never receive more than the Hypothetical Refund, but it would receive less if the Tax Benefit is worth less to Boston Private than it would have been worth to Gibraltar on a standalone basis. Thus, if the Tax Benefit exceeds the Hypothetical Refund, only the amount of the Hypothetical Refund would be owed. Alternatively, if the Tax Benefit is less than or equal to the Hypothetical Refund, Boston Private would owe the amount of the Tax Benefit. More simply, under Boston Private’s interpretation, it would owe the lesser of the Tax Benefit or the Hypothetical Refund.

With regard to the second timing provision, the parties agree that the phrase “the applicable Tax Return” refers to the tax return Gibraltar would file if it filed a standalone return for the tax year in question (the “Hypothetical Return”). Boston Private argues that the second timing provision is meant to protect the time value of the Tax Payment (as interpreted by Boston Private) by ensuring that Boston Private cannot delay disbursing the Tax Payment by delaying the filing of its tax return. Therefore, Boston Private contends, the second timing provision requires remittance of the Tax Payment within 15 days after the filing deadline for the Hypothetical Return, regardless of whether Boston Private has filed its tax return and realized the Tax Benefit.

Mot. for J. on the Pleadings Hr’g Tr. (“Hr’g Tr.”), Aug. 31, 2011, at 17.
Boston Private sums up its interpretation of the relevant portion of Section 5.5(d) as such:

Aside from the initial directive that “[Boston Private] shall pay,” the remaining phrases in the provision modify that directive by detailing (1) who [Boston Private] shall pay (“to [Gibraltar]”), (2) what [Boston Private] shall pay (“the amount of such Tax Benefit”), (3) when [Boston Private] shall pay (“when and if realized by [Boston Private] or, if sooner, within 15 days after the applicable Tax Return would be due”), and (4) to what extent [Boston Private] shall pay (“if and to the extent [Boston Private] and its Subsidiaries would be entitled to a refund of income Tax if they had filed a separate income Tax Return historically”).

Gibraltar’s primary arguments in opposition to Boston Private’s interpretation of Section 5.5(d) are that Section 5.5(d) is unambiguous and its own interpretation is mandated by the text’s plain meaning, supported by the last antecedent rule, and confirmed by extrinsic evidence. Additionally, citing related precedent, Gibraltar contends that if Section 5.5(d) was meant to have the meaning proposed by Boston Private, a comma should have been inserted before the limiting clause. It is true that if this additional comma were present, this case would be much easier to decide, and its absence is an argument against Boston Private’s interpretation. Still, where a contract provision is ambiguous, the absence of punctuation that would clearly support one interpretation does not necessarily render such an interpretation unreasonable.

These arguments in favor of Gibraltar’s interpretation of Section 5.5(d) are explained in further detail below.


The relevant language would then read: “[Boston Private] shall pay to [Gibraltar] the amount of such Tax Benefit when and if realized by [Boston Private] or, if sooner, within 15 days after the applicable Tax Return would be due[,] if and to the extent [Gibraltar] and its Subsidiaries would be entitled to a refund....”

See Whitcraft v. Parsons, 2002 WL 927377, at *2 (Del. Ch. Apr. 30, 2002) (finding that there was “enough of a question [regarding a contract’s interpretation] that summary judgment [was] not appropriate” in a case involving a similar absence of a comma).

Finally, Gibraltar contends that Boston Private’s interpretation creates “mere surplusage” out of a significant portion of Section 5.5(d) by rendering the amount of the Tax Benefit and the timing of the Tax Payment irrelevant. For the reasons explained below, this surplusage argument is unavailing. First, beyond a conclusory statement that “[b]ased on Boston Private’s interpretation ... the language regarding the [second timing provision] would be ‘mere surplusage,’” Gibraltar does not explain why Boston Private’s reading would render the timing of the Tax Payment irrelevant. While the timing of the Tax Payment does not affect the amount of the payment under Boston Private’s reading, it cannot be said that the timing of the payment is irrelevant; cash management considerations and the concept of the time value of money are just two reasons why the timing of a payment may be
important. Second, Gibraltar claims that under Boston Private’s interpretation the amount of the Tax Benefit is meaningless, since in any scenario, only the amount of the Hypothetical Refund would be owed. This argument is based upon Gibraltar’s contention that a federal policy regarding the allocation of taxes between bank holding companies and their subsidiaries (the “Interagency Policy Statement”) would apply to this provision of the Stock Purchase Agreement and forbid Boston Private from paying Gibraltar less than the value of the Hypothetical Refund. The Interagency Policy Statement was adopted by the federal banking regulatory agencies in order to harmonize their guidance regarding the allocation of taxes among a holding company and its depository institution subsidiaries, and its main thrust is that “intercorporate tax settlements between [a bank subsidiary] and the consolidated group should result in no less favorable treatment to the [bank subsidiary] than if it had filed its income tax return as a separate entity.” Therefore, argues Gibraltar, in a situation where the Tax Benefit is less than the Hypothetical Refund, Boston Private would still be required by the Interagency Policy Statement to pay Gibraltar the amount of the Hypothetical Refund, and, therefore, the Tax Payment would always equal the amount of the Hypothetical Refund. There are several problems with this application of the Interagency Policy Statement to Section 5.5(d), the foremost one being that the Interagency Policy Statement is intended to apply to banks in a holding company structure, while the instant case involves the sale of a bank out of such a structure.

Delaware courts “will read a contract as a whole and ... will give each provision and term effect, so as not to render any part of the contract mere surplusage.” Osborn ex rel. Osborn v. Kemp, 991 A.2d 1153, 1159 (Del.2010) (quoting Kuhn Const., Inc. v. Diamond State Port Corp., 990 A.2d 393, 396–97 (Del.2010)).

According to Gibraltar, based on Boston Private’s interpretation, Section 5.5(d) could be read as thus without changing its meaning:

To the extent that the separate return taxable income of [Gibraltar] and its Subsidiaries for any such taxable year is negative and generates a[sic] income Tax Benefit to [Boston Private] and [Boston Private’s] other Subsidiaries either as a result of being able to offset such loss against taxable income of [Boston Private] and its other Subsidiaries or as a result of being able to carry back such loss against prior years’ taxable income, [Boston Private] shall pay to [Gibraltar] the amount of such Tax Benefit when and if realized by Boston Private or, if sooner, within 15 days after the applicable Tax Return would be due if and to the extent [Gibraltar] and its Subsidiaries would be entitled to [as] a refund of [Income Tax if they had filed a separate income Tax Return historically.

Pl.’s Br. in Opp’n 13.

Id.


Id.

As previously discussed, under the alternative scenario where the Tax Benefit exceeds the Hypothetical Refund, Boston Private’s Tax Payment would equal the Hypothetical Refund, according to Boston Private’s reading.

When this argument is paired with Gibraltar’s interpretation of Section 5.5(d)—which posits that the Tax Payment is equal to the Tax Benefit, subject to certain prepayments—it is evident that Gibraltar’s reading would also run counter to the Interagency
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Policy Statement in a situation where the Tax Benefit is less than the Hypothetical Refund. Furthermore, federal bankruptcy courts have found the Interagency Policy Statement to be merely a non-binding policy statement, not something with the force of law. See In re Indymac Bancorp, Inc., 2011 WL 2883012, at *4 (Bankr.CD.Cal. July 15, 2011); In re Team Financials, Inc., 2010 WL 1730681, at *8 (Bankr.D.Kan. Apr. 27, 2010).

Ultimately, Boston Private’s interpretation of Section 5.5(d) is reasonable, but it is not the only reasonable interpretation. While it is notable that there is no comma before the limiting clause, given the ambiguous nature of the relevant contract language, a reasonable person could read Section 5.5(d) as suggested by Boston Private.

C. Gibraltar’s Interpretation of Section 5.5(d)

Unsurprisingly, Gibraltar’s reading of Section 5.5(d) differs significantly from that of Boston Private. Citing the first clause of the contested portion of Section 5.5(d), Gibraltar argues that the amount of the Tax Payment obligation always equals the amount of the Tax Benefit. The limiting clause, Gibraltar contends, only applies to the second timing provision, and does not limit Boston Private’s ultimate obligation. Thus, under Gibraltar’s interpretation, when the full amount of the Tax Benefit has been realized, then the entire Tax Payment must be disbursed at that time according to the first timing provision.

Stock Purchase Agreement § 5.5(d) ("... [Boston Private] shall pay to [Gibraltar] the amount of such Tax Benefit ...”).

See Hr’g Tr. at 31.

Stock Purchase Agreement § 5.5(d) ("... when ... realized by [Boston Private] ...”). If any advance payments had previously been made under the second timing provision (explained below), the amount of the advance payments would be deducted from the final payment so that Boston Private’s total payments would equal the value of the Tax Benefit. An example illustrating this scenario is provided below.

According to Gibraltar, the second timing provision, in conjunction with the limiting clause, provides for an advance payment to Gibraltar in the amount of the Hypothetical Refund, if any. An advance payment would be made if Gibraltar would have received a Hypothetical Refund and Boston Private has not yet realized a Tax Benefit. Gibraltar claims the purpose of this advance payment is to ensure Gibraltar “remain[s] in at least the same position it would have been in had it filed a separate tax return.” With regard to Boston Private, this advance payment acts as a prepayment of a portion of Boston Private’s ultimate Tax Payment obligation; when the Tax Benefit is completely realized, Boston Private would pay the difference between the total Tax Benefit and the advance payments already made. Gibraltar provides the following example of a scenario in which an advance payment would be required:

This advance payment would be due “within 15 days after [the Hypothetical Return] would be due.” Id.
For example, if Boston Private could carry forward Gibraltar’s 2009 losses and receive a $15 million tax benefit for the 2012 tax year, then Gibraltar would receive the $15 million tax benefit payment once the 2012 tax benefit was realized. [ ... ] [U]nder the same example, if Gibraltar would have been entitled to receive a $1 million tax benefit for the 2009 tax year had it filed separately as a stand-alone entity, Gibraltar would receive a $1 million payment from Boston Private within 15 days of when the [Hypothetical Return] would have been due, and would receive the remaining $14 million benefit when Boston Private realized that benefit.\textsuperscript{30}

\textit{Id.}

In order to arrive at this interpretation, Gibraltar apparently reads the relevant contract language thusly:

[Boston Private] shall pay to Gibraltar [ (i) ] the amount of such Tax Benefit when and if realized by [Boston Private] or, [ (ii) ] if sooner, within 15 days after the [Hypothetical Return] would be due if and to the extent [Gibraltar] and its Subsidiaries would be entitled to a [Hypothetical Refund].\textsuperscript{31}

See Pl.’s Br. in Opp’n 9 (stating “Section 5.5(d) provides that Boston Private must pay Gibraltar ‘[ ... ] if and to the extent [Gibraltar] and its Subsidiaries would be entitled to a [Hypothetical Refund].’ “ (emphasis added)).

While an objective reasonable third party could interpret Section 5.5(d) in this manner, the contract language does not compel this reading alone.\textsuperscript{32} Just as a missing comma undercuts Boston Private’s claim that it provides the only reasonable interpretation of an unambiguous provision, so does the awkward phrasing and grammatical construction of Gibraltar’s interpretation undercut its identical claim. When explaining its interpretation in its brief, Gibraltar paraphrases the first part of the relevant contract language, stating: “Section 5.5(d) provides that Boston Private must pay Gibraltar ‘[ ... ] if and to the extent [Gibraltar] and its Subsidiaries would be entitled to a [Hypothetical Refund]’ “ (emphasis added).\textsuperscript{33} Section 5.5(d) actually states that “Boston Private shall pay to Gibraltar ... if and to the extent [Gibraltar] and its Subsidiaries would be entitled to a [Hypothetical Refund]" (emphasis added). When reading this language with the word “to” after “pay,” the awkwardness of Gibraltar’s interpretation becomes apparent. Furthermore, to the extent that Gibraltar’s reading is grammatically correct, it would have the word “pay” simultaneously serve as both a transitive verb (when acting upon the object “the amount of such Tax Benefit” in the first timing provision) and an intransitive verb (when not acting upon any object in the second timing provision). While not unreasonable, this reading, like Boston Private’s reading, is not so self-evident that it precludes the possibility of other reasonable interpretations of Section 5.5(d).

Indeed, at oral argument Gibraltar appears to have offered a third reading of Section 5.5(d) that contains elements of both the interpretation it sponsored in its briefs and Boston Private’s interpretation. This potential third interpretation follows from Gibraltar’s explanation of the contested contract language:

[T]he first question is what is supposed to happen. Boston Private shall pay to Gibraltar. [ ... ] That’s one. [ ... ] Two is how much. How much it should pay is “the amount of such tax benefit.” [ ... ] Then three is essentially when. It’s “when and if realized by Boston Private or sooner within 15 days after the [Hypothetical Return] would be due if and to the extent Gibraltar and its subsidiaries would be entitled to a [Hypothetical Refund].”\textsuperscript{34}

Hr’g Tr. at 31. This reading, like the one offered by Gibraltar in its briefs, views the limiting clause as applying to only the second timing provision and the two, together, as providing for an advance payment. Where this interpretation appears to diverge from the one offered in Gibraltar’s briefs is at the calculation of the advance payment. Instead of an advance payment equal to the Hypothetical Refund, this interpretation would seemingly calculate the advance payment in the same manner that Boston Private calculates the Tax Payment obligation: the amount of the Tax Benefit limited to the extent of the Hypothetical Refund. This is made clear by reading the three elements together, as proposed by Gibraltar, under the assumption that an advance payment is necessary: (1) Boston Private shall pay to Gibraltar (2) the amount of such Tax Benefit (3) within 15 days after the Hypothetical Return would be due if and to the extent Gibraltar would be entitled to a Hypothetical Refund. Instead of ensuring that Gibraltar receives an advance payment in an amount at least equal to its Hypothetical Refund, regardless of whether Boston Private has received a Tax Benefit, the effect of this reading is that Boston Private would be required to make an advance payment when it receives a Tax Benefit but there is a delay in the realization of this Tax Benefit. By preventing Boston Private from delaying its Tax Payment by delaying the filing
of its tax return, the effect is the same as that of the second timing provision under Boston Private’s interpretation. But, crucially, Boston Private’s ultimate obligation still equals the Tax Benefit it received, as under the interpretation offered by Gibraltar in its briefs. As such, the amount owed by Boston Private in the instant case would be the same under either of Gibraltar’s interpretations.

Pl.’s Br. in Opp’n 9.

*6 Boston Private challenges Gibraltar’s reading of Section 5.5(d) by arguing that its own interpretation is consistent with the contract’s plain meaning and advancing other textual arguments. Boston Private’s first textual argument posits that Gibraltar misconstrues the word “or” placed between the two timing provisions (“or, if sooner ...”) (the “contested ‘or’ “). According to Boston Private, here the word “ ‘or’ ” demonstrates the alternative character of the timing provisions; in other words, there is only one payment (the Tax Benefit to the extent of the Hypothetical Refund) to be made either (i) when the Tax Benefit is realized by Boston Private or (ii) if sooner, within 15 days after the Hypothetical Return would be due. Boston Private goes on to contend that Gibraltar’s interpretation effectively transforms the contested “or” into a “but.” While Boston Private’s construction of “or” results in a reasonable reading of Section 5.5(d), in this case, it does not prevent Gibraltar’s reading from also being reasonable. Furthermore, the Court does not agree that Gibraltar’s interpretation requires that the word “but” be read in place of the contested “or”; while Gibraltar’s reading could have been expressed using the word “but,” the current formulation may be reasonably interpreted in the manner advanced by Gibraltar.

Stock Purchase Agreement § 5.5(d).

Def.’s Reply Br. 12.

Boston Private also contends that Gibraltar’s reading of the second timing provision is grammatically unsound because there is no verb following the contested “or” that provides for a payment, and thus, Boston Private argues, there is no basis for an advance payment without reading additional words into the contract. But this is an overly technical reading of Section 5.5(d) that looks at one part of a sentence in isolation. Earlier in the sentence, there is verbiage that provides for a payment. While this clause was not repeated after the contested “or,” a reasonable third party could read this clause as applying to both of the timing provisions. Such a reading would not add unwritten language to Section 5.5(d) because it is common for a subject and verb written before a conjunction to not be repeated after the conjunction, even where that subject and verb are meant to apply to the clause following the conjunction. As such, interpreting contract language in this manner is reasonable.


Boston Private’s final textual argument contends that Gibraltar’s interpretation is undermined by the absence of language regarding partial payments, remainder payments, or any indication that Boston Private must make payments to Gibraltar over time. Moreover, Boston Private maintains that Gibraltar’s reading makes no provision for a scenario in which the Hypothetical Refund exceeds the final Tax Benefit—which presumably would require Gibraltar to refund the difference to Boston Private—or for Section 5.5(d)”s express directive that the 2009 tax year Tax Benefit is calculated using Gibraltar’s loss net of any taxable gain realized by Boston Private from the sale of the Gibraltar shares. In response, Gibraltar points to the portion of Section 5.5(d) directing that the “remainder” of any
losses not used in the current tax year be “carried back and then forward, as applicable.” Gibraltar argues that this language provides for a situation “in which some portion—the ‘remainder’ of Gibraltar’s unused losses—could be ‘carried ... forward’ and such portion of the Tax Benefit would be paid ‘when and if realized’ at some future time.”

Stock Purchase Agreement § 5.5(d) (“... provided, however, that in the case of the short 2009 taxable year any gain recognized for federal income tax purposes by [Boston Private] on the sale of the Shares hereunder shall first be taken into account to offset on a dollar-for-dollar basis any negative taxable income of [Gibraltar], and only the net amount, if any, remaining after such offset shall be taken into account for purposes of calculating any loss or Tax Benefit for the short 2009 taxable year under this Section 5.5(d).”) (emphasis in original). The netting of Boston Private’s tax gain against Gibraltar’s loss is one specific reason why the Hypothetical Refund could have exceeded the Tax Benefit for the 2009 tax year.

Pl.’s Reply Br. in Further Supp. of Its Cross-mot. for J. on the Pleadings 6 (quoting Stock Purchase Agreement § 5.5(d)).

*7 In addition to asserting that its interpretation is consistent with the plain language of Section 5.5(d), Gibraltar contends that it is mandated by the last antecedent rule. Applying this rule, it argues the clause “if and to the extent [Gibraltar] and its Subsidiaries would be entitled to a refund” could only relate to the immediately preceding clause (“if sooner, within 15 days after the applicable Tax Return would be due”) and, therefore, would not limit the payment owed under the first timing provision.

“[O]rdinarily, qualifying words or phrases, where no contrary intention appears, usually relate to the last antecedent.” Rag American Coal Co., 1999 WL 1261376, at *4 (citation omitted).

Boston Private challenges Gibraltar’s use of the last antecedent rule on both grammatical and substantive grounds. First, Boston Private claims that the last antecedent rule is improperly applied by Gibraltar because the clause to which the limitation is applied in Gibraltar’s reading is, according to Boston Private, not an “antecedent” because an “antecedent” must be a noun or noun-equivalent. Additionally, Boston Private argues that even if the last antecedent rule could be applied in the manner suggested by Gibraltar, it still would not be applicable in this situation, since a contrary intent is expressed by the text, namely, Boston Private’s interpretation of Section 5.5(d).

The Court need not presently resolve the question of whether the last antecedent rule applies in this case, as the Court ultimately finds that the provision in question is ambiguous. As such, even if the Court were to find that the last antecedent rule does apply, it would only serve as an aid in interpreting an ambiguous contract clause.

Considering the current procedural posture of this case and the Court’s finding that the disputed clause is ambiguous, even with the aid of the last antecedent rule, there would not be sufficient grounds for a ruling in favor of Gibraltar.

See Paxson Commc ’ns Corp., 2005 WL 1038997, at *6 (“[T]he last antecedent rule is but one of numerous rules designed to assist in the discovery of intent and is not to be inflexibly or uniformly applied.”) (citing E.I. DuPont de Nemours & Co. v. Green, 411 A.2d 953, 956 (Del.1980); Rag American Coal Co., 1999 WL 1261376, at *5 (“Delaware law holds that the ‘last antecedent rule’ is ‘not inflexible,’ and this court will not hang a party’s liability on weary drafters’ placement of a comma where there is room for doubt as to the parties’ intent.”) (quoting E.I. DuPont de Nemours & Co., 411 A.2d at 956).

Finally, Gibraltar argues that its interpretation of Section 5.5(d) is confirmed by extrinsic evidence. Although Gibraltar admits that extrinsic evidence cannot be used to “discern an ambiguity,” it contends that extrinsic evidence may be used to “confirm [the Court’s] conclusion that the contract language is unambiguous....”
Gibraltar offers two pieces of extrinsic evidence to confirm its interpretation of Section 5.5(d). The first is an email sent on March 18, 2010, from Boston Private’s Tax Manager to Gibraltar’s Executive Vice President and Chief Financial Officer (“CFO”) (the “March 18 Email”). In response, Boston Private’s Tax Manager provided a number of spreadsheets filled with accounting entries. One of these spreadsheets includes an item entitled “Receivable to Gibraltar for 2009 Loss” and the details of its calculation; the value of this account is listed as $15,368,699. The figures that compose this sum are recorded on another spreadsheet in a column entitled “(Payable)/ Receivable.” Boston Private’s Tax Manager also noted in the email that the calculation “includes estimates” and that the final amount owed to Gibraltar would be determined “shortly after the preparation of the [tax] returns.” Gibraltar claims this evidence confirms its interpretation of Section 5.5(d), and is in fact a confirmation by Boston Private of its obligation to pay approximately $15 million under Section 5.5(d).

*8 Gibraltar’s second piece of extrinsic evidence is nothing more than a bald assertion of what the evidence will show—purportedly, that Section 5.5(d) was meant to implement the past tax allocation practices of Boston Private and Gibraltar, which, according to Gibraltar, achieved the same allocation as its interpretation of Section 5.5(d).

See Pl.’s Br. in Opp’n 16 (“Finally the drafting history and communications between the parties will show that all of the parties understood the meaning of the contract to be the interpretation proffered by Gibraltar. Indeed, the intent of Section 5.5(d) was to implement the past practice between Gibraltar and Boston Private ...”) (emphasis added). In fact, one could interpret Gibraltar’s Complaint and Brief in Opposition as arguing that the mere existence of this past tax allocation practice supports Gibraltar’s reading of Section 5.5(d). See Compl. 1, 4, 5 (claiming that Section 5.5(d) was intended to implement the past tax allocation practice); Pl.’s Br. in Opp’n 1, 5, 7 (same). There is no reference to this previous tax allocation practice in the Stock Purchase Agreement, nor, as explained above, does Gibraltar even attempt to offer actual extrinsic evidence to support its contention that Section 5.5(d) was intended to implement this past tax allocation practice. The simple fact that Boston Private and Gibraltar adhered to a certain tax allocation practice prior to Gibraltar’s sale does not warrant a controlling inference that Section 5.5(d) was intended to implement this practice.

Boston Private disputes Gibraltar’s interpretation of the proffered extrinsic evidence, and challenges
Gibraltar’s use of extrinsic evidence at this stage of the proceedings and in relation to a contract that contains an integration clause.

The Court will not consider extrinsic evidence at this time. Even under the standard offered by Gibraltar, extrinsic evidence at this stage of the proceedings may only be used to “confirm [the Court’s] conclusion that the contract language is unambiguous,” and the Court has determined that the contract language in question is ambiguous.

Pl.’s Reply Br. 7.

In sum, the Court concludes that Gibraltar’s interpretation of Section 5.5(d) is reasonable, but it is not the only reasonable interpretation. Similar to Boston Private’s reading, Gibraltar’s interpretation would be aided by the insertion of an additional comma—in this case, a comma before the words “... or, if sooner....” Also, while the contract language referring to carrying forward a “remainder” does, perhaps, allude to future payments, it is notable that the payment scheme sponsored by Gibraltar is not fleshed out in greater detail in Section 5.5(d), including provision for the rather obvious issues raised by Boston Private. This, of course, could be merely the result of hasty drafting or the fact that certain scenarios were so unlikely that the negotiators failed to provide for them, but at this time, it is impossible for the Court to know if this is the case here.

Indeed, Gibraltar’s reading of the text of the most heavily contested portion of Section 5.5(d) may be the more natural of the two interpretations, especially in light of the absence of a comma before the limiting clause.

In conclusion, the relevant portion of Section 5.5(d) is ambiguous. Since each party has advanced a reading of Section 5.5(d) that is reasonable, neither party has met its burden of demonstrating that its interpretation is the only reasonable interpretation. Judgment on the pleadings is not appropriate.

V. CONCLUSION

For the foregoing reasons, the cross-motions for judgment on the pleadings are denied. An order will be entered in accordance with this Memorandum Opinion.

ORDER

AND NOW, this 30th day of November, 2011, for the reasons set forth in the Court’s Memorandum Opinion of even date,

IT IS HEREBY ORDERED that:

1. Defendant’s Motion for Judgment on the Pleadings be, and the same hereby is, denied; and
2. Plaintiff’s Cross-Motion for Judgment on the Pleadings be, and the same hereby is, denied.
Defendant-appellant, the estate of Patrick Whitlow, M.D., appeals after the trial court denied it summary judgment, and instead granted summary judgment to plaintiff-appellee SDC University Circle Developer, L.L.C. We affirm.

SDC filed a declaratory judgment action against the estate seeking an order declaring that the estate was not a member of the company, but rather, an assignee entitled only to receive economic distributions. The parties filed cross-motions for summary judgment. SDC, in its motion, argued that pursuant to the plain terms of the operating agreement, Whitlow’s interest devolved to his estate upon his death. In the estate’s motion, it argued that the operating agreement permitted Whitlow’s entire interest, including his membership interest, to transfer to the estate. The trial court agreed with SDC, finding the operating agreement dictated that Whitlow’s interest devolved to his estate upon death, and that as such, the estate was not a member of the company, and was instead an assignee entitled only to receive economic distributions.

On appeal, the estate raises two interrelated assignments of error. In the first, it argues that the trial court erred by granting summary judgment to SDC. In the second, it argues that the trial court erred by denying it summary judgment.

This court’s review of a case decided on summary judgment is de novo, affording no deference to the trial court. Tomaydo-Tomahdo L.L.C. v. Vozary, 2017-Ohio-4292, 82 N.E.3d 1180, ¶ 8 (8th Dist.). Summary judgment is appropriate where the evidence properly before the trial court, when viewed most favorably to the nonmoving party, shows no genuine issue of material fact, the moving party is entitled to judgment as a matter of law, and that reasonable minds can come to but one conclusion, which is adverse to the nonmoving party. Civ.R. 56(C).

Because the estate’s arguments are connected, we address both assignments of error together. The estate complains that SDC never produced an operating agreement that Whitlow signed and it rejects the operating agreement offered by SDC. It claims the estate owns Whitlow’s entire interest, including his membership rights. And the estate argues that the operating agreement permits Whitlow’s entire interest to be transferred the estate, including his membership interest in SDC. We reject each of these contentions in turn.

I. Whitlow Acquired Interest in SDC Via Signed Subscription Agreement

In November 2011, and prior to his death, Patrick Whitlow purchased a Class B membership interest in SDC for $200,000 via a subscription agreement that he signed. The subscription agreement outlined the terms of Whitlow’s investment. As relevant to this case, Section 3 of the subscription agreement contains specific “representations, warranties and covenants” that govern Whitlow’s investment, and to which Whitlow agreed by virtue of becoming a “Subscriber.” In relevant part the subscription agreement provides:

*2 c. The Subscriber has been given full opportunity to review all material information relating to the Interest and the Company and has reviewed and understands the Operating Agreement of the Company and Articles of Organization of the Company.

d. The Subscriber has been provided, to its satisfaction, the opportunity to ask questions concerning the Company and the terms and conditions of the offering of the Interest.

* * *

f. The Subscriber is aware that the Operating Agreement of the Company imposes certain limitations and restrictions on the circumstances under which the Subscriber may offer to sell, transfer or otherwise dispose of the Interest, so that it might not be possible to liquidate this investment readily and it may be necessary to hold the investment for an indefinite period.

* * *

i. The Subscriber hereby acknowledges that this Agreement shall not be transferable or assignable without the prior written consent of the Company.

Thus, the subscription agreement makes clear that Whitlow agreed that his membership interest in SDC was governed by the SDC operating agreement, irrespective of whether he signed the operating agreement.

II. The SDC Operating Agreement

The SDC operating agreement, originally adopted in June 2010, provides the basic purpose and function of the company. It outlines the levels of membership in the company: the “Managing Member” as well as
other listed persons are the “Class A Members,” and persons subsequently admitted to the company as members, would be the “Class B Members.” The operating agreement lists the various rights and entitlements of the membership levels as well as the restrictions on the transfer of such interests. Pursuant to the operating agreement, Whitlow, as a Class B member, was entitled in some circumstances to inspect and copy the company’s books and demand certain information relating to the company.

{¶9} The operating agreement also contains a section providing for and outlining the process for amending the operating agreement. For example, the managing member may unilaterally amend the operating agreement “if such amendment is solely for the purpose of clarification and does not change the substance hereof,” or in order to substitute members. However, any amendment that does not have “equal applicability” to all members requires unanimous member approval. Regardless, any amendment adopted or approved must be mailed to each member.

{¶10} As noted, SDC attached to its complaint the operating agreement amended in December 2011, after Whitlow became a Class B member. The estate makes an issue of this, complaining that the December 2011 version does not control because it was adopted after Whitlow became a member and because there is no evidence that Whitlow signed it. Instead, the estate argues that the original operating agreement controls, however it claims that this version was “not produced to the [t]rial court at any time and is not part of the record on appeal.” We reject this claim outright, as the estate attached the original June 2010 operating agreement to its motion for summary judgment, and referred to it before the trial court as well as this court on appeal. Second, as related to this case, we find no meaningful difference between the original June 2010 operating agreement and the December 2011 amended version. The estate makes no argument to the contrary. As previously stated, Whitlow’s subscription agreement simply refers to the operating agreement; it does not refer to a specific version of the operating agreement or require Whitlow’s signature on the operating agreement before binding him to its terms.

*3 {¶11} Article IX of the operating agreement outlines limitations on the transfer of SDC membership interests. In relevant part, Section 9.1(a) provides that absent specified consent, a Class B interest is nontransferable, and that absent specified consent, such a transferee of a Class B interest is only entitled to economic rights and not be a member:

The Membership Interest owned by * * * a Class B Member * * * shall not be Transferable to any person(s) and any attempted Transfer shall be ineffective to Transfer any such Membership Interest, unless the Managing Member consents in writing to the transfer.

* * *

Upon the Transfer of a * * * Class B Member’s Membership Interest, the transferee shall not become a Member, without the prior written consent of the Managing Member. A transferee who has not been admitted to the Company as a Member shall have only Economic Rights, and shall not have the right to * * * review the Company’s books and records, or any other right, except as specifically permitted by law.

The original June 2010 operating agreement refers to the singular “Managing Member” here as well as elsewhere, whereas the December 2011 amended operating agreement refers to “Managing Members” in the plural. This difference does not impact our analysis and is only included for purposes of completeness.

{¶12} Article IX section 9.3 places limitations on the transfer of a Class B membership upon death of such a member, and provides that any successor would not become a member absent specified consent:

Upon the death * * * of * * * a Class B Member, * * * the Membership interest owned by such a deceased * * * Class B Member * * * shall be transferred to or devolve upon the heirs, devisees, representatives, beneficiaries, successors, assigns, or estate of the [deceased Class B Member]. * * * However no Person succeeding to the Membership Interest of * * * a Class B Member upon the events specified in this Section 9.3 shall become a Member without
Contrary to the estate’s assertion, the operating agreement is clear: as a general rule, a member cannot transfer his or her membership interest without consent of the managing member. Even where the managing member consents to a transfer, the transferee does not become a member unless the managing member further consents. Here, the estate is entitled to Whitlow’s interest, however, that interest devolved into economic rights only, as the managing member did not consent to estate membership.

The estate nevertheless argues that the operating agreement permits transfer of membership rights absent managing member consent pursuant to Article IX, section 9.1(b). That section relevantly provides: “[a]ny * * Class B Member may, without the consent of the Managing Member or any other Member, transfer a portion, or all of his Membership Interest by gift, bequest, sale, or exchange to or for the benefit of any family member.”

Even if this more general provision, relating to permitted family transfers, controls, as opposed to the more specific provision relating to death of a member, the result does not change. But see Royal Appliance Mfg. Co. v. Fernengel, 8th Dist. Cuyahoga No. 51268, 1987 WL 16189, *6 (Aug. 27, 1987) (“It is well established that when a contract contains both general and specific language the more specific language controls.”). Assuming that pursuant to section 9.1(b) Whitlow was able to transfer his membership interest without managing member consent, section 9.1(a) nevertheless still requires managing member consent before the transferee could become a member of the company.

As such, regardless of whether the transfer of Whitlow’s interest is viewed as a permitted transfer to family pursuant to section 9.1(b), or as a transfer on death pursuant to section 9.3, in the absence of managing member consent, the interest devolved into purely economic interests.

Judgment affirmed.

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801 F.2d 1001
United States Court of Appeals,
Seventh Circuit.

SALLY BEAUTY COMPANY, INC., a Delaware corporation, Plaintiff-Appellant,
v.
NEXXUS PRODUCTS COMPANY, INC., a California corporation, Defendant-Appellee.

No. 85–2039.

Argued Feb. 11, 1986.


CUDAHY, Circuit Judge.
Nexxus Products Company ("Nexxus") entered into a contract with Best Barber & Beauty Supply Company, Inc. ("Best"), under which Best would be the exclusive distributor of Nexxus hair care products to barbers and hair stylists throughout most of Texas. When Best was acquired by and merged into Sally Beauty Company, Inc. ("Sally Beauty"), Nexxus cancelled the agreement. Sally Beauty is a wholly-owned subsidiary of Alberto-Culver Company (*1002 ("Alberto-Culver")), a major manufacturer of hair care products and a competitor of Nexxus’. Sally Beauty claims that Nexxus breached the contract by cancelling; Nexxus asserts by way of defense that the contract was not assignable or, in the alternative, not assignable to Sally Beauty. The district court granted Nexxus’ motion for summary judgment, ruling that the contract was one for personal services and therefore not assignable. We affirm on a different theory—that this contract could not be assigned to the wholly-owned subsidiary of a direct competitor under section 2–210 of the Uniform Commercial Code.

I.

Only the basic facts are undisputed and they are as follows. Prior to its merger with Sally Beauty, Best was a Texas corporation in the business of distributing beauty and hair care products to retail stores, barber shops and beauty salons throughout Texas. Between March and July 1979, Mark Reichek, Best’s president, negotiated with Stephen Redding, Nexxus’ vice-president, over a possible distribution agreement between Best and Nexxus. Nexxus, founded in 1979, is a California corporation that formulates and markets hair care products. Nexxus does not market its products to retail stores, preferring to sell them to independent distributors for resale to barbers and beauticians. On August 2, 1979, Nexxus executed a distributorship agreement with Best, in the form of a July 24, 1979 letter from Reichek, for Best, to Redding, for Nexxus:

Dear Steve:

It was a pleasure meeting with you and discussing the distribution of Nexus Products. The line is very exciting and we feel we can do a substantial job with it—especially as the exclusive distributor in Texas (except El Paso).

If I understand the pricing structure correctly, we would pay $1.50 for an item that retails for $5.00 (less 50%, less 40% off retail), and Nexus will pay the freight charges regardless of order size. This approach to pricing will enable us to price the items in the line in such a way that they will be attractive and profitable to the salons.

Your offer of assistance in promoting the line seems to be designed to simplify the introduction of Nexus Products into the Texas market. It indicates a sincere desire on your part to assist your distributors. By your agreeing to underwrite the cost of training and maintaining a qualified technician in our territory, we should be able to introduce the line from a position of strength. I am sure you will let us know at least 90 days in advance should you want to change this arrangement.

By offering to provide us with the support necessary to conduct an annual seminar (ie. mailers, guest artist [sic] ) at your expense, we should be able to reenforce our position with Nexus users and introduce the product line to new customers in a professional manner.

To satisfy your requirement of assured payment for merchandise received, each of our purchase orders will be accompanied by a Letter of Credit that will become negotiable when we receive the merchandise. I am sure you will agree that this arrangement is fairest for everybody concerned.

While we feel confident that we can do an outstanding job with the Nexus line and that the volume we generate will adequately compensate you for your continued support, it is usually best to have an understanding should we no longer be distributing Nexus Products—either by our desire or your request. Based on our discussions, cancellation or termination of Best Barber & Beauty Supply Co., Inc. as a distributor can only take place on the anniversary date of our original appointment as a distributor—and then only with 120 days prior notice. If Nexus terminates us, Nexus will buy back all of our inventory at cost and will pay the freight charges on the returned
merchandise.

Steve, we feel that the Nexus line is exciting and very promotable. With the program outlined in this letter, we feel it can be mutually profitable and look forward to a long and successful business relationship. If you agree that this letter contains the details of our understanding regarding the distribution of Nexus Products, please sign the acknowledgment below and return one copy of this letter to me.

Very truly yours,

/s/ Mark E. Reichek

President

Acknowledged /s/ Stephen Redding Date 8/2/79. Appellant’s Appendix at 2–3.

In July 1981 Sally Beauty acquired Best in a stock purchase transaction and Best was merged into Sally Beauty, which succeeded to Best’s rights and interests in all of Best’s contracts. Sally Beauty, a Delaware corporation with its principal place of business in Texas, is a wholly-owned subsidiary of Alberto-Culver. Sally Beauty, like Best, is a distributor of hair care and beauty products to retail stores and hair styling salons. Alberto-Culver is a major manufacturer of hair care products and, thus, is a direct competitor of Nexxus in the hair care market.

The appellant does not appear to dispute the proposition that Alberto-Culver is Nexxus’ direct competitor, see Reply Brief at 8–10; rather it disagrees only with Nexxus’ contention that performance by Sally Beauty would necessarily be unacceptable. See infra.

Shortly after the merger, Redding met with Michael Renzulli, president of Sally Beauty, to discuss the Nexxus distribution agreement. After the meeting, Redding wrote Renzulli a letter stating that Nexxus would not allow Sally Beauty, a wholly-owned subsidiary of a direct competitor, to distribute Nexxus products:

As we discussed in New Orleans, we have great reservations about allowing our NEXXUS Products to be distributed by a company which is, in essence, a direct competitor. We appreciate your argument of autonomy for your business, but the fact remains that you are totally owned by Alberto-Culver.

Since we see no way of justifying this conflict, we cannot allow our products to be distributed by Sally Beauty Company.

Appellant’s Appendix at 475.

In August 1983 Sally Beauty commenced this action by filing a complaint in the Northern District of Illinois, claiming that Nexxus had violated the federal antitrust laws and breached the distribution agreement. In August 1984 Nexxus filed a counterclaim alleging violations of the Lanham Act, the Racketeer Influenced and Corrupt Organizations Act (“RICO”) and the unfair competition laws of North Carolina, Tennessee and unidentified “other states.” On October 22, 1984 Sally Beauty filed a motion to dismiss the counterclaims arising under RICO and “other states’ law.” Nexxus filed a motion for summary judgment on the breach of contract claim the next day.

The district court ruled on these motions in a Memorandum Opinion and Order dated January 31, 1985. It granted Sally’s motion to dismiss the two counterclaims and also granted Nexxus’ motion for summary judgment. In May 1985 it dismissed the remaining claims and counterclaims (pursuant to stipulation by the parties) and directed the entry of an appealable final judgment on the breach of contract claim.

One of the two antitrust counts had already been dismissed by stipulation of the parties in May 1984.
Sally Beauty’s breach of contract claim alleges that by acquiring Best, Sally Beauty succeeded to all of Best’s rights and obligations under the distribution agreement. It further alleges that Nexxus breached the agreement by failing to give Sally Beauty 120 days notice prior to terminating the agreement and by terminating it on other than an anniversary date of its formation. Complaint, Count III, Appellant’s Appendix at 54–55. Nexxus, in its motion for summary judgment, argued that the distribution agreement it entered into with Best was a contract for personal services, based upon a relationship of personal trust and confidence between Reichek and the Redding family. As such, the contract could not be assigned to Sally without Nexxus’ consent.

In opposing this motion Sally Beauty argued that the contract was freely assignable because (1) it was between two corporations, not two individuals and (2) the character of the performance would not be altered by the substitution of Sally Beauty for Best. It also argued that “the Distribution Agreement is nothing more than a simple, non-exclusive contract for the distribution of goods, the successful performance of which is in no way dependent upon any particular personality, individual skill or confidential relationship.” Appellant’s Appendix at 119.

In ruling on this motion, the district court framed the issue before it as “whether the contract at issue here between Best and Nexxus was of a personal nature such that it was not assignable without Nexxus’ consent.” It ruled:

The court is convinced, based upon the nature of the contract and the circumstances surrounding its formation, that the contract at issue here was of such a nature that it was not assignable without Nexxus’s consent. First, the very nature of the contract itself suggests its personal character. A distribution agreement is a contract whereby a manufacturer gives another party the right to distribute its products. It is clearly a contract for the performance of a service. In the court’s view, the mere selection by a manufacturer of a party to distribute its goods presupposes a reliance and confidence by the manufacturer on the integrity and abilities of the other party.... In addition, in this case the circumstances surrounding the contract’s formation support the conclusion that the agreement was not simply an ordinary commercial contract but was one which was based upon a relationship of personal trust and confidence between the parties. Specifically, Stephen Redding, Nexxus’s vice-president, travelled to Texas and met with Best’s president personally for several days before making the decision to award the Texas distributorship to Best. Best itself had been in the hair care business for 40 years and its president Mark Reichek had extensive experience in the industry. It is reasonable to conclude that Stephen Redding and Nexxus would want its distributor to be experienced and knowledgeable in the hair care field and that the selection of Best was based upon personal factors such as these.

Memorandum Opinion and Order at 56 (citation omitted). The district court also rejected the contention that the character of performance would not be altered by a substitution of Sally Beauty for Best: “Unlike Best, Sally Beauty is a subsidiary of one of Nexxus’ direct competitors. This is a significant distinction and in the court’s view, it raises serious questions regarding Sally Beauty’s ability to perform the distribution agreement in the same manner as Best.” Id. at 7.

[1] We cannot affirm this summary judgment on the grounds relied on by the district court. Under Fed.R.Civ.P. 56(c) summary judgment may be granted only where there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law. The burden on the movant is stringent: “all doubts as to the existence of material fact must be resolved against the movant.” Moore v. Marketplace Restaurant, Inc., 754 F.2d 1336,
Nexxus did not meet its burden on the question of the parties’ reasons for entering into this agreement. Although it might be “reasonable to conclude” that Best and Nexxus had based their agreement on “a relationship of personal trust and confidence,” and that Reichek’s participation was considered essential to Best’s performance, this is a finding of fact. See Phillips v. Oil, Inc., 104 S.W.2d 576, 579 (Tex.Civ.App.1937, writ ref’d n.r.e.) (question whether contract was entered into because of parties’ “personal” confidence and trust” is for the determination of trier of fact). Since the parties submitted conflicting affidavits on this question, the district court erred in relying on Nexxus’ view as representing undisputed fact in ruling on this summary judgment motion. See Cedillo v. Local 1, International Association of Bridge & Structural Iron Workers, 603 F.2d 7, 11 (7th Cir.1979) (“questions of motive and intent are particularly inappropriate for summary adjudication”).

Reichek stated the following in an affidavit submitted in support of Sally Beauty’s Memorandum in Opposition to Nexxus’ Motion for Summary Judgment:

At no time prior to the execution of the Distribution Agreement did Steve Redding tell me that he was relying upon my personal peculiar tastes and ability in making his decision to award a Nexxus distributorship to Best. Moreover, I never understood that Steve Redding was relying upon my skill and ability in particular in choosing Best as a distributor.

I never considered the Distribution Agreement to be a personal service contract between me and Nexxus or Stephen Redding. I always considered the Distribution Agreement to be between Best and Nexxus as expressly provided in the Distribution Agreement which was written by my brother and me. At all times I conducted business with Nexxus on behalf of Best and not on my own behalf. In that connection, when I sent correspondence to Nexxus, I invariably signed it as president of Best.

Neither Stephen Redding nor any other Nexxus employee ever told me that Nexxus was relying on my personal financial integrity in executing the Distribution Agreement or in shipping Nexxus products to Best.

Affidavit of Mark Reichek, ¶¶ 19–21, Appellant’s Appendix at 189–190.

It is also possible to read the district court’s decision as ruling that all distribution agreements are as a matter of law personal services contracts and therefore nonassignable. For the reasons explained infra, we do not believe that this is an accurate statement of the law.

[2] We may affirm this summary judgment, however, on a different ground if it finds support in the record.

United States v. Winthrop Towers, 628 F.2d 1028, 1037 (7th Cir.1980). Sally Beauty contends that the distribution agreement is freely assignable because it is governed by the provisions of the Uniform Commercial Code (the “UCC” or the “Code”), as adopted in Texas. Appellants’ Brief at 46–47. We agree with Sally that the provisions of the UCC govern this contract and for that reason hold that the assignment of the contract by Best to Sally Beauty was barred by the UCC rules on delegation of performance, UCC § 2–210(1), Tex.Bus. & Com.Code Ann. § 2–210(a) (Vernon 1968).

The parties agree that the contract is governed by the law of Texas. See Zlotnick v. MacArthur, 550 F.Supp. 371, 373–74 (N.D.Ill.1982).

III.


[4] Several of these courts note that “a distributorship agreement is more involved than a typical sales contract,” Quality Performance Lines, 609 P.2d at 1342, but apply the UCC nonetheless because the sales aspect in such a contract is predominant. See Corensweet, 594 F.2d at 134 (“Although most distributorship agreements, like franchise agreements, are more than sales contracts, the courts have not hesitated to apply the Uniform Commercial Code to cases involving such agreements.”); Zapatha, 408 N.E.2d at 1374–75 n. 8 (courts have applied UCC to distribution agreements because the sales aspect is predominant). This is true of the contract at issue here (as embodied in the July 24, 1979 letter from Reichek to Redding). Most of the agreed-to terms deal with Nexxus’ sale of its hair care products to Best. We are confident that a Texas court would find the sales aspect of this contract dominant and apply the majority rule that such a distributorship is a contract for “goods” under the UCC.

IV.

[5] The fact that this contract is considered a contract for the sale of goods and not for the provision of a service does not, as Sally Beauty suggests, mean that it is freely assignable in all circumstances. The delegation of performance under a sales contract (whether in conjunction with an assignment of rights, as here, or not) is governed by UCC section 2–210(1), Tex.Bus. & Com.Code § 2–210(a) (Vernon 1968). The UCC recognizes that in many cases an obligor will find it convenient or even necessary to relieve himself of the duty of performance under a contract, see Official Comment 1, UCC § 2–210 (“T[his section recognizes both delegation of performance and assignability as normal and permissible incidents of a contract for the sale of goods.”). The Code therefore sanctions delegation except where the delegated performance would be unsatisfactory to the obligee: “A party may perform his duty through a delegate unless otherwise agreed to or unless the other party has a substantial interest in having his original promisor perform or control the acts required by the contract.” UCC § 2–210(1), Tex.Bus. & Com.Code Ann. § 2–210(a) (Vernon 1968). Consideration is given to balancing the policies of free alienability of commercial contracts and protecting the obligee from having to accept a bargain he did not contract for.
We are concerned here with the delegation of Best’s duty of performance under the distribution agreement, as Nexxus terminated *1007 the agreement because it did not wish to accept Sally Beauty’s substituted performance.6 Only one Texas case has construed section 2–210 in the context of a party’s delegation of performance under an executory contract. In *McKinzie v. Milford, 597 S.W.2d 953 (Tex.Civ.App.1980, writ ref’d, n.r.e.), the court held that nothing in the Texas Business and Commercial Code prevented the seller of a horse from delegating to the buyer a pre-existing contractual duty to make the horse available to a third party for breeding. “[I]t is clear that Milford [the third party] had no particular interest in not allowing Stewart [the seller] to delegate the duties required by the contract. Milford was only interested in getting his two breedings per year, and such performance could only be obtained from McKinzie [the buyer] after he bought the horse from Stewart.” Id. at 957. In McKinzie, the Texas court recognized and applied the UCC rule that bars delegation of duties if there is some reason why the non-assigning party would find performance by a delegate a substantially different thing than what he had bargained for.

If this contract is assignable, Sally Beauty would also, of course, succeed to Best’s rights under the distribution agreement. But the fact situation before us must be distinguished from the assignment of contract rights that are no longer executory (e.g., the right to damages for breach or the right to payment of an account), which is considered in UCC section 2–210(2), Tex.Bus. & Com.Code Ann. § 2–210(b) (Vernon 1968), and in several of the authorities relied on by appellants. The policies underlying these two situations are different and, generally, the UCC favors assignment more strongly in the latter. See UCC § 2–210(2) (non-executory rights assignable even if agreement states otherwise).

In the exclusive distribution agreement before us, Nexxus had contracted for Best’s “best efforts” in promoting the sale of Nexxus products in Texas. UCC § 2–306(2), Tex.Bus. & Com.Code Ann. § 2–306(b) (Vernon 1968), states that “[a] lawful agreement by either buyer or seller for exclusive dealing in the kind of goods concerned imposes unless otherwise agreed an obligation by the seller to use best efforts to supply the goods and by the buyer to use best efforts to promote their sale.” This implied promise on Best’s part was the consideration for Nexxus’ promise to refrain from supplying any other distributors within Best’s exclusive area. See Official Comment 5, UCC § 2–306. It was this contractual undertaking which Nexxus refused to see performed by Sally.

In ruling on Nexxus’ motion for summary judgment, the district court noted: “Unlike Best, Sally Beauty is a subsidiary of one of Nexxus’ direct competitors. This is a significant distinction and in the court’s view, it raises serious questions regarding Sally Beauty’s ability to perform the distribution agreement in the same manner as Best.” Memorandum Opinion and Order at 7. In *Berliner Foods Corp. v. Pillsbury Co., 633 F.Supp. 557 (D.Md.1986), the court stated the same reservation more strongly on similar facts. Berliner was an exclusive distributor of Haagen-Dazs ice cream when it was sold to Breyer’s, manufacturer of a competing ice cream line. Pillsbury Co., manufacturer of Haagen-Dazs, terminated the distributorship and Berliner sued. The court noted, while weighing the factors for and against a preliminary injunction, that “it defies common sense to require a manufacturer to leave the distribution of its products to a distributor under the control of a competitor or potential competitor.” Id. at 559–60. We agree with these assessments and hold that Sally Beauty’s position as a wholly-owned subsidiary of Alberto-Culver is sufficient to bar the delegation of Best’s duties under the agreement.

The effort by the dissent to distinguish Berliner merely because the court there apparently assumed in passing that distributorship agreements were a species of personal service contracts must fail. The Berliner court emphasizes that the sale of a distributorship to a competitor of the supplier is by itself a wholly sufficient reason to terminate the distributorship.

We do not believe that our holding will work the mischief with our national economy that the appellants predict. We hold merely that the duty of performance under an exclusive distributorship may not be delegated to a competitor in the market *1008 place—or the wholly-owned subsidiary of a competitor—without the obligee’s consent. We believe that such a rule is consonant with the policies behind section 2–210, which is concerned with preserving the bargain the obligee has struck. Nexxus should not be required to accept the “best efforts” of Sally Beauty when those efforts are subject to the control of Alberto-Culver. It is entirely reasonable that Nexxus should conclude that this performance would be a different thing than what it had bargained for. At oral argument, Sally Beauty argued that the case should go to trial to allow it to demonstrate that it could and would perform the contract
as impartially as Best. It stressed that Sally Beauty is a “multi-line” distributor, which means that it distributes many brands and is not just a conduit for Alberto-Culver products. But we do not think that this creates a material question of fact in this case. When performance of personal services is delegated, the trier merely determines that it is a personal services contract. If so, the duty is per se nondelegable. There is no inquiry into whether the delegate is as skilled or worthy of trust and confidence as the original obligor: the delegate was not bargained for and the obligee need not consent to the substitution. And so here: it is undisputed that Sally Beauty is wholly owned by Alberto-Culver, which means that Sally Beauty’s “impartial” sales policy is at least acquiesced in by Alberto-Culver—but could change whenever Alberto-Culver’s needs changed. Sally Beauty may be totally sincere in its belief that it can operate “impartially” as a distributor, but who can guarantee the outcome when there is a clear choice between the demands of the parent-manufacturer, Alberto-Culver, and the competing needs of Nexxus? The risk of an unfavorable outcome is not one which the law can force Nexxus to take. Nexxus has a substantial interest in not seeing this contract performed by Sally Beauty, which is sufficient to bar the delegation under section 2-210, Tex. Bus. Com. Code Ann. § 2-210 (Vernon 1968). Because Nexxus should not be forced to accept performance of the distributorship agreement by Sally, we hold that the contract was not assignable without Nexxus’ consent.

We do not address here the situation in which the assignee is not completely under the control of a competitor. If the assignee were only a partially-owned subsidiary, there presumably would have to be fact-finding about the degree of control the competitor-parent had over the subsidiary’s business decisions.

Of course, the obligee makes such an assessment of the prospective delegate. If it thinks the delegated performance will be as satisfactory, it is of course free to consent to the delegation. Thus, the dissent is mistaken in its suggestion that we find it improper—a “conflict of interest”—for one competitor to distribute another competitor’s products. Rather, we believe only that it is commercially reasonable that the supplier in those circumstances have consented to such a state of affairs. To borrow the dissent’s example, Isuzu allows General Motors to distribute its cars because it considers this arrangement attractive. Nor is distrust of one’s competitors a trait unique to lawyers (as opposed to ordinary businessmen), as the dissent may be understood to suggest.

This disposition makes it unnecessary to address Nexxus’ argument that Sally Beauty breached the distribution agreement by not giving Nexxus 120 days’ notice of the Best-Sally Beauty merger.

The judgment of the district court is AFFIRMED.

POSNER, Circuit Judge, dissenting.

My brethren have decided, with no better foundation than judicial intuition about what businessmen consider reasonable, that the Uniform Commercial Code gives a supplier an absolute right to cancel an exclusive-dealing contract if the dealer is acquired, directly or indirectly, by a competitor of the supplier. I interpret the Code differently.

Nexxus makes products for the hair and sells them through distributors to hair salons and barbershops. It gave a contract to Best, cancellable on any anniversary of the contract with 120 days’ notice, to be its exclusive distributor in Texas. Two years later Best was acquired by and merged into Sally Beauty, a distributor of beauty supplies and wholly owned subsidiary of Alberto-Culver. Alberto-Culver makes “hair care” products, too, though they mostly are cheaper than Nexxus’s, and are sold to the public primarily through grocery stores and drugstores. My brethren conclude that because there is at least a loose competitive relationship between Nexxus and Alberto-Culver, Sally Beauty cannot—as a matter of law, cannot, for there has been no trial on the issue—provide its “best efforts” in the distribution of Nexxus products. Since a commitment to provide best efforts is read into every exclusive-dealing contract by section 2-306(2) of the Uniform Commercial Code, the contract has been broken and Nexxus can repudiate it. Alternatively, Nexxus had “a substantial interest in having his original promisor perform or control the acts required by the contract,” and therefore the delegation of the promisor’s (Best’s) duties to Sally Beauty
was improper under section 2–210(1).

My brethren’s conclusion that these provisions of the Uniform Commercial Code entitled Nexxus to cancel the contract does not leap out from the language of the provisions or of the contract; so one would expect, but does not find, a canvass of the relevant case law. My brethren cite only one case in support of their conclusion: a district court case from Maryland, *Berliner Foods Corp. v. Pillsbury Co.*, 633 F.Supp. 557 (D.Md.1986), which, since it treated the contract at issue there as one for personal services, *id* at 559 (a characterization my brethren properly reject for the contract between Nexxus and Best), is not helpful. *Berliner* is the latest in a long line of cases that make the propriety of delegating the performance of a distribution contract depend on whether or not the contract calls for the distributor’s personal (unique, irreplaceable, distinctive, and therefore nondelegable) services. See, e.g., *Bancroft v. Scribner*, 72 Fed. 988 (9th Cir.1896); *Detroit Postage Stamp Service Co. v. Schermack*, 179 Mich. 266, 146 N.W. 144 (1914); *W.H. Barber Agency Co. v. Co-Op. Barrel Co.*, 133 Minn. 207, 158 N.W. 38 (1916); *Paige v. Faure*, 229 N.Y. 114, 127 N.E. 898 (1920). By rejecting that characterization here, my brethren have sawn off the only limb on which they might have sat comfortably.

A slightly better case for them (though not cited by them) is *Wetherell Bros. Co. v. United States Steel Co.*, 200 F.2d 761, 763 (1st Cir.1952), which held that an exclusive sales agent’s duties were nondelegable. The agent, a Massachusetts corporation, had agreed to use its “best endeavors” to promote the sale of the defendant’s steel in the New England area. The corporation was liquidated and its assets sold to a Pennsylvania corporation that was not shown to be qualified to conduct business in Massachusetts, the largest state in New England. On these facts the defendant was entitled to treat the liquidation and sale as a termination of the contract. The *Wetherell* decision has been understood to depend on its facts. See *Jennings v. Foremost Dairies, Inc.*, 37 Misc.2d 328, 235 N.Y.S.2d 566, 574 (1962); 4 Corbin on Contracts, 1971 Pocket Part § 865, at p. 128. The facts of the present case are critically different. So far as appears, the same people who distributed Nexxus’s products for Best (except for Best’s president) continued to do so for Sally Beauty. Best was acquired, and continues, as a going concern; the corporation was dissolved, but the business wasn’t. Whether there was a delegation of performance in any sense may be doubted. Cf *Rossetti v. City of New Britain*, 163 Conn. 283, 303 A.2d 714, 718–19 (1972). The general rule is that a change of corporate form—including a merger—does not in and of itself affect contractual rights and obligations. *United States Shoe Corp. v. Hackett*, 793 F.2d 161, 163–64 (7th Cir.1986).

The fact that Best’s president has quit cannot be decisive on the issue whether the merger resulted in a delegation of performance. The contract between Nexxus and Best was not a personal-services contract conditioned on a particular individual’s remaining with Best. Compare *Jennings v. Foremost Dairies, Inc.*, supra, 235 N.Y.S.2d at 574. If Best had not been acquired, but its president had left anyway, as of *1010* course he might have done, Nexxus could not have repudiated the contract.

No case adopts the per se rule that my brethren announce. *The cases ask whether, as a matter of fact, a change in business form is likely to impair performance of the contract. Wetherell* asked this. So did *Arnold Productions, Inc. v. Favorite Films Corp.*, 298 F.2d 540, 543–44 (2d Cir.1962), and *Des Moines Blue Ribbon Distributors, Inc. v. Drewrys Ltd.*, 256 Iowa 899, 129 N.W.2d 731, 738–39 (1964). *Green v. Camlin*, 229 S.C. 129, 92 S.E.2d 125, 127 (1956), has some broad language which my brethren might have cited; but since the contract in that case forbade assignment it is not an apt precedent.

My brethren find this a simple case—as simple (it seems) as if a lawyer had undertaken to represent the party opposing his client. But notions of conflict of interest are not the same in law and in business, and judges can go astray by assuming that the legal-services industry is the pattern for the entire economy. The lawyerization of America has not reached that point. Sally Beauty, though a wholly owned subsidiary of Alberto-Culver, distributes “hair care” supplies made by many different companies, which so far as appears compete with Alberto-Culver as vigorously as Nexxus does. Steel companies both make fabricated steel and sell raw steel to competing fabricators. General Motors sells cars manufactured by a competitor, Isuzu. What in law would be considered a fatal conflict of interest is in business a commonplace and legitimate practice. The lawyer is a fiduciary of his client; Best was not a fiduciary of Nexxus.
Selling your competitor’s products, or supplying inputs to your competitor, sometimes creates problems under antitrust or regulatory law—but only when the supplier or distributor has monopoly or market power and uses it to restrict a competitor’s access to an essential input or to the market for the competitor’s output, as in Otter Tail Power Co. v. United States, 410 U.S. 366, 93 S.Ct. 1022, 35 L.Ed.2d 359 (1973), or FTC v. Brown Shoe Co., 384 U.S. 316, 86 S.Ct. 1501, 16 L.Ed.2d 587 (1966), or United Air Lines, Inc. v. CAB, 766 F.2d 1107, 1114–15 (7th Cir.1985). See also Olympia Equipment Leasing Co. v. Western Union Telegraph Co., 797 F.2d 370, 376–79 (7th Cir.1986). There is no suggestion that Alberto-Culver has a monopoly of “hair care” products or Sally Beauty a monopoly of distributing such products, or that Alberto-Culver would ever have ordered Sally Beauty to stop carrying Nexxus products. Far from complaining about being squeezed out of the market by the acquisition, Nexxus is complaining in effect about Sally Beauty’s refusal to boycott it!

How likely is it that the acquisition of Best could hurt Nexxus? Not very. Suppose Alberto-Culver had ordered Sally Beauty to go slow in pushing Nexxus products, in the hope that sales of Alberto-Culver “hair care” products would rise. Even if they did, since the market is competitive Alberto-Culver would not reap monopoly profits. Moreover, what guarantee has Alberto-Culver that consumers would be diverted from Nexxus to it, rather than to products closer in price and quality to Nexxus products? In any event, any trivial gain in profits to Alberto-Culver would be offset by the loss of goodwill to Sally Beauty; and a cost to Sally Beauty is a cost to Alberto-Culver, its parent. Remember that Sally Beauty carries beauty supplies made by other competitors of Alberto-Culver; Best alone carries “hair care” products manufactured by Revlon, Clairol, Bristol-Myers, and L’Oreal, as well as Alberto-Culver. Will these powerful competitors continue to distribute their products through Sally Beauty if Sally Beauty displays favoritism for Alberto-Culver? Is it really credible that Alberto-Culver would sacrifice Sally Beauty in a vain effort to monopolize the “hair care” market, in violation of section 2 of the Sherman Act? Is not the ratio of the profits that Alberto-Culver obtains from Sally Beauty to the profits it obtains from the manufacture of *1011 “hair care” products at least a relevant consideration?

Another relevant consideration is that the contract between Nexxus and Best was for a short term. Could Alberto-Culver destroy Nexxus by failing to push its products with maximum vigor in Texas for a year? In the unlikely event that it could and did, it would be liable in damages to Nexxus for breach of the implied best-efforts term of the distribution contract. Finally, it is obvious that Sally Beauty does not have a bottleneck position in the distribution of “hair care” products, such that by refusing to promote Nexxus products vigorously it could stifle the distribution of those products in Texas; for Nexxus has found alternative distribution that it prefers—otherwise it wouldn’t have repudiated the contract with Best when Best was acquired by Sally Beauty.

Not all businessmen are consistent and successful profit maximizers, so the probability that Alberto-Culver would instruct Sally Beauty to cease to push Nexxus products vigorously in Texas cannot be reckoned at zero. On this record, however, it is slight. And there is no principle of law that if something happens that trivially reduces the probability that a dealer will use his best efforts, the supplier can cancel the contract. Suppose there had been no merger, but the only child of Best’s president had gone to work for Alberto-Culver as a chemist. Could Nexxus have canceled the contract, fearing that Best (perhaps unconsciously) would favor Alberto-Culver products over Nexxus products? That would be an absurd ground for cancellation, and so is Nexxus’s actual ground. At most, so far as the record shows, Nexxus may have had grounds for “insecurity” regarding the performance by Sally Beauty of its obligation to use its best efforts to promote Nexxus products, but if so its remedy was not to cancel the contract but to demand assurances of due performance. See UCC § 2–609: Official Comment 5 to § 2–306. No such demand was made. An anticipatory repudiation by conduct requires conduct that makes the repudiating party unable to perform. Farnsworth, Contracts 636 (1982). The merger did not do this. At least there is no evidence it did. The judgment should be reversed and the case remanded for a trial on whether the merger so altered the conditions of performance that Nexxus is entitled to declare the contract broken.
Excerpt from Chapter 5
Carter G. Bishop & Daniel S. Kleinberger,
LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW
(Warren Gorham & Lamont, 1994; Supp. 2018-2)

¶ 5.06[3][f][iv] Interpreting operating agreement according to entity resemblance.¹

¶ 5.06[3][f][iv][A] Entity resemblance explained.

In 1990, in *Reves v. Ernst & Young*, the United States Supreme Court adopted a “family resemblance” test for “determining whether an instrument denominated a ‘note’ is a ‘security.’”¹⁰⁰⁶.³ In 2016, the Delaware Court of Chancery advanced an entity resemblance test for interpreting operating agreements. The operating agreement at issue established a corporate-like governance structure, which the court took as a signal to interpret the agreement by “draw[ing] on analogies to corporate law.”¹⁰⁰⁶.⁴

The court placed this holding within a more general proposition—interpretation by entity resemblance:

Using the contractual freedom that the LLC Act bestows, the drafters of an LLC agreement can create an LLC with bespoke governance features or design an LLC that mimics the governance features of another familiar type of entity. The choices that the drafters make have consequences. If the drafters have embraced the statutory default rule of a member-managed governance arrangement, which has strong functional and historical ties to the general partnership (albeit with limited liability for the members), then the parties should expect a court to draw on analogies to partnership law. If the drafters have opted for a single managing member with other generally passive, non-managing members, a structure closely resembling and often used as an alternative to a limited partnership, then the parties should expect a court to draw on analogies to limited partnership law. If the drafters have opted for a manager-managed entity, created a board of directors, and adopted other corporate features, then the parties to the agreement should expect a court to draw on analogies to corporate law.¹⁰⁶.⁵

¹ In 2017, Delaware amended its act apparently to overrule Obeid. 2017 Delaware Laws Ch. 89 (S.B. 72) § 11 (amending Section 407 of the Delaware act). For the authors’ skepticism about the amendment’s effectiveness, see the forthcoming supplement of this treatise (2019-1).
Although *Obeid* has precedential effect only as to Delaware LLCs, the case’s logic could apply equally well under any state’s LLC statute. All LLC statutes allow almost unlimited flexibility in structuring LLC governance and other matters of internal affairs.\textsuperscript{1006.6}

**§ 5.06[3][f][iv][B] Understanding entity resemblance in the context of contract law.**

What is the logic of *Obeid*? What underlies the assertion that “the parties to the agreement should expect a court to draw on analogies to” the law of an analogous entity? Because an operating agreement is a contract, to be interpreted according to the ordinary principles of contractual interpretation,\textsuperscript{1006.2} *Obeid*’s underlying logic must be found within those principles.

The two cardinal principles of contract interpretation are: (1) “When interpreting . . . a contract, ‘the role of a court is to effectuate the parties’ intent.’”\textsuperscript{1006.8} (2) Courts generally “‘adhere[] to the “objective” theory of contracts, i.e. a contract’s construction should be that which would be understood by an objective, reasonable third party.’”\textsuperscript{1006.9}

The second principle controls the first. That is, “under an objective theory of contract, a party will be legally responsible for a contractual obligation if a reasonable person in the same circumstances would have understood that they were taking on such an obligation; a subjective belief to the contrary is not relevant.”\textsuperscript{1006.10} The objective approach:

place[s] a reasonable person in the position of the parties, and interpret[s] the disputed term according to what a reasonable person would expect it to mean under the circumstances. In determining the parties’ intentions under these standards, the court must give the disputed term the meaning ‘which the party using the words should reasonably have apprehended that they would be understood by the other party, and the meaning which the recipient of the communication might reasonably have given to it.’”\textsuperscript{1006.11}

Determining the meaning of disputed language is typically a matter of fact—initially by the court to determine whether the language is susceptible to more than one reasonable interpretation,\textsuperscript{1006.12} and, if so, by the finder of fact under the objective standard.\textsuperscript{1006.13} The latter factual inquiry focuses on the reasonable expectations of the parties, and may include references to generally applicable facts—for example (and notably for present purposes) a usage of trade:

A usage of trade is a usage having such regularity of observance in a place, vocation, or trade as to justify an expectation that it will be observed with respect to a particular agreement. . . . The existence and scope of a usage of trade are to be determined as questions of fact. . . . Unless otherwise agreed, a usage of trade in the vocation or trade in which the parties are engaged or a usage of trade of which they know or have reason to know gives meaning to or supplements or qualifies their agreement.\textsuperscript{1006.14}

Usage of trade is an important example, because a usage of trade is a factual finding as to a *generalized understanding* and *Obeid* states a *factual generalization*. “The choices that the drafters make have consequences”\textsuperscript{1006.15}—not merely for the drafters of the *Obeid* LLC agreement but also for the drafters of any operating agreement (and their respective clients).
However, while a factual inquiry into a usage of trade is an inquiry into whether there exists “a usage having such regularity of observance in a place, vocation, or trade as to justify an expectation that it will be observed with respect to a particular agreement,” Obeid imposes upon all drafters of all operating agreements the court’s invariable expectation about what drafters mean when they create an entity resemblance.

As summarized in the following chart, Obeid’s family resemblance rule is a factual generalization of a very unusual nature:

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<tr>
<th>Entity expectations resemblance jurists</th>
<th>Factual inquiry</th>
<th>Role of factual generalization</th>
<th>Source</th>
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<tr>
<td>No-a factual presumption:</td>
<td>Applies a</td>
<td>general norm/actors</td>
<td>The</td>
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<td>&quot;the parties to the agreement should expect a court to draw on [entity] analogies”</td>
<td>determined inference to interpret all operating agreements involving an entity resemblance</td>
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Since the purpose of contract interpretation is to determine objectively the intent of the parties, Obeid amounts to a determination as a matter of law that parties to an operating agreement should understand (through those engaged to do the drafting) what the courts will make of a family resemblance. The factual generalization is not about generalized meanings “on the ground”—i.e.,
among parties in circumstances comparable to the parties to the agreement at issue, but rather imposes on all parties a meaning determined by the court. 1006.17

In sum, the logic of Obeid is radically inconsistent with the cardinal rules of contract interpretation. 1006.18

¶ 5.06[3][f][iv][C] Coping with Obeid.

Delaware law is often persuasive to courts of other jurisdictions, and, as shown in ¶ 5.06[3][iii][B], the radicalism of Obeid is not immediately apparent. Thus, the entity resemblance approach should concern drafters regardless of whether Delaware law applies.

The following suggestions may help drafters avoid unwarranted use of the entity resemblance approach:

1. Avoid using terms of art from the law or practice of other entities. For example, if a limited liability company is to be managed collectively by a group of persons, eschew “board of managers” and use instead “committee of managers” or “management council” or the like.

2. Delineate clearly and completely the role, authority, responsibilities, and duties of any person with management authority and likewise the details and practical ramifications of any inter se arrangements that might seem to mimic arrangements under the law or practice of other entities. Analogy by entity resemblance presupposes some significant gap in the operating agreement.

3. Expressly reject interpretation by entity resemblance. For example, “Whether a right, duty, authority, structure, or other relationship provided by this agreement resembles a relationship commonly or usually present in the law or practice of an entity other than a limited liability company is irrelevant to the interpretation and application of this agreement.” 1006.19

4. If a matter comes to court, use Obeid’s own cautionary language to undercut the applicability and reach of entity resemblance:

It is important not to embrace analogies to other entities or legal structures too broadly or without close analysis, because “the flexibility inherent in the limited liability company form complicates the task of fixing such labels or making such comparisons. The drafters of an LLC agreement may have adopted partnership-like features for particular aspects of their relationship and corporate features for others.” 1006.20

1006.19 Reves v. Ernst & Young, 494 US 56, 67, 110 S. Ct. 945, 952, 108 L. Ed. 2d 47 (1990): We conclude, then, that in determining whether an instrument denominated a “note” is a “security,” courts are to apply the version of the “family resemblance” test that we have articulated here: A note is presumed to be a “security,” and that presumption may be rebutted only by a showing that the note bears a strong resemblance (in terms of the four factors we have identified) to one of the enumerated
categories of instrument. If an instrument is not sufficiently similar to an item on the list, the decision whether another category should be added is to be made by examining the same factors.


1006.6 See ¶¶ 5.06[1][b], 5.06[2].

1006.7 Condo v. Conners, 266 P3d 1110, 1115 (Colo. 2011) (stating that “the Operating Agreement itself is framed in terms of a multilateral agreement among the members and it is appropriate to interpret it in light of prevailing principles of contract law”). See generally ¶ 5.06[3][f][i].


1006.12 Eagle Indus., Inc. v. DeVilbiss Health Care, Inc., 702 A2d 1228, 1232 (Del. 1997). Courts have for years confused law students by referring to this factual determination as a question of law. The more accurate description is “a question of fact to be decided by the judge” for various policy reasons.

1006.13 GMG Capital Invs., LLC v. Athenian Venture Partners I, LP, 36 A3d 776, 783 (Del. 2012), stating that “where reasonable minds could differ as to the contract’s meaning, a factual dispute results”).

1006.14 Restatement (Second) of Contracts § 222 (1981).


1006.16 Restatement (Second) of Contracts § 222(1) (1981) (emphasis added).

1006.17 Cf. Application of Doughboy Indus., Inc., 17 AD2d 216, 219, 233 NYS2d 488, 492–493 (1962) (“Recognizing, as one should, that the business men in this case acted with complete disdain for the ‘lawyer’s content’ of the very commercial forms they were sending and receiving, the question is what obligation ought the law to attach to the arbitration clause. And in determining that
question the traditional theory is applicable, namely, that of constructive knowledge and acceptance of contractual terms, based on prior transaction[s] and the duty to read contractual instruments to which one is a party.”).

1006.18 See, e.g., UCC §§ 1-303, cmt. 1 (“The Uniform Commercial Code rejects both the “lay-dictionary” and the ‘conveyancer’s’ reading of a commercial agreement. Instead, the meaning of the agreement of the parties is to be determined by the language used by them and by their action, read and interpreted in the light of commercial practices and other surrounding circumstances. The measure and background for interpretation are set by the commercial context, which may explain and supplement even the language of a formal or final writing.”) (emphasis added).

1006.19 Cf. UCC § 2-202, cmt. 2 (“[W]ritings are to be read on the assumption that the course of prior dealings between the parties and the usages of trade were taken for granted when the document was phrased. Unless carefully negated they have become an element of the meaning of the words used.”) (emphasis added).

Contracts and Disputes: Winning the War or Waging the Peace?

Commercial contracts need not be confined to the role of drawing battle lines, says the author. Lawyers who negotiate and draft commercial agreements can do much to help their clients avoid disputes by focusing on the contract as a tool of prevention.

Daniel S. Kleinberger

The widget supplier and its customer have fallen into an angry dispute about forecasting schedules and delivery schedules. When things get bad enough, lawyers are called in and they pull from file drawers copies of the widget contract—which no one has even looked at, much less consulted, since the day the document was signed.

The contract now becomes the focus of the dispute, with counsel for the customer pointing out that the contract, which contains an integration clause, makes no reference whatsoever to the forecasting requirements that the supplier claims exist. Counsel for supplier counters that the parties had an "oral understanding" about forecasting which was and remains part of "the basis of the bargain."

At trial, the court refuses to allow testimony about the claimed supplemental understanding, quoting Lehman v. Stutsman on the parol evidence rule. Where parties have reduced their contract to writing, the contract may not be proved by prior or contemporaneous understandings or writings and... have an entirely material for the purpose of the contract at issue." The court's ruling is affirmed on appeal.

For most lawyers who draft contracts for a living, the victory of the complete-integrated-widget contract would be a confirmation devoutly to be wished. What a draft could fail to take note in a document that "speaks for itself," silence prior rebuttal, and put a litigated end to a business dispute? The contract has done its job. In the words of the Lehman case, "The writing is the contract, not merely the evidence thereof." The party that sought to prove otherwise has misstaked the battlelines and has been defeated.

True, the deal has gone sour, and what once appeared a viable business opportunity has been lost. Moreover, even the winning side has suffered the noncompensable costs of litigation. But none of these things are the fault of the finely drafted contract.

Or are they? Commercial contracts need not be confined to the role of drawing battlelines. If the lawyer who negotiates and drafts commercial agreements will focus on the preventive nature of contracts, contracts and the contracting process can do much to avoid disputes.

For many lawyers and most business people, using contracts as a tool of prevention will require a basic change of perspective. Adopting that perspective will implicate a number of practical approaches. This article seeks to explain the preventive perspective and outlines some of the practical approaches.

The Preventive Perspective

Advancing the preventive role requires as a first step a basic change in common preconceptions about the function and nature of a commercial contract. To most business people, documenting a business agreement "in legal form" seems a bureaucratic requirement essentially unrelated to the real business of putting the deal together. Formal contracts are merely loopholes lawyers hold out for business people to jump through. Thus, are commonly heard comments like, "Now that we understand what we want, let's get the lawyers to put the boilerplate together."

Lawyers, of course, have a different view. By training, experience, and self-interest they understand contracts to be important, frequently, though, the lawyer's view of this importance is overly oriented toward breach. Although the contract is seen as defining the obligations of performance, the purpose of the definition is to show the conditions that must be met to avoid being in breach and to circumscribe the remedies available should breach occur. The typical drafter does not think of the contract's description of performance obligations as providing an "operating manual" for the business deal.

Both the business and legal perspectives just described are essentially pessimistic. For the business person, a contract is a nuisance; for the lawyer the contract will come into its own only if the transaction goes wrong. It is these pessimistic views that must be replaced if contracts are to serve to prevent rather than merely regulate commercial disputes.

The replacement perspective is an optimistic one that sees the process of
"Part of the lawyer's preparation concept be in
learning just what his or her client actually wants from the deal."

existence or correction of that information.
To take double hit information at face value would jeopardize the client, because the existing contract would rest on false premises.

To approach a representative of the client and discuss a question of relia-
bility surely requires diplomacy but the task is sometimes impossible. It is no
exploiting to say, "It is not my job to tell the business people how to run their business, I merely have to give legal advice."

Makingsure that the legal arrangements rest on correct factual assumptions is part of the legal work of negotiating and drafting a contract.

Consider, for instance, the sale of an ongoing, tidy manufacturing operation. Part of the deal involves selling an inventory of components, and one type of component is soon to be antiquated. Who is going to swallow the
soon-to-be-outmoded inventory? To evaluate its position on this issue, the
seller obviously must know how much of the particular component is likely to be in stock, or the closing daze.

If you are the lawyer representing the seller, it is important not only that you know the estimate made by the appropriate representative of your client but also that you know whether that representative generally produces dependable information. But if that business person tells you that approxi-
mately 5,000 of the components will be in stock, at closing, and you therefore negotiate to have the buyer pay full price for the 5,000, you will be distressed to later learn that at a closing day inventory only some 500 of the units were found on the warehouse shelves.

Knowing the Other Party

Knowing one's own client, a lawyer needs to spend some energy making sure
the client knows the other party and its players. Having an unfavorable contract is an important safeguard for a business, but it rarely compares with the value of finding a good "other party to the second part!" Civil litigation is simply impotent in dealing with thieves, shad-
ders, and gross incompetents and even an award of damages against a solvent defendant rarely makes the judgment creditor fully whole. Cautious empir makes a good master for evaluating the other party to a contract.

Evaluating Potential Business Associates

be they suppliers, customers or joint owners — part of the art and science of being an entrepreneur, and the lawyer should not try to substitute his or her assessment for the client's "business judgment." The lawyer must, however, encourage the client to become as informed as the lawyer reasonably can.

The lawyer may also suggest techniques for developing that informed basis. For example, the lawyer might get hold of the other company's facility and get a sense of that company's "corporate culture." Has the client run a judgment check on the other company? How the client likely good to have a 50-page, intricate agree-
ment with a thinly capitalized company whose principal has 40 satisfied judgment outstanding against him.

A Philosophy for Negotiation

During negotiations, lawyers need to keep their competitive urges and those of their clients in check. If the goal is to establish a relationship that will work one time, it is dangerous to drive taut
bargains; the victory can be Pyrrhic.

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A petition for bankruptcy can undo the object of contract language, and even a financially stable company may tend to be only gradually responsive in the performance of an unprofitable deal.

Moreover, if a party feels short-changed, it will escape the relationship as soon as possible, depriving the "winning" side of the benefits that flow from a long-term business relationship.

The lawyer’s goal, therefore, is not to get the best deal possible. It is to find for the client the best possible deal that is feasible for the other party. To paraphrase a more recent client, "I see no virtue in buying any company a piece of a bankruptcy or a lawsuit. If there’s no way the other guy can make a profit on the deal, one way or the other the deal is likely to turn sour." Thus, looking for a fair deal is not altruistic; it is pragmatic.

Negotiations as a Dry Run

Pragmatism also dictates that the lawyer and the client approach contract negotiations as an opportunity to build trust between the parties, not merely as an exercise in hammering out details. At least if the parties have not dealt with each other before, contract discussions present the first occasion for the parties to work together to resolve common problems. If both sides view the negotiations as a series of win-lose propositions, the negotiations will merely encourage the self-protection that is necessary for the relationship and promote future discord. If, in contrast, the parties use the differences that surface during negotiations as an opportunity to learn how to communicate and compromise, the negotiating process will help establish a precedent for and a model of cooperation. Once a precedent is established, the model will help the relationship remain constructive when later, inevitable problems of interpretation occur. Proper contract interpretation requires the parties to resolve differences.

The Document Itself

The Importance of Readability: Organized to suit the drafter’s convenience and written in language that only a lawyer could love, most contract documents come out of the tile only twice in their existence: first, when they are being negotiated and signed; and second, when some problem arises.

“If the goal is to establish a relationship that will work over time, it is dangerous to drive too hard a bargain, the victory can be Pyrrhic.”

If a contract’s structure and language make it practically meaningless to the deal’s participants, the contract forfeits two major preventive opportunities.

First, a coherently organized contract, written in English rather than in jargon, can serve to clarify the parties’ understanding as the deal is being negotiated. While it is standard practice to ask clients to review contract drafts, esoteric language and Byzantine style typically prevent the client from making any meaningful comments. Contracts drafted in the lawyer’s style and for the lawyer’s convenience actually alienate the client from the process of formally expressing the client’s interest.

Once the contract is signed, a poorly drafted document is of no use in guiding the day-to-day performance of the parties. In contrast, a clearly written contract can serve the parties as an "operating manual" and help them keep their performance on track. In this sense a contract document is analogous to the rules of a game. The provisions of both need to be complete, unambiguous, and comprehensive to the participants in the enterprise.

It is no excuse to claim that complicated business transactions require complicated documentation. Comprehensibility is not always the same as simplicity. Complex arrangements may in fact require complex descriptions, but the descriptions can be spaced out so as to be accessible and understandable to the people whose conduct is being described.

The Importance of Coherent Structure: The most important consideration in drafting a "user-friendly" document is to find a logical structure. Many lawyers assume that "plain English" drafting essentially entails avoiding jargon, and jargon is indeed a major barrier to coherence. But good word choice is nowhere near as important (or as difficult) as finding the proper overall organization for the document. The guiding organizational principle should be the reader’s convenience. Provisions should be sequenced so that sense to a reader who is using the document as a practical guide to behavior.

Concept Outlines, Not Drafts: As a general matter, well-written contract language helps both to crystallize and to confirm points of agreement. But ironically, the lawyer’s penchant for “getting it down on paper” can work against the development of a consensus between the parties. Many lawyers are inclined to begin exchanging drafts as soon as the clients appear to have even a vague idea of the shape of the deal. Almost inevitably the draft focuses attention on fine points while the major parts of the agreement remain unresolved.

This approach wastes a lot of time, since later decisions about major points can moot hours of prior discussion generated by a particular word or phrase. Even more importantly, premature focus on actual language sometimes causes the parties to overlook completely some major areas of concern. Lawyers can help avoid losing the “forest for the trees” by using their drafting skills first to develop concept outlines. A concept outline states the substantial concerns of each party and proposes in general terms the way those concerns should be handled. As discussion yields increasing agreement on the major points, successive drafts of the outline become increasingly specific. Eventually outline drafting gives way to contract drafting, with the last outline serving as the basis for the first draft of the contract language.

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Cross-References and Indirect References: Although some cross-referencing within a document is sometimes inevitable, frequent cross-referencing usually indicates poor document structure. Provisions that begin "notwithstanding any of the foregoing" are an anathema. Lawyers may understand a concept through being told what the concept is not, but ordinary mortals prefer (and in fact need) a direct approach.

Consider, for example, the way a lawyer might define a bush.

A. As used herein the term "bush" shall mean a plane of baked dough, circular in shape, with rounded edges.

B. Notwithstanding any of the foregoing, "bush" shall not mean or include the circular crumb portion of said plane.

Contract the more straightforward approach: a bush is a ring of baked dough. When the reader must "connect the dots" from various provisions in order to understand the picture, comprehensibility suffers substantially and the usefulness of the document declines dramatically.

Dangers of Definitions: When defining a term, one must never allow the reader to remember the definition. Consider, as a matter of contract law, the duty of a contract law. Once the duty is right when he said, "When I use a word, it means just what I choose it to mean." As a matter of good drafting, however, a definition of a term or a concept must merely force the reader to return repeatedly to the definition section. For instance, it would serve confusion rather than clarity to follow the example of an English statute and provide: "Whenever the word 'where' occurs in this Act it shall be construed to include any place, place, or point of集结.

Also, avoid embedding substantive provisions in definitions. Besides being difficult to follow, such constructions are likely to lead to unintended results. Consider, for example, a residential lease that defines "tenant" as "The people who signed this lease and are living or coming to visit the apartment with the permission of anyone who signed this lease." The language about eviction has been embedded in the definition to establish the actual tenants' liability for any damage done to the building by people visiting the tenants. But the definition could have embarrassed effect if the lease also involved a provision that the building is reserved for vehicles owned by tenants. All others will be towed.

Spiders of Style: Linguistics research indicates that writing style does affect comprehension, but a detailed discussion of drafting style is beyond the scope of this article. Two points of style do, however, stand out.

Avoid the passive voice: Instead of, A foreseen must be delivered by the fifth day of the month, Write: Buyer must deliver a forecast before the fifth day of each month. The passive voice is more difficult to follow than the active voice, and the passive invites the writer to omit important information. "Mary hit" is not a complete sentence, but "John was hit" is. Moreover, the passive voice encourages exceedingly complicated syntax. In thought, people might write, "Although, the clauses that run on for a page and a half, with thought embodied in thought embedded in thought..." To be understood, make the contexts that are accessible to lay readers.

Beware of redundancy. Lawyers have a habit of repeating words, and the repetition gets in the way of comprehension. For example, the Norman Conquest, it may have made wise for drafters of documents to express important concepts in words accessible to both the conquered Anglo-Saxon population and the Norman conquerors, (e.g. "will" from the Anglo-Saxon) and void (from the French). But words are like the tradition may be, redundancy alienates the typical business reader, who sees the repetitive style as a sign of "lawyers" and assumes that "no lay reader need apply."

Special Challenges to Clarity: Specifications: Many business contracts include or incorporate by reference a set of technical specifications, and these specifications are as important as any other part of the contract. Yet lawyers often neglect these specifications, and that neglect can cause serious problems. Errors, omissions, or ambiguities in the specifications can confuse or defeat the objectives of the party. Lay attempts to include "legal boilerplate" in specification documents can stretch the lawyers' work in the main contract.

Frequently the lawyer's reluctance to get involved with the specifications results from a lack of technical expertise in the specifications' subject matter. How can the attorney, who knows nothing about the chemistry involved or about the mathematical measurements used to establish acceptable tolerances, review technical requirements for raw material being purchased? One way around this problem is to use the client's own experts to test the specifications for completeness and clarity. Consider a discussion among two or three of your client's technicians and you to them the following question:

1. Would a reasonable person skilled in this area but ignorant of this project have a complete, clear, and unambiguous understanding of what is being specified?

2. Could reasonable experts differ in the meaning of any provision of the specifications?

3. Have you sensed any differences in opinion as to meaning or intent in these specifications, either in your

"Lawyers may understand a concept through being told what the concept is not, but ordinary mortals prefer a more direct approach."
To discuss among yourselves or in your discussions with your counterparts from the other company?

The resulting discussion should give you a good feel for the adequacy of the specifications.

Samples: Drafting good technical specifications takes considerable skill and effort, and clients will sometimes wish to rely instead on a sample. The Uniform Commercial Code recognizes this approach as a legitimate way to express a bargain, but the method can sometimes confuse rather than clarify. It itself, a sample does not indicate which of its characteristics are significant and which are not. This inherent ambiguity may cause serious problems.

For example, a would-be supplier may furnish a sample quantity of industrial adhesive for a prospective purchaser to test. The purchaser may make the test, be delighted with the results, and enter into a purchase contract based on the sample. Later the seller may change the formulation of the adhesive in ways that do not affect performance except in applications under conditions of extremely high humidity. This change, although invisible to almost all of the seller's other customers, may prejudice the buyer, who happens always to apply the adhesive under conditions of high humidity. The buyer will cry foul, claiming that the sample tested fine under high humidity and that the high humidity performance characteristic was an element of the sample that became a basis of the bargain. The seller, with equal conviction, may well respond, "We had no idea that high humidity was a particular need of yours. If you had wanted us to commit to meeting that need, you should have told us."  

How can the lawyer reduce the likelihood of this type of confusion without abandoning samples completely? He or she should make sure that the parties have a clear and documented understanding of which characteristics of the sample are material. By specifying which attributes are to be relied on, the contract can avoid later disputes about what it was that the sample was intended to exemplify.

"By specifying targets and requiring the parties to consult when revisions are in order, the contract can encourage an ongoing dialogue."

How Much Detail?

How comprehensive should a good contract be? How much detail should be included? Unfortunately, there are no mechanical ways to answer these questions. In each particular situation the lawyer needs to exercise judgment, to use his or her "intelligence guided by experience." Some general principles do exist, however, to guide the exercise of that judgment.

Most fundamentally, the document must be comprehensive enough to function as an "operating manual" for the participants on all material points of the bargain. Unless the document goes into such detail, there is no reason to believe that the process of negotiating and drafting the agreement will have identified and sorted out possible misunderstandings about important points. Moreover, a lack of comprehensiveness may negate the integration clause and open the door to parol evidence in the event of a dispute.

Although integration clauses and the parol evidence rule may seem related more to the conduct of litigation than to its avoidance, they actually play a preventive role as well. The more predictable the results of contract litigation, the more likely are the parties to resolve their differences short of the courtroom. Why litigate when the outcome is preordained? Nothing undermines predictability as much as parol evidence, so an enforceable integration clause can help prevent differences of opinion from turning into causes of action.

Some provisions are so important as to require routine inclusion (e.g., the price term) while the importance of other provisions varies from situation to situation. For example, in a requirements contract where the quantity sold will comprise 30 to 40 percent of the supplier's output, the parties need to have a definite understanding of how far in advance and in what detail the purchaser will make known its evolving requirements. The parties should therefore discuss and agree to a detailed provision on forecasts. In contrast, where the requirements will amount to no more than 2 percent of the supplier's volume, detailed forecasting is probably immaterial.

In almost all contracts, it makes sense to prescribe the processes that will foster cooperation between the parties. For example, if the contract involves research and development work, it is usually worthwhile to specify milestones—often if the critical dates are merely targets. By specifying targets and requiring the parties to consult when revisions are in order, the contract can encourage an ongoing dialogue.

With regular communication, change can be evolutionary and consensual rather than sudden and discordant. Even when no development work is involved, if the relationship is to be a longstanding one, it may make sense to require periodic review meetings with key personnel from both parties. Such meetings will help to "air out" troublesome issues before the issues turn into significant disputes.

Of course, prudent business people will have periodic discussions even about the absence of contractual obligation, and breach of a contractual duty to consult is not likely to warrant a lawsuit. But by making the obligation to consult an ongoing one, the contract document can focus the participants' attention on the wisdom and necessity of keeping communication open.

Postexecution Lawyering

No matter how well-discussed the

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Parties will inevitably come to differ over some aspect of the agreement.

This can reduce the likelihood that a difference of opinion will degenerate into litigation. To the extent that litigation may produce unpredictable results, filing a lawsuit is seductive. To the extent that the meaning of the contract is clear and incontrovertible, litigation is unnecessary.

If a contact's integration clause is to function to deter litigation, the lawyer's job cannot end when the contract is signed. The case law on integration clauses reflects deep judicial hostility toward the parol evidence rule. If postexecution performance differs from the dictates of the contract, courts will frequently ignore integration and allow parol evidence. Where the words of the agreement and the facts of performance diverge, courts stand ready to decide whether "course of performance" has given new meaning to contractual provisions or whether the disclaimer between word and deed circumstantially supports a claim of postexecution modification. Either theory dispossesses the parol evidence rule, and the contract ceases to impede lawsuits based on expensive "sweating contracts."

For a lawyer, the practical response to this problem is certainly not to forbid clients from evolving their business relationships. The lawyer should, however, educate the client that inconsistency between the performance of the deal and the provisions of the contract a dangerous. The lawyer should urge the client to keep the lawyer informed as the deal evolves, so that the lawyer can update the contract. It simply makes no business sense for a client to spend a lot of time, energy, and legal fees documenting a deal as it begins, and then allow natural business developments to strip the document of much of its prophetic function.

Proselytizing to the client will not be enough, however. The lawyer must also be prompt, diligent, and cost-conscious in responding to client requests for contract updates. Where changes are likely to occur regularly and in technical areas (e.g., specifications), the lawyer should create a contract structure that will allow the parties to update the contract with a minimum of turnaround time.

For example, if product specifications are to evolve over time, the contract can incorporate the original specifications as an exhibit and then provide that successive revisors of the exhibit will take effect when signed by both parties — without any requirement that the main contract be formally amended. With this arrangement, the parties will not have to have frequent, time-consuming, and expensive recourse to counsel and the contract will continue to maintain its role as an instrument of clarity. In general, if the lawyer can help the client understand the importance of congruence and then minimize the costs and delay that lawfying frequently imposes on those who seek to preserve congruence, the lawyer will be preserving the contract as a tool for the avoidance of disputes.

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NOTES

1. 201 N.W.2d 660 (Minn. 1973), 261 Minn. at 623 (Roberts, J., dissenting).


4. E.g., Saab v. Trum (7th Cir. 1998).

5. E.g., Badger v. Ritenour (Minn. 1977), 251 Minn. at 464 (Guyson, J., concurring).

6. E.g., Badger v. Ritenour (Minn. 1977), 251 Minn. at 464 (Guyson, J., concurring).


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Protecting the Sacred Writing: The Operating Agreement

IN BRIEF

• How do you protect an LLC’s operating agreement from claims of oral or implied-in-fact modification? The answer comes down to three basic tactics:
• Recall and deploy the three bulwarks that contract law provides to protect written agreements—PER, SOF, and NOM.
• Choose the jurisdiction of LLC formation carefully—especially in terms of the jurisdiction’s respect for written contracts in general and operating agreements in particular.
• Draft with at least three audiences in mind—the business people, who need an “operator’s manual” they can understand and actually rely on; the judiciary which is generally unsympathetic or even hostile to claims to confine the evidence to the writing; and jurors, who are best helped by coherent organization and plain English drafting.
My previous column in *Business Law Today* explained how, “Like Great Britain, a Limited Liability Company May Have an Oral Constitution ([https://businesslawtoday.org/2017/09/like-great-britain-a-limited-liability-company-may-have-an-unwritten-constitution/](https://businesslawtoday.org/2017/09/like-great-britain-a-limited-liability-company-may-have-an-unwritten-constitution/)” and noted some of the resulting dangers. This column shifts focus and provides practical steps toward protecting a written operating agreement from claims of oral or implied-in-fact modification. Such claims undercut the purpose of “reducing the agreement to writing,” replacing definiteness with uncertainty and substituting swearing matches for the written word. See, e.g., *Laurel Hill Advisory Grp., LLC v. Am. Stock Transfer & Tr. Co., LLC*, 112 A.D.3d 486, 486, 977 N.Y.S.2d 213, 214–15 (2013) (“The dispute over the validity of the written agreement and the inconsistent terms between that agreement and the alleged oral agreement raise factual issues that cannot be resolved at this juncture [on a motion to dismiss]”).

**UNDERSTANDING THE CONTEXT—GOVERNING LAW AND CONTRACT LAW**

**The Three Bulwarks from Contract Law: SOF, PER, NOM**

Contract law provides three principal bulwarks to protect written agreements: statutes of frauds, “no oral modification” provisions, and the parol evidence rule. As you will recall, a statute of frauds specifies a type of contract (e.g., “a contract for the sale of goods for the price of $500 or more,” U.C.C. § 2-201) and makes unenforceable an oral agreement of the specified type. For example, *Filippi v. Filippi*, 818 A.2d 608, 618 (R.I. 2003), applied the statute of frauds to an alleged oral agreement to transfer land owned by a limited partnership to one of its partners. Equally important, in most instances and jurisdictions, if a contract is subject to a statute of frauds, the statute will preclude an oral modification unless the modification takes the contract out of statute. Restatement (Second) of Contracts § 149. But see *Grp. Hosp. Servs., Inc. v. One & Two Brookriver Ctr.*, 704 S.W.2d 886, 890 (Tex. App. 1986) (“Not every oral
modification to a contract within the Statute of Frauds is barred. The critical determination is whether the modification *materially* effects [sic] the obligations in the underlying agreements.”) (Emphasis in the original). Judge-made law and some statutes provide exceptions to some statutes of frauds; in most instances reliance is a necessary (though not sufficient) element.

A “no oral modification” (NOM) provision amounts to a statute of frauds adopted by private agreement. Both the phrase and its acronym are misnomers; if the provision is properly drafted, it precludes implied-in-fact modification as well. A better acronym would be WMO—written modifications only.

In any event, “as a general rule, no-oral-modification clauses are disfavored in the law.” *Bank of Am., N.A. v. Corporex Realty & Inv., LLC*, 875 F. Supp. 2d 689, 701 (E.D. Ky. 2012). In the words of Justice Cardozo, “Those who make a contract may unmake it. The clause which forbids a change may be changed like any other. The prohibition of oral waiver may itself be waived.” *Beatty v. Guggenheim Expl. Co.*, 225 N.Y. 380, 387, 122 N.E. 378, 381 (1919) (superseded by statute). We will revisit this disfavor below.

Although the statute of frauds (when applied to modifications) and NOM/WMO provisions both aim at post-formation claims, the parol evidence rule addresses the contract formation process. If a written agreement fully integrates the parties' deal, the rule bars evidence of prior agreements, statements, understandings, etc. if the evidence is offered to vary or contradict the writing.

**Choosing the Governing Law**

Choosing the jurisdiction of formation for a limited liability company chooses the governing law for the internal affairs of the company, and that law includes not only the jurisdiction's LLC statute, but also the jurisdiction's law of contracts. Some LLC statutes are better than others with regard to protecting written operating agreements. The
same is true with regard to the common law of contracts. Thus, protecting the operating agreement begins with choosing the jurisdiction of formation.

The most important criterion is the LLC statute’s approach to NOM/WMO provisions. Some statutes seek to supersede the judicial disfavor. For example, the Uniform Limited Liability Company Act (2006) (Last Amended 2013) (http://uniformlaws.org/Act.aspx?title=Limited%20Liability%20Company%20(2006)%20(Last%20Amended%202013)) supports NOM/WMO provisions in two separate sections. Section 105(a)(4) states that “the operating agreement governs . . . the means and conditions for amending the operating agreement.” Section 107(a) states in relevant part: “An operating agreement may specify that its amendment requires . . . the satisfaction of a condition. An amendment is ineffective if its adoption does not . . . satisfy the specified condition.” An official comment notes, “Because ‘[a]n operating agreement may specify that its amendment requires . . . the satisfaction of a condition,’ an operating agreement can require that any amendment be made through a writing or a record signed by each member.” The Delaware LLC statute has a similar provision. Del. Code Ann. tit. 6, § 18-302(c).

A related criterion is whether the LLC statute ousts the statute of frauds. To the surprise of many practitioners (especially those who “dabble in Delaware (https://businesslawtoday.org/2017/07/dont-dabble-in-delaware/)”), the Delaware statute does exactly that: “A limited liability company agreement is not subject to any statute of frauds . . . .” Del. Code Ann. tit. 6, § 18-101(7). It is thus theoretically possible for a Delaware limited liability company to assert that under an oral term of the company’s operating agreement, a member has transferred to the company title to land, or vice versa. (Delaware enacted this statute to negate a decision of the Delaware Supreme Court applying the one-year provision of the statute of frauds to operating agreements. Olson v. Halvorsen, 986 A.2d 1150, 1161 (Del. 2009). However, a good NOM/WMO provision should cover this problem.)
As to the law of contracts, the most important criterion is whether the jurisdiction follows Williston or Corbin on the parol evidence rule:

Under the restrictive ‘plain meaning’ view [advanced by Williston] of the parol evidence rule, evidence of prior negotiations may be used for interpretation only upon a finding that some language in the contract is unclear, ambiguous, or vague. . . . . Under the view embraced by Professor Corbin and the Second Restatement [of Contracts], there is no need to make a preliminary finding of ambiguity before the judge considers extrinsic evidence.


Secondary criteria include:

- the strength of the judicial antipathy to NOM/OWM provisions and what the law requires to establish waiver in the face of a no-waiver provision. See EWB-I, LLC v. PlazAmericas Mall Texas, LLC, 527 S.W.3d 447, 468 (Tex. App. 2017) (noting the “general view . . . that [a] party to written contract can waive [a] contract provision by conduct despite existence of antiwaiver or failure-to-enforce clause in [the] contract”); and
- whether the jurisdiction treats merger clauses as dispositive.

**DRAFTING TECHNIQUES**

**The Duty to Scriven with Precision**

Clear, comprehensive drafting is important in every term of a written contract, and “the [lawyer’s] duty to scriven with precision,” is enhanced when he or she drafts provisions disfavored by the courts. Willie Gay LLC v. James & Jackson LLC, No. CIV.A. 1781, 2006 WL 75309, at *2 (Del. Ch. Jan. 10, 2006), aff’d, 906 A.2d 76 (Del. 2006). For example, in EWB-I,
LLC v. PlazAmericas Mall Texas, LLC, 527 S.W.3d 447, 468 (Tex. App. 2017), the court considered the following nonwaiver provision:

No delay or omission by any Party hereto in exercising any right or power accruing upon the non-compliance or failure of performance by any other Party under the provisions of this Agreement shall impair any such right or power or be construed to be a waiver thereof. A waiver by any Party of any of the covenants, conditions or agreements herein to be performed by any other Party shall not be construed to be a waiver of any subsequent breach or of any other covenant, condition or agreement herein contained.

(Emphasis added by the court.) Noting that “[t]his nonwaiver clause addresses waiver premised on inaction—the failure to demand that another party comply with contractual requirements”—and that the claim of waiver rested in part on action taken by the other party, the court reversed a summary judgment based on the nonwaiver clause. Id.

In contrast, the Maine Supreme Court approved the following language as sufficient to protect a written lease from parol evidence:

Section 17.06 of the lease addresses integration, providing that “[n]o oral statement or prior written matter shall have any force or effect. [Tenant] agrees that it is not relying on any representations or agreements other than those contained in this Lease. This Lease shall not be modified or cancelled except by writing subscribed by all parties.” Through this unambiguous integration clause, the parties clearly expressed their intention to treat the lease as the complete integration of their agreement. The court therefore correctly concluded that it could not consider evidence extrinsic to that clause in deciding whether the contract was integrated.
Do We Really Want to Exclude Evidence of Course of Dealing/Performance and Usage of Trade?

When writing a NOM/WMO provision, it is worthwhile to consider what to say about course of performance, course of dealing, and usage of trade. A comment to U.C.C. Section 1-303 provides the best explanation for allowing these constructs to affect the words of a contract, no matter how carefully scrivened:

The Uniform Commercial Code rejects both the “laidictionary” and the “conveyancer’s” reading of a commercial agreement. Instead the meaning of the agreement of the parties is to be determined by the language used by them and by their action, read and interpreted in the light of commercial practices and other surrounding circumstances. The measure and background for interpretation are set by the commercial context, which may explain and supplement even the language of a formal or final writing.


However, in the context of an operating agreement, course of dealing and performance are prime targets for a well-drafted NOM/WMO provision. As for usage of trade, the concept is a nonsequitur in a business organization. In a commercial transaction, it makes sense to look at any “practice or method of dealing having such regularity of observance in a place, vocation, or trade as to justify an expectation that it will be observed with respect to the transaction in question,” U.C.C. § 1-303(c). But relations among members of a limited liability company are sui generis—whatever vocation or trade the company pursues.
Think of the Operating Agreement as the Owners’ Manual and Draft Accordingly—in Plain English

Oliver Wendell Holmes taught us that “The life of the law has not been logic; it has been experience.” Oliver Wendell Holmes, Jr., The Common Law (Boston, 1881). Similarly, if experience (conduct) suggests one rule and a writing states another, the deviation threatens the writing. But how often do clients think of an operating agreement (or any other contract) as the relevant rules of the game?

In my experience, seldom. The problem comes from lawyer’s language (and byzantine formulations) that are incomprehensible and therefore alienating to business people. How can a lawyer expect such language to be the ready reference for LLC managers and members?

The solution is to draft operating agreements in language the members can understand and live by. Granted, if the deal is complex, its expression will probably be complex, but business people can understand complex concepts. For example, the business analysis of whether and how to terminate a manufacturing company’s highest volume dealer is as complex as any legal rule (except perhaps for the rule against perpetuities, the rule of 78s, and the Treasury Regulations sections on “substantial economic effect”). In addition, keep in mind the background and training of those who will be reading the language if the operating agreement later becomes an issue in litigation.

Assuming the language of the operating agreement is accessible to the members whose deal it expresses and governs, it is important to teach the client(s) the importance of conforming conduct to language or vice versa. A longstanding deviation evidences a modification implied in fact or a waiver. A good NOM/WMO provision will refer to and reject claims of “agreements implied in fact, whether labeled course of performance, course of dealing, usage of trade, or otherwise, or not labeled at all.” (drafted by the author)
Nonetheless, a sustained, substantial deviation between word and deed invites a court to reject even a well-written NOM/WMO provision. Moreover, the deviation raises the specter of waiver, which is perhaps the most difficult assertion to negate early on in litigation.

**Shift the Burden**

Finally, in addition to a merger provision (parol evidence rule) and a NOM/WMO provision, consider obliging members to speak up before relying on either alleged conversations or patterns of conduct. I offer the following suggestion, based on a model operating agreement drafted some 20+ years ago for the first edition of Bishop & Kleinberger, *Limited Liability Companies: Tax and Business Law*. The language presupposes a well-written merger provision (i.e., “entire agreement” for PER purposes) and an equally well written NOM/WMO provision.

SECTION 3.03. Invalidity and Unreasonableness of Expectations Not Included in This Agreement

(A) The Members fear the uncertainty and the potential for discord that would exist if:

(1) the unstated expectation, expectancy, understanding, or other belief (“expectation of belief”) of one or more Members can be used to gain advantage through litigation; or

(2) an expectation or belief stated or expressed outside the confines of this Agreement can become actionable even though not all Members agree with the expectation or belief or have assented to them and even though some Members have expressed or may harbor conflicting expectations or beliefs.

(B) The Members therefore agree that:

(1) it is unreasonable for any Member to have or rely on an expectation or belief that is not reflected in this Agreement;
any Member who has or develops an expectation or belief contrary to or in addition to the contents of this Agreement has a duty to:

(a) immediately inform [the Managers and] all other Members; and

(b) promptly seek to have this Agreement amended to reflect the expectation or belief;

if a Member who has or develops an expectation or belief contrary to or in addition to the contents of this Agreement neglects or fails to obtain an amendment of this Agreement as provided in Section 3.03(B)(2)(b):

(a) is evidence that the expectation or belief was not reasonable; and

(b) bars the Member from asserting that expectation or belief as a basis for any claim against the Company or any other Member;

no Member has a duty to agree to an amendment proposed under Section 3.03(B)(2)(b) if the Member:

(a) holds an inconsistent expectation or belief, regardless of whether the expectation or belief:

(i) is reasonable; or

(ii) has been previously expressed to the Company or any other member of the Company; or

(b) believes that the amendment is not in the best interests of the Company or is contrary to the legitimate self-interests of the Member, regardless of whether the belief is reasonable.

In the next column, we change gears and consider Remedies – Beginning with the Distinction between Direct and Derivative Claims.
ABOUT THE AUTHOR

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Daniel S. Kleinberger

Education
A.B., 1972, Harvard University
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Mitchell Hamline School of Law: emeritus professor of law, 2015-.

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Like Great Britain, a Limited Liability Company May Have an Unwritten Constitution

Under Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 291 (Del. 1999), the operating agreement is...
From the Uniform Law Commission:  
Delineating the Implied Covenant and Providing for “Good Faith”  

By Daniel S. Kleinberger  

In the March 2017 issue, this column considered the implied contractual covenant of good faith and fair dealing in the context of operating and partnership agreements and compared how the Uniform Limited Liability Company Act (ULLCA) and the Delaware limited liability company act each approach the covenant. Access the article here.

This month’s column considers whether an operating or partnership agreement can delineate the implied contractual obligation, again comparing ULLCA and the Delaware Act, and then warns of the dangers of carelessly imposing by contract an express requirement of “good faith.”

We begin with ULLCA, because the answer to the delineation question appears straightforward under the uniform act. This column quotes from ULLCA (2013), text and comments, but the analysis applies equally to ULLCA (2006), sometimes informally referred to as “RULLCA” or “Re-ULLCA,” and also to ULLCA (1996), the first uniform LLC act.

ULLCA (2013), Section 105(c)(6) states that, while an operating agreement may not “eliminate the contractual obligation of good faith and fair dealing under Section 409(d),” the agreement “may prescribe the standards, if not manifestly unreasonable, by which the performance of the obligation is to be measured.” The official comment provides several examples, including this one:

**EXAMPLE:** The operating agreement of a manager-managed LLC gives the manager “sole discretion” to make various decisions. The agreement further provides: “Whenever this agreement requires or permits a manager to make a decision that has the potential to benefit one class of members to the detriment of another class, the manager complies with Section 409(d) of [this act] if the manager makes the decision with:

a. the honest belief that the decision:
   i. serves the best interests of the LLC; or
   ii. at least does not injure or otherwise disserve those interests; and
b. the reasonable belief that the decision breaches no member’s rights under this agreement.”

This provision “prescribes[s] the standards by which the performance of the [Section 409(d)] obligation is to be measured.”

Under Delaware law, the delineation question requires a different and more complicated analysis. The conceptual answer is “not possible,” but the practical answer is “can do.” Under Delaware law, the implied covenant acts as a special type of “gap filler,” a process of interpolation implied by law: “An implied covenant claim . . . [asks] what the parties would have agreed to themselves had they considered the issue in their original bargaining positions at the time of contracting.” Gerber v. Enter. Prods. Holdings, LLC, 67 A.3d 400, 418 (Del. 2013) (quotation marks and citations omitted).

By its nature, this approach is invariable. The law supplies the gap-filling methodology, which no agreement has the power to change. For instance, an operating agreement may not provide that “a manager’s act in any manner pertaining to this agreement satisfies the implied covenant of good faith and fair dealing if the person asserting a breach of the implied covenant had at the time of contracting reason to know that the agreement could reasonably be interpreted to authorize the act.”

However, a Delaware operating or partnership agreement can reign in the implied covenant by avoiding gaps. Consider the above example from the ULLCA comments, revised as follows:

Whenever this agreement requires or permits a manager to make a decision that has the potential to benefit one class of members to the detriment of another class, the manager complies with Section 409(d) of [this act] if the manager’s decision is binding and breaches no duty to the company or its members if the manager makes the decision with:
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May 2017

The conduct of the Limited Partners in this case does not approach the sort of unreasonable conduct that is necessarily undertaken in bad faith. A test is nevertheless required; the Limited Partners’ conduct must be analyzed under some rubric. . . . The definition prescribed in [Delaware’s Uniform Commercial Code] § 1–201(20) [“honesty in fact and the observance of reasonable commercial standards of fair dealing”] is at least as broad of a definition of good faith as that applied to contracts at common law, and . . . the Limited Partners can meet the [the broader] definition. . . . Thus, the Limited Partners necessarily satisfy Delaware’s common law definition of good faith as applied to contracts, which is the definition of good faith that the Court presumes was adopted in [the limited partnership agreement].

The Delaware Supreme Court flatly rejected the lower’s court methodology, substituting a standard far more easily met. Relying on one of its own decisions, the court held that the limited partners’ “determination will be considered to be in good faith unless the Limited Partners went ‘so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.’”

A graduate of Harvard University (A.B. 1972, summa cum laude) and Yale Law School (J.D. 1979), Daniel S. Kleinberger is Emeritus Professor of Law at Mitchell Hamline School of Law in Saint Paul, MN, where he taught business law for 28 years. Since 1997, Professor Kleinberger has served as Reporter or Co-Reporter for five major projects of the Uniform Law Commission. He serves regularly as theお願い}
as a testifying and consulting expert, as a member of or counsel to special litigation committees, and as special counsel to determine an individual’s right to advances or indemnification. His scholarly work has been cited by the Third, Seventh, Eighth, Tenth, and Eleventh Circuits of the Federal Courts of Appeal, various federal district courts, the New York Court of Appeals, the Supreme Court of Georgia, the Minnesota Supreme Court, the Supreme Court of South Dakota, the Supreme Court of Tennessee, the California Court of Appeals, the New Mexico Court of Appeals, the federal bankruptcy court, and Delaware Court of Chancery, as well as the Restatement of Agency, and the Restatement of Employment Law.
Careful What You Wish For – Freedom of Contract and the Necessity of Careful Scrivening

By: Daniel S. Kleinberger
William Mitchell College of Law
St. Paul, Minnesota

Led by Delaware, a bevy of states have inserted “Contract is God” provisions into their respective LLC statutes. Freedom has its risks, and a trio of recent cases illustrate that “she or he who lives by the contractarian sword can get skewered by that sword” – especially if she or he is a transactional lawyer. This essay first provides some context by recalling a Delaware limited partnership case from 1998 and a Delaware LLC case from 2000 and then recounts and analyzes the trio of recent cases.

“A Rose Is a Rose Is a Rose” But a Cell Phone Might Not Be a Cell Phone

It is fitting to begin with a Delaware limited partnership case, because, as the Delaware Supreme Court has explained, “The Delaware [LLC] Act has been modeled on the popular Delaware LP Act. In fact, its architecture and much of its wording is almost identical to that of the Delaware LP Act. . . . The policy of freedom of contract underlies both the [LLC] Act and the LP Act.”

In 1998, the Delaware Supreme Court decided Cincinnati SMSA Ltd. P’ship v. Cincinnati Bell Cellular Sys. Co., which concerned a limited partnership formed to develop a cell phone business. One partner invested in a competing venture that used “PCS” technology, and the limited partnership cried foul. The limited partnership agreement had specifically defined the partners’ non-compete duties, and – unfortunately for the plaintiff – the agreement phrased those duties in terms of technology rather than markets. The agreement prohibited competition as to cellular service but was silent as to PCS technology.

The plaintiff therefore had recourse to the implied covenant of good faith and fair dealing, which at first thought seems quite plausible. “[T]his implied covenant of good faith and fair dealing 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.”

However, where contract is deity, you shall know the fruit by reading narrowly the words of the contract. “[I]mplying obligations based on the covenant of good faith and fair dealing is a cautious enterprise,” and the implied covenant is not a safety net for less-than-prescient drafting.

In this case, the plaintiff articulates a policy argument, which is cogent at first blush, in support of implying an additional noncompete obligation with respect to PCS. The Limited Partnership sets forth two circumstances underlying its case: (1) the development and licensing of PCS was unforeseen at the time the parties entered into the Agreement; and (2) from a subscriber’s perspective, PCS and “Cellular Service” are indistinguishable.

The Limited Partnership concludes that, based on principles of good faith and fair dealing, partners are also forbidden to compete with the Limited Partnership through independent interests in PCS, even though PCS does not fall within the strict definition of “Cellular Service” in the Agreement. Cogent as this argument might have been ex ante when the Agreement was negotiated, it is not a persuasive argument to vary the Agreement ex post.

7. Id. at 993 (footnote omitted).
Thus the plaintiff lost, because “[i]t is the task of the parties [not the courts] to refashion the agreement to reflect new developments.”8 Translation: if the limited partnership wanted a noncompete based on markets [well, duh], its business people and lawyers should have figured that out and written it down.9

**Walker [not the Texas Ranger], at the Turn of the Century**

In 2000, the Delaware Chancery Court decided a case involving an LLC member’s failure to provide part of the consideration he had promised in return for his membership interest, as well as sundry other misconduct.10 The other three members apparently believed that the failure of consideration warranted cancellation of the membership interest, but the operating agreement did not so provide. The result was a lesson in drafting from the Vice Chancellor and a constructive trust in favor of the miscreant member. “for the expropriation of [his] equity interest.”11

Article X [of the Operating Agreement], does address the voluntary and involuntary withdrawal from membership but identifies no instance even arguably applicable in this case. The absence of such a provision is surprising, considering what the three Bills [the controlling members] knew about Walker [the minority member] at the time they entered into this agreement. They knew that he had embarrassed the company, experienced bouts of drunkenness and alcohol abuse, misrepresented his sophistication in financing transactions and borrowed money from the very person with whom he was supposed to be negotiating on [the company’s] behalf. Most importantly, they knew or had every reason to know that if the Appian deal fell through, they could not rely on Walker to find an alternative source of financing for [the company]. Thus, the three Bills could easily have protected themselves in the Operating Agreement against the failure of negotiations [in the Appian deal] by simply making Walker’s [LLC] interest contingent on successfully closing a deal with Appian. They failed to do so for reasons that are unexplained. Since the Operating Agreement does not justify Walker’s removal, defendants are left to the default rules [which provided no recourse].12

**Case One of the Trio – The Duty to Scriven Carefully**

A more recent Delaware case contains a similar lesson on careful drafting, this time including the elegantly-phrased admonition to “scriven with precision.”13 Willie Gary LLC v. James & Jackson LLC involved an LLC whose operating agreement purported to require the arbitration of disputes pertaining to the operating agreement while also permitting members to bring to court claims for injunctive relief and for dissolution.14 The result was an arbitration provision empty of force, since virtually any contractual dispute can be styled so as to appear to warrant injunctive relief and any serious contractual dispute can justify an attempt to apply the “not reasonably practicable” standard for dissolution.15

The Vice Chancellor was direct in his criticism of the drafting: “With the contractual freedom granted by the LLC Act comes the duty to scriven with precision. Regrettably for J & J [the party seeking to compel arbitration], the drafters of the MBC LLC Agreement crafted an unwieldy dispute resolution scheme that gives parties alleging claims for compulsory relief the right to litigate, rather than arbitrate, their claims.”16

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8 Id. at 993, n.20 (quoting Coca-Cola Bottling Co. of Elizabethtown, Inc. v. The Coca-Cola Co., 988 F.2d 386, 404 (3d Cir. 1993)).
9 The result is even more noteworthy given the court’s delineation of the proper province for using good faith as a gap filler: “where obligations can be understood from the text of a written agreement but have nevertheless been omitted in the literal sense, a court’s inquiry should focus on ‘what the parties likely would have done if they had considered the issue involved.’” Id. at 992 (quoting DuPont v. Pressman, 679 A.2d 436, 443 (Del. 1996)).
11 Id. at 801.
12 Id. at 813-814.
14 Id.
15 Like many LLC statutes, the Delaware LLC Act empowers a court to dissolve a limited liability company “whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement.” Del. Code Ann.tit. 6 § 18-802 (West 2006). For a detailed analysis of this standard, which derives from the Revised Uniform Limited Partnership Act, see CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 9.02[7][a][i].
16 Willie Gary LLC, 2006 WL 75309 at *2. The Vice Chancellor was equally blunt with regard to J & J’s efforts to construe the LLC agreement as permitting resort to the court only if arbitration failed to timely address an urgent situation. He characterized J & J’s argument as “a litigator’s invention that is not supported in any manner by the text of the LLC Agreement.” Id. at *9. See Ishimaru v. Fung, No. Civ.A. 929, 2005 WL 2899680, at *12.
Case Two of the Trio – Is That an Offer in Your Pocket or Are You Just Glad to See Me . . . Go?

Georgia was an early convert to Delaware’s contract-as-deity approach, enacting the “maximum effect” language in 1993.\(^{17}\) Georgia courts take seriously the legislative instruction, and a recent decision by the Georgia Court of Appeals illustrates that in Georgia, as in Delaware:

- “in the alternative entity context, it is frequently impossible to decide fiduciary duty claims without close examination and interpretation of the governing instrument of the entity giving rise to what would be, under default law, a fiduciary relationship”\(^{18}\) and, as result,

- seemingly straightforward provisions in “the governing instrument” can have unanticipated consequences on questions of fiduciary duty.

The case, Ledford v. Smith,\(^{19}\) involved an LLC that had as members both “hands on” folks and a passive investor (Dyna-Vision). The operating agreement labeled the former “Active Members” and contained a provision permitting either the Active Members or Dyna-Vision to trigger a “Mandatory Put and Call” by giving a “Notice of Offer to Sell or Purchase.”\(^{20}\) Under that provision, the Notice had to specify the buy/sell price. Then:

The Members receiving the Notice of Offer to Sell or Purchase shall have thirty (30) calendar days to decide whether to sell all their Interest at that price or to purchase all the Interest of the group giving Notice of Offer to Sell or Purchase at the Price set forth in the Notice of Offer to Sell or Purchase.\(^{21}\)

The Active Members triggered the Mandatory Put and Call, and Dyna-Vision decided to sell. Later, Dyna-Vision learned that, when the Active Members gave the Notice, they had in hand an offer from a third party to purchase the LLC’s assets:

On April 30, 2002, Dyna-Vision and the Active Members closed on the sale of Dyna-Vision’s interest in SHC [the LLC] to the Active Members for $3.5 million, which the Active Members financed with a loan from Peeples [the third party]. On May 7, 2002, SHC sold its assets to PFLC, a company controlled by Peeples. PFLC paid SHC $2.5 million for its assets and Peeples forgave the $3.5 million loan to the Active Members.\(^{22}\)

Naturally, Dyna-Vision cried foul, invoking the affirmative duty of disclosure owed by those in a fiduciary relationship.\(^{23}\) The Court of Appeals said no, giving a narrow reading to an operating agreement provision that required each member to disclose offers to purchase membership units (inapplicable, stated the court, to asset purchase offers)\(^{24}\) and an expansive interpretation to another provision that delineated and restricted the fiduciary duty not to compete.

The latter provision appeared to be a fairly standard, limited authorization to compete:

The Members and their respective Affiliates may engage in all such other business ventures, including without limitation ventures involving the purchase, sale and operation of other businesses, but no Active Member shall engage in businesses similar to the business of the Company by competing with the business of the Company while they are employed with the Company . . .\(^{25}\)

The Court of Appeals, however, read between the lines and discovered a quite unusual ramification:

This provision gave the Active Members wide latitude to engage in all other business activities except those ‘similar to the business of‘ SHC, that is, a ‘competing‘ carpet company. The provision was broad enough to allow the Active Members to negotiate with Peeples for the purpose of obtaining financing to fund their buy-out of Dyna-Vision’s interest in SHC. This activity did not ‘compete’ with SHC; thus, it

\(^{17}\) Charles R. Beaudrot, Jr. and Kendall Houghton, Effective Use of Limited Liability Companies in Georgia: An Overview of Their Characteristics and Advantages, 45 Mercer L. Rev. 25, 29 (1993) (“The first principle that the drafters used in preparing the Georgia statute was to endorse freedom of contract to the fullest extent possible.”).

\(^{18}\) Douzinas v. ABS Nautical Sys., LLC, Nominal Defendant, 888 A.2d 1146, 1149-1150 (Del. Ch. 2006).


\(^{20}\) Id. at 630.

\(^{21}\) Id. at 630.

\(^{22}\) Id. at 633.

\(^{23}\) Id. at 633-635. For a discussion of the duty of disclosure under Delaware law, see BISHOP & KLEINBERGER, supra note 15, at ¶ 14.05[3A].

\(^{24}\) Id. at 633-635.

\(^{25}\) Id. at 631.
did not fall within the exception. Any fiduciary duty of disclosure that the Active Member’s may have owed Dyna-Vision with respect to such a business arrangement was eliminated by the terms of an operating agreement that allowed the business activity which occurred.26

Evidently, the contractual permission to compete with the LLC as a business meant (implicitly) that the members were at arm’s length when deciding who would own the business.

**Case Three of the Trio – The Books Might Be Cooked But At Least the Deal Is Final**

American Anglian Environmental Technologies, L.P. v. Environmental Management Corporation involved a two member LLC with the same type of “buy or sell” provision as was at issue in *Ledford v. Smith.*27 The American Anglian operating agreement “contained a buy/sell provision allowing either [member] to make an unconditional offer/acceptance at a price it chose – forcing the offeree to choose either to buy the offeror’s entire interest, or to sell the offeree’s entire interest.”28

Environmental Management Corporation (EMC) triggered the buy-sell provision, and American Anglian Environmental Technologies (AAET) decided to buy.29 “Throughout the company’s life, EMC managed the financial affairs and day-to-day business operations of the company,” which included maintaining the LLC’s books,30 and after the closing AAET discovered that EMC’s accounting methods violated generally accepted accounting principles. Asserting that the accounting irregularities breached EMT’s duties under the operating agreement and inflated the company’s value by $713,000, AAET sued EMT for damages.31

The Court could have disposed of this claim on causation grounds. Missouri law precludes recovery of damages for “a contingent, speculative possibility”32 and “AAET never state[d] that it would have sold – rather than bought – half of the company [had accurate accounting figures been provided]. AAET’s strongest statement is that it would have ‘considered’ selling.”33

Unfortunately, the Court made this point only as part of a broader pronouncement about “freedom of contract” under the Missouri LLC Act. Invoking “the policy of Missouri [which is] to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements,”34 the Court:

- stated that “[t]he buy/sell provision in the Operating Agreement is intended to achieve finality, expeditiousness, fairness and continuity”35 and
- held that the member’s “requested relief is prohibited by the Operating Agreement [which] provides: once the buy/sell offer is made, it is ‘irrevocable,’ ‘shall not be conditioned on anything,’ and requires no ‘representations and warranties.’”36

In sum, the operating agreement “preempts recalculating the price and ‘other steps’ for relief (other than enforcing the buy/sell provision).”37

It does not seem that AAET accused EMT of acting with *sciente*, and the opinion does not mention that concept. However, read broadly the holding could encompass even active misrepresentation.

**Aesop**

An old man that had travelled a great way under a huge burden of sticks, found himself so weary, that he cast it down, and called upon Death to deliver him from a more miserable life. Death came presently at his call, and asked him his business. Pray good sir, says he, do me but the favour to help me up with my burden again.38

Unbridled fiduciary duty is not exactly a huge burden of sticks, and contract-as-deity is not Death. However, for lawyers drafting operating agreements in a “freedom of contract” regime, Aesop’s fable is worth remembering.

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26 Id. at 636.
28 Id. at 957.
29 Id.
30 Id. at 959.
31 Id. at 957.
32 Id. at 962.
33 Id.
34 Id.
35 Id.
36 Id. at 961-962
37 Id. at 962.
Re: Prior Work Conflict Consent

Dear _____________:

As you know, this firm represents __________________________________________________________________________ (“Client”) in a litigation pending before the __________________________________________________________________________. As we discussed during our teleconference on __________________________________________________________________________, we are required to advise a client if, during a representation, a conflict or potential conflict of interest arises between our firm and the client, so that the client can decide whether to continue the representation. This letter further explains our firm’s potential conflict in handling this matter and seeks your informed consent to the conflict.

Delaware’s Rule of Professional Conduct 1.7(b) states that “[a] lawyer shall not represent a client if the representation of that client may be materially limited by . . . the lawyer’s own interests, unless: (1) the lawyer reasonably believes the representation will not be adversely affected; and (2) the client consents after consultation . . . .” Our firm’s continued representation creates a potential conflict under Rule 1.7(b) because the Court decided that the agreement between Client and counter party is ambiguous on certain material terms and this firm represented Client during its negotiations with counter party and drafted relevant terms of the agreement. The case has now been remanded to the Court for further proceedings and the meaning of those terms drafted by our firm could be the subject of a trial. Litigating issues arising from a law firm’s prior legal work may generate a conflict of interest under the rule when there is a plausible claim that the firm’s prior work was deficient, especially if there are alternative strategies for handling the litigation, and one is better for the law firm and another is better for the client. In that instance, the potential exists that the law firm will pursue the litigation strategy that is better for the firm so as to protect its prior work from blame.

In this situation, it could be argued that the language in the agreement that was drafted by our firm was deficient or inadequate. Theoretically, the firm could handle the litigation so as to minimize that issue. For example, the firm could encourage a settlement to avoid criticism of our work on the agreement.
The most likely alternative to your consent to our continued representation of it in the litigation is that you would need to find and engage new lawyers to handle the litigation.

Although the firm’s handling of this litigation creates a potential conflict, as described above, we do not believe that our commitment, dedication, and ability to effectively represent Client’s interests will be adversely affected by our own interests, and we believe that we will be able to provide you with competent and diligent representation. Nevertheless, in deciding whether to consent to the conflict, you should consider carefully how our prior work for it and our desire to protect our firm’s interests may affect it.

This is an important decision, and we suggest that you consider consulting independent counsel to assist in deciding whether to consent. There is no requirement to do so, and whether Client consults such counsel is its decision.

Please review this matter carefully. If you have any questions that would like me to answer prior to reaching a decision on this issue, please let me know. After appropriate review, if Client is willing to consent to our continued representation of it in this matter, please sign the enclosed copy of this letter in the space provided and return it to me.

Sincerely yours,

Client understands the risks described above and consents to the terms of representation set forth above.

CLIENT

By:____________________________________

Title:____________________________________

Date:____________________________________

12380776
108 A.D.2d 677
Supreme Court, Appellate Division, First Department, New York.

David Hitzig, Plaintiff-Appellant,
v.
Borough–Tel Service, Inc., et al., Defendants-Respondents.


Synopsis
Plaintiff, an officer removed as an officer and employee of corporation, brought action against corporation and other officers and directors. The Supreme Court, New York County, Seymour Schwartz, J., entered an order denying plaintiff's motion for an order for an immediate trial of subject action and a disqualification of law firm representing defendants corporation and other officers and directors, and an appeal was taken. The Supreme Court, Appellate Division held that where member of firm of attorneys representing corporation and officers and directors other than officer who brought suit arising out of his removal as an officer and employee of corporation was himself a party defendant in action and would likely be called to testify as a witness on behalf of his clients, his law firm would be disqualified from continued representation of its clients in action.

Affirmed as modified.

West Headnotes (1)

[1] Attorney and Client Organizations and corporations, employment by or representation of Attorney and Client Acting in different capacities; counsel as witness
Where member of firm of attorneys representing corporation and officers and directors other than officer who brought suit arising out of his removal as an officer and employee of corporation was himself a party defendant in action and would likely be called to testify as a witness on behalf of his clients, law firm would be disqualified from continued representation of its clients in action.

4 Cases that cite this headnote

Attorneys and Law Firms

**542 *677** J.S. Dweck, New York City, for plaintiff-appellant.
P.A. Greenberg, New York City, for defendants-respondents.

Before ROSS, J.P., and BLOOM, FEIN and KASSAL, JJ.

Opinion

MEMORANDUM DECISION.
Order of the Supreme Court, New York County, entered May 11, 1984, denying plaintiff's motion for an order, among other things, for an immediate trial of the subject action and a disqualification of the law firm representing defendants, unanimously modified, on the law and the facts, to direct that the law firm representing defendants be disqualified from further representing them in this action and, except as so modified, affirmed, without costs.

*678* Plaintiff and defendants Barsel and Steinberg were the sole owners of Borough-Tel Service, Inc. Borough-Tel operated a medical house call service under the name of Doctors on Call. By agreement among the parties, plaintiff was designated Chairman of the Board of Borough-Tel while Barsel was named as President and Steinberg as Vice-President. The salaries to be received by each were specified in the agreement.

Plaintiff alleges that on August 3, 1983, at a meeting of the directors called without notice, he was removed “for cause as an officer and employee of Borough-Tel Service, Inc.,” effective as of midnight that day by a majority vote of the Board of Directors. One of the directors who participated in the meeting and voted to oust plaintiff was Philip A. Greenberg, a member of the firm of attorneys representing Borough-Tel and a member of the firm of attorneys representing the defendants in this action. Indeed, as a member of the Board who participated in the meeting, he is a party-defendant in this action.

Disciplinary Rule DR–5–101(B), provides, in pertinent part:

“A lawyer shall not accept employment in contemplated or pending litigation if he knows or it is obvious that he or a lawyer in his firm ought to be called as a witness * * * ”.

Disciplinary Rule DR5–102 provides that an attorney, after undertaking employment in contemplated or pending litigation, ascertains or it becomes obvious that he, or a lawyer in his firm, ought to be called as a witness on behalf of his client or a party other than his client shall withdraw as such attorney.

If nothing else, the various affidavits submitted by Greenberg, both in this action and in at least one other action flowing from Hitzig's discharge, demonstrate that he will be called and, indeed, ought to be called as a witness either for his clients or on behalf of defendant. Furthermore, inasmuch as it is contended that plaintiff's discharge was “for cause” which, inferentially **543** warranted deviation from the express terms of the agreement among the principals of Borough-Tel, it is manifest that Greenberg will, in all probability, be called upon to explain the reason for his actions. In such circumstances, it would be improper for Greenberg, or his firm, to continue to represent defendants (Hempstead Bank v. Reliance Mtg. Corp., 81 A.D.2d 906, 439 N.Y.S.2d 202).

With respect to the request for an immediate trial, plaintiff has shown no greater urgency than exists in the ordinary case. Accordingly, we hold that the branch of the motion seeking that relief was properly denied.

All Citations

108 A.D.2d 677, 485 N.Y.S.2d 541
IN RE: CORPORATE RESOURCE SERVICES, INC., et al., Debtors.
James S. Feltman, Not Individually, But Solely in His Capacity as Chapter
11 Trustee of the Estate of Corporate Resource Services, Inc., et al., Plaintiff,
v.
Staff Management Group LLC and Staff Holding Group
LLC f/k/a Staff Management Group, LLC, Defendants.

Case No. 15–12329 (MG) (Jointly Administered)
| Adv. Pro. No. 16–01199 (MG)
| Signed October 20, 2017

Synopsis
Background: Chapter 11 trustee moved to disqualify attorney and his firm from representing defendants in fraudulent transfer avoidance proceeding.

Holdings: The Bankruptcy Court, Martin Glenn, J., held that:

[1] attorney who had advanced $550,000 of his own money to company as short-term loan, to facilitate company's prepetition purchase of assets from Chapter 11 debtor at heavily discounted price, and who thereafter acquired ownership interest in company, was disqualified from representing company and other defendants in fraudulent transfer avoidance proceeding arising out of purchase transaction;

[2] attorney's conflict had to be imputed, so as to disqualify his firm; and

[3] likelihood that attorney would be called as witness disqualified both attorney and firm.

Motion granted.

West Headnotes (14)

[1] Attorney and Client Disqualification in general
Federal Courts Inherent powers
Federal courts have discretion to disqualify attorneys for ethical violations, a discretion which derives from their inherent power to preserve integrity of adversary process.

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Cases that cite this headnote

In exercising its authority to disqualify attorneys for ethical violations, federal court must be solicitous of client's right freely to choose his counsel, a right which must be balanced against need to maintain the highest standards of the profession.

Cases that cite this headnote

Disqualification of attorney for ethical violations is called for only where attorney's conduct tends to taint the underlying trial; federal and state disciplinary mechanisms suffice for other ethical violations.

Cases that cite this headnote

Federal courts considering motions to disqualify a party's counsel based on his or her ethical violations often benefit from guidance offered by state disciplinary rules, but such rules merely provide general guidance, and not every violation of a disciplinary rule will necessarily lead to disqualification.

Cases that cite this headnote

Attorney and Client ⇐ Disqualification proceedings; standing
While court has discretion to disqualify attorney for unethical conduct, motions to disqualify are disfavored, and a party seeking disqualification must therefore meet a high standard of proof that disqualification is warranted.

Cases that cite this headnote

[6] Attorney and Client ⇐ Disqualification proceedings; standing
Any doubt with respect to whether attorney should be disqualified is to be resolved in favor of disqualification.

Cases that cite this headnote

[7] Attorney and Client ⇐ Representing Adverse Interests
Under New York law, a lawyer's pecuniary interest in subject matter of litigation justifies the lawyer's disqualification. Rules of Prof.Conduct, Rule 1.8(i).

Cases that cite this headnote

[8] Attorney and Client ⇐ Partners and associates
Under New York law, lawyer's conflict, as result of having pecuniary interest in subject matter of litigation, is imputed to other lawyers at law firm where the conflicted lawyer practices. Rules of Prof.Conduct, Rule 1.8(i), 1.10(a).

Cases that cite this headnote

[9] Attorney and Client Disqualification proceedings;standing
Recognizing that the “witness advocate” rule lends itself to opportunistic abuse by opposing counsel, New York courts fairly strictly scrutinize motions to disqualify under this rule, and hold movants to the burden of demonstrating: (1) specifically how and as to what issues client may be prejudiced by testimony of member of its counsel's firm, and (2) that likelihood of prejudice is substantial. Rules of Prof.Conduct, Rule 3.7(b).

Cases that cite this headnote

[10] Attorney and Client Acting in different capacities; counsel as witness
Under New York law, when the party moving to disqualify attorney under “witness advocate” rule intends to call adversary's attorney as a witness, movant must demonstrate both that the attorney's testimony is necessary and that there exists a substantial likelihood that the testimony will be prejudicial to the witness-advocate's client. Rules of Prof.Conduct, Rule 3.7(b).

Cases that cite this headnote

[11] Attorney and Client Acting in different capacities; counsel as witness
Chapter 11 trustee moving to disqualify law firm as attorney for fraudulent transfer defendants, based on fact that he wished to call member of firm as witness, would not be required to demonstrate necessity of attorney's testimony, where trustee was not seeking to call firm member as witness concerning his knowledge in his capacity as attorney, but as investor whose loan to one of fraudulent transfer defendants had facilitated transfer that was the subject of trustee's avoidance claims. Rules of Prof.Conduct, Rule 3.7(b).

Cases that cite this headnote

[12] Attorney and Client Bankruptcy
Attorney who had advanced $550,000 of his own money to company as short-term loan, to facilitate company's prepetition purchase of assets from Chapter 11 debtor at heavily discounted price, and who thereafter acquired ownership interest in company, was disqualified from representing company and other defendants in fraudulent transfer avoidance proceeding arising out of purchase transaction that attorney facilitated; attorney had pecuniary interest in subject matter of litigation. Rules of Prof.Conduct, Rule 1.8(i).

Cases that cite this headnote

Attorney and Client Partners and associates
Attorney's pecuniary interest in subject matter of fraudulent transfer avoidance proceeding, as result of his having advanced funds to allow one of defendants to participate in purchase
transaction that was challenged as fraudulent transfer, had to be imputed to other members of attorney's firm and prevented firm from acting as counsel to fraudulent transfer defendants. Rules of Prof.Conduct, Rule 1.8(i).

Cases that cite this headnote

[14] Attorney and Client ⇆ Acting in different capacities; counsel as witness

Attorney who had advanced funds to allow company to participate in purchase transaction that Chapter 11 trustee sought to avoid as constructively fraudulent transfer of debtor's assets, and attorney's law firm, were disqualified from representing fraudulent transfer defendants, based on likelihood that attorney would be called as witness, not to testify concerning his knowledge in his capacity as attorney, but as investor whose loan enabled challenged transfer to occur. Rules of Prof.Conduct, Rule 3.7(a, b).

Cases that cite this headnote

Attorneys and Law Firms


ROBINSON BROG LEINWAND GREENE, GENOVESE & GLUCK P.C., Attorneys for Defendants Staff Management Group LLC and Staff Holding Group LLC, 875 Third Avenue, 9th Floor, New York, NY 10022, By: Fred B. Ringel, Esq., William A. Rome, Esq., Nicholas M. Menasché, Esq.

MEMORANDUM OPINION REGARDING ORDER GRANTING TRUSTEE'S MOTION TO DISQUALIFY ROBINSON BROG AND A. MITCHELL GREENE AS ATTORNEYS FOR DEFENDANTS

MARTIN GLENN, UNITED STATES BANKRUPTCY JUDGE

Disqualification of counsel is never something to be decided lightly, but disqualification of counsel from representing either defendant in this case highlights the risks when a lawyer lends a substantial sum to, and acquires an equity interest in, his client, in a transaction that is at the heart of the litigation that the lawyer and his firm now seeks to defend. Additionally, documents produced in the litigation show that the lawyer is likely to be called as a witness on a material issue that is likely to be adverse to the client, and the lawyer's testimony will be in his capacity as a lender and investor and not solely as a lawyer in the transaction. Those circumstances led the Court to enter an order disqualifying Robinson Brog Leinwand Greene Genovese & Gluck, P.C. (“Robinson Brog,” or the “Firm”) and A. Mitchell Greene (“Greene”) as attorneys for Staff Management Group LLC (“New SMG”) and Staff Holding Group LLC, f/k/a Staff Management Group, LLC (“SMG”) (collectively, the “Defendants”), the Defendants in the above-captioned adversary proceeding (the “Adversary Proceeding”). (See Order Granting Trustee's Motion to Disqualify Robinson Brog and A. Mitchell Greene as Attorneys for Defendants, (“Disqualification Order,” ECF Doc. # 54, dated October 5, 2017.) The order provided that a written opinion further explaining the reasons for the disqualification stated on the record at the hearing would be issued in due course. This Opinion further explains the reasons.
James S. Feltman, the chapter 11 trustee (the “Trustee”) of Corporate Resource Services, Inc., et al. filed a motion to disqualify Robinson Brog and Greene as counsel for defendants in this case. (“Motion,” ECF Doc. # 67.) The Motion is supported by the Declaration of Luke P. Thara (the “Thara Declaration,” ECF Doc. # 68) attaching several exhibits (ECF Doc. ## 68–1–12), including documents produced to the Trustee during discovery in the Adversary Proceeding.

The Motion maintains that, pursuant to Rules 1.8(i), 1.10(a), and 3.7(a) and (b) of the New York Rules of Professional Conduct, Greene and Robinson Brog should be disqualified as attorneys for the Defendants for three independent reasons: (i) Greene holds a proprietary interest in the subject matter of the Adversary Proceeding through his ownership stake in one of the defendants, New SMG, (ii) Greene will likely be called as a witness in the Adversary Proceeding, and (iii) Robinson Brog and Greene's personal connections to the case have caused the attorneys to engage in improper conduct during discovery, including withholding materials supporting the Trustee's claims. (Mot. at 5–6, 8–9.)

The Defendants filed an opposition to the Motion (the “Opposition,” ECF Doc. # 64), asserting that Greene's and Robinson Brog's representation of the Defendants does not violate any of the New York Rules of Professional Conduct, and the Motion is a patent attempt by the Trustee to “eliminate any resistance to [the Trustee's] meritless fraudulent conveyance action, by replacing Defendants' attorneys ....” (Opp. at 5.)

Upon careful consideration of the parties' submissions, and the parties' respective arguments during an October 4, 2017 hearing on the Motion, the Court entered an order on October 5, 2017, granting the Motion. (ECF Doc. # 54.) This Opinion explains the basis for the Court's ruling.

As described in greater detail below, the Court finds that the disqualification of Greene and Robinson Brog is warranted because of Greene's role as a lender to, and an investor in, New SMG to facilitate the very transfer on which the Trustee's claims in the Adversary Proceeding hinge. Greene's pecuniary interest in New SMG warrants his disqualification under New York Rule of Professional Conduct 1.8(i), which prohibits a lawyer from obtaining a financial interest in the subject matter of his client's litigation, and Greene's conflict is imputed to Robinson Brog under New York Rule of Professional Conduct 1.10(a). Moreover, since Greene is likely to be called to testify during the Adversary Proceeding concerning the Transfer as a lender and an investor, his and Robinson Brog's disqualifications are also justified under New York Rule of Professional Conduct 3.7(b), which states that a lawyer may not advocate for a client in a court where, as here, another attorney in his firm will likely be called as a witness on a significant issue, and where the testimony may prejudice the client. For these reasons, and those set forth below, the Court granted the Trustee's Motion.

*783 I. BACKGROUND

A. Procedural Background

1. The Bankruptcy Cases

Some of the Debtors in these chapter 11 cases filed chapter 11 petitions in the U.S. Bankruptcy Court for the Southern District of New York on February 2, 2015 (the “Petition Date”), and other Debtors thereafter filed chapter 11 petitions in the U.S. Bankruptcy Court for the District of Delaware on July 23, 2015. On August 18, 2015, this Court entered an Order Granting Motion to Transfer Venue of Affiliate Cases from
Delaware to New York (Case No. 15–12329, ECF Doc. # 116). The Debtors insolvency proceedings and the appointment of a Chapter 11 Trustee resulted from a major fraud by the Debtors and their principals. Thus, the Trustee and his professionals have undertaken a lengthy investigation of transactions before each of the Debtors filed its bankruptcy petition.

In December 2015 and May 2016, the Trustee, pursuant to Bankruptcy Rule 2004, subpoenaed documents from the Defendants and third parties regarding the Debtors' assets, making broad requests for valuation materials and all documents and communications concerning certain assets purchased from the Debtors, at allegedly bargain prices, before the bankruptcy petitions were filed (the “Rule 2004 Discovery”). (Thara Decl. Exs. 6, 7.) On May 24, 2016, Greene, on behalf of Robinson Brog, filed a notice of appearance in the Debtors' chapter 11 case (Case No. 15–12329, ECF Doc. # 370), and thereafter coordinated responses to the Trustee's discovery requests. (Thara Decl. Ex. 9.)

2. The Adversary Proceeding

On August 23, 2016, the Trustee brought the Adversary Proceeding against the Defendants asserting causes of action under the Bankruptcy Code for fraudulent transfers and temporary disallowance of bankruptcy claims. (ECF Doc. # 1, the “Adversary Complaint.”) The Trustee and the Defendants initially agreed to resolve the Adversary Proceeding through mediation, but the mediation ultimately failed (ECF Doc. # 24 (Report of Mediator) ), and the parties commenced fact discovery. On June 30, 2017, Robinson Brog, on behalf of the Defendants and third party Bond Street, LLC (“Bond Street”), began producing documents to the Trustee. (Mot. at 15; Thara Decl. Ex. 10.)

B. Events Leading to the Motion

1. The Transfer

The Adversary Proceeding centers on an allegedly fraudulent transfer between debtor Diamond Staffing Services, Inc. d/b/a Corporate Resource Services, Inc. (“CRS”) and the Defendants, based on the following factual allegations. On January 31, 2014 (the “Closing Date”), CRS purchased the “Staff Management” name and business, but not its receivables, from SMG for $10 million, with $5 million in cash paid at the Closing Date, and $5 million in an unsecured note payable over twenty-four months. (Adversary Compl. ¶¶ 22–26.) On March 9, 2015, CRS transferred back its Staff Management business to members of SMG, the original sellers of Staff Management, who retook the business operations through the newly-formed entity, New SMG (“the Transfer”). (Id. ¶ 105.) The purchase price of the business operations was $250,000 in cash, and forgiveness of approximately $2.7 million of the unsecured debt that was in default. (Mot. at 12.) According to the Trustee, the inadequate consideration paid for the Transfer represents the sellers' repurchase of the Staff Management business at a bargain-basement price, and the Transfer was fraudulent.

2. Greene's Pecuniary Interest in New SMG and Robinson Brog's Conduct During Discovery

The Trustee did not know of Greene's pecuniary interest in one of the Defendants when this Adversary Proceeding was filed. (Mot. at 7.) Upon review of the document productions during discovery in the Adversary Proceeding, the Trustee learned that in March 2015, before the Closing Date, Greene made a short-term loan of $550,000 to New SMG, and shortly after the Closing Date purchased $250,000 of equity in New SMG. (Thara Decl. Ex. 8.) In addition, according to the Trustee, the productions included numerous
previously-unproduced documents that were responsive to the Rule 2004 Discovery, and that support the Trustee's fraudulent transfer claims, including the allegation that the consideration for the Transfer was insufficient. (Mot. at 15.) The productions included, for example,

1. a summary of the Transfer created eight days before the Closing Date, addressed to Greene and others touting that the assets to be transferred generated approximately $70 million in revenue (Thara Decl. Ex. 1),

2. an admission from a SMG principal four days before the Closing Date, boasting that potential investors in New SMG were paying twenty-cents on the dollar in connection with the Transfer (Thara Decl. Ex. 11), and

3. financial projections describing an estimated value of $10.5 million (Thara Decl. Ex. 8).

In the Motion, the Trustee also claims that during discovery there were numerous “unusual circumstances and inexplicable lapses in [Greene's and Robinson Brog's] judgment.” (Mot. at 8.) The Trustee notes that:

• When the Trustee indicated to Greene that the Trustee might commence an adversary proceeding as a result of the Transfer, Greene made written threats to the Trustee with claims that are contradicted by documents the Defendants provided to the Trustee (Mot. at 10);

• Greene recently claimed that he had no documents concerning his pecuniary interest in New SMG (aside from a handful of documents produced by the Defendants), including no checks, no periodic reports and no loan documents (id. at 10–11); and

• Robinson Brog refused to provide full details concerning Greene's participation in, and lending relationship with, New SMG (id. at 11).

Based on the Trustee's belief that this conduct indicated Robinson Brog's and Greene's personal connection to the facts underlying the Adversary Complaint compromised Greene's and the Firm's exercise of their professional judgment, the Trustee filed the Motion seeking their disqualifications from the case.

II. LEGAL STANDARD

A. Motion to Disqualify

Federal courts have the discretion to disqualify attorneys for ethical violations, “derive[d] from [federal courts'] inherent power to preserve the integrity of the adversary process.” United States v. Prevezon Holdings Ltd., 839 F.3d 227, 241 (2d Cir. 2016) (internal citation and quotation marks omitted); see also United States v. Hammad, 858 F.2d 834, 837 (2d Cir. 1988) (stating that “[t]he federal courts enforce professional responsibility standards pursuant to their general supervisory authority over members of the bar”). “In exercising this power, the Court must be solicitous of a client's right freely to choose his counsel—a right which of course must be balanced against the need to maintain the highest standards of the profession.” Bacote v. Riverbay Corp., 2017 WL 945103, at *785 (S.D.N.Y. Mar. 10, 2017) (internal citation and quotation marks omitted). Thus, disqualification is called for only where “an attorney's conduct tends to taint the underlying trial, because federal and state disciplinary mechanisms suffice for other ethical violations.” Id. (internal citation and quotation marks omitted). Courts considering disqualification motions “often benefit from guidance offered by ... state disciplinary rules, [but] such rules merely provide general guidance and not every violation of a disciplinary rule will necessarily lead to disqualification ....” Hempstead Video, Inc. v. Inc. Vill. of Valley Stream, 409 F.3d 127, 132 (2d Cir. 2005) (internal citations omitted).

B. Pecuniary Conflicts—Rule 1.8(i)
New York Rule of Professional Conduct 1.8(i) prohibits counsel from “acquir[ing] a proprietary interest in the cause of action or subject matter of litigation that the lawyer is conducting for a client.” 22 N.Y.C.R.R. § 1200, Rule 1.8(i). Comments on Rule 1.8(i) make clear that “a lawyer should not acquire property rights that would adversely affect the lawyer’s professional judgment in representing the client.” New York State Bar Association, New York Rules of Professional Conduct With Commentary, available at http://www.nysba.org/WorkArea/DownloadAsset.aspx?id=5067 (as amended Jan. 1, 2017). The rule reflects a well-established principle in New York predating the New York Rules of Professional Conduct, that it is ethically suspect and generally unwise for attorneys to engage in business relationships with clients. See Balestriere PLLC v. CMA Trading, Inc., 2014 WL 7404068, at *12 n.17 (S.D.N.Y. Dec. 31, 2014) (disqualifying an attorney who had an incorporation agreement with his client that provided him with an option to loan the client funds and entitled him to 40% of the client’s revenues, and noting that “it is obvious that [the attorney] has a significant proprietary interest in this action and the subject matter underlying it”); Norma Brothers & Manheimer Corp. v. Earl’s Fashions, Inc., 1984 WL 166, at *2 (S.D.N.Y. Apr. 12, 1984) (applying Disciplinary Rule 5–103(A) to disqualify a lawyer who was an assignee of the accounts receivable on which the litigation was based because he would benefit monetarily from a judgment in favor of his client).

C. Imputation of Pecuniary Conflicts—Rule 1.10(a)
Under Rule 1.10(a) of the New York Rules of Professional Conduct, a lawyer’s conflict under Rule 1.8(i) is imputed to other lawyers at the law firm where the conflicted lawyer practices. The Rule states that “[w]hile lawyers are associated at a firm, none of them shall knowingly represent a client when one of them doing so practicing alone would be prohibited from doing so by Rule 1.7, 1.8, or 1.9 ....” 22 N.Y.C.R.R. § 1200, Rule 1.10(a). According to Rule 1.10(a)'s commentators, the rule is premised on the belief that “a firm of lawyers is essentially one lawyer for purposes of the rules governing loyalty to the client” or the premise that “each lawyer is vicariously bound by the obligation of loyalty owed by each lawyer with whom the
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D. Witness Advocate Rule—Rule 3.7

Rule 3.7(a) of the New York Rules of Professional Conduct, which codifies the well-established “witness advocate rule,” prohibits an attorney from acting “as an advocate before a tribunal in a matter in which the lawyer is likely to be a witness on a significant issue of fact.” 22 N.Y.C.R.R. 1200, Rule 3.7(a). Rule 3.7(b) goes a step further, and imputes a lawyer-witness's conflict to other lawyers at the lawyer's firm: “[a] lawyer may not act as an advocate before a tribunal” where “another lawyer in the lawyer's firm is likely to be called as a witness on a significant issue other than on behalf of the client” and “it is apparent that the testimony may be prejudicial to the client.” Id., Rule 3.7(b).

[9] [10] [11] New York courts have noted that the witness advocate rule lends itself to opportunistic abuse by opposing counsel, and have applied “fairly strict scrutiny” to motions to disqualify under the Rule 3.7, holding that the movant “bears the burden of demonstrating specifically how and as to what issues in the case the prejudice may occur and that the likelihood of prejudice occurring [to the witness-advocate's client] is substantial.” Bacote, 2017 WL 945103, at *6 (citing Murray v. Metro. Life Ins. Co., 583 F.3d 173, 178 (2d Cir. 2009)). “Prejudice” means testimony that is “sufficiently adverse to the factual assertions or account of events offered on behalf of the client, such that the bar or the client might *787 have an interest in the lawyer's independence in discrediting that testimony.” Id. Thus, when the party moving for disqualification intends to call the adversary's attorney as a witness, “the movant must demonstrate both that the lawyer's testimony is necessary and that there exists a substantial likelihood that the testimony would be prejudicial to the witness-advocate's client.” Bell, 2017 WL 4296781, at *3 (internal citation and quotation marks omitted). Here, this Court is loath to require the Trustee to show that Greene's testimony is necessary, as cases applying the “necessary” requirement generally deal with situations in which a lawyer is being called by an adversary as a witness to testify as a lawyer qua lawyer, in other words, concerning his knowledge in his capacity as an attorney. See, e.g., Paramount Commc'ns, Inc. v. Donaghy, 858 F.Supp. 391, 398 (S.D.N.Y.1994) (holding that where an attorney's advice to a client was relevant to the suit, disqualification of the attorney in order to allow the attorney to testify regarding that advice was unnecessary where the client could also testify to the advice). In those instances, the “necessary” requirement insures that a lawyer will not be disqualified merely because he is being called as a witness concerning knowledge about subject matter others can similarly testify about. But here, the testifying lawyer would be testifying in his capacity as a fact witness (i.e., in his capacity as a lender and an investor), and should therefore not be permitted to evade disqualification on the basis that he also wore the hat of attorney in the transaction about which he will testify. “For more than three centuries it has now been recognized as a fundamental maxim that the public ... has a right to every man's evidence.” Jaffee v. Redmond, 518 U.S. 1, 9, 116 S.Ct. 1923, 135 L.Ed.2d 337 (1996) (internal quotation marks and citations omitted). A lawyer testifying as a fact witness is not entitled to any special treatment or protection from being called as a fact witness that the “necessary” standard would afford.

III. DISCUSSION

The Court is sensitive to the Defendants' right to choose their own counsel, but Greene's personal involvement in the Transfer underlying this Adversary Proceeding amounts to one of the infrequent instances where the attorney's representation of his client presents a significant risk of trial taint. The Court finds that the Trustee has met his burden in establishing that there are at least two grounds warranting Greene's and Robinson Brog's disqualifications. Since Greene's financial interest will be directly impacted by
the outcome of the Adversary Proceeding, he holds a pecuniary stake in the outcome of the case warranting both his disqualification under Rule 1.8(i) and Robinson Brogs's disqualification under Rule 1.10(a). The Court further finds that Greene's and Robinson Brogs' disqualifications are independently warranted under Rule 3.7(b). While Greene's deposition has not yet been taken in this case, documents provided to the Court in connection with the Motion support that Greene will likely be called to testify concerning his role as a lender and investor in New SMG, and there is a substantial likelihood his testimony would be prejudicial to the Defendants.

A. Greene is Disqualified Pursuant to Rule 1.8(i) Because of His Proprietary Interest in the Subject Matter of the Adversary Proceeding
[12] Greene's approximate 4% ownership stake in New SMG warrants his disqualification under Rule 1.8(i). There is no dispute that Greene advanced $550,000 of his own money to make a short-term loan to New SMG to facilitate the Transfer, purchased an ownership stake in New SMG, and continues to own New SMG equity. (10/5 Hearing Tr. 10:9–12; 28:5–16, ECF Doc. # 71.) Since the outcome of the Adversary Proceeding will necessarily impact directly Greene's personal financial interest, Greene has “acquire[d] a proprietary interest in the ... subject matter of litigation that [Greene] is conducting for [the Defendants],” barring his representation of the Defendants under Rule 1.8(i). See, e.g., Peggy Walz, Inc., 1996 WL 88556, at *2 (disqualifying an attorney who had an incorporation agreement with his client that provided him with an option to loan the client funds and entitled him to 40% of revenues, and noting that “it is obvious that [the attorney] has a significant proprietary interest in this action and the subject matter underlying it”). Disqualification to prevent Greene's “property rights” and “self interest” from affecting his “exercise of independent [and] professional judgment” (see Rule 1.8(i), cmt. 3A) applies with great force here, where Greene's conduct during discovery appears to have already borne out the risks of an attorney whose personal interests are at stake in a litigation. For example, Roninson Brog has improperly withheld documents throughout discovery, has made several threats to the Trustee, and has withheld critical information about Greene's interest in the Transfer. (Mot. at 17.) As the Court noted during the October 4, 2017 hearing on the Motion, the Court did not base its disqualification decision on the discovery disputes raised by the parties (10/5 Hearing Tr. 26:19–21, ECF Doc. # 71), but these lapses in judgment during discovery nonetheless indicate that Greene's personal involvement in the Transfer presents the risk of trial taint.

Robinson Brog's assertions that Greene should not be disqualified because (i) at the time of the Transfer Greene represented third-party Bond Street and not New SMG, (ii) Greene's loan and purchase of equity occurred before Robinson Brog represented New SMG in the Adversary Proceeding, and (iii) Greene will not serve as trial counsel for New SMG (Opp. at 19–22) are beside the point and belied by the text of Rule 1.8(i). The drafters of Rule 1.8 did not limit its application to trial counsel, and the rule provides guidance with respect to conflicts that arise with *current* clients (indeed, the title of Rule 1.8 is “Current Clients: Specific Conflict of Interest Rules”). The inquiry for the Court is thus whether an attorney's interests are currently conflicted by a pecuniary interest. Here, since Greene *currently* represents the Defendants, and *currently* holds equity in a Defendant, his interests are conflicted under the rule.

B. Robinson Brog is Disqualified Pursuant to Rule 1.10(a) Because Greene's Rule 1.8(i) Conflict is Imputed to Robinson Brog
[13] Greene's conflict is imputed to Robinson Brog under Rule 1.10(a), which explicitly states that “[w]hile lawyers are associated at a firm, none of them shall knowingly represent a client when one of them doing so practicing alone would be prohibited from doing so by ... Rule 1.8[,]” 22 N.Y.C.R.R. § 1200, Rule 1.10(a). Application of this rule is especially appropriate here because there is a significant risk that other attorneys at Robinson Brog may feel undue pressure during their representation of the Defendants to remain loyal to Greene, given Greene's prominent role at Robinson Brog as a member of the Firm's Board and its Executive
Committee. See, e.g., Cohen v. Strouch, 2011 WL 1143067, at *2 (S.D.N.Y. Mar. 24, 2011) (explaining that “[w]hen a conflict of interest is found, an attorney's conflicts are ordinarily imputed to his firm based on the presumption that associated attorneys share client confidences”) (internal citation and quotation marks omitted). This concern is magnified by the fact that Greene's own conduct is implicated in the Adversary Proceeding, and others in the firm could be called upon to testify about documents that Greene received, such as the summary of the Transfer sent to Greene, stating that the business assets to be transferred generated approximately $70 million in revenue. (Thara Decl. Ex. 1.)

C. Greene and Robinson Brog are Disqualified Pursuant to Rule 3.7

The disqualifications of Greene and Robinson Brog are also appropriate for the independent reason that there is a substantial likelihood that Greene will be called upon to testify in the Adversary Proceeding concerning the Transfer, and that his testimony will be prejudicial to the Defendants. Rule 3.7(a) states that “[a] lawyer shall not act as an advocate before a tribunal in a matter in which the lawyer is likely to be a witness on a significant issue of fact.” 22 N.Y.C.R.R. § 1200, Rule 3.7(a). Here, Greene will likely be a witness on a central factual issue in the Adversary Proceeding: whether the consideration for the Transfer was adequate. For example, the Defendants may argue that the value of the business assets transferred declined before the closing of the Transaction, and Greene may be called to testify concerning why he nevertheless chose to provide a loan to facilitate the Transfer. Robinson Brog's argument that Greene is not trial counsel in the Adversary Proceeding fails because the rule does not specify that the conflict is limited to trial counsel, and, as Robinson Brog itself acknowledges, Rule 3.7 is designed to protect against the concern that “the lawyer's testimony might place opposing counsel in a difficult position when she has to cross-examine her lawyer-adversary and attempt to impeach his credibility,” a concern that would likely be present here Murray, 583 F.3d at 178 (citations omitted), a concern that would likely be present here. Robinson Brog's argument that Greene's testimony will not be harmful to the Firm's client likewise fails. Robinson Brog asserts that Greene's testimony would benefit the client because “at the time of the ... Transaction, the assets were worth very little and the purchase price reflected that. Greene's loan helped the new entity–SMG–repair the damage wrought by CRS's mismanagement and tax evasion, and his investment reflected confidence in the new management team.” (Opp. at 25.) But since the Trustee contends that Greene improperly withheld documents concerning SMG's contemporaneous opinion of the Transfer (Mot. at 9), Greene may be asked to testify regarding why these documents were withheld, and more importantly, will likely be called to testify about the content of the documents themselves, as he is a recipient of at least one of the documents which appears to support the Trustee's claim that the sale was at a bargain price (i.e., a summary of the Transfer addressed to Greene by an SMG principal eight days before the Transaction closed). Understanding that New York courts apply “fairly strict scrutiny” to disqualification motions under Rule 3.7, the Court nevertheless finds that disqualification is warranted because Greene's role as a likely fact witness in this case presents a significant risk of prejudice to the Defendants, and of trial taint.

IV. CONCLUSION

For the reasons discussed above, the Court previously granted the Trustee's Motion to disqualify Greene and Robinson Brog as attorneys for the Defendants in this Adversary Proceeding.

On October 18, 2017, Robinson Brog and Greene moved for a stay of the Disqualification Order pending appeal. (ECF Doc. # 73.) The Court believes that the appeal lacks merit and a stay will delay the progress of this case. Under the current Seventh Amended Case Management and Scheduling Order, fact discovery is scheduled to be completed by November 17, 2017. (ECF Doc. # 40, ¶ 1(a).) Some extension of discovery may be required to permit new counsel to get up-to-speed, but further delay would prejudice the
Trustee in seeking expeditiously to resolve this adversary proceeding. The Court will nevertheless stay the disqualification order for a period of seven (7) days from the date of this Opinion to permit the disqualified counsel to apply to the District Court for a further stay.

With respect to the stay motion (ECF Doc. # 73), IT IS HEREBY ORDERED that the Court grants a seven (7) day stay of the Disqualification Order from the date of this Opinion.

All Citations


Footnotes

1 The Debtors in these chapter 11 cases are: (1) Corporate Resource Services, Inc.; (2) Accountabilities, Inc.; (3) Corporate Resource Development, Inc.; (4) Diamond Staffing Services, Inc.; (5) Insurance Overload Services, Inc.; (6) Integrated Consulting Services, Inc.; (7) The CRS Group, Inc.; and (8) TS Staffing Services, Inc.

2 The Trustee notes that, in addition to holding equity in one of the Defendants, Greene is also personally connected to the Adversary Proceeding because his brother, Eugene Greene, is a principal of New SMG. (Mot. at 5.)

3 Attorneys arguing in this Court must abide by the New York State Rules of Professional Conduct, 22 N.Y.C.R.R. § 1200, which replaced the old Canons and Disciplinary Rules that were formerly in place in the State of New York. See S.D.N.Y. Local Rule 1.3. The New York Rules of Professional Conduct were revised and implemented on April 1, 2009.
On August 22, 1995, plaintiff J.E. Rhoads & Sons, Inc. (the “Corporation” or “Rhoads & Son”) filed a complaint seeking injunctive relief from this Court against defendants Kevin Wooters (“Wooters”) and Richard Miller (“Miller,” collectively, “Wooters and Miller” or the “Defendants”). Wooters and Miller retained the law firm Prickett, Jones, Elliott, Kristol and Schnee (“Prickett Jones”) to represent them in this matter. The Corporation, however, asks this Court to disqualify Prickett Jones from representing Wooters and Miller in this suit because Prickett Jones previously represented the Corporation. Specifically, the Corporation alleges that Prickett Jones represented the Corporation as its primary outside counsel for 20 years. As such, Prickett Jones represented the Corporation in connection with Mr. Robert VanVolkenburgh’s (“VanVolkenburgh”) acquisition of the Corporation. The Corporation contends that a key issue in its suit for injunctive relief is whether the parties executed employment agreements in connection with the acquisition and, if so, what these agreements require.

I heard oral argument on the motion on January 23, 1996. This is my decision on the Corporation's motion to disqualify.

I. BACKGROUND FACTS

The parties differ as to many of the underlying facts in this matter. The parties agree, however, that Prickett Jones served as the Corporation's primary outside counsel for over 20 years, through December of 1993. The Corporation, a manufacturer of commercial belting systems, last retained Prickett Jones in 1993 to facilitate VanVolkenburgh's purchase of the Corporation's stock from its previous owner, Mr. John P.
McGough ("McGough"). In this capacity, Prickett Jones (1) provided VanVolkenburgh a legal opinion as to the corporate status of the Corporation; (2) gave advice to the directors and shareholders of the Corporation with respect to the sale; and (3) gave advice to Wooters and Miller with respect to negotiating an employment agreement with the Corporation under its new ownership. Thus, in its capacity as counsel to the Corporation, Prickett Jones provided legal services to each of the parties involved in this dispute. Moreover, although VanVolkenburgh consulted with other attorneys, the Prickett Jones' attorneys appear to have been the attorneys that facilitated the transaction. The Prickett Jones attorneys did not draft the original agreements. However, besides negotiating the agreements, they “swapped drafts” of the agreements and “hammered out the final language” contained in the agreements. Prickett Jones claims that McGough “insisted” that Prickett Jones represent Wooters and Miller in the employment agreement negotiation. Prickett Jones, however, billed the Corporation for these services.

Additionally, McGough, as president of the Corporation at the time of these negotiations, claims to have waived any conflict of interest between the Corporation and Wooters and Miller. However, Prickett Jones has not provided this Court a copy of signed waiver so that the Court may evaluate what conflict of interest McGough waived. Notably, McGough indicated in his deposition that he never contemplated a future conflict when he consented to Prickett Jones' joint representation of the parties to the transaction. Thus, according to the record before the Court, even if McGough consented to Prickett Jones jointly representing the parties in facilitating the change of control on behalf of Corporation, McGough did not consent to Prickett Jones' representation of Miller and Wooters in future litigation between the parties. Further, VanVolkenburgh never consented to Prickett Jones' representation of Wooters and Miller either in an individual capacity during the change of control transaction, or as a representative of the Corporation in the current litigation.

In 1995, Wooters and Miller left the Corporation's employ and, in a companion case to this suit, sued the Corporation for, in part, breaching employment contracts negotiated as part of the sale of the Corporation. The Corporation claims that it never signed these agreements and that it is not bound by their terms. The Corporation filed a counterclaim in Superior Court against Wooters and Miller seeking damages. In addition to the Superior Court action, the Corporation seeks injunctive relief from this Court. The Corporation asks this Court to preclude Wooters and Miller from improperly competing with the Corporation. In its Chancery Court complaint, the Corporation denies that the employment agreements are valid. However, in the event that the Court decides that the employment agreements are binding as a matter of law, then, the Corporation argues, the agreements preclude Wooters and Miller from soliciting the Corporation's customers. Therefore, the Corporation also requests injunctive relief on the basis of the employment contracts if the Court determines that those contracts are, in fact, binding.

Given these essential facts, the Corporation argues that this Court should disqualify Prickett Jones from representing Wooters and Miller. In the Corporation's view, Prickett Jones may violate Rules 1.9 and 3.7 of the Delaware Lawyers' Rules of Professional Conduct (the “Rules”) by representing Wooters and Miller in the current litigation. Therefore, the Corporation contends that this Court should require Prickett Jones to withdraw from the present case.

II. Rule 1.9: CONFLICT OF INTEREST: FORMER CLIENT

Rule 1.9 states:
A lawyer who has formerly represented a client in a matter shall not thereafter:

(a) represent another person in the same or a substantially related matter in which that person's interest are materially adverse to the interest of the former client unless the former client consents after consultation.

Rule 1.9 (emphasis added). Delaware Courts have found the following substantial relationship test helpful in determining whether the moving party has demonstrated that a current piece of litigation is substantially related to the prior representation:

1. What is the nature and scope of the prior representation?

2. What is the nature of the present lawsuit against the former client?

3. In the prior representation, might the client have disclosed to the attorney a confidence which could be relevant to the present action. If so, could those confidences be detrimental to the former client in the current litigation.


A. The Arguments

Citing Rule 1.9, the Corporation argues that Prickett Jones may not represent Miller and Wooters in the current litigation. First, the Corporation asserts that Prickett Jones represented the Corporation and each of the parties involved in the sale of control transaction. Next, the Corporation contends the litigation here, with respect to the existence and interpretation of employment contracts, is substantially related to this sale of control transaction. Because of this substantial relationship and the fact that the Corporation has not consented to Prickett Jones' current representation of Wooters and Miller in this litigation, the Corporation insists that Prickett Jones cannot represent Wooters and Miller against the Corporation in this litigation.

*3 Defendants, on the other hand, deny that Prickett Jones' former representation of the Corporation places Prickett Jones in a conflict of interest. Primarily, Wooters and Miller contend that the current litigation is not substantially related to the matters in which Prickett Jones represented the Corporation. First, Defendants deny that Prickett Jones represented the Corporation in connection with the employment agreements. Instead, they argue that Prickett Jones only represented the Corporation with respect to giving advice to the directors and shareholders prior to the sale, and by issuing a legal opinion to VanVolkenburgh on behalf of the Corporation. With respect to the employment contracts, Defendants suggest, Prickett Jones represented only Wooters and Miller. Further, they believe that the Corporation consented to this bifurcated arrangement. Moreover, Defendants argue that this case is only superficially related to the 1993 acquisition. Defendants note that the breaches of contract in question occurred after Prickett Jones ceased representing the Corporation. Additionally, Defendants argue that Prickett Jones did not obtain any confidential communication from the Corporation that is relevant to this case in spite of the fact that it represented the Corporation in the 1993 sale of control.

In response, the Corporation states that Prickett Jones clearly represented all the parties in the 1993 acquisition. McGough testified that Mr. Grey gave legal advice “to all of us so that this contract could be squared away and so that we could sign the Stock Purchase Agreement.” Pl. Rep. Br. at 8. In the Corporation's view, the employment contracts that are at issue in the current litigation were a part of the overall negotiations in the 1993 acquisition so that the Defendants are “splitting hairs” by suggesting that
Prickett Jones could represent the Defendants, alone, with respect to the employment contracts. Since the present litigation involves those contracts, and some Prickett Jones' lawyers would have been privy to all of the Corporation's private information by virtue of Prickett Jones longstanding representation of Rhoads & Son, the Corporation asserts that this Court must disqualify Prickett Jones.

B. Discussion
The substantial relationship test provides the framework for determining whether a conflict of interest exists for purposes of Rule 1.9. First, as to the nature and scope of the prior representation, Prickett Jones previously represented the Corporation for 20 years. Thus, Prickett Jones represented the Corporation on a wide scope of matters and had access to a great deal of information about the Corporation. More specifically, McGough retained Prickett Jones to represent “all of us” in the sale of the Corporation to VanVolkenburgh. As a part of that representation, Prickett Jones also counseled Wooters and Miller as they negotiated over the employment contracts. Thus, at the very least, Prickett Jones acted as an intermediary for each of the parties regarding the sale of control. Further, they redrafted and “hammered” out the final language of the employment agreement.

As to the nature of the current litigation, it involves several of the same parties to the sale transaction and several causes of action. In one of these claims, the Corporation asks for relief based upon the employment contract negotiated at the time of the acquisition if the Court finds that a binding employment agreement existed. Clearly, then, the current litigation is substantially related to matters in which Prickett Jones previously counseled the Corporation and acted as an intermediary for all parties. The Defendants' characterization of the relationship between the previous litigation and the present case as superficial is not persuasive. Nor is Prickett Jones' attempt to bifurcate their representation between the parties helpful.

As to potential confidential and detrimental communications, one must note that Prickett Jones seemingly provided legal services to all sides to the acquisition in some capacity. Because those parties were not in an adversarial position at the time they completed the sale, one can easily conceive that the Corporation or McGough may have disclosed to Prickett Jones a confidence which could be relevant to the present action as well as detrimental to the Corporation in the current litigation. Delaware's Federal District Court analyzed the confidential communications factor in *Webb v. E.I. Du Pont De Nemours & Co. Inc.*, D. Del., 811 F. Supp. 158 (1992). There, the Court discussed the issue of confidential communications where an attorney who worked for Du Pont for 27 years attempted to represent a client against Du Pont:

> One of the major concerns of Rule 1.9 is, ..., the unfair advantage that a lawyer may take of his former client. In the case at hand there is no question that Mr. Stull was involved in a substantially related matter while working for Du Pont, since he drafted the very documents he is now offering in evidence against Du Pont. It is immaterial that those documents would be available to any attorney in discovery. Rule 1.9(a) is *not directed to the documents but to the representation in general*. Plaintiff's attorney is *not any attorney*. He has been employed as an attorney for Du Pont for 27 years....

*Id.* at 162. The Court noted that the conflict problem is not simply a matter of whether an attorney will make use of confidential communications, but rather that because of the prior representation, the attorney knows “what to ask for in discovery, which witnesses to seek to depose, what questions to ask them, what lines of attack to abandon and what lines to pursue, what settlements to accept and what offers to reject....”
Id. (citing Ullrich v. Hearst Corp., 809 F. Supp. 229, 235-6 (S.D.N.Y. 1992). Obviously, the Corporation faces these potential prejudices if Prickett Jones continues to represent Wooters and Miller in this case.

Moreover, this case is similar to Audio Jam, Inc. v. Fazelli, Del. Ch., C.A. No. 14368, Chandler, V.C. (Aug. 17, 1995). In Audio Jam, the lawyer previously acted as an intermediary by facilitating a transaction with the same parties involved in the current litigation. In facilitating the past transaction, the lawyer drafted a shareholder agreement and provided advice to each of the parties. When a conflict arose between the parties, one of those parties retained the lawyer as counsel. That litigation, however, involved the very transaction in which the lawyer was the intermediary. Thus, the Court disqualified the lawyer. Id. at 5.

*5 Perhaps Prickett Jones may represent Wooters and Miller in a host of other situations without placing the law firm in a conflict of interest. In the present case, however, a conflict or the appearance of a conflict arises. Notably, Prickett Jones provided legal services to the Corporation for many years. More importantly, the current litigation is substantially related to a facet of Prickett Jones' previous representation of the parties. At the least, Prickett Jones acted as an intermediary between the very parties that now are in materially adverse positions as to the transaction. Thus, I conclude that in the current situation, absent waiver, Prickett Jones places itself in a conflict of interest by representing Wooters and Miller in the current litigation.

C. Waiver

Next, Defendants suggest that the Corporation, via McGough, did in fact consent to Prickett Jones representing Wooters and Miller. Although Prickett Jones has not produced a signed waiver, the firm contends that Walter P. McEvilly, Jr., Esquire, apprised McGough of the risks involved in joint representation.

The Corporation responds by emphasizing McGough's testimony which indicates that when McGough consented to Prickett Jones representing Wooters and Miller, McGough did not consider what would occur if the parties became adversaries at a later time. Thus, in the Corporation's view, it is unreasonable to assume that the original consent effectively waived the conflict of interest raised by this litigation.

Although clients may waive disqualification of their attorneys in subsequent litigation, waiver is not effective unless the attorney discloses his intended role on behalf of the new clients. See Comment to Rule 1.9. Defendants do not suggest that the Corporation consented to Prickett Jones representation in the current litigation. Nor do they suggest that Mr. McEvilly disclosed Prickett Jones' specific role in the situation at hand. Moreover, McGough, whom Prickett Jones believes provided the Corporation's waiver, testified that when he gave his consent to Prickett Jones representing Wooters and Miller, he did not consent to their representation in the future. Instead, he stated that he never contemplated such a situation. Thus, I find that McGough did not give the Corporation's consent to Prickett Jones' representation of Wooters and Miller in the current litigation.

This Court has the authority to regulate the conduct of the attorneys who appear before it and may disqualify those that violate the Rules. In re Estate of Waters, Del. Supr., 647 A.2d 1091 (1994); In re Appeal of Infotechnology, Inc., Del. Supr., 582 A.2d 215, 216 (1990). While courts generally prefer to allow litigants to retain the lawyers of their choice, courts should not allow litigants to prejudice the integrity of the judicial process. Scott v. New Drug Services, Inc., Del. Ch., C.A. No. 11336, Allen C. (Sept. 6, 1990), Letter. Op. at 6. This Court recognizes that law firms routinely counsel all parties to a transaction when those parties choose to retain a single firm because of cost and convenience. However, if a conflict between the parties arises which involves the documents from the original transaction, then that law firm best serves the legal system if it heeds Canon 9 and avoids “even the appearance of impropriety.” Since the Corporation has
demonstrated that the current litigation is substantially related to the transaction in which Prickett Jones previously represented the Corporation, I grant the Corporation's motion to disqualify Prickett Jones from representing Wooters and Miller in the current litigation.

III. CONCLUSION

*6 Because the current litigation is substantially related to Prickett Jones' previous representation of the parties in the 1993 acquisition, I grant the Corporation's motion to disqualify. Thus, I do not find it necessary to address the question of whether Rule 3.7 also precludes Prickett Jones from representing Wooters and Miller in this matter. 5

Accordingly, Prickett Jones shall withdraw from representing Wooters and Miller further in this litigation. I expect Defendants to retain alternative counsel in a timely manner. After they have done so, counsel should agree on a briefing schedule for the preliminary injunction motion as well as a case management scheduling order.

IT IS SO ORDERED.

All Citations

Not Reported in A.2d, 1996 WL 41162

Footnotes

1 The parties disagree as to whether Prickett Jones represented all parties in each of the transactions. VanVolkenburg, and to some extent McGough, appear to believe that Prickett Jones provided services to all of the parties to the transaction. Prickett Jones, however, argues that they provided individual services for various entities involved in the sale. For example, Prickett Jones contends that they did not represent VanVolkenburg in any way, while Mr. VanVolkenburgh alleges that they did because he was responsible for part of the legal fees. Additionally, Prickett Jones contends that it represented only Wooters and Miller with respect to the employment agreement negotiations, whereas VanVolkenburg and McGough appear to believe that Prickett Jones represented all parties.

   During the oral argument, Defendants' counsel argued, for the first time, that they represented only the "sellers" in the sale transaction. The record, however, does not support this assertion.

2 Mr. Howard Kelly was also involved in the transaction, but Mr. Kelly is a business broker rather than an attorney.

3 Apparently, Mr. McGough paid a portion of the bill that Prickett Jones addressed to the Corporation.

4 The complaint contains numerous other counts, several of which request equitable remedies.

5 Defendants suggest that Judge Herlihy of the Superior Court already denied the Corporation's motion to disqualify, and that the Corporation has not provided the Court with grounds to depart from that ruling. However, the transcript demonstrates that Judge Herlihy denied the motion without prejudice so that the parties could undertake discovery on this issue. He did not make a decision based upon the merits of the disqualification issue. That issue is properly before this Court.
1990 WL 135932

UNPUBLISHED OPINION. CHECK COURT RULES BEFORE CITING.

Court of Chancery of Delaware.

Dana M. SCOTT

v.

NEW DRUG SERVICES, INC., Bernard Cabana, Michael P. Adams, and William Schary.

CIV. A. No. 11336.


Decided: Sept. 6, 1990.

Opinion

ALLEN, Chancellor.

*1 It appears that in early 1988, plaintiff, Dr. Dana Scott, and defendants, Drs. Bernard Cabana, Michael Adams, and William Schary agreed to form a new company to assist drug manufacturers in applying for approval from the U.S. Food and Drug Administration for new drugs. The parties arranged for an attorney at Baker & Hostetler in Washington, D.C., Eric Stoer, to assist them in incorporating a closely-held Subchapter S corporation, New Drug Services, Inc. (“NDS”). The union was short-lived. By early 1989, the principals had fallen into disagreement among themselves. In December 1989, Cabana, Adams, and Schary decided that the friction between Adams and Scott had become so pronounced as to warrant action by the board of directors. At a December 1989 board meeting, despite the existence of an employment contract, Scott was terminated as president of NDS.

Scott promptly brought suit on behalf of himself as well as on behalf of the corporation. In this lawsuit, Scott alleges, among other things that the NDS board of directors has breached duties of fairness and candor to him as a minority shareholder by ousting him from his executive position and by preventing NDS from paying Scott his fair share of the corporate profits; that the members of the board have committed waste in paying themselves exorbitant bonuses; that NDS has breached its employment contract with him; and that NDS has breached a covenant of good faith and fair dealing.

Defendants answer that NDS has not breached the employment contract because Scott was not satisfactorily performing under the contract and that Scott has no standing to assert the derivative claims because he is no longer a shareholder of NDS. ¹

Currently pending is a motion to disqualify Eric Stoer, the Baker & Hostetler firm, and Mr. Stoer's current firm from representing the corporation or the individual defendants in this action. Three grounds are asserted: (1) Stoer has a conflict of interest resulting from, among other acts, his participation in the incorporation process, including the drafting of Scott's employment agreement, and his participation in the
December board meeting at which Scott was terminated; (2) given Stoer's role in drafting the incorporation documents, his testimony will be necessary to their interpretation; and (3) Stoer should not be permitted to represent both the corporation and director defendants in a derivative action because of potential conflict of interest between those persons.

Defendants respond that Stoer has no conflict of interest because throughout his association with NDS he was representing Dr. Cabana, never the corporation or the other principals, and he advised all the parties of this fact. They contend that he is not a necessary witness because it is not the interpretation of Scott's employment agreement that is at issue, but rather his performance under the contract. They also assert that even though derivative claims are purportedly involved, the interests of the corporation and the director defendants are, in this case, perfectly aligned.

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*2 The parties actively contest most of the facts in this case, but there are some facts upon which the parties seem to agree. In 1988, Dr. Cabana, President of International Drug Company (“IDR”), a Maryland corporation, approached Drs. Schary, Adams, and Scott, then employed at the DuPont Corporation, to inquire about their interest in leaving DuPont to work instead for IDR. For various reasons, Schary, Adams, and Scott declined Cabana's offer of employment with IDR. The parties did agree, however, to form NDS as a joint venture. NDS was to be a Subchapter S corporation that would guide drug manufacturers through the maze of bureaucracy leading to FDA approval for new drugs.

In March 1988, in connection with the formation of NDS, the parties consulted Stoer who drafted NDS's corporate documents, including the Shareholders' Agreement, the employment contracts of Scott as president and Adams as vice president of NDS, and the Cabana and Schary Consulting Agreements. For his services, Stoer was paid, after the incorporation of NDS, by a check from NDS. At this time, Scott did not seek any separate counsel.

In early 1989, Scott, Adams, and Schary consulted another attorney, Mike Perna of the Pennsylvania firm of Rigler & Perna, about a dispute that NDS was having with Cabana's corporation IDR. The dispute was settled, however, after Perna talked to Stoer, who represented Cabana and IDR.

Stoer also attended occasional NDS board meetings, including the December 28, 1989 board meeting at which Scott was terminated.

The parties, however, disagree on a host of material facts. Of critical importance, the director defendant insist that at their meetings with Stoer about the incorporation of NDS, Stoer advised Adams, Schary, and Scott that he was representing only Cabana and that the others should seek separate, independent counsel. Scott denies ever having been so informed.

Scott contends that Stoer was paid out of NDS funds, a portion of which was contributed by him. The defendants deny that NDS actually paid Stoer. They maintain that Cabana actually put up all the capital funds for NDS and that, as a matter of convenience, Cabana paid Stoer out of NDS funds. The defendants deny that Scott made any capital contributions to NDS, saying that Scott was reimbursed for any monies he may have advanced the new corporation. Scott counters that this “reimbursement” was not really a repayment of his capital contribution, but rather, payment for services rendered. He also denies Cabana's contribution to NDS was intended as capital, but says rather, the money Cabana contributed to NDS (via IDR) was the first payment on a subcontract with IDR.
Defendants point to the fact that Scott consulted Rigler & Perna as evidence that Scott was aware that Stoer was representing Cabana. Scott, on the other hand, argues that Perna advised Adams, Schary, and Scott of Stoer's conflict of interest but says that he didn't make a big issue of that at the time because the matter in that case was settled.

*3 Scott contends that at the December 28, 1989 board meeting he consulted Stoer and confided in Stoer his plans, strategies and alternatives should he be terminated. Stoer denies any confidential conversations with Scott occurred at that meeting.

While each party argues that these factual differences are irrelevant and that each is entitled to prevail on this motion, I am unable to agree. I conclude that it is necessary to take evidence in order to determine disputed facts relevant to the question whether trial counsel should be disqualified in this instance. I see no reason at this point, however, to disqualify Stoer based on any alleged necessity of calling him as a witness or based on the fact that his firm would be representing both the corporation and the director defendants.

II.

This court is aware of the gravity of disqualification. Disqualification of counsel forces the client to relinquish counsel of its choice and to obtain new counsel, which implies added cost and possible time delays. Similarly, the disqualified lawyer and his firm may suffer embarrassment and financial loss as a result. See G. Hazard, The Law of Lawyering 177 (1989). Yet, the important need that the legal professions' standards of ethical conduct be maintained requires that, in appropriate instances, a court before whom a matter is being litigated must act to disqualify an attorney. That action must never be taken lightly, but neither can it be shirked out of feelings of solicitude.

Turning first to the question of disqualification on the ground that counsel is a likely witness, I note that in order to succeed on such a motion, plaintiff must establish that there is a reasonable probability that Mr. Stoer will be a “necessary” witness **1566 in this litigation. See Cannon Airways v. Franklin Holdings, Corp., 669 F.Supp. 96, 99 (D.Del.1987); Brady v. Delaware Trust Co., Del.Ch., C.A. No. 8827, Allen, C. (Sept. 14, 1988). To be “necessary” for purposes of disqualification, the attorney's testimony cannot be merely cumulative. See Cannon Airways, 669 F.2d at 102.

It does not appear likely at this point that Mr. Stoer's testimony will be “necessary” within the meaning of Rule 3.7 and any corresponding motion to disqualify Mr. Stoer on that basis is, therefore, premature. Plaintiff argues that, as the lawyer who drafted the documents that are the subject of this litigation, his testimony will be necessary to resolve questions of intent and interpretation. It is not clear, however, that this case involves questions of intent or interpretation of the employment contract. Even assuming, as plaintiff alleges, that the parties intended Dr. Scott's employment agreement to be a lifetime employment contract, this aspect of the case may turn on Scott's performance under the contract. If Scott did not perform under the contract, as defendants allege, then the corporation may be relieved of its obligations under the contract, even if it were a lifetime employment contract. Defendants' assertion that it is performance, not interpretation, that is at issue in this case, seems plausible. In that event, Stoer's testimony would be unnecessary.

*4 Further, even if questions of intent or interpretation arise, there is no evidence at this stage of the litigation that Stoer's testimony would be anything more than cumulative. There are still three other
principals, Cabana, Adams, and Schary, who are competent to testify as to the parties' intent under the contracts in question. Should matters appear to be different at a later time, the motion may be renewed.

The propriety of joint representation of both the corporation and the director defendants in a derivative action is question on **1567 which courts here are divided. In *Otis & Co. v. Pennsylvania R. Co.*, 57 F.Supp. 680 (E.D.Pa.1944), aff'd 155 F.2d 522 (3d Cir.1946) (per curiam), the court found that dual representation was permissible, at least in the absence of “any allegation of breach of confidence or trust” by a party to the attorney-client relationship. 57 F.Supp. at 684.

On the other hand, there is substantial support for the idea that the corporation and the shareholders should retain separate counsel in derivative lawsuit where the underlying claim sounds in fraud (as opposed to negligence) and where the corporation takes “an active role” in the litigation. See *Messing v. FDI, Inc.*, 439 F.Supp. 776, 781-82 (D.N.J.1977); *Cannon v. U.S. Acoustics, Corp.*, 398 F.Supp. 209, 213 (N.D.Ill.1975) aff’d 532 F.2d 1118 (7th Cir.1976); *Clark v. Lomas & Nettleton Fin. Corp.*, 79 F.R.D. 658 (1978); see also Op. 842, 15 Record B.A.C.N.Y. (1960) (corporation should obtain separate counsel whenever the corporation elects to pursue an “active role”); Note, *Independent Representation for Corporate Defendants in Derivative Suits*, 74 Yale L.J. 524 (1965) (corporation should always be separately represented in derivative suits).

While, in theory, separate representation may be the better practice (and might be expected to enhance the credibility of any position taken by the corporation), I am mindful that it may be “unreasonable and wastefully expensive to require separate counsel to represent the corporate and individual defendants ... [when] the corporation will remain a neutral party whose counsel is generally unable to alter the outcome of the litigation.” 74 Yale L.J. at 530. Consequently, I am not persuaded that separate representation is mandated in all situations.

What circumstances will require separate representation is obviously a question that is highly fact-specific. Counsel (and a court required to pass upon a disqualification motion) must attempt to assess the likelihood that the corporation will be required, or it will be in its interest, to take an active part in the litigation. It does not appear at this time that the corporation will be required or it will be in its interest to take an active role in this litigation. Therefore, I will decline to grant the disqualification sought on this ground at this time.

I turn then to the last ground asserted as requiring disqualification, the alleged disloyalty involved in suing a former client. This question turns on the requirement contained in Rule 1.9 of the Delaware Lawyers Rules of Professional Conduct:

**5 **1568 *A lawyer who has formerly represented a client* in a matter shall not thereafter:

(a) represent another person in the *same or a substantially related matter* in which that person's interests are materially adverse to the interests of the former client unless that former client consents after consultation

(b) use information relating to the representation to the disadvantage of the former client except as Rule 1.6 would permit with respect to a client or when the information has become generally known. (Emphasis added).

A lawyer should be disqualified based on a conflict of interest where there has previously been a lawyer-client relationship and such relationship is “substantially related” to the subject matter of the current lawsuit or by reason of a prior professional relationship the lawyer has acquired confidential information relevant in the later suit. G. Hazard, *supra* at 176-176.2; see also Model Rule 1.9 of the Delaware Lawyers Rules of Professional Conduct.
In this instance, the parties assert materially different views of the relevant facts. That fact makes it impossible to establish, absent an evidentiary hearing, whether a lawyer-client relationship existed or whether confidential information substantially related to this matter was disclosed. Even assuming, as plaintiff argues, that the putative client's reasonable belief as to whether an attorney was acting as his lawyer is the governing standard relating to the existence of a former representation, it is apparent that the taking of evidence will be necessary under the circumstances here. Whether or not a lawyer in fact disclaimed representing the putative client would certainly affect the reasonableness of any belief the putative client may hold in the existence of a lawyer-client relationship.

It is also disputed whether confidential information was disclosed to Mr. Stoer by Dr. Scott of a kind and in circumstances that would disable him from this representation.

For the foregoing reasons, I will deny the motion to disqualify based on the allegation that Mr. Stoer is likely to be a “necessary” witness and based on any purported conflict of interest between the corporation and the directors defendants. Pending further proceedings, I will reserve judgment whether Mr. Stoer must be disqualified based on any former attorney-client relationship with Mr. Scott. The parties should confer and attempt to stipulate what **1569 contested facts (in addition to the claim that Mr. Stoer told plaintiff that he did not represent him and when and the reasonableness of any contrary belief of Mr. Scott's) they may seek to have determined at this time. Discovery should be available in connection with the necessary hearing. Once the parties are ready for a hearing, we can confer by telephone for scheduling purposes.

All Citations

Not Reported in A.2d, 1990 WL 135932, 16 Del. J. Corp. L. 1561

Footnotes

1 The defendants argue that the termination of Scott as president triggered a buy-sell provision in the Stock Agreement, and NDS thereafter repurchased Scott's shares.

2 Rule 3.7 of the Delaware Lawyers Rules of Professional Conduct provided in pertinent part:
   (a) A lawyer shall not act as an advocate at a trial in which the lawyer is likely to be a necessary witness except where....
   (3) disqualification of the lawyer would work substantial hardship on the client
   (b) A lawyer may act as an advocate in a trial in which another lawyer in the lawyer's firm is likely to be called as a witness unless precluded from doing so by Rule 1.7 or Rule 1.9. (Emphasis added).
27 Misc.3d 237
Supreme Court, Kings County, New York.

Peter CARAVOUSANOS, Plaintiff,
v.
KINGS COUNTY HOSPITAL, AWL Industries, Mega/
Makro Contracting and QNCC Electric, Defendants.

AWL Industries Inc., Third–Party Plaintiff, against Third–Party Index No. 75432/08
v.

Nelson Air Device Corporation, Second Third–Party Plaintiff,
v.


Synopsis
Background: In personal injury action of contractor's employee, contractor brought third-party action against subcontractor's performance bond issuer, seeking indemnification and contribution. Contractor moved to disqualify bond issuer's attorney and his law firm, alleging that attorney had jointly represented contractor and bond issuer in earlier related action.

Holdings: The Supreme Court, Kings County, Robert J. Miller, J., held that:

[1] attorney's simultaneous representation of contractor and bond issuer, without contractor's permission, was violation of professional conduct rule;

[2] earlier related action and indemnification action were substantially related, warranting disqualification; and


Motion granted.

West Headnotes (11)

[1] Attorney and Client Particular Cases and Problems
Attorney's simultaneous representation of contractor and subcontractor's performance bond issuer in adverse capacity, without contractor's permission, constituted violation of professional conduct rule regarding conflicts of interest, thus warranting attorney's disqualification from representing bond issuer in contractor's subsequent third party indemnification action against bond issuer arising from personal injury action of contractor's employee, even if joint representation had ceased.
Cases that cite this headnote

Disqualification of an attorney is a matter that rests within the sound discretion of the court.

2 Cases that cite this headnote

Earlier action in which attorney and his law firm had jointly represented contractor and subcontractor's performance bond issuer and contractor's later indemnification action against bond issuer, arising from underlying personal injury action, were substantially related, and thus attorney and his firm were disqualified from continuing to represent bond issuer in indemnification action; possibility that confidential information concerning contractor's intent with respect to relevant contracts and agreements could have been divulged to firm in context of earlier action, and relevant completion contract, and its interpretation, was central to both actions.

Cases that cite this headnote

[4] Attorney and Client Interests of former clients
Party seeking to disqualify an attorney or law firm must establish (1) the existence of a prior attorney-client relationship and (2) that the former and current representations are both adverse and substantially related.

2 Cases that cite this headnote

[5] Attorney and Client Acting in different capacities; counsel as witness
Attorney who, after undertaking employment in pending litigation, ascertains, or it becomes obvious that he or she, or a lawyer in his or her firm, ought to be called as a witness on behalf of either his or her client or another party, is constrained to withdraw as counsel.

Cases that cite this headnote

[6] Attorney and Client Acting in different capacities; counsel as witness
When making a determination as to the necessity of an attorney's testimony, such as to require the attorney's withdrawal as counsel, factors such as the significance of the matter in which he or she was involved, weight of the testimony, and availability of other evidence must be considered.

Cases that cite this headnote

Party's entitlement to be represented in ongoing litigation by counsel of his or her own choosing is a valued right which should not be abridged absent a clear showing that disqualification is warranted.

Cases that cite this headnote
[8] Attorney and Client ← Disqualification proceedings; standing
Party seeking to disqualify a law firm or an attorney bears the burden on the motion.

Cases that cite this headnote

[9] Attorney and Client ← Disqualification in general
Court may disqualify an attorney not only for acting improperly, but also to avoid the appearance of impropriety.

1 Cases that cite this headnote

[10] Attorney and Client ← Disqualification proceedings; standing
Any doubts as to the existence of a conflict must be resolved in favor of disqualification of an attorney.

Cases that cite this headnote

[11] Attorney and Client ← Acting in different capacities; counsel as witness
Attorney/witness rule warranted disqualification of attorney and his law firm from representing subcontractor's performance bond issuer in contractor's indemnification action arising from underlying personal injury action; attorney executed completion contract on behalf of bond issuer, implying that he played role in negotiating and/or drafting it, and thus he should have been called as witness by one of parties with respect to their intentions as to completion contract and relation of those intentions to their intentions as to subcontract and related performance bond.

Cases that cite this headnote

Attorneys and Law Firms

**820** Law Office of Anthony C. Donofrio, P.L.L.C, for plaintiff.

Michael A. Cardozo, Esq., Corporation Counsel of the City of New York, for defendant Kings County Hospital.

Rafter & Associates, PLLC, by Howard Fishman, Esq., of counsel, for defendant third-party plaintiff AWL Industries.

Bivona & Cohen, P.C., for defendant Mega/Makro Contracting.


Wilson, Elser, Moskowitz, Edelman & Dicker, LLP, for third-party defendant/second third-party plaintiff Nelson Air Device Corporation.

Smith, Mazure for second third-party defendant Bradshaw Mechanical Co, Inc.
Opinion

ROBERT J. MILLER, J.

*238 Upon the foregoing papers, defendant/third-party plaintiff, AWL Industries, Inc. (AWL) moves for an order, pursuant to sections 1200.21, 1200.24 and 1200.27 of the Rules of the Appellate Division,\(^1\) to disqualify Neil B. Connelly, Esq. and the law firm of Neil B. Connelly, Esq., P.L.L.C. (collectively the Connelly Law Firm) from representing third-party defendant Nova Casualty Company (Nova) in the instant action, on the ground that the prior dual representation by the Connelly Law Firm of AWL and Nova in a related action compels disqualification with respect to its current representation of Nova in the case at bar. AWL also seeks the imposition of costs and sanctions against the Connelly Law Firm and an order compelling Neil B. Connelly, Esq. to appear for a deposition. Nova opposes the motion on *239 the grounds that AWL has failed to establish that the Connelly Law Firm previously represented both AWL and Nova on a matter that could be construed as “substantially related” to the instant action, no confidential information was revealed to the Connelly Law Firm by AWL during such prior representation and there is insufficient evidence to demonstrate that attorney Neil B. Connelly, ought to be called as a witness in the action at bar.

In support of its motion for disqualification, AWL submits the affidavit of its president, Robert Pavlovich, which asserts that the Connelly Law Firm’s prior representation of both AWL and Nova occurred when AWL (as obligee) in a construction contract for Kings County Hospital called upon Nova (as surety) to complete a subcontract where the principal had defaulted. Nova retained Nelson Air Device Corp. (“Nelson”) to do the labor required by the subcontract. On or about October 31, 2006, Nelson commenced litigation entitled Nelson Air Device Corp. v. Nova Casualty Company, AWL Industries Inc., Dormitory Authority of the State of New York, the State of New York, Liberty Mutual Insurance Company and Bradshaw Mechanical Company, Inc. (the Nelson Action). *821

[1] In the Nelson Action, Nova had agreed to provide AWL with a defense and the Connelly Law Firm appeared on behalf of both AWL and Nova.

In connection with the Nelson Action, Nova, AWL and Liberty Mutual Insurance Company (Liberty Mutual) entered into an indemnity agreement dated March, 2007. Pursuant to the agreement, Liberty Mutual and Nova (but not AWL) mutually agreed “to waive the potential conflict of interest that may exist” by reason of the Connelly Law Firm’s representing Nova and Liberty Mutual.

On or about December 15, 2006, the Connelly Law Firm interposed an answer in the Nelson Action on behalf of AWL, Nova and Liberty Mutual.

While still representing AWL in the Nelson Action and without obtaining the consent of AWL, the Connelly Law Firm on June 6, 2008 filed on behalf of Nova a motion to dismiss AWL’s third-party complaint which had been interposed against Nova in the instant action.

Section 1200.7 [Rule 1.7] (Conflict of Interest: Current Clients) of the Rules of the Professional Conduct provides:

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if a reasonable lawyer *240 would conclude that either:

(1) the representation will involve the lawyer in representing different interests; or
(2) there is a significant risk that the lawyer's professional judgment on behalf of a client will be adversely affected by the lawyer's own financial business, property or other personal interests.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.

Here for a period of approximately 2 years, in violation of Section 1200.7(b)(3) of the Rules of Professional Conduct, the Connelly Law Firm represented the interests of Nova in an adverse capacity against the interest of it's other client AWL without the permission of AWL.

In February, 2009, this clear conflict ended when the Connelly Law Firm was substituted as counsel for AWL by another firm in the Nelson Action.

Mr. Pavlovich also states that “I had several discussions with Mr. Connelly and other attorneys with his firm regarding AWL's defense in the Nova action.” That certain litigation decisions were made and that Mr. Connelly never advised AWL that a conflict might arise.

In opposition to the instant motion, Nova submits the affidavits of two associates of the Connelly Law Firm, Aaron A. Mitchell, Esq. and Sharon M. Edwards, Esq., as well as the affidavit of the firm's principal, Neil B. Connelly, Esq.

With respect to the Connelly Law Firm's representation of both Nova and AWL, Mr. Mitchell asserts that at the time the Connelly Law Firm was representing AWL in the Nelson Action that AWL tendered its defense and permitted representation knowing that the firm was counsel to Nova in many other related actions and that during the representation “no proprietary information was exchanged”. Mr. Mitchell states that the Nelson Action was for breach of contract and is unrelated to this indemnification action with entirely different legal theories and strategies. In her affidavit, Ms. Edwards describes the prior dual representation of Nova and AWL by the Connelly Law Firm, stating that the Connelly Law Firm never received privileged or confidential documents from AWL during discovery or at any time, that confidentiality was never claimed with regard to any discovery phase of the Nelson Action, that subsequently the Connelly Law Firm perceived that Nelson and Nova may have differing contract issues and advised Nova it should substitute counsel for itself and AWL.

In addition, Mr. Connelly, the principal of the Connelly Law Firm, submits an affidavit concerning his firm's representation of Nova and AWL in the Nelson Action stating that he did not receive any confidential communication from AWL in defending the Nelson Action and that his joint representation of Nova and AWL was taken with the knowledge and consent of AWL.

Mr. Connelly in his affidavit also asserts that the claims in the Nelson Action are completely unrelated to any issues pending in this personal injury action by Caravousanos because the claims by AWL against Nova
are for contractual indemnity under a written agreement which the Connelly Law Firm did not negotiate or execute. With respect to Nova's motion to dismiss the third-party claims asserted against it by AWL, this Court denied said motion by order and decision dated January 29, 2009. The Court based said denial, in relevant part, upon the following reasoning:

Here, the court finds multiple ambiguities in the contracts identified by the parties as relevant to the instant third-party action and, therefore, cannot find that the action is subject to dismissal.

* * *

From the ... terms of the Bond and Subcontract it is not clear, without reference to extrinsic evidence, whether the intent of the parties was to limit the obligations of the surety to remedy the actual performance-of-work default of Cole or to extend such obligation to encompass Cole's duties under the subcontract of indemnification or procurement of insurance naming AWL as an additional insured. Neither party has identified authority definitively establishing that the incorporation *242 by reference of a subcontract in a performance bond is either automatically limited to performance-of-work clauses contained in the subcontract or also encompasses indemnification and insurance clauses found therein.

* * *

[The submission of [documentary evidence by the parties] has merely served to highlight the ambiguities of the contracts and agreements relied upon, particularly when read in conjunction with one another, and the factual questions presented by same which, in this court's view, necessitate further discovery in aid of resolution.


[3] [4] In any event, even if the Court were to accept the argument of the Connelly Law Firm that the rules with respect to former clients apply, disqualification is warranted. It is well settled that “[a] party seeking to disqualify an attorney or law firm, must establish (1) the existence of a prior attorney-client relationship and (2) that the former and current representations are both adverse and substantially related” (Solow v. W.R. Grace & Co., 83 N.Y.2d 303, 308, 610 N.Y.S.2d 128, 632 N.E.2d 437 [1994]; see also Falk v. Chittenden, 11 N.Y.3d 73, 78, 862 N.Y.S.2d 839, 893 N.E.2d 116 [2008]; Jamaica Pub. Serv. Co. Ltd. v. AIU Ins. Co., 92 N.Y.2d 631, 636, 684 N.Y.S.2d 459, 707 N.E.2d 414 [1998]; Tekni–Plex, Inc. v. Meyner and Landis, 89 N.Y.2d 123, 131, 651 N.Y.S.2d 954, 674 N.E.2d 663 [1996] ). Although neither the Court of Appeals nor the Appellate Division, Second Department (see Bloom v. St. Paul Travelers Companies, Inc., 24 A.D.3d 584, 586, 806 N.Y.S.2d 692 [2005] ) have issued definitive rulings concerning the scope of the term “substantially related,” the First Department has variously stated that the prior attorney-client relationship at issue either must have involved issues that are “identical to” or “essentially the same” as those presented in the litigation at bar (Lightning Park, Inc. v. Wise Lerman & Katz, P.C., 197 A.D.2d 52, 55, 609 N.Y.S.2d 904 [1994] )

or, more liberally, *243 that the “substantial relationship” prong is satisfied where the former and present matters share a “common subject matter” (Anonymous v. Anonymous, 262 A.D.2d 216, 216, 691 N.Y.S.2d 769 [1999]). Therefore, the mere representation at an earlier time of one of the contesting litigants does not constitute a bar to present representation of the other litigant (District Council 37 v. Kiok, 71 A.D.2d 587, 587, 418 N.Y.S.2d 433 [1st Dept.1979]). Furthermore, disqualification generally is not warranted unless there is a reasonable probability of disclosure of confidential information obtained as a result of the prior representation (NYK Line N. Am. v. Mitsubishi Bank, Ltd., 171 A.D.2d 486, 488, 567 N.Y.S.2d 409 [1991]).

It is not essential, however, that the prior client establish that confidential information will necessarily be disclosed in the course of the litigation (Narel Apparel Ltd. v. American Utex Intl., 92 A.D.2d 913, 914, 460 N.Y.S.2d 125 [1983]). A reasonable probability of disclosure should be sufficient (id). Courts will infer the “reasonable probability of disclosure of confidences” from the particular nature of the past and present representations at issue (see generally Forbush v. Forbush, 107 A.D.2d 375, 379–380, 485 N.Y.S.2d 898 [1985]).

In addition, it is well settled that an attorney who, after undertaking employment in pending litigation, ascertains, or it becomes obvious that he or she, or a lawyer in his or her firm, “ought to be called” as a witness on behalf of either his or her client or another party, is constrained to withdraw as counsel (see Hitzig v. Borough–Tel Serv., Inc., 108 A.D.2d 677, 678, 485 N.Y.S.2d 541 [1985], lv. dismissed 65 N.Y.2d 784 [1985]; see also Talvy v. American Red Cross in Greater New York, 205 A.D.2d 143, 152, 618 N.Y.S.2d 25 [1994], affd. 87 N.Y.2d 826, 637 N.Y.S.2d 687, 661 N.E.2d 159 [1995]). In such a case, a finding that the attorney's testimony is necessary is required, **824 and the attorney's mere relevant knowledge or involvement in a transaction central to the litigation is not determinative (Hitzig, 108 A.D.2d at 678, 485 N.Y.S.2d 541) When making a determination as to the necessity of an attorney's testimony, such factors as the significance of the matter in which he or she was involved, weight of the testimony, and availability of other evidence must be considered (id). Here, the Connelly Law Firm concedes that it represented both Nova and AWL in the Nelson Action prior to being substituted by other counsel and that the interests of AWL and Nova in the present action are irrefutably adverse. However, it contends that the Nelson Action and the present indemnification action are not substantially related and no confidences of AWL were transmitted to the Connelly Law Firm during the course of its representation of AWL in the Nelson Action.

The Nelson Action involved a claim *244 for payment brought by Nelson pursuant to the Completion Contract and as against AWL and Nova. The gravamen of the instant third-party claims asserted against Nova by AWL is that Nova is obligated to indemnify AWL for certain acts of negligence arising out of work performed by Nelson, as completion contractor on the subject project, pursuant to the performance bond issued by Nova in favor of AWL. Although said actions diverge as to the parties asserting and/or defending claims and the legal theories asserted, the salient link between the two cases is the Completion Contract and the obligations of AWL, Nova and Nelson pursuant to same. Given the centrality of this document to both actions, the court finds that there is a reasonable probability that confidential communications may have been relayed from AWL to the Connelly Law Firm, during the Nelson Action, concerning the terms of said contract and the concomitant obligations of the parties created by same, as well as the underlying default of Cole and the intent of AWL with respect to Nova's obligations under the subject Performance Bond.

Indeed, the Connelly Law Firm concedes that during the course of its dual representation of both Nova and AWL, certain information emerged as to the possibility of conflicting claims or defenses as between Nova and AWL which resulted in the Connelly Law Firm's withdrawal from its representation of either party in the Nelson Action. Accordingly, unlike actions where both parties share a common interest and, therefore, information divulged by such parties during the course of such actions is not construed as confidential with respect to the jointly-represented parties, even if the interests of such parties diverge in subsequent litigation (see generally In re McCormick, 287 A.D.2d 457, 457, 730 N.Y.S.2d 880 [2001]; Finn v. Morgan, 46 A.D.2d 229, 229, 363 N.Y.S.2d 321 [1974]), the adversity of the interests of AWL and Nova were identified by the Connelly Law Firm during the course of the Nelson Action, and the Connelly Law Firm withdrew as counsel.
for both parties based upon said parties’ “differing positions with respect to contract issues.” Accordingly, it appears that the conversations between AWL and the Connelly Law Firm and the documents produced during the Nelson action were not relevant to a common interest of AWL and Nova, but rather revealed the adversity of the parties' positions related to, among other contractual matters, the Completion Contract and the parties' respective obligations thereunder.

[7] [8] [9] [10] The court is mindful that “[a] party's entitlement to be represented in ongoing litigation by counsel of his or her own choosing is a valued right which should not be abridged absent a clear showing that disqualification is warranted” and “[t]he party seeking to disqualify a law firm or an attorney bears the burden on the motion” **825 (Aryeh v. Aryeh, 14 A.D.3d 634, 634, 788 N.Y.S.2d 622 [2005]; see also Petrossian v. Grossman, 219 A.D.2d 587, 588, 631 N.Y.S.2d 187 [1995]). In addition, such motions must be scrutinized by the court in light of their potential to be used to delay, or gain a strategic advantage in, pending litigation (see generally Tekni–Plex, Inc., 89 N.Y.2d at 131–132, 651 N.Y.S.2d 954, 674 N.E.2d 663). The court is also cognizant, however, of the longstanding principle that “the court may disqualify an attorney not only for acting improperly, but also to avoid the appearance of impropriety” (Solomon v. New York Prop. Ins. Underwriting Assn., 118 A.D.2d 695, 695, 500 N.Y.S.2d 41 [1986]; see also Sellouk v. USAA, 166 A.D.2d 641, 642, 560 N.Y.S.2d 974 [1990]). Indeed, “[t]hat the attorney in question may not have obtained confidential information from plaintiffs during his earlier representation of them did not render his disqualification inappropriate, since plaintiffs were entitled to be free from the apprehension, naturally arising under the circumstances at bar, that the prior representation would inure to their current adversaries' advantage” (Decana Inc. v. Contogouris, 27 A.D.3d 207, 207, 810 N.Y.S.2d 453 [2006]). Moreover, any doubts as to the existence of a conflict must be resolved in favor of disqualification (see Sirianni v. Tomlinson, 133 A.D.2d 391, 392, 519 N.Y.S.2d 385 [1987], lv. dismissed 74 N.Y.2d 792, 545 N.Y.S.2d 106, 543 N.E.2d 749 [1989]).

Given that the court previously determined that “the ambiguities of the contracts and agreements relied upon, particularly when read in conjunction with one another, and the factual questions presented by same ... necessitate further discovery” (Caravousanos, 2009 Slip Op. 50156 at *8) in the indemnification action, thereby precluding the court's interpretation of such contracts as an issue of pure law, extrinsic evidence of the parties' intent vis-a-vis such documents is highly relevant. Therefore, the possibility that confidential information concerning AWL’s intent with respect to same may have been divulged to the Connelly Law Firm in the context of the Nelson Action, coupled with the centrality of the Completion Contract, and its interpretation, to both actions which provides, in this court's view, at the very least, common subject matter arguably sufficient to demonstrate that the actions are “substantially related,” support the disqualification of the Connelly Law Firm from representing Nova in the instant action.

[11] *245 In addition, the court also finds that the “attorney/witness” rule warrants the disqualification of the Connelly Law Firm. It has been held that an attorney who has negotiated and drafted an agreement, and may have knowledge of the intent of the parties with respect to such document where said document was adjudged to be ambiguous, “ought to be called” as a witness since it is likely that his or her testimony will be necessary (see Brunette v. Gianfelice, 171 A.D.2d 719, 720, 567 N.Y.S.2d 279 [1991]; cf. S & S Hotel Ventures Ltd. Partnership v. 777 S.H. Corp., 69 N.Y.2d 437, 446, 515 N.Y.S.2d 735, 508 N.E.2d 647 [1987] [finding that attorney's testimony was not material or necessary because “there was no occasion to go behind the various agreements to determine their intent, the issues raised under the agreements being solely questions of law”]). Here, Neil B. Connelly, Esq. executed the Completion Contract on behalf of Nova and the inference is that he played a role in negotiating and/or drafting same. Accordingly, he ought to be called as a witness by either Nova or AWL with respect to the intentions of the parties to the Completion Contract and the relation of same to the intentions of Nova and AWL with respect to the Subcontract
and related Performance Bond. Accordingly, the “attorney-witness” rule also precludes the Connelly Law Firm's continued representation of Nova in the instant action.

As a result, the motion to disqualify the Connelly Law Firm from representing Nova in the instant action is granted. Nova shall have 60 days from the date of this decision and order to substitute counsel for the Connelly Law Firm. The motion to sever by Nova currently pending is denied without prejudice with leave to renew when new counsel is substituted. The court denies that portion of AWL's motion seeking costs and fees, as AWL has not demonstrated that it is entitled to same as a sanction. It further denies that portion of AWL's motion which seeks to compel the deposition of Neil B. Connelly, Esq. as premature given that it has not demonstrated that said deposition has been noticed or that Mr. Connelly has objected to, or otherwise refused to comply with, same.

The foregoing constitutes the decision and Order of the Court.

All Citations


Footnotes

1 AWL cites to former Part 1200 (Disciplinary Rules of the Code of Professional Responsibility) which have been superceded effective April 1, 2009 by the Rules of Professional Conduct which were promulgated as Joint Rules of the Appellate Divisions of the Supreme Court. The new sections are Section 1200.29 [Rule 3.7] Lawyer as Witness; Section 1200.7 [Rule 1.7] Conflict of Interest—Current Client; Section 1200.8 [Rule 1.8] Current Clients: Specific Conflict of Interest Rules; Section 1200.9 [Rule 1.9] Duties to Former Clients.
LESSONS FROM THE TRENCHES
Limited Liability Company Issues Arising Under Delaware Law

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The Delaware Limited Liability Company Act, 6 Del. C. § 18-101 et seq. (the “DE LLC Act”), is renowned for its flexibility. The Delaware Supreme Court has noted that the DE LLC Act “can be characterized as a ‘flexible statute’ because it generally permits members to engage in private ordering with substantial freedom of contract to govern their relationship, provided they do not contravene any mandatory provisions of the Act,” Elf Atochem N. Am. v. Jaffari, 727 A.2d 286, 290 (Del. 1999)(noting that the provisions deemed to be mandatory “are likely to be those intended to protect third parties, not necessarily the contracting members.” 727 A.2d at 292.) But courts and commentators alike have universally cautioned that the freedom of contract embodied in the DE LLC Act is coupled with a responsibility to scriven with care and clarity. Many of the issues addressed in this outline also apply to Delaware limited partnerships; however, since limited liability companies are more commonly used, this outline focuses on limited liability companies (sometimes referred to as “LLCs”). The matters addressed in this outline are a nonexclusive list of drafting issues and inadvertent missteps that commonly arise under the DE LLC Act. Some of these topics could spawn an entire in-depth CLE program on their own. The treatment in this outline is not a complete list of potential problem areas.

I. Formation/Existence Issues. While these issues are not likely to spawn litigation, they nonetheless can create problems for transactional lawyers who are giving legal opinions or who are performing due diligence in connection with an investment or acquisition transaction.

A. Authority to Execute a Certificate of Formation and Admit a Member.
Under Delaware law, a certificate of formation may be executed by an “authorized person.” The DE LLC Act does not define or establish parameters for who is an “authorized person.” This raises the question, who authorizes the authorized person to execute a certificate of formation? Practitioners often include language in the LLC Agreement stating that the member authorized the authorized person to file the certificate of formation or affirming that the “authorized person” had the authority to form the company. This assumes that the member was in existence at the time the certificate of formation was executed and filed. But what if it was not?

1. Section 18-201(d) of the DE LLC Act contemplates that a limited liability company agreement may be entered into prior to the filing of the certificate of formation, which would resolve the authorization question. Section 18-201(b) states that a limited liability company is
formed at the time of the filing of the initial certificate of formation in the office of the Secretary of State or at any later date or time specified in the certificate of formation if, in either case, there has been substantial compliance with the requirements of [Section 18-201] (which includes the requirement in Section 18-301(d) that a limited liability company agreement is “entered into or otherwise existing either before, after or at the time of the filing. Section 18-201(d) also states that regardless of whether the limited liability company agreement is entered into or otherwise existing before, after or at the time of such filing, it may be made effective as of the effective time of such filing or at such other time or date as provided in or reflected by the limited liability company agreement.” This neatly sidesteps the chicken and egg issue by confirming that an LLC will be properly formed even if there is a gap between the filing of the certificate of formation and the coming into being of the limited liability company agreement.

2. The “authorized person” is not typically considered the equivalent of an incorporator under the corporate law. So how is the member admitted to the limited liability company? Section 18-301 of the DE LLC Act provides that, in connection with the formation of a limited liability company, a person is admitted as a member upon the later to occur of:

a. The formation of the limited liability company; or

b. The time provided in and on compliance with the limited liability company agreement or, if the limited liability company agreement does not provide, when the person’s admission is reflected in the records of the limited liability company.

3. **Example 1: Erroneous “appointment” of a member.** What happens if the individual who signed the certificate of formation signed a “Resignation and Consent of Organizer” erroneously appointing an individual (“X”) as the sole member and manager of the company?

a. The “organizer” worked for a service company. The client, a Nevada limited liability company (“NV LLC”), contacted the service company to form a Delaware limited liability company and intended that NV LLC would be the sole member of the newly-formed Delaware limited liability company (“DE LLC”). The service company employee who signed the certificate of formation executed a “Resignation and Consent of Organizer” appointing X as the sole member of DE LLC and sent it to NV LLC with the certified copy of the filed certificate of formation. It is unclear whether the service company accidentally overwrote a form for another client, but the people associated with NV LLC were not acquainted with X. NV LLC nonetheless placed the “Resignation and Consent of Organizer” in its files with the other records for DE LLC. NV LLC signed a limited liability company agreement as the sole member of the new Delaware limited liability company. Sometime later, in connection with the diligence to render a legal opinion to a lender, counsel discovers this document appointing X as the sole member of DE LLC, which predates the limited liability company agreement. Counsel for DE LLC contacts the service company to inquire as to who X is and why X was named as a member and manager of DE LLC. The organizer still works at the service company but has no
recollection why X’s name appears in the documentation for DE LLC has no idea who X is, or where to find her.

b. Is the “Resignation and Consent of Organizer” part of the records of DE LLC such that X was admitted as a member of DE LLC? In this situation, there was no LLC agreement in place until NV LLC executed the agreement; X never executed a limited liability company.

B. Use of Nominees. Foreign clients often want to use “nominee” members and managers, which can lead to issues. While this has become a red flag in recent years, sometimes overseas clients that appear to be legitimate still want to use nominees.

1. Example 2: The Option and Premature Withdrawal. A prominent lawyer and law professor ("X") in a Balkan country, acting through a nominee, which was an offshore corporation ("Nominee"), retained a service company to form a Delaware limited liability company ("LLC"). X indicated that the purpose of the company was to invest in interests in other entities and he wished to keep his involvement private in countries where commercial registers are public. A representative ("Y") of the service company, acting as authorized person on behalf of Nominee, filed the certificate of formation for LLC with the Office of the Delaware Secretary of State in 2001. The certificate of formation included optional information identifying Nominee as the sole member of LLC and appointing a named individual ("A") as the initial member of the Board of Directors of LLC. Nominee entered into a limited liability company agreement (the “LLC Agreement”) which identified Nominee as the sole member of LLC, provided for a Board of Directors to manage LLC. The LLC Agreement interchangeably refers to “Directors” or “Operating Managers” but does not define either, nor does it indicate how they are appointed or removed. Broad powers are given to the Director (singular) but specific paragraphs refer to specific duties being undertaken by the Operating Managers. The LLC Agreement also states that it is made pursuant to the District of Columbia Limited Liability Company Act, although the LLC is a Delaware limited liability company – we assume this is a holdover reference from one of the base forms (since the agreement seems to be a patchwork quilt).

The LLC Agreement permits a member to assign its interest, but states that “[t]he transferee is entitled to receive only the share of profits or other compensation by way of income and return of contributions to which that member otherwise would be entitled.” It also provides “The Assignee or Substitute Member shall have all the rights and powers and is subject to all of the restrictions and liabilities of the Member who initially assigned the Membership Interest.” “Assignee” is not defined but a “Substitute Member” is defined as an Assignee who has [sic] admitted to all of the rights of membership pursuant to [the LLC Agreement].” One section of the LLC Agreement states that a person may be admitted as an “additional Member upon the written consent of all Members.” Another section provides: “Each Additional Member shall make the Contribution and shall perform the Commitment described in the Admission Agreement entered into between the Additional Member and the Company.” Neither “Contribution,” “Commitment” nor “Admission Agreement” are defined. Yet another section says that “The Members may admit Additional Members and determine the Capital Contributions [also not defined] of such Members.”
X explained that he now desires to ensure that he is the sole member of LLC and, in addition to the LLC Agreement and the certificate of formation, provided copies of the following additional documents:

a. A purchase option agreement, dated 2 weeks after the formation of LLC in 2001, by Nominee, as Seller, and X, as Buyer (the “POA”), pursuant to which Nominee granted to X an option to purchase the “Shares” in ABC, LLC for US$1,500. The option was exercisable during a two-year window commencing on a date that was 5.5 years after the date of the POA but required X to pay the purchase price in advance on the date of execution of the POA. An individual (“B”) executed the POA as a representative of Nominee. X indicates now that he and Nominee believed that the POA and accompanying documentation would establish his beneficial ownership of the limited liability company interest in LLC but would further his goal to maintain anonymity in Europe.

b. A receipt acknowledging that Nominee received from X of the purchase price under the option, dated the same date as POA, signed on behalf of Nominee by B.

c. A contemporaneously dated “resolution of the members” of LLC, executed by B as authorized person for Nominee, acknowledging that Nominee is transferring its 100% interest in LLC and stating (in present tense) that Nominee “resigns” as a member of LLC.

d. A 2005 certificate of incumbency signed by the registered agent for LLC that identifies A as the Director of the Company, and states that A was appointed on the formation date.

e. An undated assignment of the limited liability company interest in LLC, which is notarized as of a date in 2007. No documentation purporting to effect the admission of X as a member, either in 2001 or in 2007, was provided.
f. A Nominee Directors Agreement, dated 2007, signed by 2 individuals (“C” and “D”) in 2007, consenting to serve as Directors of LLC and to take no action unless “unambiguously asked in written form, signed by X as “ultimate interest holder.”

g. An amended and restated certificate of formation, filed in 2007, identifying C and D as Operating Managers, signed by C as “President” of LLC and referencing “a resolution of the Members and Operating Managers of the corporation” dated a few days earlier. The A&R Certificate states that LLC will be managed by the Operating Managers and identifies C and D as the Operating Managers.

h. Minutes of a meeting held in December, 2012, listing as attendees X, as “sole beneficial owner” of LLC, and two other individuals (“E” and “F”) and stating that the purpose of the meeting was “to receive and consider the resignation of the members of the Company, the appointment of new members in his [sic] stead.”. The minutes purported to approve the resignation of C and D as of January 1, 2013 and the “appointment” of E and F as members as of such date, which E and F accept.

i. Agreement for the Provision of Nominee Services and Indemnification of Nominee, by X, as beneficial owner, and E and F, requesting that E and F act as director of LLC and acknowledging that E and F have no direct or beneficial interest in LLC.

j. An amended and restated certificate of formation executed by E and F as “members” of LLC, identifying E and F as “Operating Managers” of LLC.


These are the only records X has and the registered agent does not have any other documentation. Nominee has now been dissolved. X, A, B, C, D, E and F desire to correct the situation to clarify that X has always been the real party in interest, that Nominee never intended to resign as a member of LLC prior to the assignment of its limited liability company interest to X, to revoke any dissolution of LLC that may have occurred by virtue of the failure at any time to have a properly admitted member, with X agreeing that he was admitted as the sole member of LLC effective as of Nominee ceasing to be a member, and to confirm that E and F were never members of LLC. Evidently, none of them understood that the “member” of a limited liability company was the equivalent of a shareholder or beneficial owner. X also amended and restated the LLC Agreement, appointed E and F as “Operating Managers” and filed a certificate of correction to the 2013 amended and restated certificate of formation, and a new amended and restated certificate of formation.

2. **Example 3: The Missing Nominee.** An individual (“N”) resident of Europe authorized the formation of a Delaware limited liability company and used a British Virgin Islands company as nominee member. The limited liability company agreement stated that the company was managed by its members. The BVI company turned out to be disreputable and, after being involved in numerous scandals, closed its doors and N could not reach his contacts there. Upon investigation, N discovered that the Delaware limited liability company had not paid
its annual tax and the State had cancelled its certificate of formation for nonpayment. N would like to revive the LLC., but a certificate must be signed by an “authorized person.” Since N is not the member nor is N acting under a delegation of authority from the member, N is not an authorized person within the meaning of Section 18-204 of the DE LLC Act. N is considering whether he wants to file a petition in the Delaware Court of Chancery to have himself designated as the true member of the LLC.

C. Assignment Without Admission.

1. Section 18-301(b)(2) of the DE LLC Act provides that an assignee of a limited liability company interest is admitted as provided in Section 18-704(a) at the time provided in and upon compliance with the limited liability company agreement or, if the limited liability company agreement does not so provide, when any such person’s permitted admission is reflected in the records of the company.

   a. Section 18-704(a) of the DE LLC Act states that the assignee becomes a member (1) as provided in the limited liability company agreement, (2) unless otherwise provided in the limited liability company agreement, upon the vote or consent of all of the members of the limited liability company, or (3) unless otherwise provided in the limited liability company agreement by express reference to Section 18-704(a)(3) or otherwise provided in connection with the assignment, upon the voluntary assignment (i.e., consented to by the member at the time of the assignment and not effected by foreclosure or similar legal process) by a sole member of the LLC of the entire LLC interest to a single assignee.

   b. What constitutes the admission being reflected in the records of the LLC? Is it an amendment and restatement of the limited liability company agreement by the assignees? Section 18-704(a)(3) refers to the admission being automatic only if a sole member voluntarily assigns its entire interest to a single assignee. What if a single member assigns its interest to its members, partners or stockholders?

   c. Many LLC Agreements (including single member LLC Agreements) expressly state that an assignee must be admitted as a member upon complying with certain requirements. This may include the consent of the manager or certain other formalities that are often overlooked.

   d. Pursuant to Section 18-801(a)(4) of the DE LLC Act, a limited liability company is dissolved at any time there are no members, unless (1) (except as otherwise provided in the LLC Agreement) within 90 days (or such other period as is provided in the LLC Agreement) after the occurrence of the event that terminated the continued membership of the last remaining member, the personal representative of the last remaining member agrees to continue the limited liability company and agrees to the admission of the personal representative of such member or its nominee or designee to the limited liability company as a member, effective as of the occurrence of the event that terminated the continued membership of the last remaining member, or (2) a member is admitted to the company in the manner provided in the LLC Agreement, effective as of the occurrence of the event that terminated the continued membership.
of the last remaining member within 90 days (or such other period as is provided for in the limited liability company agreement) after the occurrence of the event that terminated the continued membership of the last remaining member, pursuant to a provision of the LLC agreement that specifically provides for the admission of a member to the limited liability company after there is no longer a remaining member of the limited liability company.

a. If the parties miss the specified window within which the personal representative may continue the business or within which a new member may be admitted, the LLC is dissolved. The effect of dissolution is that the LLC can no longer conduct the business for which it was formed and must focus on winding up and liquidating. See 6 Del. C. § 18-803.

ii. Provided that a certificate of cancellation has not been filed, Section 18-806(3) of the DE LLC Act permits the revocation of a dissolution that occurs when the LLC no longer has a member unless the LLC Agreement prohibits revocation of a dissolution, pursuant to the vote or consent of the personal representative of the last remaining member or the assignee of all of the limited liability company interests in the LLC (and the approval of any other persons whose approval is required under the LLC Agreement to revoke a dissolution). If there is no remaining member and the personal representative of the last remaining member or the assignee of all of the limited liability company interests votes to continue the LLC, the personal representative or assignee must agree to the admission of a nominee or designee as a member, effective as of the occurrence of the event that terminated the continued membership of the last remaining member.

iii. Section 18-806(3) refers to a single assignee consenting to the continuation and to the admission of a nominee or designee. What if there are multiple assignees? Section 18-806(3) states that it shall not be construed to limit the accomplishment of a revocation of dissolution by other means permitted by law.

D. Premature Cancellation. The parties involved with a limited liability company or a limited partnership sometimes prematurely file a certificate of cancellation under the mistaken understanding that the filing initiates the dissolution process and a winding up period, as with a Delaware corporation. But pursuant to Section 18-203 of the DE LLC Act, a certificate of cancellation is filed “upon the dissolution and the completion of winding up of a limited liability company” (or under certain other enumerated circumstances).

1. Dissolution occurs by operation of law pursuant to Section 18-801 of the DE LLC Act upon the occurrence of an event specified in the Act or the limited liability company agreement (some of which may be cured as set forth in the Act or the limited liability company agreement).

a. Upon the dissolution of a limited liability company agreement, the company is to be wound up and liquidated as set forth in Sections 18-803 and 18-804 of the Act and the limited liability company agreement.
b. A dissolved limited liability company is no longer authorized to conduct the business for which it was formed.

c. As noted in C above, Section 18-806 permits the revocation of a dissolution under certain clauses of Section 18-801, but applies only to the extent that no certificate of cancellation has been filed.

2. Originally, a party wishing to restore a prematurely cancelled limited liability company had no choice but to file an action in the Court of Chancery seeking to void the certificate of cancellation.

3. A practice developed of filing a certificate of correction to void the filing, on the theory that the certificate of correction was erroneously or defectively executed because the prerequisites for its filing (i.e., that the dissolution and completion of winding up) had not occurred. Now Section 18-203 has been amended to expressly provide that “A certificate of cancellation that is filed in the office of the Secretary of State prior to the dissolution or the completion of winding up of a limited liability company may be corrected as an erroneously executed certificate of cancellation by filing with the office of the Secretary of State a certificate of correction of such certificate of cancellation in accordance with § 18-211 of this title.”

II. Drafting issues.

A. Optional Language in a Certificate of Formation. Section 18-201(a) and (b) provide that a certificate of formation is required to set forth the name of the limited liability company, the address of its registered office and the name and address of the company’s registered agent for service of process. Section 18-201(c) also permits the certificate of formation to include any other matters the members determine should be included.

1. Under Section 18-207, the fact that a certificate of formation is on file in the office of the Secretary of State provides constructive notice of the facts that are required to be in a certificate of formation under the Delaware LLC Act or that are permitted to be set forth in a certificate of formation as a condition to limitations on interseries liabilities under Section 18-215(b) (and, after August 1, 2019, Section 18-218(d)).

2. Placing optional provisions in a certificate of formation does not provide constructive notice of the facts set forth in those optional provisions.

3. Many provisions in the Delaware LLC Act that establish default rules permit the parties to provide otherwise in the limited liability company agreement. But providing otherwise in a certificate of formation, even though this is on the public record, without including analogous or coordinating provisions in the limited liability company agreement, does not override default rules.
4. If a matter is addressed in the certificate of formation, and a change is made, Section 18-202(b) of the Delaware Act requires a manager or member to amend the certificate of formation if the change renders the certificate of formation false in any material respect. Given the fact that inclusion of optional language does not provide constructive notice, may not override provisions in the LLC Agreement and will require a filing to update the certificate of formation in the event of a change, consider whether it makes sense to include optional information.

B. Voting Provisions. Here is an example of a poorly drafted voting provision:

**Example 4:** “This Company is being formed with three Membership Interests. All voting events and decisions referenced in this Agreement shall consist of three votes, one for each Membership Interest. The vote of a Membership Interest that is owned jointly shall be determined by a majority vote of the LLC Interests comprising that Membership Interest. If a majority vote is not be [sic] reached by the reasonable deadline set by whomever called for the vote, that Membership Interest shall be deemed to have voted in accord with the Membership Interest(s) whose vote(s) were reached in time. If the other Membership Interests voted at odds with each other, the vote will fail. All Membership Interests shall be entitled to vote on any matter submitted to a vote of the Members.”

“Membership Interest” was defined “as one of the three original LLC Interests owned by an original Member or one of the aggregates of the LLC Interests owned by the successors to a single original Member.”

“Member” was defined as “a person who executes the Company Agreement and is listed on Schedule A as a Member.”

However, the Agreement had 4 signatories, A, B, C and D, and there was no Schedule A attached. C and D were husband and wife and although A indicated that he held 1/3, B held 1/3, C held 1/6 and D held 1/6.

1. The default rule under Section 18-402 of the Delaware LLC Act is:

**Unless otherwise provided in a limited liability company agreement,** the management of a limited liability company shall be vested in its members in proportion to the then current percentage or other interest of members in the profits of the limited liability company owned by all of the members, the decision of members owning more than 50 percent of the said percentage or other interest in the profits controlling.

2. Section 18-302(b) further provides:

A limited liability company agreement may grant to all or certain identified members or a specified class or group of the members the right to vote separately or with all or any class or group of the members or managers, on any matter. Voting by members may be on a per capita, number, financial interest, class, group or any other basis.
3. The provision above appears to be a poorly drafted attempt to provide for create three groups or cohorts that have the right to vote” a group voting arrangement among (1) A and his successors and assigns, holding a collective 1/3 interest, (2) B and his successors and assigns, holding a collective 1/3 interest, and (3) C and D and their successors and assigns, holding a collective 1/3 interest.

4. Another issue presented by the language quoted above is a process question. Many significant issues required a unanimous vote. This provision seems to allow any member to call a vote and establish a deadline for response. It is not clear how a “vote” is submitted and whether it is by written consent or by some other means. No other provision of the agreement set requirements for prior notice or established a deadline for submission of a vote or consent. It appears that if a member group did not timely respond to a request for votes, and the other two groups voted consistently, the vote would be deemed to be unanimous, even if the third group’s opposing “vote” was not timely submitted. B, C and D all lived in the same town, but A lived in another state. This provision would seem to allow B, C or D to call for a vote on a matter, provide notice by U.S. mail and set a deadline that might be prior to A’s receipt of the notice on a matter requiring unanimous approval. If A’s vote was not timely received, he would be deemed to have voted with B and C/D, if they were in agreement.

C. Management. Under Delaware law, where flexibility is a hallmark of the LLC Act, an LLC can be managed by its members or by one or more managers, but it is not a binary analysis.

1. Section 18-402 of the LLC Act provides that “if a limited liability company agreement provides for the management, in whole or in part, of a limited liability company by a manager, the management of the limited liability company, to the extent so provided, shall be vested in the manager who shall be chosen in the manner provided in the limited liability company agreement. The manager shall also hold the offices and have the responsibilities accorded to the manager by or in the manner provided in a limited liability company agreement. . . . Unless otherwise provided in a limited liability company agreement, each member and each manager has the authority to bind the limited liability company [emphasis added].

a. Simply stating that the limited liability company shall be managed by a manager does not sufficiently address the authority of the manager, nor does it divest the member(s) of the authority to bind the limited liability company. Thus, a statement in the LLC Agreement (or a certificate of formation) that the company is “manager-managed” may not be sufficient to authorize the manager to control the company without the need for approvals by the members or prevent a member from taking acts to bind the company.

i. The definition of “manager” in the DE LLC Act does not address the duties or responsibilities that accompany the title – a “manager” is merely “a person who is named as a manager of a limited liability company in, or designated as a manager of a limited liability company pursuant to, a limited liability
company agreement or similar instrument under which the limited liability company is formed.” 18 Del. C. § 18-101(10).

b. Section 18-401 specifies that an LLC may have more than one manager. Many limited liability companies follow the board model. This may be a board of managers, in which each manager is an agent of the LLC. Alternatively, the governance structure may resemble a corporate model, in which the members of the board are referred to as “directors” and the entire board functions as a “manager” so that management is vested in the entire board as a unit and officers carry out the day-to-day duties.

i. Either way, the LLC Agreement should adopt rules, similar to those found in corporate bylaws, to establish quorum and approval requirements, notice requirements, meeting schedules or a process to call meetings, waivers of notice, record dated, proxies, written consent procedures and other voting matters. Over the years, default rules have developed to fill the vacuum created by the lack of specific governance procedures in the statute. 6 Del. C. § 18-404(c).

ii. Section 18-402 provides as a default matter that in a member-managed LLC, the decision of members owning more than 50 percent of the percentage or other interest in the profits will control. But it merely states that if the LLC provides for management by a manager, to the extent provided, the management of the company is vested in the manager, without regard to how decisions are made if there are multiple managers. Section 18-404(b) provides merely that voting by managers may be on a per capita, number, financial interest, class, group or any other basis, without specifying a default rule.

2. The DE LLC Act also expressly permits a member or manager to delegate its rights, power and duties to manage and control the company’s affairs to agents, officers and employees of a member or manager or of the LLC, and may enter into a management agreement or other agreement with or otherwise to delegate to other persons, except to the extent such right of delegation is limited, conditioned or restricted in the LLC Agreement. 6 Del. C. § 18-407.

a. Parties providing for officers will sometimes use language in the LLC Agreement that states that, to the extent duties are not expressly set forth in the LLC Agreement or in a written delegation, officers shall have duties analogous to those assigned to officers having those titles under the Delaware General Corporation Law.

i. By incorporating corporate law duties, the drafters may unintentionally be bringing in corporate law fiduciary duties. It would be better to avoid the reference to the DGCL or to refer to “responsibilities” rather than duties, and to include a disclaimer of an intent to incorporate corporate law
fiduciary duties by use of corporate titles and a reference to the section of
the agreement that establishes the standard of conduct for officers.

D. Interests vs. Units vs. Shares

As a default rule, the interest of a member in a limited liability company interests, like partnership
interests, encompasses a bundle of rights. A great deal of confusion exists regarding the separation of a
“transferable” interest (economic rights) from the “management” rights that are limited to those
admitted as members. These default rules can be altered by contract in the limited liability company
agreement. But under Delaware law, the term “limited liability company interest” is expressly defined
as “a member’s share of the profits and losses of a limited liability company and a member’s right to
receive distributions of the limited liability company’s assets.” 6. Del. C. § 18-101(8). Note that the term
“membership interest” is not used at all in the DE LLC Act.

1. Limited liability company interests are generally not certificated but can be.

a. Section 18-702(c) of the DE LLC Act provides “Unless otherwise provided in a limited
liability company agreement, a member’s interest in a limited liability company may be
evidenced by a certificate of limited liability company interest issued by the limited
liability company. A limited liability company agreement may provide for the assignment
or transfer of any limited liability company interest represented by such a certificate and
make other provisions with respect to such certificates.”

b. While Section 18-702(c) prohibits bearer certificates, evidencing ownership by
certificates does not transform a certificated interest to a negotiable instrument. The
rules regarding transfer of the certificate must be set forth in the LLC Agreement.

c. Under the Uniform Commercial Code as in effect in Delaware, a limited liability
company interest, like a partnership interest, is a general intangible. Thus, absent an
Article 8 opt-in, taking possession of a certificate evidencing a limited liability company
interest does not perfect a security interest in the LLC interest or constitute “delivery” of
the certificate for transfer purposes under Article 8.

i. Given the language of Section 18-702(c) of the DE LLC Act, it is possible that for
purposes of the DE LLC Act, the language of the LLC Agreement may provide that
endorsement and delivery of the certificate is an effective assignment, but may not
effectively constitute an Article 8 opt-in for UCC perfection purposes.

2. Limited liability company interests by default are not divided into “units” or “shares.” Given
the contractual flexibility under the DE LLC Act, a limited liability company agreement can
provide for the interest to be divided into “shares” or “units,” but the drafting must
establish the structural framework that establishes how these concepts work.

a. A certificate of incorporation establishes an “authorized” number of shares of corporate
stock. A limited liability company agreement must indicate whether there is a finite
number of “authorized” units of limited liability company interest that may be issued
without further action (such as amendment of the agreement, a member vote to authorize additional units or a manager vote to authorize additional units). Note that the concept of “issuance” is not an established LLC concept, so consider whether the LLC Agreement should indicate what is required for “issuance,” especially if legal opinions might be required.

b. Do the units have an established “value” or purchase price for which they may be issued? If not, who decides the consideration to be paid? The agreement should specify this.

c. It is not uncommon for parties to create and deliver membership certificates evidencing a specified number of “shares” or “units” when the limited liability company agreement does not mention certificated interests or units. The status and effect of these certificates is questionable, especially where the parties purport to endorse the certificates to effect a transfer.

d. If the interests are divided into “units” or “shares,” these concepts must be carried over into the provisions of the limited liability company dealing with voting rights, allocations, distributions, capital contributions and other relevant sections. Limited liability company interests are not necessarily an undivided interest in each and every attribute of the limited liability company. Note that voting, allocations and distributions in an alternative entity need not be handled in an identical manner. The business deal may be that voting rights are governed by one hierarchy, and different items are allocated on an entirely different basis, with certain members getting a preferred return, or a greater share of distributions, losses or other items that may be inconsistent with the number of “units” or “shares” assigned to each member. The waterfalls may be different depending upon whether the company is making interim distributions or is distributing capital proceeds. All of these sorts of issues must be addressed.

e. Where an LLC Agreement uses these terms without defining them, a court will interpret terms such as “create,” “authorize” and “issue” in a manner that gives them meaning and effect. Zimmerman v. Crothall, 62 A.3d 676, 691 (Del. Ch. 2013) (“Because the Operating Agreement does not set forth a process for authorizing units, I conclude that the most reasonable interpretation of the Agreement is that the parties intended the authorization of units to be accomplished by an amendment to the Operating Agreement”). The LLC agreement set forth the number, classes and series of units the LLC was authorized to issue and required the consent of a required majority of the holders of a class of preferred units to “create, authorize or reserve” units, while authorizing the board to “issue” additional units or create additional classes or series of units. Amendment of the LLC Agreement required member consent “Except as otherwise provided in Section 3.8 . . . with respect to the issuance of additional Units.” In interpreting an LLC Agreement, the court may construe ambiguous contract terms against the drafter, depending on the circumstances. Zimmerman, at 698.

i. To avoid a court assigning a meaning to a corporate term, which may not reflect the intent of the parties, it is better to define the terms as the parties wish them to be interpreted. So if the intent is
for the board of managers to have the authority to admit new members in their discretion and to express the interests of those members in units, as they see fit, it would be best to avoid any reference to “authorized” units and to clearly state that the board has the discretion to create additional units of interest and to cause the company to admit additional members and to determine the number of units each additional member will receive and to increase the number of units held by existing members, with or without use of the term “issue.”

ii. While Section 18-702(c) refers to the “issuance” of certificates, it might make sense to define the term in the LLC agreement if interests are to be certificated, particularly if it might be necessary for counsel to opine as to “due issuance” of certificated interests.

3. Because a limited liability company interest affords only economic rights, parties who intend for interests to be freely transferable and for a transferee to succeed to all rights of the transferor, including voting and management rights, must make sure that the limited liability company agreement entitles the transferee to be admitted.

a. The default rule under 18-702(b)(1) is that, unless the limited liability company agreement provides otherwise, assignment of a limited liability company interest does not entitle the assignee to become a member or to exercise any rights that are exclusive to members.

b. Section 18-704(a) elaborates that the right of an assignee to become a member is dependent upon (A) language in the limited liability company affording that assignee the right to be admitted (and compliance with any conditions imposed upon such admission), (B) unless otherwise provided in the limited liability company agreement or in connection with the assignment, upon the vote or consent of all members, or (C) in the absence of a provision in the limited liability company providing for the admission of an assignee, unless the limited liability company agreement expressly negates the operation of Section 18-704(a)(3), the voluntary assignment by the sole member of a single member limited liability company of the entire interest of the limited liability company to a single assignee.

i. The caveats in 18-704(a)(3) mean that a member can override the automatic admission of an assignee of 100% of the limited liability interest by contract, and that this savings clause only applies if there is a single assignee.

ii. A voluntary assignment is expressly limited to an assignment consented to by the member at the time of the assignment, and expressly excludes a transfer pursuant to a foreclosure or other similar legal process.

c. If the parties intend for an existing member to succeed to the rights of a member rather than an assignee with respect to an interest assigned by another member without the consent of the remaining member(s), the LLC Agreement should provide for automatic admission of an assignee that is already a member.
i. While there is Delaware precedent in which Chancellor Strine held that an existing member had voting and management rights with respect to an interest assigned to it by another member, *Achaian, Inc. v. Leemon Family, LLC*, 25 A.3d 800 (Del. Ch. 2011), this decision was based on the Chancellor’s interpretation of the language of the LLC agreement in that particular case. In the *Achaian* opinion, the Chancellor relied upon language authorizing a member to transfer “all or any portion of its Interest” and the definition of “Interest” as a member’s “entire ownership interest in” the LLC to conclude that a member could freely transfer voting and management rights as well as economic rights. Chancellor Strine opined that a member who had already been admitted as a member need not be admitted again as to an additional incremental interest.

ii. The *Achaian* holding has been criticized by scholars such as the late Professor Larry Ribstein, who asserts that because the DE LLC Act defines the term “interest” by reference to economic rights only, an assignment of the “entire” limited liability company interest of a member does not confer rights exclusive to members, such as voting rights. Commentators have noted that the attribution of voting rights to a member who acquires the interest of another member shifts the balance of voting power and that a member not a party to the transfer might consider the transferee’s increase in voting power a material change. Consider a situation in which an LLC has 3 equal 1/3 members. If one assigns its 1/3 to another and the assignee succeeds to the assignor’s voting rights, the situation changes from one in which the LLC has 3 minority members to one in which there are only 2 members, one of which has a 2/3 majority.

E. **Mismatched Defined Terms.** Mixing and matching provisions from different forms often results in the use of capitalized terms without definitions or defined terms that are slightly different from the terms actually used. Definitions for terms that are not used presents less of an issue. While software solutions are available to catch these sorts of errors, these inconsistencies can give rise to ambiguities.

F. **Amendment of Limited Liability Company Agreements.**

1. A limited liability company agreement may impose requirements for amendment, including requiring the consent of a person who is not a party to the agreement and may establish conditions to amendment. § 18-302(e).

   a. For example, a lender or other third party can be afforded express consent rights in the agreement, thus baking in the lender consent requirement as a condition precedent to the effectiveness of an amendment, rather than merely relying on an amendment being a breach of the loan agreement.

   b. Any person having a right to approve an amendment may waive its approval rights, and a condition precedent may be waived by all intended beneficiaries of the condition.
2. An agreement of merger or consolidation or a plan of merger involving a Delaware limited liability company may effect an amendment to the limited liability company agreement or adopt a new limited liability company agreement for any Delaware limited liability company that survives the merger or results from the consolidation. 6 Del. C. § 18-209(f). The amendments so adopted are effective notwithstanding the requirements of a provision in the limited liability company agreement addressing amendment, unless that amendment provision expressly states that it applies to an amendment effected pursuant to a merger, or to the adoption of a new limited liability company agreement pursuant to a merger or consolidation.

   a. If the limited liability company agreement provides that members holding an aggregate voting percentage of 80% must approve an amendment, but does not state expressly that this threshold applies to an amendment or a new limited liability company agreement adopted pursuant to a plan or agreement of merger, and if a merger need only be approved by a majority of the members, amendments set forth in the plan or agreement of merger approved by members holding a voting percentage of 60% will be binding and effective, notwithstanding that it did not receive 80% approval.

3. If the limited liability company agreement of a Delaware limited liability company whose certificate of formation was filed on or after January 1, 2009 does not expressly address the manner in which it may be amended, the agreement may be amended only with the unanimous approval of all members or as otherwise permitted by law, including pursuant to Section 18-209(f). 6 Del. C. § 18-302(f). This default rule is not applicable to LLCs formed prior to January 1, 2009; the common law rule applicable prior to the enactment of Section 18-302(f) continues to apply to those limited liability companies, to the extent that the members did not address the process for amendment in the applicable limited liability company agreement.

4. A provision in a limited liability company agreement that states generally that any provision of the agreement that requires a supermajority approval by the members to authorize the company to take a specified act may be amended only with the approval of the members having the voting power to take the specified action does not extend to a default rule set forth in the statute. 6 Del. C. § 18-302(e).

   a. For example, Section 18-801(a)(3) of the DE LLC Act includes as an event of dissolution of a limited liability company: “Unless otherwise provided in a limited liability company agreement, upon the vote or consent of members who own more than 2/3 of the then-current percentage or other interest in the profits of the limited liability company owned by all of the members.” Since this statutory default rule may be varied by contract, if the agreement may be amended by a majority in interest of the members, a majority in interest of the members could amend the agreement to add a provision authorizing a majority in interest to approve the dissolution of the company, even if the agreement contains a “supermajority voting provision” stating that the vote or consent required under any provision of the agreement may not be amended except by vote the vote or consent threshold required to take the action authorized under that provision.
G. Failure to Reflect the Parties’ Expectations in the Contract.

1. While the parties may have agreed that they will fulfill certain obligations in consideration of their interests in the LLC, these often do not make it into the LLC Agreement. Instead, the agreement states that each member is making a nominal capital contribution for its interest and is silent about the “commitment” that each party has agreed to make.

2. It is not uncommon for a client, in an initial call or meeting, to tell a tale of another member’s failure to perform his, her or its commitment and to seek to void the member’s interest for failure of consideration. However, when they provide the documentation, the limited liability agreement states merely that each member’s capital contribution is some nominal amount that does not reflect the business deal the client has described. Generally, there is no writing memorializing the terms that the parties orally discussed prior to entering into the LLC Agreement.

3. If the limited liability company agreement contains an integration clause in which the parties have acknowledged that any prior discussions are superseded by the limited liability agreement to the extent the subject matter is expressed in the agreement, absent allegations of fraud in the inducement, a court may be unwilling to consider parol evidence as to the expectations of the parties. If the agreement either specifies that a member’s interest is granted in consideration of a nominal capital contribution, without reference to any other commitment or obligation to perform, or if it merely allocates interests without regard to a capital contribution, a court is not likely to entertain an argument that there was another element of consideration for the interest. See, e.g., Grove v. Brown, C.A. No. 6793-VCG, 2013 WL 4041495 at *6 (Del. Ch. Aug. 8, 2013)(V.C. Glasscock). In Grove, while the limited liability company obligated each member to contribute $10,000 and reflected that each member had a 25% interest, Vice Chancellor Glasscock concluded that the agreement did not indicate that the allocation of relative ownership interests was contingent on the members’ actions post-signing. The Vice Chancellor notes that “Though the Operating Agreement imposes an obligation on the members to provide capital to [the LLC], the Operating Agreement does not provide that one member’s failure to do so divests that member of his or her share of the company.” See also Black Horse Capital, LP v. Xstelos Holdings, Inc., C.A. No. 8642-VCP, 2014 WL 5025926 at *24 (Del. Ch. Sept. 30, 2014)(construing a standard integration clause “to indicate that there were no separate oral contracts regarding the subject matter of [the relevant agreements], and that there was no separate consideration or inducement for entering into those [a]greements.”).

a. Example 6: A and B, individuals, form a limited liability company to operate an online start-up business with the understanding that A will provide funding for development of the website, and B will perform certain services to get the site up and running and will perform marketing and other functions. A’s expectation is that B will devote 20 – 30 hours per week to the venture. But the LLC Agreement states merely that the interests in the LLC are divided 50/50 and that each member will make a nominal capital contribution for his interest. A funds development by third parties and B devotes less than 5 hours per week to the business. A approaches B and orally negotiates distributions to fund return of capital to A and specified compensation to B until A’s
unreturned capital is reduced to zero and a percentage shift from 50/50 to 70/30 so that A gets 70% and B gets 30% thereafter. But B reneges and refuses to cooperate on any decision or to devote any further time to the venture, leading to deadlock. A has been operating the business under the status quo, building value which will ultimately benefit of B.

b. Section 18-502 permits a limited liability company agreement to impose specified penalties for, or specified consequences of, a member’s failure to make a required capital contribution, including reducing or eliminating the defaulting member’s proportionate interest in the limited liability company, subordinating the member’s interest to that of nondefaulting members, forcing a sale of the defaulting member’s limited liability company interest, forfeiture of the defaulting member's limited liability company interest, the lending by other members of the amount necessary to meet the defaulting member's commitment, but often in these situations, the members have not included any such provision.

c. Often a limited liability company agreement will refer to a schedule of members and their interests and the parties will have neglected to attach that schedule. While everyone is getting along, they can agree on the content of the schedule, but if a dispute arises, and there were conflicting versions of the schedule circulated prior to finalizing the LLC Agreement, this can be a problem.

H. Elimination of Fiduciary Duties or Liability for Breach (Exculpation). The DE LLC Act permits the parties to expand, restrict or eliminate common law fiduciary duties by language in the limited liability company agreement. 6 Del. C. § 18-1101(c). The DE LLC Act also permits the parties to retain default fiduciary duties but to limit or eliminate liabilities for breach of contract and breach of fiduciary duties (other than liability for a bad faith violation of the implied contractual covenant of good faith and fair dealing). 6 Del. C. § 18-1101(e).

1. Delaware courts have cautioned that contractual provisions designed to eliminate fiduciary duties must be "plain and unambiguous." Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC, C.A. 3658-VCS, 2009 WL 1124451 (Del. Ch. April 20, 2009) at *9. Where the agreement contains potentially conflicting language courts may find that fiduciary duties have not been effectively eliminated.

2. But parties often rely on exculpatory language relieving them of liability for breaches of fiduciary duty for the proposition that they have eliminated fiduciary duties. However, retaining fiduciary duties but eliminating liability does not always achieve the same result. As noted by Vice Chancellor Laster in the seminal decision Feeley v. NHAOCG, 62 A.3d 649, 664 (Del. Ch. 2012), exculpatory language eliminating liability but leaving common law fiduciary duties in place preserves remedies other than monetary damages against the fiduciaries. These may include injunctive relief, specific performance, rescission (including rescissory damages), constructive trust and other equitable remedies.

3. Delaware courts acknowledge that even where a limited liability company agreement eliminates common law fiduciary duties, it may impose contractual duties in their stead,
such as a duty to act “in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner [such person] reasonably believes to be in the best interests of the Company.” MHS Capital LLC v. Goggin, C.A. No. 2017-0449-SG, 2018 WL 2149718 (Del. Ch. May 10, 2018). Where a limited liability company agreement also contained language eliminating liability by a manager to the Company or any member for monetary damages for breach of such person’s duty as a manager, except as required under the DE LLC Act. Id. at *3. Any such claim sounding in contract will supersede a separate breach of fiduciary duty claim based on the same conduct that forms the basis of the breach of contract claim. MHS at *8 (citing Renco Grp., Inc. v. MacAndrews AMG Holdings LLC, 2015 WL 394011, at *7 (Del. Ch. Jan. 29, 2015)); Grunstein v. Silva, C.A. No. 3932-VCN, 2009 WL 4698541 at *6 (Del. Ch. Dec. 8, 2009). This may impact whether D&O insurance is available for a claim, to the extent that liability for breach of contract has not also been eliminated. Section 18-1101(e). Vice Chancellor Glasscock noted in his opinion that on a motion to dismiss he would not consider whether some forms of equitable relief were so close to a request for monetary damages that they might run afoul of the exculpatory provision in the LLC Agreement.

4. The DE LLC Act provides limited exculpatory language protecting a member, manager or liquidating trustee who relies in good faith on the LLC’s records or upon information, opinions, reports or statements presented by other representatives of the company or any other person with respect to matters reasonably believed to be within such other person’s professional or expert competence. 6 Del. C. § 18-406. This includes information, opinions, reports or statements relating to the value and amount of the assets, liabilities, profits or losses of the LLC, or of assets, reserves, contracts, agreements or other undertakings available to pay or make reasonable provision to pay claims and obligations of the LLC or to any other facts pertinent to the existence and amount of assets from which distributions to members or creditors are properly payable.

5. Section 18-1101(d) of the DE LLC Act provides that a member or manager or other person has no liability for breach of fiduciary duty, whether to the LLC or to another member or manager or any other person that is a party to or is otherwise bound by the limited liability company agreement, for such person’s good faith reliance on the provisions of the limited liability company agreement (except to the extent that the limited liability company agreement provides otherwise).

6. Section 1101(h) adopts the doctrine of independent legal significance, which provides that an action validly taken under one provision of the DE LLC Act is not invalid solely because it is identical or similar to an action that could have been taken under another provision of the DE LLC Act but fails to comply with one or more of the requirements of such other provision. Presumably, this affords protection to a person involved in consummating such action in reliance upon and in compliance with the governing provision.

I. Issues Involving Indemnification Provisions. The DE LLC Act empowers a limited liability company to indemnify and hold harmless any member or manager or other person from and against any and all claims and demands whatsoever, subject to any standards and restrictions in the limited liability company agreement. 6 Del. C. § 18-108. This is a much broader statement
of indemnification authority than is found in the Delaware General Corporation Law but it does not create an entitlement on the part of an indemnitee. The provisions of the limited liability company agreement will establish the entitlement of a covered party. Absent such a provision, indemnification will be in the discretion of the decisionmakers for the company.

1. The Delaware Court of Chancery has expressed that “Section 108 defers completely to the contracting parties to create and to limit rights and obligations with respect to indemnification and advancement.” Majkowski v. American Imaging Management Services, LLC, 913 A.2d 572, 591 (Del. Ch. 2006).

2. Many parties follow the rules for indemnification set forth in Section 145 of the Delaware General Corporation Law, which provides for mandatory indemnification under certain circumstances and permissive indemnification in others. Section 145 requires that the indemnification relate to an act that the indemnitee took in his or her official corporate capacity and that the indemnitee acted in good faith. Prudent drafting would dictate establishing a standard of conduct in connection with the entitlement to indemnification that makes sense in the context of the roles of the parties and how they benefit the LLC. Consider controls with regard to the ability of controlling persons to unilaterally determine their own right to be indemnified and advancement where indemnification is permissive. Also, avoid duplication of indemnification obligations and consider which indemnitior has primary liability and which is secondarily liable if there are several indemnitors.

a. Delaware courts have acknowledged an exception to the Delaware policy favoring freedom of contract by declining on public policy grounds to permit the parties agree to shift the risk of one party’s fraudulent conduct to the other or to relieve a party of liability for intentional or willful acts. EMSI Acquisition, Inc. v. Contrarian Funds, LLC, C.A. no. 12468-VCS, 2017 WL 1732369 (Del. Ch. May 3, 2017 Slichts, V.C.). James v. Getty Oil Co., 472 A. 2d 33, 36 (Del. Super. 1983). While these are not cases addressing indemnification in a limited liability company agreement, it is likely that a similar rationale would bar an LLC from affirmatively indemnifying for these sorts of wrongful behaviors.

b. Delaware courts will permit a party to be indemnified for its own negligence, but only if the intent to do so is clear from the drafting. Query whether this applies only to simple negligence or whether indemnification for gross negligence is enforceable.

3. Absent an enabling provision entitling representatives of a Delaware limited liability company to advancement of expenses, a person entitled to indemnification has no right to require the LLC to fund its expenses on an ongoing basis, and must fund the litigation to its outcome, subject to reimbursement upon the conclusion of the action following a determination as to entitlement. An individual member or manager may not have the liquidity to fund a defense if sued, so a right to advancement can significantly impact the outcome of litigation.
4. While the indemnification provision may not ultimately cover willful conduct, fraud or bad faith acts. But unless the contract otherwise provides, a broad advancement provision will require the LLC to fund advancement of a claim alleging conduct that would render the actor ineligible for indemnification, subject to a right to claw back the advanced expenses. In drafting an indemnification provision for a limited liability company agreement, the parties should consider whether to provide for disqualifying factors such as fraud, gross negligence, bad faith, a material breach of the limited liability company agreement, a breach of the DE LLC Act, willful misconduct or a knowing violation of the law. The LLC may want to require that any indemnification for a matter brought on behalf of the company or a matter that is adverse to the company is an adverse party must be approved by the company. Also consider addressing the types of expense that may be advanced, the nature and status of the legal proceedings and the capacity in which the person seeking indemnification was acting.

a. In construing indemnification agreements, Delaware courts read such contracts to provide coverage when reasonable. “When an advancement provision is, by its plain terms, expansively and mandatory, it will be enforced as written.” *DeLucca v. KKat Management Company, L.L.C.*, C.A. No. 1384-N, 2006 WL 224058 (Jan. 23, 2006) (V.C. Strine), slip op. at 14 (noting Delaware’s “strong public policy in favor of assuring key . . . personnel that the [company] will bear the risks resulting from the performance of their duties on the grounds that such a policy best encourages responsible persons to occupy positions of business trust.”). Unless the agreement by its terms limits advancement to a person who has allegedly committed tortious acts, breaches of contractual or fiduciary duties or misappropriation, fraud or bad faith, such allegations do not disqualify the claimant to advancement. *Fillip v. Centerstone Linen Services, LLC*, C.A. No. 8712-ML (Del. Ch. Feb. 27, 2014)(Glasscock, V.C.); *DeLucca*, at 24 – 27 (noting that the advancement provision would obligate DeLucca to repay the funds advanced if she were found liable of the allegations in the subject litigation.

b. A company that has agreed to advance expenses for claims until a final adjudication that the party seeking indemnification is not entitled to be indemnified cannot escape its advancement obligations by arguing that a material contract providing for advancement or forming the basis of the party seeking advancement’s entitlement was fraudulently induced and should be voided. *Trascent Management Consulting, LLC v. Bouri*, 152 A.3d 108, 113 (Del. 2016)(“allowing Trascent to avoid its contractual duty to make immediate advancement payments by making a belated fraudulent inducement claim would . . . impair the public policies served by contractual advancement provisions.”). An advancement action is a summary proceeding.

5. A contract entitling a person to advancement “to the fullest extent of the law” includes “fees on fees” – that is, reasonable fees and expenses incurred in prosecuting an advancement action, unless the LLC Agreement provides otherwise. *Harrison v. Quivus Systems, LLC*, C. A. No. 12084-VCMR (Del. Ch. Aug. 5, 2016)(V.C. Montgomery-Reeves) transcript at 24; *DeLucca*, at 33.
6. From the perspective of an indemnitee, make certain that the indemnification provision covers former members, managers, officers, employees, etc. who may face claims with regard to circumstances that occurred while they fulfilled those roles following their separation from the company. Also consider language stating that the right to indemnification exculpation cannot be retroactively amended without the consent of a covered person.

III. Dispute Resolution Procedures/Exit Strategies.

A. Individual clients often do not like to address these sorts of issues. Often, they insist that they will always be able to come to an agreement. Ideally, they can be convinced that the best time to rationally think through an exit mechanism or a means of resolving a dispute is while the parties are getting along and not dealing with stress, financial difficulties or emotions. What works in one situation does not always make sense in another. Factors to consider in fashioning an appropriate provision include (but are not limited to) the role each party will play in the success of the business, the relative financial means and liquidity of the members, the resources contributed by each party, whether the business could be divided into separate, stand-alone divisions or businesses. Alternatives that parties include (in no particular order), are:

1. **Unanimous Approval Requirements.** Parties who believe that they will never become deadlocked often impose unanimous approval requirements without a mechanism to deal with a potential a deadlock. Their justification is often that they always agree and if they do not, they will work it out. Alternatively, they believe that the threat of litigation or judicial dissolution as the only alternative to an agreement will force the parties to the bargaining table.

   a. Deadlock may be a basis for judicial dissolution if it can be established that “it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement.” 6 Del. C. § 18-802. Judicial dissolution is a discretionary remedy, however; Section 18-802 provides that the Court of Chancery “may” order judicial dissolution if the standard is not met and the courts consider judicial dissolution an extraordinary remedy that is granted “sparingly.” A deadlock with no means to resolve the deadlock can be a basis for this remedy. See *In re GR Burgr, LLC*, C. A. No. 12825-VCS, 2017 WL 366511 (Del. Ch. Aug. 25, 2017) (Judicial dissolution granted where the LLC’s sole business relationship (a trademark/IP license) was terminated by Caesars Entertainment Corporation because the defendant member’s felony conviction rendered the LLC an ineligible business connection under the casino gaming regulations applicable to Caesars. In *Haley v. Talcott*, 864 A.2d 86, 97 (Del. Ch. 2004), the Court of Chancery ordered judicial dissolution where two equal members were unable to agree whether to on a course of action, notwithstanding a put option, where the Court concluded that the exercise of a put was not fair and equitable where the member being bought out would cede control of the LLC to the other member but would not be relieved of his liability as a guarantor under the company’s mortgage financing.

   b. While judicial dissolution may be a remedy for a crippling deadlock, the nuclear option may not be in the interests of all parties. The judicial dissolution remedy may be denied

c. Litigation is costly. **Example 5:** A, B and C, individuals, are having a discussion about their industry. The conversation gives A an idea for a technological advance. A decides to share the credit with B and C, and names them all on a patent application. A, B and C form a limited liability company to commercialize the technology, with each of them getting a 1/3 interest. The technology subject to the pending patent is assigned to the LLC. The LLC Agreement provides for all decisions to be made by unanimous approval of the members. The parties agree to cause the LLC to license the technology to B’s company, which is in the industry to which the technology relates, with royalties based on sales, and payment deferred for 18 months. B refuses to cooperate with any attempt to license the technology to other licensees. The agreement requires unanimous member approval to make capital calls. As the patent process progresses, B is unwilling to agree to a capital call to pay the costs to pursue the patent. A funds these costs out of what is his nest egg. B’s company does not pay the royalties to the LLC once they start becoming due. B tells A that he has acquired the interest of C in the LLC Agreement without complying with the transfer restrictions. A takes no action because (1) he believes that he cannot cause the LLC to act without unanimous member approval, and (2) he was hired as a consultant by B’s company, which has not paid him and he is afraid to jeopardize his relationship with B. If C’s interest has been disenfranchised by an assignment to B without admission, each of A and B has merely a 50% voting interest. By the time A seeks legal advice (after settling his litigation against B’s company for a fraction of what was owed), the LLC’s royalty claims have become time-barred as to a large chunk of royalties (several million dollars). While there may be derivative claims A could bring without unanimous approval of the members, A cannot afford to fund litigation.

B. **Put or Call.** A put or call right can be one method of dealing with deadlock. But valuation is sometimes a stumbling block for these provisions.

1. Any method that requires the parties to periodically agree on a price has a number of shortfalls. First, the price may not be realistic or equate to a fair value, if the parties are not knowledgeable about valuation. Second, the parties often fail to meet and reset the value.

2. Appraisal can be costly, especially if more than one appraiser is selected.

3. Another pricing method is the Russian Roulette/Suicide Option, also sometimes referred to as “I Cut, You Choose.” These sorts of provisions work best in 50/50 ventures in which one party initiates a buyout by making a binding offer to the other to buy the interest of the other party at a specified price. The offeree has the option of either accepting the offer and selling its interest to the offeror or requiring the offeror to purchase the interest of the offeree at that price; the offeree cannot simply decline to sell without agreeing to purchase. The offeror must sell at that price if the offeree reverses the offer. The theory is that the knowledge that the offeror may have to sell at the offered price induces the offeror to make
a fair offer. If both parties are similarly situated, with comparable liquid assets or access to capital and either could successfully run the company or keep it running, this can be an effective method to resolve a deadlock.

a. But if one party is at a disadvantage, either financially or in terms of that party’s ability to effectively assume control of the business, the other party can manipulate the process by offering an artificially low price.

b. If the members have differing rights to distributions, allocations, or other economic rights such that the interests are not equivalent, this is not an appropriate solution, as the interest may not have the same value.

c. Even if there are no special rights to distributions or allocations and the interests are equivalent undivided interests that carry proportionate rights and privileges, if there are multiple members or if the ownership percentages not equal, the drafting of such a provision becomes much more complicated, as the pricing would need to be adjusted to account for the different percentages of the offeror and the offeree and whether one or more offerors must make the offer to all of the remaining members.

C. Arbitration Provisions. Arbitration is a common dispute resolution mechanism. Depending upon how the arbitration is to be conducted, the process can be time consuming and costly (although the parties can specify a timeline). Arbitration provisions must be drafted carefully.

1. An arbitration agreement can be preceded by an agreement to engage in mediation.

2. If the parties wish to have the arbitration governed by the rules of the American Arbitration Association (“AAA”) or JAMS, they must consider whether they wish to use AAA or JAMS arbitrators, or wish the freedom to select other arbitrators and merely require those arbitrators to follow the AAA or JAMS rules. The parties often agree to limit discovery, to expedite the process. There is a fair amount of published interpretive guidance with regard to the Commercial Arbitration Rules of the AAA. Consider whether to impose confidentiality requirements as to the fact that an arbitration proceeding has been instituted, the substance of the claims and any materials submitted, as well as the ultimate outcome.

3. Consider the location of the arbitration and whether it is more convenient or costly for some of the potential parties than others, as well as the costs of the arbitrators to attend.

4. Consider the scope of the matters to be submitted to arbitration. Under Delaware law, for example, there are broad arbitration clauses, that require all disputes arising under or related to the LLC to be submitted to arbitration, and there are narrower provisions, which permit certain types of issues to be litigated in a court or which limit the arbitrable issues to those relating to a limited universe of disputes. The scope of the arbitral matters can be fairly limited or it can be broad, with carveouts for matters that may be litigated, such as seeking injunctive relief, seeking other equitable remedies, breach of fiduciary duty matters or seeking judicial enforcement of an order of arbitration.
a. A gating issue that often arises is whether the parties have agreed that issues as to scope of the arbitration clause in an agreement, referred to as “substantive arbitrability,” are to be determined by the arbitrator or a court.

b. The rule in Delaware, consistent with the view of the United States Supreme Court, is that the question of substantive arbitrability is determined by a court rather than the arbitrator, unless the contract provides clear and unmistakable evidence that the parties intended to submit the issue of substantive arbitrability to the arbitrator. James & Jackson, LLC v. Willie Gary, LLC, 906 A.2d 76, 78 (Del. 2006). The Delaware Supreme Court held in Willie Gary that the “clear and unmistakable evidence” requirement is satisfied where (1) the arbitration clause provides for arbitration of all disputes, and (2) the arbitration clause also incorporates a set of arbitration rules (such as the AAA rules) that empowers arbitrators to decide substantive arbitrability. Id. At 80. However, the Court of Chancery subsequently held that if the party seeking judicial relief can clearly establish, in a limited judicial review, that the party seeking arbitration has only frivolous arguments, the court need not refer the question of substantive arbitrability to the arbitrator. McLaughlin v. McCann, 942 A.2d 616 (Del. Ch. 2008).

D. Tie-breakers.

1. Tie breakers can involve consulting a designated outside person who is viewed as impartial. In one case, a client who was an experienced real estate investor set up an LLC for his 4 sons, who ranged in age from 19 – 30, to invest in real estate projects. He wanted the company to be member managed so that the boys would learn the industry and make decisions jointly. The father established himself as the tie breaker, since he brought experience to the table and all of his sons respected his opinion.

2. The parties can agree to rotate casting the deciding vote on successive issues where they reach impasse. This is a bit riskier for major decisions, to the extent that one member could manipulate the issues to ensure that he or she is the tie-breaker on a material decision.

3. Some parties resort to chance, such as flipping a coin. Obviously, a method such as this does not result in an optimal decision, since it ignores the relative merits of the parties’ positions and leaves no room for a negotiated solution that might advance the interests of both parties.

   a. Nonetheless, proponents argue that it is simple, provides a quick resolution (assume the parties abide by the decision) and draws a clear, bright line (assuming the question is binary).

   b. A sample provision coin toss provision from an agreement where the parties ultimately decided to use this alternative follows:

In the event the parties are unable to mutually agree with respect to a Material Decision, the parties will negotiate in good faith for a period of 21 days to reach a resolution. If, after expiration of such 21-day period, the parties remain deadlocked, they shall jointly select a
disinterested person to officiate over a coin toss. [Party 1] shall toss the coin. [Party 2] shall call “heads” or “tails” while the coin is in the air. If [Party 2] correctly calls the result of the coin toss, [Party 2] shall make the decision. If [Party 2] incorrectly calls the result of the coin toss, [Party 1] shall make the decision. The disinterested person shall have the authority, in his or her sole discretion, to require a new coin toss if the outcome of the toss is questionable. If the coin toss is repeated, [Party 2] shall toss the coin and [Party 1] shall call “heads” or “tails” and the roles shall reverse for each consecutive coin toss.

E. Judicial Dissolution/Equitable Dissolution. Section 18-802 of the DE LLC Act provides a mechanism for judicial 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.” This remedy is an extreme remedy that will not be available absent disabling circumstances that prevent the LLC from operating in accordance with its LLC Agreement. In re Seneca Inv., LLC, 2008 WL 5704773 (Del. Ch. Sept. 23, 2008) (declining to dissolve LLC that merely serves as passive investment vehicle that holds cash and certain equity investments, without having had a business plan, sought or obtained capital, sold or sought to sell any stock, held any board meetings or made any new investments over a 4-year period, where the LLC has a broad purpose clause and no deadlock is alleged). Factors that are likely to support a court-ordered dissolution include: (1) an irreparable deadlock at the management level, (2) with no mechanism in the limited liability company agreement to rectify the deadlock, and (3) financial conditions that effectively foreclose the company’s ability to operate. Fisk Ventures, LLC v. Segal, C.A. No. 3017-CC, 2009 WL 73957 (Del. Ch. Jan. 13, 2009). In Fisk Ventures, Chancellor Chandler held that while the LLC Agreement provided for a put option, entitling the plaintiff to be bought out by the LLC at the fair market value of its interest, the plaintiff was not obligated to exercise the option to resolve the deadlock where it has concluded that it would be disadvantageous to do so.

1. In determining whether it is practicable to conduct business “in conformity with the limited liability company agreement, the court will consider the breadth of the purpose clause. Where the purpose clause includes catch-all language authorizing the company to engage in “such other lawful business as the Management Committee chooses to pursue,” a departure from the original business plan adopted by the parties in light of changed economic conditions is not a basis for a member to seek judicial dissolution. In re Arrow Investment Advisors, LLC, C.A. 4091-VCS, 2009 WL 1101682 (Del. Ch. April 23, 2009).

a. When negotiating the agreement, the parties should consider whether the venture is for a limited purpose and an investor whose participation is tied to a specific business model should either seek a limited purpose clause or bargain for a veto right to change the nature of the business (and specify the contemplated scope of the business).

i. Parties who negotiate for a limited terms of their investment should be entitled to enforce the agreed limitations to preserve the benefit of their bargain. In re NextMedia Investors, LLC, C.A. No. 4069-VCS, 2009 WL 1228665 (Del. Ch. May 6, 2009). Where an investor became a member in an LLC that provided for the LLC to dissolve on or prior to a specified date eight years later, an amendment to the LLC agreement extending the life of the company or affecting a member’s right to
withdraw will materially alter a meaningful economic term. Because depressed economic conditions had depreciated the value that could be obtained for the LLC’s assets upon liquidated, the managers sought to amend the LLC agreement to defer the dissolution date for an additional four years. Vice Chancellor Slichts held that because the agreement required the consent of all members that were adversely affected, an amendment could not be implemented without the consent of the plaintiff.

2. The remedy of judicial dissolution is limited to a member or a manager under the express terms of Section 18-802. Accordingly, an assignee that has not been admitted as a member lacks standing to petition for judicial dissolution. In re Carlisle Et cetera LLC, 114 A.3d 592 (Del. Ch. 2015). But where the sole member transferred its interest in a joint venture LLC to its wholly owned subsidiary, and the other member treated the subsidiary as a member, and the LLC’s board of directors, composed of two designees of the assignor/parent and two designees of the other member, reached a deadlock, Vice Chancellor Laster decreed an equitable dissolution.

F. The Role of the Implied Covenant of Good Faith and Fair Dealing. When a transaction does not work out as expected, a party may try to reform the agreement by reference to the implied contractual covenant of good faith and fair dealing. To succeed in an implied covenant claim, a plaintiff must show that the contract contains a gap in terms, and that it is necessary to imply a term to fill the gap to prevent that party from being deprived of a material part of the benefit for which the other bargained. The implied covenant is a gap filler to enforce the reasonable expectations of the parties at the time a contract was entered into, in a manner that the parties did not or could not have reasonably anticipated at the time of the negotiations, but would have addressed had they thought about it. Nemec v. Schrader, 991 A.3d 1120, 1129 (Del. 2010) Gerber v. Enterprise Products Holdings, LLC, 67 A.3d 400, 418 (Del. 2013).

1. In order to successfully maintain a breach of the implied contractual covenant of good faith and fair dealing, generalized allegations of bad faith are not enough; a party must establish (1) a specific implied contractual obligation, (2) a breach of that obligation by the defendant, and (3) resulting harm to the plaintiff by virtue of the breach. Kuroda v. SPJS Holdings L.L.C., 971 A.2d 872 at 888 (Del. Ch. 2009) (citing Fitzgerald v. Cantor, 1998 WL 842316, at *1 (Del. Ch. Nov. 10, 1998).

2. The implied covenant is an objective standard that looks at the terms of the contract and the facts and circumstances at the time of contracting to determine whether a party’s subsequent acts or proposed behavior was foreseeable and is consistent with the parties’ reasonable expectations at the time of the contracting. The implied covenant bars arbitrary or unreasonable conduct that would prevent a party from realizing the benefits of its bargain. Nemec, 991 A2d at 1129; Kuroda v. SPJS Holdings, L.L.C., 971 A.2d 872, 888 (Del. Ch. 2009).

3. “Delaware’s implied duty of good faith and fair dealing is not an equitable remedy for rebalancing economic interests after events that could have been anticipated but were not that later adversely affected one party to the contract.” Nemec at 1128. Parties cannot
anticipate and contractually provide for every future possibility, but a Delaware court will not rewrite the agreement based upon foreseeable changed circumstances, where the parties failed to negotiate for protections. *Winshall v. Viacom International, Inc.*, 76 A.3d 808 (Del. Supr. 2013).

a. This is particularly true where the negotiation involved sophisticated parties. *West Willow-Bay Court, LLC v. Robino-Bay Court Plaza*, LLC, C.A. No. 2742-VCN, 2007 WL 3317551 (Del. Ch. Nov. 2, 2007).

4. The implied covenant of good faith and fair dealing is not a tool to remedy bad drafting. Although the focus of the implied covenant is on the circumstances at the time of contracting, the Delaware Supreme Court recently acknowledged that “the parties’ sloppiness and failure to consider the implications of” developments occurring subsequently to the original contract negotiations do not “equate to a contractual gap.” See *Oxbow Carbon & Minerals Holdings, Inc. v. Crestview-Oxbow Acquisition, LLC*, C.A. Nos. 12447-VCL and 12509-VCL, ___ A.3d ___, 2019 WL 237360 at * 39 (Del. January 17, 2019). The facts of *Oxbow* are illustrative:

a. In the *Oxbow* case, a PE fund investor sought to force an exit sale under a provision of the LLC Agreement entitling it to do so if the LLC did not honor its put right. The relevant provisions stated that (1) the exit sale required the transfer of “all, but not less than all” of the Company’s outstanding equity securities in a single arm’s length transaction or a series of related transactions, and (2) an exit sale could only be consummated if each member received a return on its invested capital at a multiple of 1.5x (including prior distributions). But the LLC Agreement also required that each unit transferred pursuant to an exit sale must be transferred on identical terms and conditions as each other unit so transferred and that the proceeds of a sale, after tax distributions, were to be distributed to the members based on their respective percentage interests. *Id.* at 16 – 22. The difficulty was that after the fund negotiated the terms of its investment and its exit, certain small minority holders associated with William Koch, part of the controlling block, were admitted at a higher price per unit. By that time, all the other members had received distributions exceeding their 1.5x return. While the LLC Agreement empowered the board to establish the rights and powers of new members, and to issue different classes or series of units, the board did not establish any terms differentiating the rights of these members, who acquired a combined 1.4%. As the exit date for the initial investors approached, the LLC had insufficient liquidity to fund a buyout of the PE investor, who agreed several times to defer the date at which it could exercise its put right before finally attempting a put. When the LLC did not honor the put, the PE investor attempted to force an exit sale over the objection of the 1.4% holders, who had not attained their 1.5x return.

b. The PE investor tried to argue that the parties had never intended to allow the small investors to block an exit sale based on their failure to realize a 1.5x return on their capital contributions. After a trial and post-trial briefing, the Court of Chancery found this to be a gap that could be filled by the implied covenant, and implied a term enabling the LLC to apply sale proceeds first to satisfy the small minority holders’ right to a 1.5x
return, and then to allocate the remaining sale proceeds pro rata among the members based upon their respective percentage interests.

c. The Supreme Court, in analyzing the implied covenant argument, noted that the parties’ failure “give adequate attention to the effect that the admission of new Members at a higher entry price would have on the Exit Sale Right provisions of the agreement” did not create a gap to be filled by application of the implied covenant of good faith and fair dealing. *Id.* At 41. The court noted that the LLC Agreement was amended in 2014, after the small minority holders invested and while the PE fund was planning for its exit, and concluded that the PE fund had ample opportunity to negotiate terms that would allow an exit sale to proceed notwithstanding the failure of these small minority members to receive their 1.5x return prior to the exit sale. See also *Black Horse Capital* at *28 (“Delaware courts do not apply the implied covenant “to give plaintiffs contractual protections that ‘they failed to secure for themselves at the bargaining table.’”)*

d. The court also noted the unwillingness of Delaware courts to imply new contract terms merely because a contract grants discretion to the board – in *Oxbow*, the discretion to fix the terms of the units issued to the small minority holders to disqualify them from equal treatment in connection with an exit sale. *Id.* at 37.

*NOTE: The contents of this outline do not constitute legal advice.*