As litigators, we often think to ourselves, “if only I had a hand in drafting this agreement, I would have told the drafter to do it differently to avoid this situation!” With this in mind, we created a “Top Ten” list of liability and governance issues for deal attorneys and litigators that includes the most commonly litigated topics in this area. While it is impossible to think of every possible situation or issue when drafting a limited partnership agreement or operating agreement, this “Top Ten” list should serve as a useful guide for areas to pay particular attention to during negotiations.

1. **Advancement and Indemnification**

Advancement and indemnification issues are often some of the most contested areas in the Delaware courts. This is because they are often included in form agreements, but most do not even realize they are included. Many times, the indemnitee is not even aware that he or she is entitled to advancement or indemnification until an attorney familiar with Delaware law reviews the agreement. Pursuant to 6 Del. C. § 17-108 and 6 Del. C. § 18-108, indemnification and advancement are permissive, meaning that the limited partnership agreement and limited liability company agreement do not have to include such rights. Contrast this with 8 Del. C. § 145(c), which mandates indemnification when a present or former director or officer has been “successful on the merits or otherwise.”

2. **Dissolution**
Under New York law, there is no basis for dissolution when members are deadlocked and neither of the articulated standards of Section 702 are satisfied. In re 1545 Ocean Ave., LLC, 72 A.D.3d 121 (2d Dep’t 2010). Therefore, if the LLC agreement is silent as to dissolution, the parties’ only option is to comply with the requirements of Section 702 and 1545 Ocean Avenue.

3. Fiduciary Duties

Freedom of contract is one of the most attractive aspects of forming an LLC or LP. The Delaware LLC Act provides parties forming a business entity maximum contractual flexibility to meet their objectives 6 Del. C. § 18-1101(b). One such flexibility is that fiduciary duties may be expanded, restricted or eliminated provided that the implied covenant of good faith and fair dealing is not eliminated. To the extent that fiduciary duties are waived, plaintiffs typically need to bring an action claiming a breach of the implied covenant.

4. Buyout and Company Sales

This issue has come up recently in the Delaware courts where majority members of a Delaware LLC sought a declaratory judgment that they could block a proposed sale of the LLC based on the terms of the LLC Agreement. Oxbow Carbon & Minerals Hldgs, Inc. v. Crestview-Oxbow Acquisition, LLC, 202 A.3d 482 (Del. Jan. 17, 2019). The Court of Chancery concluded that the LLC agreement permitted the majority members to block the sale, but found a gap in the LLC agreement and used the implied covenant to permit the sale. The Delaware Supreme Court reversed, noting that invoking the implied covenant is a “cautious enterprise” that should be applied only when the contract is truly silent.

5. Deadlock

When starting a business, one often does not think about how to get out of it in the event of deadlock. Unfortunately, this often happens. However, even if an agreement includes deadlock
resolution provisions, the drafter should be sure that they are clear and unambiguous. See Acela Invs. LLC v. DiFalco, 2019 WL 2158063 (Del. Ch. May 17, 2019). Other options in the event of deadline are: put rights, “Russian Roulette,” “Texas Shoot Out” or Dutch Auctions. See Lola Cars Int’l Ltd. V. Krohn Racing, LLC, 2010 WL 3314484 (Del. Ch. Aug. 2, 2010); Fisk Ventures, LLC v. Segal, 2009 WL 73957 (Del. Ch. Jan 13, 2009).

6. Transfer Restrictions

Pursuant to the Delaware LLC Act, an LLC interest is assignable in whole or in part except as provided by an LLC Agreement. 6 Del. C. § 18-702. However, the assignee has no right to participate in the management of the LLC except as provided in the agreement or, unless otherwise provided in the LLC agreement, upon the vote or consent of all of the members of the LLC. Restrictions on transferability of LLC interests is at the heart of the LLC as a business entity choice, and the ability to “pick your partner.” See REG v. Iowa Renewable Energy, 2017 Iowa Dist. LEXIS 3 (Iowa Dist. Ct. Sept. 27, 2017).

7. Assertion of Derivative Claims by a Member of a Limited Liability Company

The Revised Uniform Limited Liability Company Act (“RULLCA”), which has been adopted by twenty states, provides that a member may maintain a derivative action. Other states that have not adopted the RULLCA, including New York, Texas and Delaware have provided members a statutory or common law right to bring derivative claims. TX Bus. Org. §§ 101.452; 101.453; Tzolis v. Wolff, 10 N.Y.3d 100 (2017); 6 Del. C. § 18-1001.

8. Assignment of Membership Interest: What Rights are Transferred?

Typically, while transfer of a membership interest is permissible, it does not entitle the transferee to participate in management or to have access to books and records. See RULLCA §
502; NY Limit. Liab. Co. § 603; 6 Del. C. 18-702. Again, this protects the members’ interests in the LLC and the “pick your partner” doctrine.

9. Valuation

A recent Delaware case emphasized the importance of precise language for valuation of an outgoing members’ interest. Domain Associates, L.L.C. v. Shah, 2018 WL 3853531 (Del. Ch. Aug. 13, 2018). The operating agreement in Shah provided that the withdrawal of a member was entitled to the amount in his or her capital account but did not provide for a valuation mechanism in a forced withdrawal. The Court, applying 6 Del. C. § 18-1104, held that Shah was entitled to the fair value of his member interest. The Court held that although the members “could have drafted [the provision] to address required withdrawals,” they did not, and “[t]hat omission d[id] not make its terms irrational.”

10. Removal

Finally, in another example of the necessity of a precisely crafted agreement, the parties should clearly set out steps for removal. See Eames v. Quantlab Group GP, LLC, 2018 WL 2041548 (Del. Ch. May 1, 2018). In Eames, even though 96% of the voting limited partnership interests were in favor of replacing the general partner, and the representative of the original general partner agreed in favor of the succession, the precise steps of the limited partnership agreement were not followed, making the removal invalid.
Alternative Entities
“Top Ten”

Liability and Governance Issues for Deal Attorneys and Litigators - Interactive!

Presented by: Partnerships and Alternative Business Entities

Moderator: The Honorable Meghan A. Adams, Judge, Superior Court of Delaware

Panelists: The Honorable Saliann Scarpulla, Justice, Commercial Division, Supreme Court of the State of New York
Tarik Haskins, Esquire, Morris Nichols Arsht & Tunnell LLP
Erica Rice, Esquire, Foley Hoag LLP
Vanessa R. Tiradentes, Esquire, Gould & Ratner, LLP
ADVANCEMENT & INDEMNIFICATION
The operating agreement of the LLC (as Delaware entity) imposes a duty on A, as a member, to use best efforts in its capacity as member to either exchange certain real property or have it developed. LLC sues A in NJ, challenging A’s call rights based on A’s alleged failure to use its best efforts concerning the property under the operating agreement. The indemnification and advancement provisions read as follows:
Section 14(a) of the Operating Agreement, which discusses indemnification, states that

- The Company shall indemnify any person (each, an "Indemnitee") who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding brought by or against the Company, or otherwise . . . including, without limitation, any action by or in the right of the Company to procure a judgment in its favor, by reason of the fact that such Indemnitee is or was a Managing Member, Member or an officer of the Company.

Section 14(b) of the Operating Agreement, which discusses advancement, adds that

- The Company shall pay expenses incurred by any Indemnitee in defending any action, suit or proceeding described in Section 14(a) in advance of the final disposition of such action, suit or proceeding upon receipt of an undertaking by or on behalf of such Indemnitee to repay such advance if it shall ultimately be determined that such Indemnitee is not entitled to be indemnified by the Company pursuant to this Section 14.

Is A entitled to advancement?
Multiple Choice

A. A is not entitled to advancement in connection with the NJ case
B. A is not entitled to advancement in connection with the NJ case because it is not a manager of the LLC
C. A is entitled to advancement in connection with the NJ case
D. A can only seek advancement in NJ where the underlying case is pending
Discussion

  - Delaware Court of Chancery finds that member is entitled to advancement with respect to underlying suit involving member’s call rights.
  - Emphasizing that “parties are free to contract into corporate case law (or not) when they create LLCs, and courts will respect that choice,” the Court found that because the “by reason of the fact” language in the operating agreement’s indemnity and advancement provisions was “nearly identical” to the language found in the indemnity and advancement provisions of Section 145 of the Delaware General Corporation Law, that the members intended to import general corporation law principles, and thus utilized Section 145 to guide its interpretation of the indemnity and advancement provisions in the operating agreement.
  - Since the underlying action challenged the plaintiff member’s call rights based on its failure to perform its member duty to use best efforts concerning certain property under the operating agreement, the suit directly implicated the member’s performance of its official duties under the operating agreement.
Hypothetical

A is the sole manager of a Delaware LLC. A is removed as manager. A different entity of which A is the manager sues the LLC in Illinois for breach of certain asset management agreements. The LLC files a Third Party Claim against A, alleging breach of fiduciary duty. A seeks advancement in connection with his defense of the Third Party Claim, which the LLC denies. A seeks to enforce his advancement rights in Delaware. The indemnification and advancement provisions in the LLC’s operating agreement read as follows:
Hypothetical

To the extent provided by this Agreement, the Company shall indemnify, defend and hold harmless to the maximum extent permitted under the [Delaware Limited Liability Company Act], the Manager and any such other Person(s), any other Person acting on its behalf from any loss, damage, claim or liability related to or arising from a third party claim or action, including, but not limited to, reasonable attorneys’ fees and expenses, incurred by it by reason of any act performed by it in accordance with the terms of this Agreement or in enforcing the provisions of this indemnity...

Any Person entitled to indemnification under this Section 4.8 related to a third party claim or action is entitled to receive, upon application therefor, advances to cover costs of defending any proceeding against such Person.

Is A entitled to advancement?
Multiple Choice

A. A is entitled to advancement in connection with his defense of the third party claim
B. A must litigate advancement rights in Illinois as part of the underlying action
C. A is not entitled to advancement in connection with defending any claims asserted by the LLC against A
D. A is not entitled to advancement in connection with his defense of the third party claim
Discussion

  - Court rejects Defendants’ argument that Mr. Murphy is not entitled to advancement because the claims asserted against him are not third party claims under the LLC. In giving “meaning” to the phrase “third party claim” - an undefined term in the operating agreement - the Court interprets it to mean “any claims involving third parties to the agreement.” Since Mr. Murphy is not a signatory to the operating agreement, he is a third party to the operating agreement.
DISSOLUTION
Hypothetical

- An LLC with two fifty percent shareholders (A and B) have a falling out. The LLC has no operating agreement or is otherwise silent or inadequate with regard to withdrawal and voluntary dissolution rights. The business is profitable and continues to carry on the purpose of the business. Under New York Law, if A and B are deadlocked and A wants to dissolve the LLC, what is her remedy?
Multiple Choice

A. A can unilaterally dissolve the LLC
B. A is left only with the statutory remedy of judicial dissolution
C. Judicial dissolution is not an option, but A can recover from B for any wrongdoing
D. A can only buyout B’s interest
Discussion

- **In re 1545 Ocean Ave., LLC, 72 A.D.3d 121 (2d Dep’t 2010)**
  - Case of first impression defining the dissolution standard of “not reasonably practicable,” holding that the petitioner must establish either: (1) that the management of the LLC is unwilling or unable to promote the stated purpose of the business, or (2) that continuing the entity is financially unfeasible.
  - Applying the standard to the case, the Appellate Division, Second Department determined that even though the parties were deadlocked, the purpose of the LLC was being met and, therefore, judicial dissolution was improper.
  - There remains no basis of dissolution when members are deadlocked and neither of the articulated standards are satisfied.
Advanced 23 v. LLC v. Chambers House Partners, LLC, Index 650025/2016

Petitioner sought judicial dissolution of an LLC that operated a building located in Manhattan, and members were 50/50 owners.

Disputes arose between the members, and the Court determined that, although disagreements between members alone is not enough for dissolution, petitioner made a prima facie showing that satisfied the 1545 Ocean Ave standard because the LLC was unable to make decisions such as refinancing their mortgage.

However, the Court denied the petition for dissolution because respondents raised issues of fact regarding petitioner’s alleged bad faith in purposefully causing the dispute to force dissolution and gain control of the building.

After referring the issue to a Special Referee, the Court confirmed the Referee’s determination that petitioner attempted a forced dissolution and therefore, denied the petition for dissolution.
Hypothetical

- There is an LLC with two members, A and B. The LLC was formed under the laws of Delaware. A resides in New York. B resides in Vermont. The LLC operates in New York. After a dispute arises between A and B, A decides to seek a judicial dissolution of the LLC. Where should A file her lawsuit for judicial dissolution?
Multiple Choice

A. A should file in New York
B. A should file in Vermont
C. A should file in Delaware
D. A can file in any of the above listed venues
Discussion

  - Plaintiff filed complaint seeking judicial dissolution of two Delaware LLCs; Defendants filed motion to dismiss on grounds that Vermont court lacks subject matter jurisdiction to grant judicial dissolution of Delaware LLCs.
  - Court granted Defendants motion to dismiss, holding that it did not have subject matter jurisdiction to dissolve Delaware LLCs under §18-802 of the Delaware LLC Act.
  - Court noted that “Section 18-802 [of the Delaware LLC Act] does not grant subject matter jurisdiction to any other court. It does not identify any other court by name, and it does not use permissive or generic terms suggesting that subject matter jurisdiction would be appropriate in any court where personal jurisdiction can be maintained . . . Therefore, a plain reading of the statute suggests that the default rules governing dissolution grant subject matter jurisdiction only to the Delaware Court of Chancery, and not to any other court.”
 Plaintiff filed complaint seeking judicial dissolution of 17 Delaware LLCs; Defendant moved to dismissed base on Matter of Raharney Capital, LLC v. Capital Stack LLC, 138 A.D. 3d 83 (1st Dept. 2016), where the court “held that the courts of New York do not have subject matter jurisdiction to dissolve a foreign business entity.”

Plaintiff filed amended complaint that did “not seek judicial dissolution per se” but sought “equitable relief associated with judicial dissolution.” Specifically, in the amended complaint plaintiff sought a court order (1) forcing the sale of the assets owned by the LLCs or (2) a buy-out of plaintiff’s and defendant’s interests in the LLCs.

Court dismissed the amended complaint and noted that the amended complaint was “clearly an ill-disguised attempt to make an end-run around the rule expressed in Raharney.”
FIDUCIARY DUTIES
Benefits of LLC Form

- The ability to modify or eliminate fiduciary duties, including the ability to prefer the interests of the designating member.
- The ability, through the limited liability company agreement, to designate the standard of review by the reviewing court.
- The ability to exculpate members and/or managers from any and all liability, other than a bad faith violation of the implied contractual covenant of good faith and fair dealing.
- The ability to tailor management rights, including designating the appropriate person(s) to initiate exit transactions.
- No statutory appraisal rights.
Benefits of LLC Form

- The ability to modify information rights of members pursuant to Section 18-305 of the Delaware LLC Act.
- The ability to modify the requisite vote to amend constituent documents, including the limited liability company agreement.
- The ability to modify the requisite vote to approve fundamental transactions, including: mergers and sale of assets.
- Flexibility regarding the issuance of limited liability company interests.
- Ease of ability to convert LLC into corporation in advance of initial public offering.
FIDUCIARY DUTIES: Delaware LLC Act Building Blocks

Flexibility

- Section 18-1101(b) of the Delaware LLC Act states “It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.” (emphasis added).

- The Delaware LLC Act seeks to provide maximum flexibility to parties forming a business entity to meet the objectives of the parties.
Management

- The Delaware LLC Act provides by default for management by its members, but expressly provides that the LLC Agreement of a limited liability company can provide for other forms of management. See Section 18-402 of the Delaware LLC Act.
FIDUCIARY DUTIES: Delaware LLC Act Building Blocks

**Fiduciary Duties**

- Under Section 18-1101(c) of the Delaware LLC Act, “to the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager … [such] duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.”
Exculpation

- Section 18-1101(e) of the Delaware LLC Act states that “A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager....” Provided that an LLC Agreement cannot eliminate liability for a bad faith violation of the implied contractual covenant of good faith and fair dealing.
Implied Covenant

- Implied Covenant of Good Faith and Fair Dealing
  - In general, the implied covenant of good faith and fair dealing:
    - Protects a party from being deprived of the fruits of the bargain;
    - Is based on the reasonable expectations at the time contract was entered into;
    - Applies to the exercise of discretionary authority.

- To the extent that fiduciary duties are waived, plaintiffs will typically need to bring an action claiming a breach of the implied covenant of good faith and fair dealing.
Fiduciary Duties

- **SAMPLE LANGUAGE ELIMINATING FIDUCIARY DUTIES**

  - The Manager undertakes to perform such duties, and only such duties, as are specifically set forth in this Agreement in accordance with the provisions of this Agreement, and no implied duties, covenants or obligations shall be read into this Agreement against the Manager. Notwithstanding any other provision of this Agreement, the Manager shall have no fiduciary duty to the Company, any Member or any other Person; provided, that the foregoing shall not eliminate the duty to comply with the implied contractual covenant of good faith and fair dealing. The provisions of this Agreement, to the extent that they restrict or eliminate the duties (including fiduciary duties) and liabilities of the Manager otherwise existing at law or in equity, are agreed by the Company, each Member and each other Person bound by this Agreement to restrict or eliminate such other duties and liabilities of the Manager and substitute for them the duties and liabilities specifically set forth in this Agreement.
Contractual Standards of Conduct

- **Relationship Between Discretion and Fiduciary Duties**
  - Unless the contract includes language expressly providing otherwise, exercise of discretion, including sole discretion, is subject to applicable fiduciary duties.

- **Sample Language Providing Discretion Not Subject to Fiduciary Duties.**

  Whenever in this Agreement the Manager is permitted or required to make a decision in its “sole discretion” or “discretion” or under a similar grant of authority or latitude, the Manager shall be entitled to consider only such interests and factors as it desires, shall have no duty or obligation to give any consideration to any interests or factors affecting the Company, the Members or any other Person and shall not be subject to any other standard imposed by this Agreement, any other agreement contemplated hereby, under the Delaware LLC Act or any other law, rule or regulation or at equity.
Contractual Standard Cases


- Chancery Court previously dismissed plaintiffs claims on grounds that plaintiff did not sufficiently allege bad faith by the GP and its affiliates in an MLP’s repurchase of a pipeline interest from an affiliate.

- The Supreme Court found that the Chancery Court erred when it held that “good faith” provisions in an LPA modified the more specific requirement in Section 6.6(e) that the challenged transaction be “fair and reasonable to the Partnership.”

- The case was reversed and remanded to the Chancery Court to determine whether the transaction violated Section 6.6(e) and whether monetary damages or equitable relief were appropriate.
The Chancery Court noted that the Supreme Court held that the transaction was expressly governed by Section 6.6(e). Thus:

- Derivative breach of contract claims could proceed;
  - Plaintiff did not allege any transfer of voting power that could lead to a dual-natured claim
- Aiding and abetting claims against the financial advisor could proceed; and
  - While one cannot aid and abet a breach of contract, there is an exception where the LPA creates “contractual fiduciary duties”, which this LPA did
- Rescission and reformation claims could proceed.
  - Again, due to the “contractual fiduciary duty” standard

However, the implied covenant claim, “secondary” claims and tortious interference claim against the financial advisor failed.

The Chancery Court also found that it previously improperly dismissed claims against affiliates and indemnitees on the grounds that they were not parties to the LPA.

*   *   *
Contractual Standard Cases


- LPA required GP to use its “best efforts” to conduct Blue Bell’s business “in accordance with sound business practices in the industry.”
- In addition, LPA provided that any standard of care or duty imposed by the LPA, DRULPA or other applicable law shall be modified, waived or limited as required to permit the GP to act under the LPA and to make any decision under the LPA, so long as the action is reasonably believed by the GP to be in, or not inconsistent with, Blue Bell’s best interests. The court called this a “contractual good faith” standard, using terminology from _Enbridge_.
- The court cited to _Enbridge_, noting that a general good faith standard operates only where there is no other specific standard, and the operative standard for the claims at issue was the “best efforts” standard.
- Chancery Court dismissed aiding and abetting claims because the obligations under the LPA were contractual.
  - Contrast to _Enbridge_, where the court permitted aiding and abetting claims against the financial advisor to proceed on the basis that there was a “contractual fiduciary duty” standard.
The court also distinguished between “contractual fiduciary duties” and pure contractual duties. The court stated that a contractual duty is a fiduciary duty (i) the scope of which is established by contract or (ii) compliance with which is measured by a contractual standard. When an LPA eliminates the GP’s common law fiduciary duties, the GP does not owe contractual fiduciary duties. In this case, the court held that the contractual good faith standard eliminated all common law fiduciary duties and thus that the plaintiff’s claim was a breach of contract claim rather than a breach of contractual fiduciary duty claim.

This distinction was important in this case for a few reasons:

- Eliminated aiding and abetting claims against the GP’s controlling persons because Delaware law does not recognize aiding and abetting a breach of contract.
- Eliminated claims against the GP’s controlling persons under the USACafes line of cases because the court held that where an LPA entirely eliminates the GP’s common law fiduciary duties, it is doubtful that the GP’s controlling persons owe any fiduciary duties.
- If this case had involved a conflict of interests, this distinction could have resulted in the burden being on plaintiffs, rather than defendants, to prove entire fairness.
Contractual Standard Cases


- Illustrates facts that could make it “reasonably conceivable” that GP did not subjectively believe action (merger) was in the best interests of the Partnership.

- Example of expressly eliminating all duties (including fiduciary duties) and replacing them with a contractual obligation that the GP subjectively believe that its actions were in the best interests of the Partnership.
  - No aiding and abetting; possibly no reformation or rescission of transaction

- Contrast to *Enbridge*, which incorporated a contractual fiduciary duty standard (“fair and reasonable to the Partnership” was something akin to entire fairness; good faith standard was a contractual fiduciary duty).
  - Can aid and abet; reformation or rescission of transaction are possible remedies

*     *     *
BUYOUT & COMPANY SALES
Company Sale and Exit Transactions


- In Court of Chancery action, majority members of a Delaware limited liability company sought a declaratory judgment that they could block a proposed sale of the LLC based on the terms of the LLC Agreement. The Court of Chancery agreed with the majority members of the Delaware limited liability company and concluded that the plain meaning of the LLC Agreement permitted the majority members to block the sale; however the Court of Chancery found a gap in the LLC Agreement and used the implied covenant of good faith and fair dealing to permit the sale.
On appeal, Oxbow argued that the Court of Chancery improperly applied the implied covenant and that there was no contractual gap.

- The Supreme Court concluded that there was no contractual gap in the LLC Agreement, and determined that granting the board of directors discretion to determine the terms upon which new members would be admitted was a contractual choice, not a gap.

- The Supreme Court further emphasized the limited reach of the implied covenant, emphasizing that:
  - Invoking the “implied covenant” is a cautious enterprise.
  - The “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 a contract.”

- The “implied covenant” only applies when the contract is truly silent.
Company Sale and Exit Transactions


- Plaintiffs claimed that HCP & Company and its affiliates, which controlled the Board of Managers of an LLC, violated the implied covenant of good faith and fair dealing by authorizing the sale of the LLC without conducting an auction or open sales process designed to achieve the highest value reasonably available for all of the members of the LLC.

- Under the distribution waterfall, in the event of a sale, approximately 90% of the first $30 million in sales proceeds would go to the HCP Entities. After the first $30 million in sales proceeds, other classes of members would receive millions of dollars in proceeds before the HCP Entities would again share pro rata in the sales price.
Company Sale and Exit Transactions

- The HCP-affiliated managers on the Board pushed to accept the offer; the other managers objected, which led the buyer to increase its initial offer to $43 million, which offer was accepted.

- Plaintiffs claimed that the HCP Entities breached the implied covenant of good faith and fair dealing.

- The operating agreement explicitly waived default fiduciary duties in accordance with the Delaware LLC Act and gave the Board sole discretion as to the manner of any sale, as long as the sale was to an unaffiliated third party.

- The court held that because the scope of discretion had been specified by the parties, there was no gap in the operating agreement as to the scope of discretion and therefore no reason for the court to invoke the implied covenant to determine how discretion should be exercised.
Company Sale and Exit Transactions

- The court noted that some courts have applied the implied covenant to sole discretion clauses because an unqualified grant of sole discretion presents the opportunity that a party entitled to exercise that discretion may abuse it for self-interested reasons and thereby deprive the other party of the benefit of its bargain. However, the court found that those cases were not controlling because the parties to the operating agreement had explicitly addressed this concern by providing that the Board did not retain sole discretion to sell the company to affiliates or insiders and therefore the parties had recognized and filled that gap that some courts have found in contracts that provide for an unqualified grant of sole discretion.

- The court found that defendants’ conduct during the sale process was not arbitrary, unreasonable or unanticipated *in light of the provisions of the operating agreement*. 
Company Sale and Exit Transactions

- On appeal the Supreme Court disagreed with the Chancery Court on whether the terms of the LLC Agreement displaced the implied covenant entirely.
- However, the Supreme Court affirmed the Chancery Court’s decision because it agreed with the “essential holding that the implied covenant could not be used to imply Revlon-type sale requirements,” particularly when the LLC Agreement expressly eliminated fiduciary duties.
DEADLOCK
Three friends form a Delaware LLC for the purpose of starting a vegan burger restaurant. Each holds a 1/3 interest in the company. When it comes time to sourcing their vegan patties, two of the friends prefer Impossible Burgers (the “Impossible Members”) and one prefers Beyond Meat Burgers (the “Beyond Member”). The operating agreement requires a 75% vote of the members for all material decisions, and provides that deadlocks can be resolved by mediation. The operating agreement also includes a put right, giving each member the option to force the other members to purchase their interest at fair market value at any time. What options do the friends have?
Multiple Choice

A. The Impossible Members can force the Beyond Member to exercise its put right and sell its interests to them
B. Any member may petition the Court of Chancery to administer a blind taste test
C. Any member may apply for judicial dissolution of the LLC
D. The members must mediate the dispute
Judicial Dissolution due to Deadlock

- **Section 802 of the Delaware Limited Liability Company Act**
  - An LLC may be judicially dissolved if “it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement.”

- **Fisk Ventures, LLC v. Segal, 2009 Del. Ch. LEXIS 7 (Jan. 13, 2009)**
  - Factual circumstances courts consider when evaluating whether it is “reasonably practicable” for the company to carry on its business: (1) members are deadlocked at the Board level, (2) the operating agreement gives no means of navigating around the deadlock and (3) due to the financial condition of the company, without resolution of the deadlock there is effectively no business to operate.
  - Factors are not dispositive, and not all have to exist for a court to find it no longer reasonably practicable for a business to continue operating.
Avoiding Judicial Dissolution

- Avoid deadlock
  - *Lola Cars Int’l Ltd. v. Krohn Racing, LLC*, 2010 WL 3314484 (Del. Ch. Aug. 2, 2010) - Court held there was no deadlock despite evenly-split board because CEO was vested with day-to-day operation of the business.

- Include clear deadlock resolution provisions
  - *Acela Invs. LLC v. DiFalco*, 2019 WL 2158063 (Del. Ch. May 17, 2019) - Ordering dissolution because deadlock resolution provision was “inherently vague and ambiguous.”

- Optional Put Right v. “Russian Roulette”/“Texas Shoot Out”/Dutch Auction
  - *Fisk* - Put right was not a means of navigating around deadlock because it was permissive on the part of the member holding the put right.
  - *Lola Cars* - “Russian Roulette” dispute resolution mechanic was sufficient to allow a disgruntled party to exit.
TRANSFER
RESTRICTIONS
The friends manage to resolve their differences and are ready to open No-Moo Burger Bar. Given all they’ve been through to get the restaurant open, they want to guarantee that none of the members sells or otherwise transfers their interest in the company to someone who might disrupt what they have built. What should the friends do to ensure that control of the No-Moo Burger Bar remains with the three original members?
Multiple Choice

A. Amend the operating agreement to include a right of first refusal on transfers of a member’s interest in the company favor of the other members

B. Amend the operating agreement to include an absolute restriction on transfer of a member’s interest in the company without the consent of all of the other members

C. None of the above

D. A or B
Delaware Law Default Rule

- **Section 702 of the Delaware Limited Liability Company Act**
  - “A limited liability company interest is assignable in whole or in part except as provided in a limited liability company agreement. The assignee of a member’s limited liability company interest shall have no right to participate in the management of the business and affairs of a limited liability company except as provided in a limited liability company agreement or, unless otherwise provided in the limited liability company agreement, upon the vote or consent of all of the members of the limited liability company.”

- “Bare economic rights” automatically inure to the benefit of a transferee of a membership interest in an LLC, but the transferee does not automatically receive governance or other rights of members.
Enforceability of Transfer Restrictions

  - Court upheld an absolute restriction on the transfer of membership interests without Board consent and refused to apply a “reasonableness” standard that some courts apply to restrictions on transfers of corporate stock.
  - “While analogies to corporate law may be appropriate in certain situations, the transferability of membership interest in an LLC entity is not one of them...“[o]ne of the most fundamental characteristics of LLC law is its fidelity to the ‘pick your partner’ principle.””
  - “[R]estrictions on the transferability of an LLC’s membership interests lies at the heart of the limited liability company as a business entity choice.”
Assertion of Derivative Claims
By a Member of A Limited Liability Company

Yes or No? If yes, how?
May A Member of Limited Liability Company Bring a Derivative Suit Against Another Member on Behalf of the LLC?

A) Generally yes.

B) Generally no.
The Revised Uniform Limited Liability Company Act ("RULLCA") has been adopted by twenty states: Arizona; Pennsylvania; Illinois; Connecticut; North Dakota; Vermont; Idaho; Washington; Alabama; Minnesota; South Dakota; Florida; New Jersey; California; District of Columbia; Utah; Nebraska; Wyoming; Iowa; Idaho. A bill was introduced to enact it in South Carolina this year.
SECTION 902. DERIVATIVE ACTION. A member may maintain a derivative action to enforce a right of a limited liability company if:
(1) the member first makes a demand on the other members in a member-managed limited liability company, or the managers of a manager-managed limited liability company, requesting that they cause the company to bring an action to enforce the right, and the managers or other members do not bring the action within a reasonable time; or
(2) a demand under paragraph (1) would be futile.

SECTION 904. PLEADING. In a derivative action under Section 902, the complaint must state with particularity:
(1) the date and content of the plaintiff’s demand and the response to the demand by the managers or other members; or
(2) if a demand has not been made, the reasons a demand under Section 902(1) would be futile.
States Not Adopting the RULLCA Have Nevertheless Provided Members a Statutory or Common Law Right to Bring Derivative Claims. Examples: Texas and New York
Sec. 101.452. STANDING TO BRING PROCEEDING.

(a) Subject to Subsection (b), a member may not institute or maintain a derivative proceeding unless:
   (1) the member:
       (A) was a member of the limited liability company at the time of the act or omission complained of; or
       (B) became a member by operation of law originating from a person that was a member at the time of the act
           or omission complained of; and
   (2) the member fairly and adequately represents the interests of the limited liability company in enforcing the right of the limited liability company.

(b) If the converted entity in a conversion is a limited liability company, a member of that limited liability company may not institute or maintain a derivative proceeding based on an act or omission that occurred with respect to the converting entity before the date of the conversion unless:
   (1) the member was an equity owner of the converting entity at the time of the act or omission; and
   (2) the member fairly and adequately represents the interests of the limited liability company in enforcing the right of the limited liability company.

Sec. 101.453 DEMAND.

(a) A member may not institute a derivative proceeding until the 91st day after the date a written demand is filed with the limited liability company stating with particularity the act, omission, or other matter that is the subject of the claim or challenge and requesting that the limited liability company take suitable action.

(b) The waiting period required by Subsection (a) before a derivative proceeding may be instituted is not required or, if applicable, shall terminate if:
   (1) the member has been [previously ] notified that the demand has been rejected by the limited liability company;
   (2) the limited liability company is suffering irreparable injury; or
   (3) irreparable injury to the limited liability company would result by waiting for the expiration of the 90–day period.
New York Common Law

In *Tzolis v. Wolff*, 10 NY3d 100 (2008), The New York Court of Appeals, in a divided decision, held that members of a New York LLC have a common law right to bring derivative actions on the LLC’s behalf, even though there are no provisions governing derivative actions in the New York Limited Liability law.

New York has not yet issued a definitive appellate decision on whether demand is required (or may be excused) for a member to assert a derivative claim.
ASSIGNMENT OF MEMBERSHIP INTEREST: WHAT RIGHTS ARE TRANSFERRED?
CONSIDER THIS HYPOTHETICAL

In the early 1990s, Grandma and Grandpa form a limited liability company, Your Inheritance, to buy a commercial building in a desirable area. Grandma and Grandpa are equal members of Your Inheritance, and they manage the LLC jointly. Your Inheritance thrives as real estate values increase.

The operating agreement of Your Inheritance does not contain a specific provision concerning the effect of a transfer of a member’s interest, either upon sale, other transfer, or death of that member.

Grandpa and Grandma divorce, and Grandpa gifts his interest in Your Inheritance to Daughter. Grandma then remarries, and Grandma and Grandma’s new husband have been managing Your Inheritance in a way that Daughter believes is detrimental to her rights in Your Inheritance.
May Daughter:

Demand a vote to oust Grandma’s new husband from managing Your Inheritance?
A) Yes.
B) No.

Demand to see the books and records of Your Inheritance?
A) Yes
B) No.

Bring a derivative suit on behalf of Your Inheritance against Grandma for breach of fiduciary duty?
A) Yes.
B) No.

Be required to pay a portion of a capital call made by Your Inheritance?
A) Yes.
B) No.
RULLCA Provisions on Transfer of Membership Interest

SECTION 502. TRANSFER OF TRANSFERABLE INTEREST.

(a) A transfer, in whole or in part, of a transferable interest:

(1) is permissible;

(2) does not by itself cause a member’s dissociation or a dissolution and winding up of the limited liability company’s activities; and

(3) subject to Section 504, does not entitle the transferee to:

(A) participate in the management or conduct of the company’s activities;

(B) except as otherwise provided in subsection (c), have access to records or other information concerning the company’s activities.

(b) A transferee has the right to receive, in accordance with the transfer, distributions to which the transferor would otherwise be entitled.

(c) In a dissolution and winding up of a limited liability company, a transferee is entitled to an account of the company’s transactions only from the date of dissolution.
Statutory Provisions in States that Have Not Adopted the RULLCA

**Texas**

**Tx Bus Org § § 101.108; 101.109**

(a) A membership interest in a limited liability company may be wholly or partly assigned.

(b) An assignment of a membership interest in a limited liability company:

(1) is not an event requiring the winding up of the company; and

(2) does not entitle the assignee to:

(A) participate in the management and affairs of the company;

(B) become a member of the company; or

(C) exercise any rights of a member of the company.

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**New York**

**NY Limit Liab Co § 603**

(a) Except as provided in the operating agreement,

(1) a membership interest is assignable in whole or in part;

(2) an assignment of a membership interest does not dissolve a limited liability company or entitle the assignee to participate in the management and affairs of the limited liability company or to become or to exercise any rights or powers of a member;

(3) the only effect of an assignment of a membership interest is to entitle the assignee to receive, to the extent assigned, the distributions and allocations of profits and losses to which the assignor would be entitled; and

(4) a member ceases to be a member and to have the power to exercise any rights or powers of a member upon assignment of all of his or her membership interest.
How Does an Assignee Become A Member of A Limited Liability Company?

**RULLCA § 401(d)**

(d) After formation of a limited liability company, a person becomes a member:
1. as provided in the operating agreement;
2. as the result of a transaction effective under Article10 [Merger, Domestication, Conversion];
3. with the consent of all the members; or
4. if, within 90 consecutive days after the company ceases to have any members:
   A. the last person to have been a member, or the legal representative of that person, designates a person to become a member; and
   B. the designated person consents to become a member.

**Tx Bus Org § 101.109(b)**

(b) An assignee of a membership interest in a limited liability company is entitled to become a member of the company on the approval of all of the company's members.

**NY Limit Liab Co § 604(a)**

(a) Except as provided in the operating agreement, an assignee of a membership interest may not become a member without the vote or written consent of at least a majority in interest of the members, other than the member who assigned or proposes to assign such membership interest.
What Liabilities Does a Transferee Assume

RULLCA § 502 (g)
(g) Except as otherwise provided in Section 602(4)(B), when a member transfers a transferable interest, the transferor retains the rights of a member other than the interest in distributions transferred and retains all duties and obligations of a member.

NY Limit Liab Co § 603(c)
c) Unless otherwise provided in an operating agreement and except to the extent assumed by agreement, until the time, if any, that an assignee of a membership interest becomes a member, the assignee shall have no liability as a member solely as a result of the assignment.

Tx Bus Org §§ 101.109(c)
(c) An assignee of a membership interest in a limited liability company is not liable as a member of the company until the assignee becomes a member of the company.
Valuation of Member’s Interests in an LLC

- Larry was a member of Venture Capital LLC, a Delaware LLC. The other members exercised their right under Venture Capital’s Operating Agreement to force Larry to withdraw and paid him the value of his capital account. Larry files an action, arguing that he should be entitled to the fair value of his member interest.

- The Operating Agreement provides that the withdrawal of a member is entitled to “an amount equal to (A) such Member’s capital account, to be determined as of the date of a Member’s death or retirement, or his withdrawal, less (b) any debt that the member may owe” to the LLC.

- LLC argues that Larry was entitled to receive the value of his capital account. Larry argues that because the LLC Agreement does not specify a payout, the default provisions of the Delaware LLC Act control, entitling him to the fair value of his member interest. Who is correct?
Who is correct?

A. Venture Capital LLC
B. Larry
Correct Answer: Larry


- The Court held that the LLC Agreement was silent as to the payout due to a member whose withdrawal was forced by the vote of the other members.

- The Court also refused to consider extrinsic evidence since the provisions were “plain and unambiguous.”

- Court also relied on the fact that the agreement was one-sided and was presented on a “take-it-or-leave-it” basis.
Removal of a General Partner

- Under Carolina Group, LP’s limited partnership agreement, Carolina Group’s general partner may be removed without cause only if: (1) at least one other general partner remains; (2) at least one of the other current general partners consents; and (3) a super majority in interest of the limited partners consents. Prior to November 6, 2018, Carolina LP’s sole general partner was Carolina GP, LLC.

- On November 6, 2018, a voting trustee, acting by written consent on behalf of approximately 96% of Carolina LP’s voting LP interests, purported to add Carolina Group GP II, LLC as a general partner of Carolina LP and then removed Carolina GP as GP.

- Michael Jordan, acting as a manager of Carolina GP, purported to consent to Carolina GP II’s addition as a general partner of Carolina LP so that a general partner would remain upon Carolina GP’s subsequent removal.
Who is the General Partner of Carolina LP?

A. Carolina I, GP because Carolina II’s addition as general partner was invalid under the limited partnership agreement

B. Carolina II, GP because the actions taken by virtue of the written consents adequately added Carolina II, GP as the general partner and removed Carolina GP as general partner
Correct Answer: A (Carolina GP)

- In an action brought under 6 Del. C. § 17-110, the unambiguous terms of the LP agreement required a second general partner before Carolina GP could be removed, and admitting a new general partner required Carolina GP’s consent. *Eames v. Quantlab Group GP, LLC*, 2018 WL 2041548 (Del. Ch. May 1, 2018)

- LP Agreement clearly set out the steps that had to be taken:
  - GP may be removed without cause only if at least one other GP remained
  - The addition of a new GP required the consent of the then-acting GP
  - GP did not agree in advance to the voting trustee’s actions by virtue of signing the voting trust agreement giving the trustee authority to consent to Carolina II’s addition as GP
  - Manager of the GP lacked unilateral authority to consent to Carolina II’s addition as GP
Analysis, cont.

- Court rejected the argument that it would be “nonsensical to create a regime whereby a sole general partner, in essence, could have to facilitate its own removal by consenting to the addition of a new general partner before any removal could be effected.”

- LPA unambiguously provided that “a General Partner may not be removed unless there is at least one remaining General Partner,” and also required the consent of a super majority of the limited partners.

- Had the parties intended to limit these requirements to allow for simultaneous removal and replacement of the lone GP without consent, they could have easily done so.
Analysis, cont.

- Court also rejected the argument that Carolina GP II’s admission as GP of Carolina GP was effected by either: (1) by Carolina GP signing the VTA, thereby agreeing in advance to the actions taken by the voting trustee; and (2) by Michael Jordan separately consenting on behalf of Carolina GP in his capacity as manager of Carolina GP.

- First, none of Carolina GP’s members ever agreed to have their Carolina membership interests voted by the voting trustee. Moreover, Carolina GP did no consent to have its LP interests voted by the voting trustee; Carolina GP was not one of the VTA’s limited partners and did not transfer its LP interest to the voting trustee.

- Second, Carolina GP did not transfer its general partnership interest or its contractual rights under the LPA to the voting trustee. Also, Michael Jordan lacked any authority to consent to admission of a new GP - this action required the unanimous consent of all of Carolina GP’s members.
What to do?

- Need for clear and unambiguous language for removal/replacement of GP
- Even though 96% of voting LP interests were in favor of replacing GP, and the representative of the original GP agreed in favor of the succession, the precise steps of the LPA were not followed