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Deadlock-Breaking Mechanisms in LLCs—Flipping a Coin Is Not Good Enough, but Is Better Than Dissolution

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This article provides a framework for addressing the importance of adopting deadlock-breaking mechanisms in limited liability company (LLC) operating agreements as an alternative to seeking judicial dissolution when a deadlock arises in an LLC.

The problems arising from deadlock in the management of an LLC are obvious to almost all practitioners, so we will not spend too much time discussing them, but a few points bear addressing. First, deadlocks in an LLC typically arise in a number of circumstances involving important decisions, including:

1. the failure of equal members or managers to reach agreement;
2. the failure to obtain a required majority vote;
3. the failure to obtain a required approval from a member with approval rights; and
4. the failure to obtain unanimous consent where unanimity is required.

Second, the failure to provide deadlock-breaking mechanisms that address any or all of the above in an operating agreement will result in significant expense, hard feelings, loss of time, and possible mediation, arbitration, or litigation—all of which are covered later in this article. Third, the ultimate stage of unresolved deadlock often will result in dissolution of the LLC, which typically involves excessive expense, lost opportunity, and bitter consequences for the members of the LLC.

Judicial Dissolution

If a deadlock arises and an LLC has not adopted a deadlock-breaking mechanism in the operating agreement, the parties most often will turn to a court seeking judicial dissolution, or a court-ordered alternative to dissolution, to resolve the deadlock. "Dissolution" has been a term of art in the law of unincorporated entities since at least the time of Roman law. Joseph Story, Commentaries on the Law on Partnership § 266 at 408 (2d ed. 1850) ("The Roman law . . . declared[] that partnership might be dissolved in various ways. . . .").

Under the Revised Uniform Limited Liability Act (RULLCA) promulgated by the Uniform Law Commission (last revised in 2013), a limited liability company is dissolved, and its activities and affairs must be wound up, upon the occurrence of any of the following:

(1) an event or circumstance that causes dissolution under the operating agreement;
(2) the affirmative vote or consent of all the members;
(3) the passage of 90 consecutive days during which the company has no members unless, before the end of the period:
    (A) consent to admit at least one specified person as a member is given by transferees owning the rights to receive a majority of distributions as transferees at the time the consent is to be effective; and
    (B) at least one person becomes a member in accordance with the consent;
(4) upon application by a member, the entry by the appropriate state court of an order dissolving the company on the grounds that:
    (A) the conduct of all or substantially all the company's activities and affairs is unlawful;

(B) it is not reasonably practicable to carry on the company's activities and affairs in conformity with the certificate of organization and the operating agreement; and

(C) the managers or those members in control of the company:

(i) have acted, are acting, or will act in a manner that is illegal or fraudulent; or

(ii) have acted or are acting in a manner that is oppressive and was, is, or will be directly harmful to the applicant ("oppression" of one or more members in an LLC is a basis for judicial dissolution under RULLCA, but not in many other state LLC acts, even in some states that have adopted RULLCA-based LLC acts, such as Florida); or

(5) the signing and filing of a statement of administrative dissolution by the Secretary of State.

Deadlock as Grounds for Judicial Dissolution

Most state statutes rely on the judicial-dissolution provisions of the LLC Act as the judicially imposed remedy when the members or managers are deadlocked and are without a clear and effective private ordering provision to control the resolution of the deadlock. Of course, there are numerous problems with leaving resolution of member or manager deadlock disputes to the courts.

Under most states' LLC Acts and case law, a Member or Manager may seek judicial dissolution in a judicial proceeding *if it is established that*:

1. the conduct of all or substantially all of the activities and affairs of the LLC are unlawful;
2. it is not reasonably practicable to carry on the company's activities and affairs in conformity with its articles and operating agreement;
3. the members or managers in control of the LLC are acting or are reasonably expected to act in a manner that is illegal or fraudulent;
4. LLC assets are misappropriated or wasted, causing irreparable injury to the LLC or to one or more of its members; or
5. *the members or managers of the LLC are deadlocked in the management of the LLC's activities or affairs, the members or managers are unable to break the deadlock, and irreparable injury to the LLC is threatened or suffered.*

The Court's Power to Provide Alternative Remedies in Deadlock

It is important to note that some state statutes (e.g., Florida) that provide for deadlock as grounds for judicial dissolution also expressly provide in such a proceeding that the court has more flexibility than simply ordering dissolution. Such statutes typically include language such as the following: "in a proceeding brought under [the section addressing judicial dissolution] *the court may order a remedy other than dissolution.*" Consequently, one must be prepared for the court to fashion a remedy that one or more of the parties did not anticipate and would not appreciate, e.g., mandating that one of the members be bought out by the company or other member(s). Additionally, courts have exercised their equitable powers to fashion alternative remedies even though the statute does not contain the express statutory provision described above.

For example, in *Lyons v. Salamone*, 32 A.D.3d 757, 758, 821 N.Y.S.2d 188 (N.Y.A.D. 1 Dept. 2006), the court held: "[w]e reject plaintiff's argument that the absence of a provision in the Limited Liability Company Law expressly authorizing a buyout in a dissolution proceeding rendered the IAS court without authority to grant the parties mutual buyout rights, and find that it is an equitable method of liquidation to allow either party to bid the fair market value of the other party's interest in the business, with the receiver directed to accept the highest legitimate bid.

In the infamous Delaware case of *Haley v. Talcott*, 864 A.2d 86, 97 (Del. Ch. 2004), the court ordered dissolution under the "not reasonably practicable standard" even though the operating agreement provided a put mechanism as a method for avoiding the impasse, noting that the operating agreement did not expressly substitute the put mechanism for the judicial-dissolution remedy, and holding that the put mechanism was not fair and equitable because it would leave the exiting member personally liable on a mortgage.

The take-away from *Haley* is that, if a put is intended to be part of the "reasonably practicable" solution to a deadlock in the operation of the LLC, the operating agreement must explicitly state as much, and must expressly acknowledge that it is to be enforced by a court in lieu of the court exercising its equitable power to fashion a different remedy. Of course, in many states, such a provision must withstand any challenge that it is "manifestly unreasonable" and therefore unenforceable (perhaps because it results in imposing company liabilities on the remaining members and exempting the exiting member from those liabilities).

Mechanisms Addressing Deadlock

The creativity that parties can employ in creating a deadlock-breaking mechanism is nearly limitless. All states provide for contractual freedom in drafting operating agreements, subject only to the "nonwaivable" default rules in the applicable LLC act. Based on *Haley*, it is critical that the operating agreement specify whether a court must enforce the chosen deadlock-breaking mechanism, unless it is deemed "manifestly unreasonable" (more on this later).

LLC operating agreements that address deadlock generally do so with a few well-known mechanisms:

1. **Buy-Sell Provisions.** Most often these take the form of either: (i) an "appraisal" model (requiring an independent appraisal by a qualified expert as to the value of the interest to be purchased); or (ii) a "shotgun" or "Russian Roulette" or "Texas Shoot Out" (or any number of other colorful names) model, which es-

sentially permits one member to offer to purchase the interest of the other deadlocked member at a set price and terms, and the offeree must then either accept that price and terms, or purchase the offeror's interest for the same price and terms (assuming equivalent percentage interests). The results of so-called shotgun models have been seen to generate litigation and unfair results, particularly where the parties have wildly different ideas about value, where there is a significant gap in knowledge about the specific business or industry, or where the parties have significantly different economic resources. On the other hand, under the right circumstances, these mechanisms have proven rather effective at forcing parties to find a way to break a deadlock to avoid the potential of one party actually pulling this trigger.

2. **External or Internal "Tie-breakers."** This is where the parties that are deadlocked will refer the decision to a tie-breaker, which may be a group like the board of an affiliated entity, inside or external professional advisors, one or more mediators/arbitrators, or "industry expert(s)." A significant problem with this approach often is that, in taking such an action, the decision is removed from the parties most familiar with the company and its business and put in the hands of third parties who may not have the requisite insight. Therefore, this mechanism should be used only when there are parties to whom the decision may be referred that have some history and familiarity with the specific business and industry.
3. **"Rotating/Alternating" or "Casting" Vote Mechanisms.** These mechanisms, which allow the members to rotate "tie-breaking" or "casting" votes whenever there is a deadlock on a decision, often are complicated to draft (to limit gamesmanship) and frequently leave everyone unhappy. In essence, the members (assuming a member-managed LLC) will try to reach agreement on a list of "major issues" when they arise, but if they fail to come to an agreement, one member will break the deadlock by exercising his or her casting vote. The next time there is a deadlock on a major issue, another member gets the "casting vote," and so on it goes. Obviously, this has significant drawbacks and rarely is successfully employed.
4. **"Put or Call Mechanisms."** These mechanisms are well known and often used as deadlock-breaking provisions in LLC operating agreements because they are common in many other contexts. However, the nuances of these mechanisms are significant and must be carefully drafted. Aside from the valuation issues in put and call mechanisms (which are an article unto themselves), perhaps the most important issues associated with put/call provisions involve the determination of triggering events. A triggering event is essentially the action, event, or circumstance that will allow one party to exercise a put or call. These provisions are heavily negotiated and careful drafting is essential. Consider questions such as whether they should be based on deadlock or on only a few specific matters (e.g., whether the company should take out a loan, make a capital call, admit a new member, or change the business), or whether they should be exercisable on matters that go beyond deadlocked vote. The list can be quite extensive, or it can be narrowly drafted. Some examples are below:

X's Triggering Events:

- Any material failure by [X] to perform its obligations under this Agreement that is not cured to [Y's] reasonable satisfaction within ten (10) days after Notice of breach by [X] regarding monetary default and within thirty (30) days after Notice of breach by [X] regarding a nonmonetary default (provided that such cure period for a nonmonetary default shall be extended for an additional period, not exceeding an additional ninety (90) days, so long as [X] as the case may be, is diligently pursuing the cure of such default during such extended cure period);
- The failure by [X] to fund, in full, any Required Amount under [the operating agreement];
- Any transfer or encumbrance of [X's] Membership Interest in the Company or any portion thereof or any direct or indirect interest therein not permitted herein without the Approval of [Y]; and
- Any act of gross negligence, willful misconduct, or fraud by [X] concerning its obligations under this Agreement.

Y's Triggering Events:

- Any material failure by [Y] to perform its obligations under this Agreement as Member [or Manager] that is not cured to [X's] reasonable satisfaction within 10 days after Notice of breach by [Y] regarding monetary default and within 30 days after Notice of breach by [Y] regarding nonmonetary default (provided that such cure period for a nonmonetary default by [Y] shall be extended . . . .);
- Any material breach of a representation, warranty, or covenant: (i) by [Y] or its Affiliates under the Noncompetition and Right of First Opportunity Agreement; (ii) by the Manager under a Management Agreement; or (iii) by [Y] or its Affiliates under any Related Party Agreement, in each case in the event such material breach is not cured within any applicable grace period. . . .;
- The failure by [Y] to obtain the Approval of [X] prior to taking any action requiring the Approval of [X] hereunder. . . .;
- The failure by [Y] to fund, in full, any Required Amount under [the operating agreement] including any grace period provided therein;
- Any transfer or encumbrance of [Y's] Membership Interest or any portion thereof or any direct or in-

direct interest therein not permitted herein without the Approval of [X];

- Any [Y] Material Change in Control not Approved by [X] under [Section _ of the operating agreement]; and
- Any act of gross negligence, willful misconduct, or fraud by [Y] or by any Affiliate of [Y] under this Agreement or any Related Party Agreement or otherwise in connection with the management and operation of the business and affairs of the Company.

Remedies for [X or Y] Triggering Event:

Upon the occurrence of an X Triggering Event, and at any time thereafter, Y may, at its option, exercise any one or more of the following remedies without the Approval of any other Member:

- cause the Company to market and sell the Properties to a third party for such price and on such terms as [Y] deems appropriate, without the need for Approval of [X] and without any right on the part of [X] to purchase any of the Properties;
- dissolve the Company;
- exercise, in its sole discretion, the Company's right to terminate (or otherwise enforce any other remedy with respect to) any Property Management Agreement or any other Related Party Agreement between the Company or any Subsidiary and [X], or any Affiliate of [X];
- replace [X] as the Member vested with day-to-day management control of the affairs of the Company as set forth in Section _, and/or remove [X] as the Property Manager with respect to the Properties; and
- in the case of an [X] Triggering Event under Section _ only, purchase the Membership Interest of [X] for an amount equal to the lesser of: (i) seventy-five percent (75%) of the [unreturned Capital Contributions] of [X]; or (ii) the [Fair Market Value] of [X's] Membership Interest.

5. **Partition or Sale of the Company or Its Assets.** The possibility of partition of the LLC business, or a forced sale of the Company or its assets, can also compel disagreeing members or managers to find a way to resolve their deadlock. Partition of the LLC assets or business can work only in limited circumstances, typically where the assets or business activities are easily segregated among the members without destroying the business model itself and where the values of those assets are equal and division is easily agreed upon by the disputing members. A forced sale of the company or its assets also has complications, particularly timing, market forces, lack of interested buyers, or understanding who sets the price and terms (remember there is already deadlock, so these issues may be difficult to agree upon later); therefore, the initial drafting must be comprehensive and often must be turned over to third parties to facilitate.

When All Else Fails: Litigation and Alternative Dispute Resolution Options

When deadlock-breaking mechanisms fail or are absent from the operating agreement, the most common alternatives include:

- involuntary or judicial dissolution
- custodianship or receivers
- injunctions
- specific performance
- judicial expulsion

1. **Involuntary or Judicial Dissolution**
An action seeking involuntary dissolution by a member is by far the most common form of getting out of an LLC in the absence of a deadlock-breaking mechanism. Involuntary dissolution petitions may be coupled with claims for other forms of relief, such as demands for an accounting, appointment of a receiver or custodian, a change in control of the LLC, etc. The petitioner ordinarily must allege and establish the following elements: (i) there is a voting deadlock; (ii) the operating agreement does not provide a means for breaking deadlock; and (iii) the LLC is functioning only as the result of "residual inertia," and there is no other reasonable method of resolving deadlock. The cons associated with judicial dissolution include a lower realized value for the membership interests or assets and an inability to continue the business. The respondent in a petition for involuntary dissolution often asserts bad faith by the petitioning member(s) as a defense. The remedy can rapidly become expensive.
2. **Custodianship/Receivership**
Think of a custodian as a form of receiver. A custodian may be appointed by a court to operate the LLC in circumstances where the members' division is so severe that it prevents the orderly operation of the business and threatens the entity with irreparable injury. The court-appointed custodian effectively replaces the members or managers in control of the company and is charged with the responsibility to operate the business until the court fashions a more permanent remedy. The principal advantages of custodians include that the cause and effect of the members' division, and the management's inability to manage the business, are removed, and the company may be saved from liquidation unless it is already insolvent. The principal disadvantage is that management decisions are placed in the hands of a third party rather than in the hands of the members or managers of the company. The custodian's exit from the scene should be accompanied by a negotiated mechanism to resolve future deadlock should the need again arise. A receiver can be appointed to liquidate the company if there is no viable alternative.
3. **Injunction**
Injunction is a familiar tool to most litigators. An injunction is a court order prohibiting or requiring the performance of certain conduct that is necessary to prevent irreparable injury to the company or its members. Injunction is

often a precursor to eventual dissolution and may be used in the context of deadlock offensively or defensively. In other words, a party may petition the court for an injunction to prevent looting, waste of corporate assets, breach of fiduciary duties, or oppression by managing members. A party that is the target of a petition for judicial dissolution or appointment of a custodian may seek an injunction to neutralize the attack. Injunction orders can be very simple affairs that prevent or mandate a well-defined behavior, or they can be more complex documents that specify the manner in which the company will do business and the managers who will manage it. Injunctions may be granted only where the requesting party can demonstrate a likelihood of success on the merits of its claim, where there is no other adequate remedy at law (e.g., the absence of a deadlock-breaking mechanism in the operating agreement and no guidance from the LLC statute), and there is a risk of irreparable harm if the relief is not granted. Although an injunction theoretically allows for the continuance of the company's business, it does not resolve deadlock, it holds a bad relationship together, and it is difficult to obtain due to a high standard of proof.

4. **Specific Performance**
   A party may seek specific performance of obligations owed by another party if the claim arises under a contract that describes the obligations to be performed, but that the respondent is not performing. Essentially, the petitioner asks the court to force the respondent to perform its contractual obligations (including obligations under the operating agreement). The standard of proof often is "clear and convincing," which is a higher standard than for most claims (preponderance of the evidence). Specific performance is not always available due to the existence of remedies at law. It features the unfortunate characteristic of forcibly keeping a contentious relationship together without providing a method to resolve future deadlock.
5. **Judicial Expulsion**
   Expulsion is an extreme remedy because it removes a member from the LLC. The standards of proof parallel those for involuntary dissolution, where it is "not reasonably practicable" for the LLC to serve the purposes and function specified in the operating agreement. The remaining members may continue to operate the company. The inquiry is peculiarly fact-driven, and the trier of fact must be satisfied that the high standard of proof establishes adequate "fault" to support expulsion of a member. Mere disagreement over how to operate the company is not sufficient. Not all states provide the remedy of expulsion.
6. **Alternative Dispute Resolution: Mediation and Arbitration**
   Operating agreements that do not provide mechanisms for breaking deadlock may nevertheless provide alternate methods of resolving disputes, such as mediation and arbitration. Mediation is a voluntary negotiation presided over by a neutral that assists the parties to overcome their differences and achieve a voluntary resolution through negotiation. Many sophisticated courts now feature mandatory mediation programs. Mediation is useful in situations where the parties are motivated to compromise, but it may be fruitless when the parties are so hostile and entrenched that compromise is impossible. A strong neutral, frequently a retired judge, often is the key to a successful mediation. A strong neutral can force the parties out of their echo chambers and recognize the risks and expense—and the distraction from profitable activity—that is associated with continued litigation.

   Arbitration is another option. Like mediation, arbitration is conducted out of court, but unlike mediation it does not involve achieving a negotiated compromise. Arbitrations essentially are private trials. One or more neutrals are paid to function as trial judges. They conduct discovery and motions practice, often in a streamlined manner, and preside at trial. Testimony is taken and evidence is submitted to the arbitral panel for consideration. The goal of arbitration is to obtain a resolution in an adversary manner more quickly than might occur in state or federal court. An advantage of arbitration is that the parties participate in selecting the triers of fact and, as a result, are often able to secure the services of neutrals with substantial experience with the subject matter in dispute. A drawback to arbitration is the need to compensate the arbitrators, an additional expense not associated with traditional litigation in which the parties pay only their attorneys. Arbitration awards may be recorded as judgments and enforced in like manner.

   A thoughtful and properly drafted operating agreement will provide deadlock-breaking mechanisms that may help the members of LLCs avoid the need for costly and distracting litigation. When all else fails, however, these tools provide parties with flexible alternatives to obtain resolution through adversary proceedings.

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