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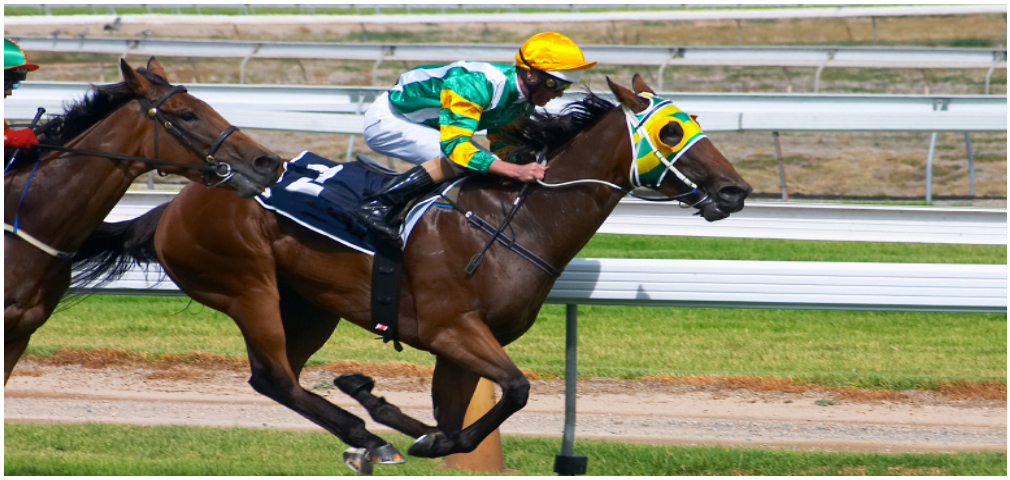
Delaware Transactional & Corporate Law *Update*

## Case Law Developments: Dissolution of Delaware Limited Liability Companies

by James P. Hughes, Jr.



Two recent decisions by Chancellor Chandler of the Delaware Court of Chancery help to sharpen several issues surrounding the dissolution of Delaware limited liability companies. In the *R&R Capital* case, which involved Delaware LLCs that owned land and race horses, the Chancellor ruled that Delaware's strong policy in favor of freedom of contract permitted parties to waive their statutory right to seek judicial dissolution of an LLC. In the *Fisk Ventures* case, the Chancellor addressed the statutory test for whether it is "reasonably practicable" to carry on the business of an LLC before declaring a dissolution. Both cases underscore the care that practitioners should take in drafting the dissolution, governance and buy-out provisions of an LLC agreement.

In *R&R Capital LLC v. Buck & Doe Run Valley Farms, LLC*, C.A. No. 3803-CC, 2008 Del. Ch. LEXIS 115 (Del. Ch. Aug. 19, 2008), the court was required to rule on two separate but related provisions in an LLC agreement. In one provision, the parties agreed to limit the events that could cause a dissolution of the entity. One of those events was the entry of a judicial dissolution pursuant to Sec. 18-802 of the Delaware LLC Act. In another provision, the members agreed to waive the right to seek judicial dissolution of the entity. In beginning its analysis, the court noted that these seemingly contradictory provisions were not necessarily in conflict, because although a member or manager could not seek a judicial dissolution as a result of the waiver, "others [could] make such applications *for* them." *Id*. at *12.

Proponents of the dissolution argued that there were two reasons for not giving effect to the waiver. First, that such a waiver was prohibited by Sec. 109(d) of the Delaware LLC Act, which provides, in part, that a "member who is not a manager may not waive its right to maintain a legal action or proceeding in the courts of the State of Delaware with respect to matters relating to the organization or internal affairs of a limited liability company." The dissolution proponents argued that this statutory mandate made the waiver of dissolution rights impermissible. But the court held that this argument was founded on a selective reading of the last sentence of Sec. 109(d), and that, taken as a whole, the section was merely designed to ensure that members of an LLC did not form a Delaware LLC and then bar jurisdiction in the state. In other words, the court held, Sec. 109(d) was intended to ensure that Delaware retained ultimate jurisdiction over its limited liability companies by providing for service of process through a registered agent in the state and for jurisdiction in state courts. *Id.* at *19.

The second and more interesting theory asserted by the dissolution proponents was that public policy concerns barred the members from waiving their judicial dissolution rights. They argued that any statutory provision in the LLC Act that does not contain the qualifier, "unless otherwise provided in a limited liability company agreement," constituted a mandatory provision that could not be waived. *Id.* at *23. Sec. 18-802 of the LLC Act, which provides for judicial dissolution, does not contain such qualifying

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language. In rejecting this theory, the court wrote at some length on the fundamental principle of freedom of contract that underlies the LLC Act.

The court noted that the "unless otherwise provided" qualifier did not speak to an outright prohibition on waivers, since other provisions of the LLC Act explicitly forbid waiver, such as Sec. 18-1102(e)'s express prohibition on the waiver of the contractual covenant of good faith and fair dealing. *Id*. at *23-24. More fundamentally, the court held that the right to judicial dissolution was not a right that was designed to protect third parties, thereby suggesting that it was not mandatory or unwaivable, and that the freedom to contract should be preserved but for those circumstances where the rights of third parties are affected:

> the public policy of Delaware with respect to limited liability companies is freedom of contract.… there are legitimate business reasons why a firm would want to set up its governance structure so that its members could not petition the Court for dissolution. Finally, the LLC Act provides protections that cannot be waived; this Court need not exercise its equitable discretion and disregard a negotiated agreement among sophisticated parties to allow this action to proceed....
>
> The LLC Act provides members with "the broadest possible discretion in drafting their [LLC] agreements" and assures that "once [members] exercise their contractual freedom in their [LLC] agreement, the [members] have a great deal of certainty that their [LLC] agreement will be enforced in accordance with its terms." One treatise concludes that "[f]lexibility lies at the core of the DLLC Act. Rather than imposing a host of immutable rules, the statute generally allows parties to order their affairs, contractually, as they deem appropriate."

*Id.* at *26-27 (internal citations omitted).

In addition to the policy reasons for permitting such freedom of contract, the court noted that it is common for lenders to insist that LLC agreements contain a provision stating that the filing of a petition for judicial dissolution will constitute a non-curable event of default. *Id*. at *30. As a result, the members of an LLC will often prospectively agree to waive their right to judicial dissolution so as to prevent a disgruntled member from pushing an LLC into default simply by filing a petition for dissolution. *Id.* at *29-30.

The court also emphasized that permitting parties to waive their statutory judicial dissolution rights was not as draconian as it might appear, since the members were still protected by the covenant of good faith and fair dealing, which the court stated would prevent them from being "trapped" in a limited liability company "at the mercy of others[.]" *Id*. at *31.

*R &R Capital* reaffirms the wide latitude that parties have in ordering, and waiving, their respective rights under the Delaware LLC Act, and confirms the covenant of good faith and fair dealing, rather than the statutory scheme, as the backstop that protects the ultimate rights of members.

* * *

One issue that frequently arises in the context of a Delaware LLC dissolution is the meaning of the term "not reasonably practicable." Section 18-802 of the Delaware LLC Act provides that a member or manager may apply for judicial dissolution whenever it is "not reasonably practicable to carry on the business in conformity with a limited liability company agreement." Not surprisingly, this standard is subject to multiple meanings. *Cf. PC Tower Center, Inc. v. Tower Center Dev. Associates*, C.A. No. 10788, 1989 Del. Ch. LEXIS 72 (Del. Ch. June 8, 1989) ("not reasonably practicable" does not mean "completely frustrated" or "impossi[ble]").

In *Fisk Ventures LLC v. Segal*, C.A. No. 3017-CC, 2009 Del. Ch. LEXIS 7 (Del. Ch. Jan. 13, 2009), the court held that although the statute does not specify what a court must consider in evaluating the "reasonably practicable" standard, there are several touchstone elements: "(1) the members' vote is deadlocked at the Board level, (2) the operating agreement gives no means of navigating around the deadlock, and (3) due to the financial condition of the company, there is effectively no business to operate." *Id*. at *11. The court also noted that these three factors were not "individually dispositive; nor must they all exist for a court to find it no longer reasonably practicable for a business to continue operating." *Id.* Indeed, the court noted that under other Delaware case law, courts have found that a company could not practicably operate even where it was "technically functioning and financially stable." *Id.* at *11-12. In short, if "a board deadlock prevents the limited liability company from operating or from furthering its stated business purpose, it is not reasonably practicable for the company to carry on its business." *Id* at *12.

Although this standard suggests that a board deadlock will serve as the critical element in justifying dissolution, it is noteworthy that the board deadlock in *Fisk* was no mere disagreement: the Board could not agree over whether to even hold meetings, and there was a "five-year track record of perpetual deadlock." *Id*. at *14. In addition, on the issue of raising capital, "one of the most important issues facing the Company," the Board was unable to negotiate terms acceptable to all parties. *Id*. at *13. Further, the LLC in *Fisk* had no office and no capital funds, generated no revenue, and had no means out of a deadlock, since there was no provision by which the company could force a buyout of one of its members. *Id*. at *12-15.

In short, although *Fisk* teaches that "not reasonably practicable" does not mean "impossibility" or "complete frustration," it also underscores the point that "not reasonably practicable" must typically be accompanied by a relatively deep and sustained board deadlock, as well as other factors, such as the absence of a buyout provision, to create the cumulative circumstances necessary to garner judicial dissolution of an LLC.

# Limitations on the Shareholder Ratification Doctrine

by Evangelos Kostoulas

A recent decision by the Delaware Supreme Court limits the scope of the common law shareholder ratification doctrine to circumstances where shareholder approval is not legally required. The holding was made by the Delaware Supreme Court in a decision to reverse a judgment by the Court of Chancery to dismiss all three counts of a complaint alleging breach of fiduciary duties. *Gantler v. Stephens*, 965 A.2d 695, 2009 Del. LEXIS 33 (Del. 2009). The Supreme Court also explicitly held for the first time that "the fiduciary duties of officers are the same as those of directors," noting in a footnote that, while a corporation may adopt certain exculpatory provisions for directors under § 102(b)(7) of the Delaware General Corporation Law, no statutory authorization existed for a similar provision for the benefit of officers. *Id*. at *30 & n.37.

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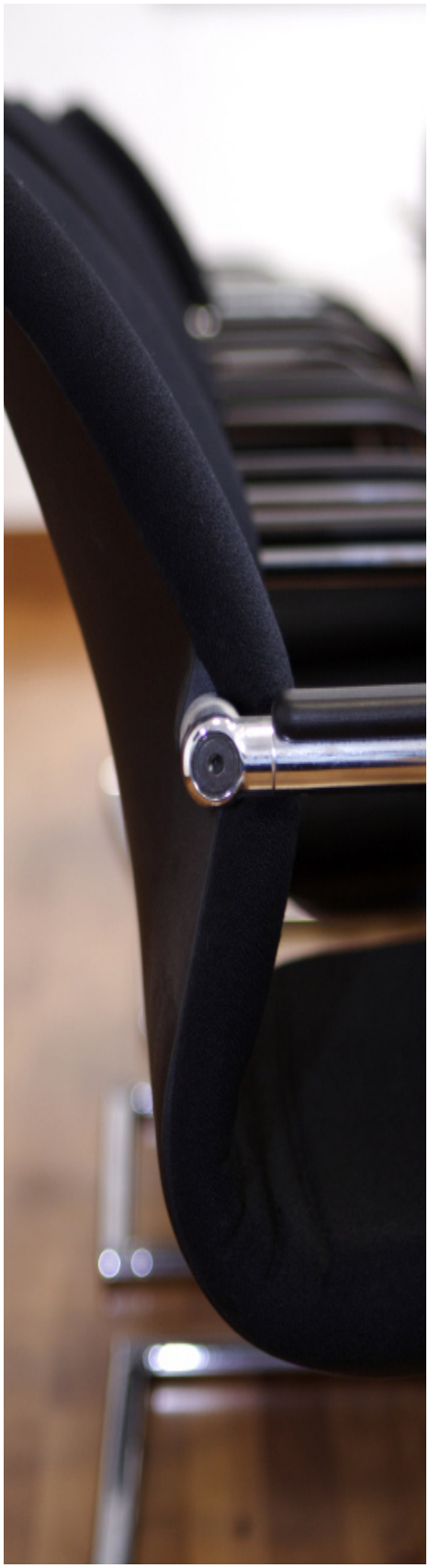
The shareholder-plaintiffs in *Gantler* sued the directors and officers of First Niles, alleging that the defendants breached their fiduciary duties by rejecting an offer to sell the corporation and distributing materially misleading proxy statements to obtain shareholder approval of an alternative plan. The directors of First Niles decided to sell the corporation in August 2004. In December 2004, offers were received from three potential acquirers: Farmers National Banc Corp., Cortland Bancorp, and First Place Financial Corp. The board's financial advisor stated that "all three bids were within the range suggested by its financial models." *Id.* at *6. The Farmers offer noted that the board of First Niles would likely not be retained, and the board did not pursue that offer. The Cortland offer also noted that the board of First Niles would not be retained, but the members would be considered for future board service. When



Cortland did not receive any due diligence materials by the deadline, despite assurances that such materials would be provided, Cortland withdrew its offer. After Cortland withdrew its offer, William Stephens, the chairman of the First Niles board, provided due diligence materials to First Place, though he had initially resisted doing so.

First Place revised its offer after completing its due diligence review, and the board's financial advisor found the revised offer to "exceed[] the mean and median comparable multiples" for similar transactions. *Id.* at *8. Although First Place subsequently increased the exchange ratio of its offer, which implied a higher share price, the board voted 4 to 1 to reject the offer without discussing it.

In June 2006, the board of First Niles decided to reclassify shares of the corporation's common stock into preferred stock. As part of the reclassification, the board submitted a proxy to the Securities and Exchange Commission that disclosed that each member of the board had an interest in the reclassification that conflicted with the interests of the shareholders. The proxy also stated that the board had rejected a merger proposal "'[a]fter careful deliberations'" because it was not in the best interests of the corporation or its shareholders. *Id.* at *13. A shareholder vote was held on December 14, 2006. The Court of Chancery found that 57.3% of all the issued and outstanding First Niles shares entitled to vote were voted in favor of the reclassification, including 50.28% of the "unaffiliated" shares. *Id.*

Certain First Niles shareholders brought suit, and the defendants moved to dismiss. In deciding the motion, the Court of Chancery dismissed three counts: (1) breach of fiduciary duty for obstructing due diligence, rejecting the offer of First Place, and terminating the sale process; (2) breach of the duty of disclosure with regard to the proxy; and (3) breach of fiduciary duty for approving the reclassification. On appeal, the Supreme Court reversed the dismissal of all three counts.

With respect to the first count for breach of fiduciary duty, the Supreme Court noted that the majority of directors had significant personal interests, beyond the mere threat of loss of a board seat present in every merger, that would be potentially jeopardized by a loss of corporate control. This, the Supreme Court found, was sufficient for a claim of breach of the duty of loyalty to survive a motion to dismiss.

With respect to the count for breach of the duty of disclosure, the complaint alleged that there was little deliberation, while the proxy stated there was "careful deliberation." Although the Chancery Court found this to be immaterial, the Supreme Court disagreed, noting that whether or not the board "carefully deliberated" prior to rejecting an offer would be considered material because the proxy disclosed that the directors had a conflict of interest with respect to the proposed transaction.

With respect to the count for breach of fiduciary duty in connection with the reclassification, the Chancery Court held that sufficient facts had been pled to rebut the business judgment rule, but that the actions of the directors had been ratified by a fully informed shareholder vote approving the reclassification. The Supreme Court reversed this ruling on two grounds. First, because the proxy had already been found to be materially misleading, the shareholder vote could not have been fully informed. This alone would have been sufficient grounds to reverse. However, the Supreme Court took the opportunity to also limit the ratification doctrine to circumstances where a shareholder vote is not legally required.

The stock reclassification at issue required an amendment to the First Niles certificate of incorporation, which in turn requires shareholder approval under Delaware law. Thus, according to the Supreme Court's holding, the shareholder vote to approve the amendment could not serve to ratify the actions of the board of the directors.

The Supreme Court noted in its analysis that, under the existing caselaw, "the scope and effect of the common law doctrine of shareholder ratification is unclear, making it difficult to apply that doctrine in a coherent manner." *Id*. at *42. In support of its decision, the Supreme Court quoted *In re Wheelabrator Technologies, Inc. Shareholder Litigation*, 663 A.2d 1194 (Del. Ch. 1995), a case where the Chancery Court identified three distinct factual circumstances under which Delaware courts had used the term "shareholder ratification" and suggested that the term had "acquired an expanded meaning intended to describe any approval of challenged board action by a fully informed vote of shareholders, irrespective of whether that shareholder vote is legally required for the transaction to attain legal existence." 663 A.2d at 1201 n.4, *quoted in Gantler*, 2009 Del. LEXIS 33, at *43. By expressly limiting the doctrine to instances where a shareholder vote is not legally required, the *Gantler* Court hoped to "restore coherence and clarity to this area of law." *Gantler*, 2009 Del. LEXIS 33, at *44.

The Supreme Court also noted that only director actions that shareholders are "specifically asked to approve" may be ratified through shareholder ratification, and, with the exception of an action whose only infirmity was that the directors lacked authority, "the 'cleansing' effect of such a ratifying shareholder vote is to subject the challenged director action to business judgment review, as opposed to 'extinguishing' the claim altogether." *Id.* at *44. In so holding, the Supreme Court overruled *Smith v. Van Gorkom* to the extent it stands for the proposition that ratification can extinguish a claim against directors for failing "to reach an informed business judgment." *Id*. at *45 n.54; *see also Smith v. Van Gorkom*, 488 A.2d 858, 889 (Del. 1985). Thus, the Supreme Court's holding in *Gantler* simultaneously clarified and limited the scope and effect of the shareholder ratification doctrine.

Previously, boards of Delaware corporations had frequently viewed shareholder approval of a transaction as a circumstance likely to reduce, if not eliminate, their risk exposure. The holding of *Gantler,* however, has removed this source of comfort in connection with most mergers, charter amendments, and other actions that require shareholder approval in order to become legally effective.

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# 2008 Amendments to the Delaware Limited Liability Company Act and Limited Partnership Act

by John J. Paschetto

Effective August 1, 2008, the Delaware legislature made several significant amendments to the state's Limited Liability Company Act and Limited Partnership Act. Among other things, the amendments clarified provisions regarding the execution of documents and effectively enlarged the subject-matter jurisdiction of the Court of Chancery. In addition, effective January 1, 2008, the legislature increased the state's annual franchise tax for limited liability companies (LLCs) and limited partnerships (LPs) from $200 to $250.

**Execution of Certificates When Entities Domesticate or Convert**

The LLC Act and LP Act permit certain entities to domesticate in Delaware and to convert to Delaware LLCs or LPs. (6 *Del. C.* §§ 18-212 (LLC domestication), 18-214 (LLC conversion), 17-215 (LP domestication), 17-217 (LP conversion).) Domestication and conversion both involve, among other things, the filing of a certificate with the Secretary of State of Delaware.

Before the 2008 amendments, such certificates were to be signed by "1 or more authorized persons" (in the case of an LLC) or by "all general partners" (in the case of an LP; *see* 6 *Del. C.* § 17-204(a)(1)). The term "authorized persons" as used in the domestication and conversion provisions of the LLC Act had created some uncertainty. The term was frequently understood to mean persons authorized by a Delaware LLC. But in the case of a domestication in Delaware as an LLC or a conversion to a Delaware LLC, the Delaware LLC would not exist until *after* the execution and filing of the appropriate certificate. Similarly, the LP Act's reference to "all general partners" could be problematic because, for example, a corporation converting to an LP would not have general partners until *after* the certificate of conversion was signed and filed.

Those concerns do not arise under the amended LLC and LP Acts. As amended, the sections dealing generally with execution of documents now provide that certificates relating to conversion or domestication may be signed by "any person authorized" by the entity to be converted or domesticated. (6 *Del. C.* §§ 18-204, 17-204.) At the same time, the amendments did not cast doubt on the effectiveness of certificates executed pursuant to the prior texts of the LLC and LP Acts, since the amended provisions retain the option of having certificates executed by "all general partners" or "1 or more authorized persons[.]"

## *Did You Know?*

*In 2001 and each year since, the number of new Delaware limited liability companies has been greater than the number of new Delaware corporations, now by a margin of nearly 3:1. Beginning in 2005, the number of existing Delaware limited liability companies has been greater than the number of existing Delaware corporations, now by a margin of nearly 2:1.*

**Chancery Court Jurisdiction over Matters Involving LLC Management**

The 2008 amendments effectively expanded the subject-matter jurisdiction of the Delaware Court of Chancery, by making the meaning of "manager" in sections of the LLC Act dealing with jurisdiction consistent with the section on managers' implied consent to service.

Formerly, "any member or manager" had standing to bring a claim in the Court of Chancery regarding the right of a person to be a manager. (6 *Del. C.* § 18-110.) The Court of Chancery also had jurisdiction over any action "to interpret, apply or enforce" the rights or duties of members or managers. (6 *Del. C.* § 18-111.) "Manager" was defined, in Section 18-101(10), as a person named as a manager in the LLC agreement or pursuant to the LLC agreement.

Thus, persons that were essentially acting as managers but were not named as such could not bring an action in the Court of Chancery under Section 18-110 (unless they were also members), and could not have their rights and duties adjudicated by the Court under Section 18-111. Moreover, in this respect Sections 18-110 and 18-111 differed from Section 18-109, under which both managers and persons that materially participate in the management of an LLC are deemed to have consented to service in Delaware in actions relating to the LLC.

As amended, Sections 18-110 and 18-111 are now consistent with Section 18-109 in their definitions of "manager." For purposes solely of those Sections, the term covers not only a person named as a manager in or pursuant to the LLC agreement, but also any person that "participates materially in the management of" the LLC. The definitions also include a proviso, to the effect that the power to select a manager or participate in the selection of a manager "shall not, by itself, constitute participation in the management of" the LLC.

**Increase in the Annual Franchise Tax; Other Changes**

The annual franchise tax payable by Delaware LLCs and LPs, and by foreign LLCs and LPs registered in Delaware, was increased from $200 to $250 by the 2008 amendments. (6 *Del. C.* §§ 18-1107, 17-1109.) This was the first increase in the annual franchise tax for LLCs and LPs since 2003. (See H.R. 268, 142d Gen. Assembly (Del. 2003).)

Clarification of certain definitions was also effected by the 2008 amendments. Before the amendments, the definition of "limited partnership" and "domestic limited partnership" included the phrase "a partnership formed by

2 or more persons under the laws of the State of Delaware[.]" (6 *Del. C.* § 17-101(9).) This phrase appeared to prohibit the *formation* of a limited partnership by one person (a sole general partner, pursuant to Section 17-201), prior to the admission of one or more limited partners and any additional general partners. To exclude that interpretation, the definition was amended to read, in pertinent part, "a partnership formed under the laws of the State of Delaware consisting of two (2) or more persons[.]"

In addition, the definition of "person" was amended in both the LLC Act and the LP Act to make clear that "person" includes all forms of trusts. (6 *Del. C.* §§ 18-101(12), 17-101(14).) In the definition, the following list of types of trusts was inserted after the word "trust": "including a common law trust, business trust, statutory trust, voting trust or any other form of trust[.]"

Finally, a new subsection was inserted in Section 17-303. That section provides that a limited partner may be liable to third parties for the obligations of the LP if "he or she participates in the control of the business[,]" and it then sets forth a non-exclusive list of rights and capacities whose exercise or assumption will not, by itself, amount to such participation. Among the capacities in that list was independent contractor, contractor, agent, or employee of the LP or of a general partner, or a fiduciary of an entity that is a general partner. (6 *Del. C.* § 17-303(b)(1).) The 2008 amendments added to the list a subsection providing that the nomination, appointment, election, or removal of the foregoing persons likewise does not constitute participation in the control of the business. (6 *Del. C.* § 17-303(b)(8)n.)

## About the Update

The Delaware Transactional & Corporate Law Update is published by the Business Planning and Transactions section of Young Conaway Stargatt & Taylor, LLP.

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