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Recent Changes to the Delaware Limited Liability Company Act

by John J. Paschetto

The Delaware legislature revised the State's Limited Liability Company Act in 2004 by adding provisions that substantially expand the right to limit the exposure of members and managers to liability. The 2004 revisions also affect rights of third parties, organic changes to LLCs, and other matters. While most of these changes are described in the legislative synopsis as "confirm[ing]" what was previously permitted under the LLC Act, they provide alternatives that were arguably not present in the pre-revision form of the Act. The changes, discussed below, went into effect on August 1, 2004.

Elimination of Fiduciary Duties and Limitation of Liability

Perhaps the most significant changes were to the LLC Act's provisions regarding the restriction of fiduciary duties and the limitation of liability. The pre-revision Act provided that the duties and liabilities of a member, manager, or other person could be "expanded or restricted" by provisions in the LLC agreement. (6 *Del. C.* § 18-1101(c)(2) (2003).) The statutory text

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Retention of Ballots after Closely Contested Stockholder Vote

by James P. Hughes, Jr.

Despite the singular importance of shareholder voting in corporate elections, there is comparatively little guidance concerning what to do with the ballots or the inspector's tally sheets once the votes have been cast, counted and verified. A recent decision by the Delaware Court of Chancery, *Baring v. Condrell*, 2004 Del. Ch. LEXIS 148 (Oct. 18, 2004) (*Baring II*), teaches that Delaware corporations, particularly closely held ones, may be well advised to create procedures for retaining and securing ballots in advance of elections that are expected to be close and subject to challenge. As the *Baring* case demonstrates, the failure to retain ballots or voting records can result in a vote being invalidated.

The Statutory Framework

Under the Delaware General Corporation Law, there is no requirement to retain the ballots to an election once the votes have been counted and the results certified, no matter how closely contested the election. For example, § 231(a) of the DGCL requires the appointment of

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did not specifically state, however, that such duties or liabilities could be *eliminated*. The Delaware Supreme Court drew attention to this fact in 2002 (in dicta referring to the almost identical provision in the State's Limited Partnership Act) and reminded "courts, commentators and practitioners" that "scrupulous adherence to fiduciary duties is normally expected." *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160, 168 (Del. 2002).

The 2004 revisions have now made it clear, first, that an LLC agreement may eliminate (as well as expand or restrict) any *duties*, fiduciary or otherwise, that a member, manager, or other person may owe to the LLC or to members, managers, or other persons bound by the LLC agreement. The only exception is that an LLC agreement may not "eliminate the implied contractual covenant of good faith and fair dealing." (6 *Del. C.* § 18-1101(c).)

Second, the 2004 revisions inserted a new subsection providing for a corresponding *limitation of the liability* of members, managers, and other persons. An LLC agreement may now limit *or eliminate* any liability for breach of contract or breach of duties, including fiduciary duties, that may be owed to the LLC or to members, managers, or other persons bound by the LLC agreement. (6 *Del. C.* § 18-1101(e).) Again, however, one narrow exception is made: the LLC agreement may not "limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing." The statute's specification of a "bad faith" violation may at first view appear to be redundant, but this belt-and-suspenders approach is arguably justified. There is some (non-Delaware) support for the proposition that a determination whether the implied covenant has been breached should be based on an objective standard, which could make it possible (absent the "bad faith" language used here) for a defendant to be found liable for breaching the implied covenant even without a culpable state of mind. *See, e.g.*, 2 E. Allan Farnsworth, *Farnsworth on Contracts* § 7.17b (discussion at p. 401) (3d ed. 2004).

A related change was made to former § 18-1101(c)(1), which became new § 18-1101(d). Before the revision, subsection (c)(1) stated that no person could be liable to the LLC, or to members, managers, or other persons bound by the LLC agreement, for "good faith reliance on the provisions of the limited liability company agreement[.]" The 2004 revision added two important qualifiers. First, this safe harbor is now a default rule that can be modified by the LLC agreement. Second, no person shall now be liable "*for breach of fiduciary duty* for [such person's] good faith reliance on the provisions of the limited liability company agreement" (emphasis added). This revision appears to open up the possibility that (unless otherwise provided in the LLC agreement) a person could be liable for breach of contract based on his or her good faith reliance on the LLC agreement.

Mergers, Transfers, and Conversions

The 2004 revisions expressly permit the cancellation of rights or interests in an LLC or other business entity, when the entity is involved in a merger, consolidation, domestication in Delaware as an LLC, transfer to or domestication in a jurisdiction other than Delaware or another state, conversion into a Delaware LLC, or conversion from a Delaware LLC into another entity or a foreign LLC. (6 *Del. C.* §§ 18-209(b), 18-212(j), 18-213(f), 18-214(i), 18-216(d).) Previously, rights or interests could only be exchanged for (or converted into) cash, property, or rights or interests in a new or different entity in the course of such transactions.

In addition, the 2004 revisions give to transfers, domestications outside Delaware, and conversions into other entities or foreign LLCs essentially the same legal effect that was previously given only to mergers, consolidations, domestications in Delaware, and conversions into Delaware LLCs. Now, in all of those transactions, the post-transaction entity retains the rights, property, duties, and liabilities of the pre-transaction entity; and, in all of those transactions except mergers and consolidations, the transactions are not deemed to effect transfers of such rights, property, duties, and liabilities.

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Amendments to LLC Agreements

A new subsection added to § 18-302 makes clear that, if an LLC agreement sets forth how it is to be amended, then it may be amended only in that way or as otherwise permitted by law. The LLC agreement may require the approval of a non-party or the satisfaction of other conditions before it may be amended. However, any approval requirement may be waived by the person whose approval is required, and any other conditions may be waived by "all persons for whose benefit such conditions were intended[.]"

Revisions to § 18-209 have streamlined the procedure for changing an LLC's name in the course of a merger. When the entity surviving a merger is a Delaware LLC, the certificate of merger may set forth amendments to the LLC's certificate of formation to change the LLC's name, and no further action will be needed to effect the change.

Rights of Third Parties and Creditors

A change to the definition of "limited liability company agreement" provides that the agreement may afford rights to any person, including a person who is not a party to the LLC agreement. (6 *Del. C.* § 18-101(7).) Finally, the 2004 revisions have clarified what is required for debts and obligations to be enforceable only against assets associated with a particular series of members, managers, or LLC interests. (6 *Del. C.* § 18-215(b).) In addition to the previously expressed requirements, the assets to be associated with such a series must be held and accounted for in "separate and distinct records[.]" †

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inspectors to act at a stockholder meeting and to make a written report of the outcome. In addition, § 231(b)(4) requires that the inspectors shall "retain for a reasonable period" a record of the "disposition of any challenges" made to any determination by the inspectors. Pointedly, it is only a record of the challenges, and not the actual ballots themselves, that must be retained.

In addition, the requirement to appoint inspectors and to retain records of inspector challenges applies only to publicly traded companies or those with more than 2,000 stockholders. *See* § 231(e).

Voting Record Retention

The absence of a statutory requirement to maintain ballots after an election — even a closely contested one — is understandable for several reasons. First, because a shareholder's vote is confidential, retaining the ballots beyond the initial count creates the potential for revealing the identities of the voters and the contents of their votes if the ballots are not properly secured. One solution, of course, is to have the ballots retained by an independent third party, such as an inspector. But if that inspector serves at the pleasure of the Board or management, the Board could presumably still access the ballots, unless resolutions are passed specifically prohibiting such access. Because of this problem, some commentators suggest that ballots should be stored for a set amount of time and then destroyed. *See* C. Goforth, *Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, But Not Too Late*, 43 Am. U.L. Rev. 379, 463 (1994). *See also* C. Bagley & D. Berger, *Proxy Contests and Corporate Control: Conducting the Proxy Campaign*, 70 C.P.S. (BNA) A-54 (1997) (observing that ballots and proxies should be "sealed and impounded" in anticipation of a court challenge by the losing factions).

Yet even this solution underscores another problem with retaining ballots and voting records: namely, that it requires a corporation's management to create a set of procedures or resolutions establishing, among other things, (i) a chain of custody, (ii) a secure place for the ballots to be stored, (iii) a date certain by which the ballots should be destroyed, and (iv) a procedure for destroying ballots and verifying their destruction. For small or closely held corporations, adopting and implementing such procedures may prove burdensome.

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The *Baring* Case

Nevertheless, the *Baring* case underlines the need for a company to establish ballot retention policies in advance of a vote that management expects to be close. In *Baring*, residents of the apartment complex adjoining the famous Watergate Hotel in Washington, D.C. were divided over a proposal to sell certain property to a developer who planned to convert the hotel into co-operative apartments. In early 2004, the membership of the non-profit corporation voted 54% to 46% to approve the sale. However, the Board majority, which opposed the sale 6-5, determined that the member vote was subject to a supermajority requirement found in the corporation's charter, and ruled that the sale was not approved.

Supporters of the sale filed suit, and the Delaware Court of Chancery, in its initial *Baring* decision, held that the supermajority provision was inapplicable, and ordered a new vote. *Baring v. Watergate, Inc.*, 2004 Del. Ch. LEXIS 17 (Feb. 25, 2004) (*Baring I*).

The second vote, held in response to *Baring I*, was closer than the first, but still favored the sale by some 492 votes. In recording the votes, an inspector hired by the anti-sale Board majority tallied the votes on a laptop computer, using a software program that both recorded how each member in the apartment complex voted and created a running tally of the final vote.

During the membership meeting that immediately preceded the vote, the Board and the corporation's membership engaged in a lengthy discussion about the voting procedures. The chairman of the Board proposed a procedure whereby the inspector would contact the members in the days after the election to confirm how their vote had been recorded. The final results would then be announced after this confirmation process.

But the chairman's proposal was rejected by the membership. The voting then commenced, and after tallying the votes, the inspector announced that the pro-sale majority had again prevailed. (Several board seats on the corporation's staggered board were up for election, and the inspector also announced those results, which swung the board to a pro-sale majority.)

Immediately after the inspector announced the results, no member of the Board appeared to have given the inspector any instructions regarding what to do with the ballots or the computer program used to tally the votes. Nevertheless, in the next several days, members of the corporation began to call and e-mail the inspector and the corporation's general manager about the results and the vote counting. As the Court concluded, at some point, the general manager became frustrated with the calls and deleted the vote results from the laptop computer where the votes had been tallied. In addition, the inspector testified that two days after the computer results were deleted, he was directed to destroy the ballots.

Although retention of the ballots was not mandated by statute, the charter, the bylaws or a board resolution, the Court held that equitable considerations, including the special protections afforded the shareholder franchise, made it necessary to invalidate the shareholder vote:

> Watergate East residents have contemplated this issue for over a year. The record establishes that the January membership vote [*Baring I*] was split by less than one-percent. Nothing changed between the time surrounding the January vote, the February 25 Order and the April vote. Nothing justified the belief that the April election would be decided by a wider margin. Thus, in light of the acrimony separating the two membership factions, the WEI board had a duty to establish a fair, open, fully informed, and verifiable vote. Once the ballots were destroyed, prior to verification and during a period of increasing inquisition, the April vote lost any indicia of reliability and fair process. I therefore find that the procedure surrounding the April 12, 2004 vote was fatally flawed and that vote is given no effect in consummating the deal. . . .

As the Court's discussion reflects, management faced with a closely contested election may be well advised to create procedures in advance of the election for securing and retaining ballots and tally sheets or computer records in the event of a challenge.

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Retention Period

Of course, a company choosing to retain such ballots or tally sheets will also need to determine a "reasonable period" for retaining them. Although there is a little guidance in the corporate literature as to what constitutes a "reasonable period," general election laws may be instructive. For example, in Delaware, the Commissioner of Elections is directed to retain voting records for one year. 15 *Del. C.* § 4981. In New York, write-in ballots must be retained for one year, *see* N.Y. C.L.S. Elec. § 3-222 (2004), while in California, ballots cast for federal offices must be preserved for 22 months. Cal. Elec. Code § 17502 (2005).

Conclusion

In overseeing a closely fought election, managers of Delaware corporations are well advised to plan ahead for the roles that inspectors will play. *Baring* demonstrates that it may be insufficient to direct inspectors simply to count the votes and prepare a report. It may also be advisable to direct the inspectors in advance of the vote to retain the ballots and their tally sheets once the results have been announced. †

Recent Delaware Cases Interpreting Indemnification & Advancement Provisions in LLC Agreements

by James J. Gallagher

Several recent decisions by the Delaware Court of Chancery concerning indemnification and advancement rights in limited liability company agreements underscore the need to craft carefully how those rights are described and defined in the agreement.

Relationship between Indemnification and Advancement Rights

In *Morgan v. Grace*, C.A. No. 20430, 2003 Del. Ch. LEXIS 113 (Del. Ch. Oct. 29, 2003), the court stated that a well-settled principle of Delaware law is "the right to indemnification and the right to advancement are distinct." Accordingly, an LLC agreement provision that required the company to "indemnify" members "[t]o the fullest extent permitted by law" did not automatically entitle members to advancement (i.e., the payment of legal expenses before the final resolution of the underlying action and thus before it can be known whether a member's conduct was indemnifiable). The court emphasized that the parties to an LLC agreement have wide latitude under the law to bargain for indemnification and advancement, and that the court "will not rewrite [an LLC agreement] to provide for a right the parties clearly did not intend."

Similarly, the court in *Senior Tour Players 207 Management Co. LLC v. Golftown 207 Holding Co. LLC*, 853 A.2d 124 (Del. Ch. 2004), emphasized that "advancement and indemnification, although obviously related, are 'distinct types of legal rights.'" Thus, even though Golftown's LLC agreement provided for mandatory indemnification and advancement in the same sentence, the limitations specified in the agreement with respect to indemnification did not necessarily, the court held, apply to advancement.

Nonetheless, an LLC agreement may be drafted such that advancement rights will be construed as a "subsidiary component" of a broad right to indemnification. In *Weinstock v. Lazard Debt Recovery GP, LLC*, C.A. No. 20048, 2003 Del. Ch. LEXIS 83 (Del. Ch. Aug. 1, 2003), the court considered an LLC agreement that provided for indemnification and advancement rights in the same section. The defendant LLC argued that the plaintiffs, who were no longer employed by the LLC, were not entitled to advancement, because another provision in that same section stated that the "*indemnification* provided by this Section 2.06" would continue for indemnitees who had ceased to act on behalf of the company (emphasis added). According to the LLC, that provision's reference to "indemnification" without also mentioning "advancement" meant that advancement was not available to former employees. Based on a close reading of the agreement's language, however, the court held that the term "indemnification" in the contested provision was intended to encompass the right to advancement.

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A second LLC agreement considered in *Weinstock* also provided for indemnification and advancement in a single section. The agreement required indemnification for a person who "is or was a . . . director," but, in the same paragraph, stated that advanced expenses were payable to "a director," with no allowance expressly made for former directors.

Nonetheless, the court held that advancement was a right of former directors. The language regarding advancement, it held, referred back to the indemnification language, and the absence of "is or was" from the former was "best explained by the drafters' belief that the inclusion of those words would have been redundant" in view of the context.

Advancement Applies Even When It Is Unclear Whether Indemnification Will Apply

In *Morgan*, one of two defendant LLCs argued that the plaintiffs, former members, were not entitled to advancement because their underlying conduct did not come within the LLC agreement's indemnification provision. Although the LLC agreement allowed advancement "[t]o the fullest extent permitted under applicable law," the company claimed that the plaintiffs' conduct was fraudulent and constituted a breach of the fiduciary duty owed to the company.

The court rejected this argument, finding that the company was confusing indemnification and advancement. Although the agreement clearly stated that members would not be entitled to indemnification if their conduct was in bad faith or grossly negligent, the company would not know whether the plaintiffs' conduct rose to that level until after the final adjudication of the underlying action. Thus, the company was required to advance fees to the plaintiffs, subject to the plaintiffs' agreeing to a suitable repayment undertaking pursuant to the LLC agreement.

Liability of Members for Indemnification

One of the LLC agreements examined in *Morgan* also included an unusual provision that required a member who brought an action against another member or the company itself to pay all attorneys' fees and legal costs of the action, except as "otherwise provided by law." The purpose of the provision was (the parties conceded) to discourage litigation among members over company affairs. The plaintiffs in *Morgan* — defendants in the underlying action — contended that this provision should have required advancement by the member who had initiated the underlying action. The court, however, was unpersuaded, primarily because the provision in question addressed only the "eventual payment" of legal expenses, not advancement.

Duty of Advancement Does Not Imply an Undertaking Requirement

In *Senior Tour Players*, the LLC argued that, assuming the court found the plaintiffs entitled to advancement, they should be required to execute a written undertaking to repay the advanced amounts if their underlying conduct were ultimately found not to be indemnifiable. After framing the issue as whether a repayment undertaking is required by law when the LLC agreement is silent, the court held that no such requirement exists. Although "advancement implies a general obligation to repay if the underlying conduct is ultimately judged to be not indemnifiable[,]" the court stated, "an obligation to repay does not necessarily imply a precondition of giving a written undertaking to do so."

Obligation to Pay Fees on Fees

Significantly, in *Weinstock*, *Morgan*, and *Senior Tour Players*, the court relied on the Delaware Supreme Court's decision in a corporate case, *Stifel Financial Corp. v. Cochran*, 809 A.2d 555, 561 (Del. 2002), in holding that the plaintiffs were entitled to recover their "fees on fees," i.e., recover their costs and expenses attributable to their successful claims for advancement and/or indemnification.

Conclusion

As the *Weinstock*, *Morgan*, and *Senior Tour Players* cases demonstrate, parties to LLC agreements are afforded great latitude in how they draft advancement and indemnification provisions. The cases underscore that, in the view of the Delaware courts, those provisions may be as broad or limited as the parties deem appropriate. †

Recent Changes to the Delaware Limited Partnership Act

by John J. Paschetto

The Delaware legislature's 2004 revisions to the State's Limited Partnership Act include two changes that moderately expand the protections afforded to limited partners against creditors. Aside from those two changes, the 2004 revisions to the Act are essentially similar to the 2004 revisions to the LLC Act, discussed in a separate article in this Update. The 2004 revisions to the Limited Partnership Act took effect on August 1, 2004.

Liability to Third Parties

A central feature of the Act is its provision that limited partners will not be liable for the obligations of the limited partnership unless (1) they are also general partners or (2) they participate in the control of the business and cause a third party to reasonably believe that they are general partners. (6 *Del. C.* § 17-303(a).) Section 17-303(b) of the Act expands upon this basic provision by listing certain rights, powers, and acts that, by themselves, will not constitute participation in the control of the limited partnership's business. Before the 2004 revisions, the § 17-303(b) list specifically excluded a limited partner's service as a general partner of a partnership that is a general partner of the limited partnership.

That exclusion has been removed by the 2004 revisions. As the statute is now written, a limited partner will not be deemed to participate in the control of the business of the limited partnership solely because the limited partner is also a general partner of the limited partnership's general partner. Of course, as a practical matter, a creditor of the limited partnership could seek recovery against such a limited partner in his or her capacity as a general partner of the general partner, if both the limited partnership and its general partner were unable to satisfy the creditor's claim. But, under the current statute, that relationship does not automatically collapse and cause the limited partner to be treated as a *de facto* general partner of the limited partnership itself.

Other Revisions

The other 2004 revisions to the Limited Partnership Act parallel those made to the LLC Act, and readers are directed to the article in this Update discussing those revisions. For ease of reference, the following table lists the amended sections of the LLC Act and the corresponding amended sections of the Limited Partnership Act:

LLC Act (6 *Del. C.* § 18-___)	**Limited Partnership Act** (6 *Del. C.* § 17-___)
18-101(7)	17-101(12)
18-209(b), (c)(4), (e)	17-211(b), (c)(4), (f)
18-212(j)	17-215(j)
18-213(f), (g)	17-216(f), (g)
18-214(i)	17-217(i)
18-215(b)	17-218(b)
18-216(d), (h)	17-219(d), (h)
18-302(e)	17-302(f)
18-1101(c), (d), (e)	17-1101(d), (e), (f)

†

About the Update

The *Delaware Transactional & Corporate Law Update* is published semi-annually by the **Business Planning, Transactions & Restructuring** section of **Young Conaway Stargatt & Taylor, LLP**.

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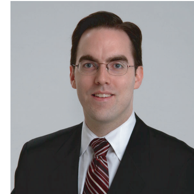
Members of the Business Planning, Transactions & Restructuring Section

Craig D. Grear, Partner. Mr. Grear has made numerous presentations nationally and internationally on a variety of Delaware business law topics, including alternative entities and Delaware holding companies. He is a 1989 graduate of Georgetown University Law Center.
(302) 571-6612 • cgrear@ycst.com

John J. Paschetto, Associate. Mr. Paschetto has contributed to several books on corporate takeovers and the limitation of director liability. He is a 1998 graduate of Harvard Law School.
(302) 571-6608 • jpaschetto@ycst.com

James P. Hughes, Jr., Partner. Mr. Hughes has litigated numerous matters in the Delaware Court of Chancery and served as in-house counsel at an Internet company. He is a 1992 graduate of the University of Pennsylvania Law School. (302) 571-6670 • jhughes@ycst.com



James J. Gallagher, Associate. Mr. Gallagher has written about issues including indemnification and fiduciary duties in the alternative-entity context. He is a 2004 graduate of the University of Pennsylvania Law School.
(302) 571-5002 • jgallagher@ycst.com

Young Conaway Stargatt & Taylor, LLP
P.O. Box 391
1000 West Street
17th Floor
Wilmington, Delaware 19801
(302) 571-6600
www.YoungConaway.com

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