YOUNG CONAWAY STARGATT & TAYLOR, LLP

DELAWARE TRANSACTIONAL & CORPORATE LAW *Update*

WINTER 2005

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NEW CAPTIVE INSURANCE LEGISLATION

by James P. Hughes, Jr.

Although Delaware is known as the first choice for incorporating companies and forming LLCs, the state still lags behind Vermont, Bermuda and the Cayman Islands as the first choice for forming captive insurance companies. In an effort to obtain a bigger share of this market, the state passed new legislation over the summer designed to make Delaware more attractive by streamlining the administration and oversight of captives, by providing captives with maximum flexibility and by making the attendant taxes and fees competitive with those of other popular captive insurance jurisdictions.

By way of example, the new legislation, enacted on July 12, 2005 and known as the Delaware Revised Captive Insurance Company Act, provides for a flat, competitive premium tax structure. This structure should make it easier for companies to calculate the premium tax that would be owed by a captive insurance company.

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CHANGES IN 2005 TO THE DELAWARE LIMITED LIABILITY COMPANY ACT AND LIMITED PARTNERSHIP ACT

by John J. Paschetto

In 2005, the Delaware legislature added several new sections to both the Limited Liability Company Act and the Limited Partnership Act. The new sections, discussed below, permit the continuation of an LLC or LP after an event has triggered its dissolution, list activities that will not by themselves require a foreign LLC to register to do business in the State, and set forth protections for partners relying in good faith on LP records. Other significant changes include eliminating foreclosure on an LLC interest as a remedy available to creditors of members; relaxing the requirements for transferring a Delaware LLC or LP to, or domesticating it in, a non-U.S. jurisdiction; increasing the protections afforded to persons relying on reports by LLC managers, members, and employees; eliminating the ban on LLCs' providing insurance; and making it easier to amend an LP agreement in the course of a merger. All of these changes went into effect on August 1, 2005.

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New Captive Insurance Legislation
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In certain jurisdictions, such as Vermont, the leading domicile for domestic captives, the tax on the first $20 million in direct premiums collected by a captive is .38%, with changing rates for subsequent premiums. (8 V.S.A. § 6014.) By contrast, Delaware applies a flat 0.2% rate to all premiums under the new legislation. (See 18 *Del. C.* § 6914.) ("Captive insurance company" refers to a wide variety of entities. "Pure" captive insurance companies are wholly owned subsidiaries that are used to manage risk for their corporate parents. The captive concept has since broadened to include captive insurance companies that serve associations, specific industries and risk retention groups, among others.)

Significantly, the new legislation enables almost any type of entity to apply for and become a Delaware captive insurance company. For example, the new law permits a corporation, nonstock corporation, limited liability company, partnership, limited partnership or statutory trust to become pure captive insurance companies or association captive insurance companies. (18 *Del. C.* § 6906(a)(b).) By contrast, Vermont does not currently provide for partnerships, limited partnerships or statutory trusts to function as pure captives or association captives. (*Cf.* 8 V.S.A. § 6006(a)(b).)

Perhaps more significant, Delaware has created a "special purpose captive insurance company," which may take the form of a corporation, nonstock corporation, limited liability company, limited partnership, statutory trust or "such other person . . . approved by the Commissioner." (18 *Del. C.* § 6906(c).) With an appropriate ruling from the Delaware Insurance Commissioner, such special purpose captives can potentially be exempt from certain requirements of the Captive Insurance Act. (*See* § 6915A.) As a practical matter, this could enable an entity to become licensed as a captive insurer where certain factors — such as the nature of the risks it proposes to insure — might otherwise preclude it from acting as a captive. In contrast, Vermont does not currently have provisions for such "special purpose" captives.

Other significant differences concern the rights of association captive insurers. Vermont forbids association captives from insuring risks of those other than their member organizations and their affiliated companies. (8 V.S.A. § 6002(a)(2).) By contrast, the new Delaware legislation permits association captives to insure the risks of third parties so long as certain requirements are met, such as the third parties' being in the same or related business as the association member. (18 *Del. C.* § 6903(a)(2).)

The investments in which pure or industrial insured Delaware captives may engage are also largely unrestricted under the new legislation. Specifically, the new statute permits them to engage in any type of investment, subject only to the Insurance Commissioner's prohibiting or limiting investments that threaten their solvency or liquidity. (*See* 18 *Del. C.* § 6910(b).)

For the full text of Delaware's new captive insurance legislation, see:

www.delcode.state.de.us/title18/c069.

For additional information about Delaware captives, see:

www.delawarecaptive.org. †

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Continuing an LLC after an Event Has Caused Its Dissolution

The LLC Act specifies certain events that, upon their occurrence, cause an LLC to be dissolved (subject to any contrary provisions in the applicable LLC agreement). (6 *Del. C.* § 18-801(a).) New § 18-806 provides that, notwithstanding an event of dissolution, members can vote to continue an LLC, provided that the certificate of cancellation has not yet been filed with the Delaware Secretary of State and the dissolution was not judicially decreed.

For the LLC to continue, approval must be given by all of its remaining members; in addition, if the LLC was dissolved pursuant to a member vote (*see* 6 *Del. C.* § 18-801(a)(3)), all persons who previously voted in favor of dissolution must give their approval. If the LLC has no remaining members, approval must come from the personal representative of the last person who was a member, and the personal representative must then agree to be a member, or admit a designee as a member, as of the termination of the last member's membership. An LLC agreement may specify additional persons whose approval would be required to continue the LLC after dissolution.

Activities That Do Not Require a Foreign LLC to Register in Delaware

A foreign LLC must register with the Delaware Secretary of State before "doing business" in the State. (6 *Del. C.* § 18-902(a).) The Act, however, previously offered little guidance regarding what constituted "doing business," other than to state that merely being a member or manager of a Delaware or foreign LLC was not sufficient to trigger the registration requirement. (*See* 6 *Del. C.* § 902(b) (2004), *now* 6 *Del. C.* § 18-912(b).)

New § 18-912 provides a non-exclusive list of twelve types of activities by foreign LLCs that do not constitute "doing business" for purposes of the registration requirement. The listed activities include holding member or manager meetings in Delaware, maintaining offices in Delaware for the transfer or registration of the LLC's own securities, soliciting orders in Delaware that become contracts only upon acceptance outside Delaware, collecting debts or foreclosing mortgages in Delaware, and doing business in Delaware as an insurance company. The new section also specifies that it does *not* apply to determinations of whether a foreign LLC is subject to service of process, taxation, or regulation under other laws in Delaware.

Protecting LLC Interests from Foreclosure

A judgment creditor of a member of a Delaware LLC could previously seek a court order to foreclose on the member's LLC interest. (6 *Del. C.* § 18-703(b) (2004).) The language permitting such foreclosures has now been removed from the Act, leaving a charging order as the judgment creditor's sole remedy with respect to a debtor's LLC interest. As the legislative synopsis of the 2005 amendments explains, "[a]ttachment, garnishment, foreclosure or like remedies are not available to the judgment creditor[,] and a judgment creditor does not have any right to become or to exercise any rights or powers of a member[.]"

A charging order pursuant to amended § 18-703 entitles the judgment creditor only to receive distributions that the debtor would otherwise have received on the charged LLC interests, to the extent of the judgment. A new subsection added to § 18-703 further provides that the Delaware Court of Chancery "shall have jurisdiction to hear and determine any matter relating to any such charging order."

Other Changes to the LLC Act

The 2005 amendments to § 18-213(b) have conformed the requirements for the transfer or domestication of a Delaware LLC with those for conversion of a Delaware LLC into another form of entity or into a foreign LLC (*see* 6 *Del. C.* § 18-216(b)).

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The approval needed by default for transfer or domestication has thus been made considerably easier to obtain. Previously, absent provisions to the contrary in the LLC agreement, the approval of all members and of all managers was needed to transfer to or domesticate in a jurisdiction other than another state. (6 *Del. C.* § 18-213(b) (2004).) Amended § 18-213(b) provides that, if the LLC agreement does not address the approval needed for transfer or domestication (and does not prohibit it), then approval will be the same as that specified by the LLC agreement for a merger. Absent that, approval will be needed only from the members holding more than half of the interest in the LLC's profits. If the LLC has more than one class of members, a comparable level of approval will need to be obtained from each class.

The protections afforded by § 18-406 to those relying in good faith on LLC records and certain other information have been expanded. Most significantly, the amendments have added liquidating trustees to members and managers as protected persons, and have eliminated the requirement that non-insiders whose information is relied upon be "selected with reasonable care by or on behalf of the limited liability company." (*See* 6 *Del. C.* § 18-406 (2004).) The section, however, retains the requirement that the protected persons reasonably believe that the information provided by non-insiders is "within such other person's professional or expert competence[.]" (6 *Del. C.* § 18-406.)

The prohibition against Delaware LLCs' "granting policies of insurance, or assuming insurance risks[,]" formerly contained in § 18-106(a), has been removed. Banking remains as the only lawful activity that a Delaware LLC may *not* pursue. (6 *Del. C.* § 18-106(a).) The amendments have also made clear that LLC members and managers, and assignees of LLC interests, are bound by the LLC agreement even if they have not executed it. (6 *Del. C.* § 18-101(7).) Finally, relatively minor changes that do not appear likely to have much impact in practice were made to the following sections of the Act: §§ 18-212(i), 18-214(g), and 18-301(b)(3) and (c).

Protecting Good-Faith Reliance on LP Records

A new section has been added to the LP Act to protect certain persons who rely on LP records and other information in much the same manner that members and managers of Delaware LLCs have been protected since the LLC Act became law in 1992. (*See* 6 *Del. C.* § 18-406 (1992).) Section 17-407 of the LP Act now provides that *limited partners and liquidating trustees* are "fully protected in relying in good faith" on partnership records and on information provided by general partners, employees of general partners, liquidating trustees, and committees of limited or general partners, and by other persons respecting matters that are reasonably believed to be within such persons' expertise. (6 *Del. C.* § 17-407(a).)

The level of protection afforded *general partners* varies, depending on whether they are partners in limited partnerships or in limited liability limited partnerships (i.e., LLLPs). General partners of LLLPs receive essentially the same level of protection as limited partners and liquidating trustees of any type of limited partnership. (6 *Del. C.* § 17-407(b).) General partners of limited partnerships that are *not* LLLPs, on the other hand, are protected only from liability to the partnership, its partners, and any other persons bound by the partnership agreement. (6 *Del. C.* § 17-407(c).)

Continuation of LPs after Dissolution

New § 17-806 of the LP Act, like new § 18-806 of the LLC Act, enables partners to continue the business of an LP after an event has triggered its dissolution, in situations where a certificate of cancellation has not

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yet been filed and the dissolution was not the result of judicial decree. (6 *Del. C.* § 17-806.) If the LP has general and limited partners when the decision to continue is made, all of those partners must approve the continuation. If only general partners remain, then continuation must be approved by all of them and by the personal representative of the last limited partner; but, if only limited partners remain, then their approval alone is needed. Finally, if neither general partners nor limited partners remain, approval must be given by the personal representative of the last limited partner.

Since an LP must have at least one general partner and one limited partner (6 *Del. C.* § 17-101(9)), whoever approves continuation where no general partners remain must also agree to appoint one or more general partners, effective as of the withdrawal of the last general partner (6 *Del. C.* § 17-806). In addition, where no limited partners remain, the personal representative who approves continuation must agree to be a limited partner or to admit a designee as a limited partner, as of the event that terminated the participation of the last limited partner.

In other respects, § 17-806 is similar to § 18-806 of the LLC Act: if the LP agreement specifies additional persons whose approval is needed for continuation, such a provision will be enforced; and, if the event of dissolution was a vote of the partners pursuant to § 17-801(2), then approval of continuation must also be obtained from all who voted in favor of dissolution.

Merger, Transfer, and Domestication of LPs

Before the 2005 amendments to the LP Act, a merger agreement could effect changes to the LP agreement of a merger party only if the LP agreement permitted doing so and contained a "specific reference" to the relevant subsection of the Act. (6 *Del. C.* § 17-211(g) (2004).) Those requirements have now been removed. Any LP formed after July 31, 2005, may amend its LP agreement by means of a merger agreement, whether or not the LP agreement permits such a procedure or refers to § 17-211(g). (6 *Del. C.* § 17-211(g).) LPs formed on or before July 31 will be governed by the prior version of § 17-211(g) unless their agreements provide otherwise.

The 2005 amendments also relaxed the requirements for transferring or domesticating a Delaware LP, in much the same way that the amendments relaxed those requirements for LLCs. Previously, the transfer of an LP to, or its domestication in, a jurisdiction other than another state required the written approval of all general and limited partners unless the LP agreement provided otherwise. (6 *Del. C.* § 17-216(b) (2004).) As amended, § 17-216(b) provides that (absent specification in the LP agreement of how transfer or domestication is to be authorized or, barring that, how a merger is to be authorized) transfer or domestication must be authorized by all the general partners and only those limited partners holding more than 50% of the interest in the profits of the LP. If the limited partners are divided into classes, then the approval must be on a class basis. On the other hand, an LP agreement may prohibit transfer or domestication entirely.

Other Revisions to the LP Act

The remaining 2005 amendments to the LP Act parallel those made to the LLC Act, discussed above. For ease of reference, the following table lists the amended sections of the LLC Act and the corresponding amended sections of the LP Act:

LLC Act (6 *Del. C.* § 18-___)	LP Act (6 *Del. C.* § 17-___)
18-101(7)	17-101(12)
18-106(a)	17-106(a)
18-212(i)	17-215(i)
18-214(g)	17-217(g)
18-301(b)(3), (c)	17-301(b)(3), (c)
18-703	17-703
18-902	17-902
18-912	17-912 †

DISPUTE RESOLUTION PROVISIONS IN ALTERNATIVE ENTITIES

by James P. Hughes, Jr.

An issue commonly confronted by practitioners drafting limited liability company (LLC) and limited partnership (LP) agreements concerns whether to include an arbitration provision for resolving disputes.

One survey of alternative entity practitioners found that roughly 25% had represented clients in disputes between majority/minority stakeholders, underscoring the extent to which LLC and LP entities — especially those that are closely held — are enmeshed in disagreements and litigation. (Sandra K. Miller, *A New Direction for LLC Research in a Contractarian Legal Environment*, 76 S. Cal. L. Rev. 351 (2003).)

Whether arbitration is the ideal vehicle for resolving LLC and LP disputes is an open question. As Miller notes in her survey, many alternative-entity lawyers rely on form agreements and may not appreciate that the presence of an arbitration clause can strip a client of its day in court, even where tortious conduct has been the foundation of a complaint. An inability to access the courts can be especially problematic for minority unit holders, who may find a slow-moving arbitration unsatisfactory when they are being squeezed out by a majority stakeholder in an imminent transaction.

For that reason, counsel may want to consider whether they should preserve certain injunctive rights in an agreement, even if there is a general arbitration provision for resolving disputes. Several Delaware decisions, for example, highlight how a general arbitration provision in an LLC agreement can hamstring a member who might otherwise prefer to be in court. In *Elf Atochem North America, Inc. v. Jaffari*, 727 A.2d 286 (Del. 1999), the LLC agreement in question provided, in pertinent part, that:

> Except as otherwise provided in this Agreement, *any* controversy or dispute arising out of this Agreement, the interpretation of any of the provisions hereof, or the action or inaction of any Member or Manager hereunder shall be submitted to arbitration in San Francisco, California before the American Arbitration Association under the commercial arbitration rules then obtaining of said Association. . . . No action at law or equity based upon any claim arising out of or related to this Agreement shall be instituted in any court by any Member except (a) an action to compel arbitration pursuant to this Section 13.8 or (b) an action to enforce an award obtained in an arbitration proceeding in accordance with this Section 13.8. [Emphasis added.]

Notwithstanding the breadth of this clause, Elf sued Jaffari, the president of the LLC, in the Delaware Court of Chancery, seeking equitable remedies based on alleged breaches of fiduciary duty, tortious interference with prospective business relations and fraud.

The Court of Chancery granted Jaffari's motion to dismiss, finding the arbitration provision controlling and dispositive. The Delaware Supreme Court affirmed and rejected Elf's contention that certain claims were derivative, on behalf of the LLC, and therefore not subject to the arbitration clause. (*Elf*, 727 A.2d at 289.) In particular, the Court placed emphasis on the arbitration provision's reference to *"any"* claim arising out of the agreement. (*Id.* at 294.) As the Court observed: "[W]e do not believe there is any doubt of the parties' intention to agree to arbitrate *all* disputed matters in California. If we were to hold otherwise, arbitration clauses in existing LLC agreements could be rendered meaningless." (*Id.* at 295 (emphasis in original). *See also Flight Options International, Inc. v. Flight Options, LLC*, C.A. No. 1459-N, 2005 Del. Ch. LEXIS 149 (Del. Ch. July 11, 2005, Redacted Public Version Sept. 20, 2005) (enjoining transaction from closing for 30 days so that plaintiff could pursue arbitration where LLC agreement required arbitration for "any dispute, controversy or claim").)

The Court of Chancery's decision in *Karish v. SI International, Inc.*, C.A. No. 19501, 2002 Del. Ch.

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LEXIS 77 (Del. Ch. June 24, 2002), also underscores how broadly arbitration provisions will be construed. *Karish* concerned an LLC Agreement that was executed the same day as a Management Agreement. The two Agreements cross-referenced various provisions but contained different remedy provisions. The Management Agreement stipulated that money damages would be an inadequate remedy for a breach and that any party "in its sole discretion [may] apply to any court of law or equity of competent jurisdiction . . . for specific performance and/or other injunctive relief. . . ." The LLC Agreement had a similar remedies provision, but one that was subject to a broad, binding arbitration clause:

> Any controversy or claim arising out of or relating to this Agreement shall be settled exclusively by final and binding arbitration in accordance with the rules of the [AAA]. . . .

The LLC Agreement also provided that any conflicts between the LLC Agreement and any other agreement would be controlled by the LLC Agreement.

When the plaintiff in *Karish* was effectively discharged from the LLC and disputed the valuation of his units, defendants pursued arbitration, which plaintiff then sought to stay in court pursuant to the remedies provision in the Management Agreement. Notwithstanding that provision, the Delaware Court of Chancery held that the arbitration provision in the LLC Agreement was controlling and denied the stay application. The Court focused in particular on the arbitration provision's "broadly written phrase 'arising out of or relating to,'" noting that it was sufficient to make the matter subject to arbitration. (*Id.* at *13.)

As *Karish* teaches, even injunctive remedies specifically carved out in a separate (albeit related) agreement can become subject to an LLC's broad arbitration provision. Other attempts to argue that disputes are outside the ambit of a broad arbitration provision have been similarly unavailing. (*See CAPROC Manager, Inc. v. The Policemen's & Firemen's Retirement System of the City of Pontiac*, C.A. No. 1059-N, 2005 Del. Ch. LEXIS 50 (Del. Ch. April 18, 2005) (holding that absence of a provision in an LLC agreement addressing removal of a manger was not "strong evidence" of an intent to exclude the matter from arbitration).)

Even preserving the right to seek injunctive relief in the same section of an agreement containing an arbitration clause may not be sufficient. The operating agreement that governed the LLC in *Cleveland v. Trapalis*, No. CV 03-417-BR, 2003 U.S. Dist. LEXIS 25528 (D. Or. July 30, 2003), required arbitration for "any dispute among the members or among the members and the LLC concerning this operating agreement," but specifically allowed the parties "to resort to a court of competent jurisdiction in those instances where injunctive relief may be appropriate." (*Id.* at *12.)

In ruling that the claims in question must be arbitrated, the *Trapalis* Court held that the claims for injunctive relief would not be subject to arbitration in light of the clause specifically preserving the right to seek injunctive relief. But that holding was likely of little comfort to the plaintiff as the Court (applying federal law) also held that all of the claims, including those for injunctive relief, would be stayed pending the arbitration of plaintiff's non-injunctive claims. Thus, even a clause specifically preserving the right to seek redress in court was subservient to the arbitration clause.

As the foregoing cases demonstrate, practitioners may wish to give careful consideration to the dispute resolution provisions that they negotiate or draft. The absence of an express provision specifically allowing a party to an LLC or LP agreement to seek relief in the courts — particularly injunctive relief — may force an investor facing irreparable harm to rely on the uncertainties of a potentially slow moving arbitration proceeding for relief. †

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