2005 ABA ANNUAL MEETING

SECTION OF BUSINESS LAW

Important Case Law Developments for Partnerships
and Limited Liability Companies

# 2004-2005 SUPPLEMENT TO

# CUMULATIVE SURVEY OF DELAWARE CASE LAW

# RELATING TO

# ALTERNATIVE ENTITIES*

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* The entire Cumulative Survey is available on the Morris Nichols website at www.MNAT.com under Publications/Legal Periodicals and Seminar Papers/Partnerships and Limited Liability Companies.

## II. LIMITED PARTNERSHIPS

### A. Fiduciary Duties

*Lazard Debt Recovery GP, LLC v. Weinstock*, 864 A.2d 955 (Del. Ch. 2004)

Defendants were co-portfolio managers and limited partners of an investment fund formed as a Delaware limited partnership. The fund was operated by two subsidiaries of Lazard Frères & Co. LLC, one of which was the general partner of the fund and the other of which was the investment manager of the fund. Defendants severed their relations with the investment fund very abruptly by terminating their employment without prior notice and then allegedly put pressure on Lazard to transfer the assets of the fund to a new fund that defendants intended to form at a competitor of Lazard. In the period in which defendants were contemplating their departure, defendants continued to function on behalf of the fund, did not disclose they were thinking about leaving and made general statements about the high quality of Lazard as an employer and that they enjoyed their jobs. Following defendants' departure, Lazard was unable to replace defendants as portfolio managers in a sufficiently timely manner and, instead of acceding to defendants' wishes and transferring the assets of the fund to defendants' new fund, Lazard elected to dissolve the fund. The fund and its general partner and investment manager then sued defendants for, among other things, breach of fiduciary duty owed to the fund and the partners who invested in the fund, breach of the partnership agreement of the fund and breach of the investment management agreement between the fund and the investment manager. Defendants moved to dismiss for failure to state a claim upon which relief upon which relief could be granted. (*See* Section III.C above for a related decision with respect to defendants' request for indemnification.)

The court first addressed the breach of fiduciary duty claim. While the court acknowledged that defendants owed fiduciary duties to the fund and its investors in connection with the investment discretion entrusted to defendants, the court held that these fiduciary duties did not extend to a duty not to resign and begin a competing business without providing adequate prior notice to allow the fund to replace defendants. The court refused to impose a fiduciary duty on defendants not to leave the fund without suitable replacements where defendants were not contractually restricted from doing so. The court stated that to impose such a duty would inequitably grant plaintiffs' with an important right that they did not bargain and pay for. The court thus dismissed this claim.

The court also dismissed several of plaintiffs' claims of breach of the partnership agreement and the investment management agreement. Plaintiffs' claims included a claim that defendants assumed the same duties as the general partner of the partnership by signing subscription agreements to invest in the fund as limited partners and a claim that defendants were bound to act in accordance with the standard of care in the indemnification provision of the partnership agreement because they fell within the coverage of the indemnification provision as members of the general partner. The court did not dismiss, however, plaintiffs' claim that defendants breached the confidentiality provision of the partnership agreement, which they were subject to as limited partners, by using confidential information in establishing the competing fund and granted plaintiffs' request for discovery to determine if defendants had misused such confidential information.

### B. Inspection of Partnership Books and Records

*Forsythe v. CIBC Employee Private Equity Fund (U.S.) I, L.P.*, C.A. No. 657-N (Del. Ch. July 7, 2005)

Plaintiffs, who had been former employees of Canadian Imperial Bank of Commerce ("CIBC") and limited partners in CIBC Employee Private Equity Fund (U.S.) I, L.P., a Delaware limited partnership (the "Fund") brought an action to inspect certain books and records of the Fund pursuant to Section 17-305 of the DRULPA. The court first considered whether plaintiffs had the required proper purpose under Section 17-305 and concluded that their stated purposes of determining the value of certain assets in the Fund (and thereby, the court assumed, the value of their units) and investigating wrongdoing in the management of the Fund were both proper purposes. The main point of contention in the case was whether the plaintiffs would be entitled to a number of the documents requested that were actually documents of CIBC. The court distinguished this case from the situation in which a defendant attempts to defeat a books and records action simply by having another entity hold the records noting that such a maneuver will not protect records if they would have been subject to the inspection had they been in possession of the defendant entity. In contrast, the court found that the records requested were actually those of CIBC. Plaintiff argued that the records should still be available because CIBC was the "alter ego" of the Fund. However, the court found that there was no factual support for plaintiffs "alter ego" theory and therefore denied plaintiffs' claim to inspect the CIBC records. The court did, however, grant plaintiffs' claim to inspect a number of the books and records of the Fund including those that were maintained by an agent of the Fund.

J. <u>Procedural Issues</u>

1. *Subject Matter Jurisdiction*

a. *Albert v. Alex. Brown Management Services, Inc.*, C.A. Nos. 04C-05-250 PLA, 04C-05-251 PLA (Del. Super. Ct. Sept. 15, 2004).

The limited partners of two Delaware limited partnerships filed suit in the Superior Court against the general partners of the partnerships, certain affiliates of the general partners and numerous members of the partnerships' management committees. Defendants moved to dismiss for lack of subject matter jurisdiction.

Plaintiffs phrased their claims as breach of contract (*i.e.*, the partnership agreements), fraud, negligence and unjust enrichment, seeking punitive damages as well as a jury trial in the Superior Court. The court rejected plaintiffs' attempt to bring suit in the Superior Court on these claims, finding that the complaint stated only claims within the sole jurisdiction of the Court of Chancery. Despite plaintiffs' careful wording of the complaint, the court determined that this was, in essence, an action for breach of fiduciary duty and that, while almost all breaches of fiduciary duty are frauds, such actions belong nonetheless in the Court of Chancery, where sophisticated standards governing the liability of entity fiduciaries have evolved in order to deal with specific policy concerns. With respect to plaintiffs' breach of contract claims, the court held that despite the permissive wording of DRULPA Section 17-111, Section 17-111 grants the Court of Chancery exclusive, rather than concurrent, jurisdiction over matters involving interpretation of partnership agreements, except to the extent that (i) there has already been an accounting or settlement of partnership affairs or (ii) the partners evince intent to segregate business out of the partnership by creating a separate instrument. The court also held that plaintiffs' fraud and negligence claims likewise had no place in the Superior Court since any duty defendants might have breached would have arisen only through the partnership agreements and to determine the scope of such a duty would necessarily involve the interpretation of the partnership agreements. Further, the court held that the unjust enrichment claims were purely equitable matters that do not properly lie before the Superior Court. The court thus granted defendants' motion to dismiss.

4. *Statute of Limitations*

a. *Albert v. Alex. Brown Management Services, Inc.*, C.A. Nos. 762-N, 763-N (Del. Ch. June 29, 2005).

After the disposition of this case by the Superior Court as discussed in Section II.J.1 above, the limited partners of the two Delaware limited partnerships filed suit in the Chancery Court against the general partners of the partnerships, certain affiliates of the general partners and numerous members of the partnerships' management committees. The defendants moved to dismiss, arguing that the plaintiffs' claims were time-barred, that the plaintiffs failed to state a claim upon which relief could be granted and finally that the plaintiffs' claims were derivative and the plaintiffs had not pleaded that demand was refused or futile. The Chancery Court held that a vast majority of the specific factual allegations made by the plaintiffs had to do with wrongful actions occurring more than three years before the parties entered into a tolling agreement and therefore any causes of action accruing as a result of these wrongful actions would be time-barred. Because it was unclear which of the plaintiffs' numerous claims were time-barred, the court ordered the plaintiffs to file supplemental arguments on this issue.

The Chancery Court began its analysis by stating that a three-year statute of limitations is applicable to tort, contract and fiduciary duty claims and that, even though statutes of limitation do not automatically bar actions in equity, the statutory period applies by analogy and it may create a presumptive time period for application of laches to bar a claim. The court stated that the statute of limitations begins to run at the time of the wrongful act, even if the plaintiff is ignorant of the cause of action. Under this analysis, the court determined that the vast majority of the wrongful acts alleged by the plaintiffs took place sufficiently far in the past so that any causes of action arising therefrom would be time-barred. According to the court, whether or not the plaintiffs could have sued for damages is not dispositive as to whether a claim accrued, since, as soon as the alleged wrongful act occurred, the plaintiffs could have sought injunctive relief. In other words, a claim accrues at the time of the alleged wrongdoing, not when a plaintiff suffers a loss. The plaintiffs went on to assert three separate theories to support a tolling of the statute of limitations: (i) inherently unknowable injuries, (ii) fraudulent concealment and (iii) equitable tolling. The court stated that each of these doctrines permits tolling of the limitations period only where the facts underlying a claim are so hidden that a reasonable plaintiff could not timely discover them and held that, in each case here, the plaintiffs were long since on inquiry notice of the existence of their claims.

K. <u>General Construction and Application of Partnership Agreements</u>

1. *Solow v. Aspect Resources LLC*, C.A. No. 20397 (Del. Ch. Oct. 19, 2004)

Plaintiff was the limited partner of Aspect/SHS Limited Partnership (the "Partnership") holding a 99% partnership interest and defendants were the general partner of the Partnership and certain controlling persons of the defendant general partner. Plaintiff had brought suit alleging that defendants fraudulently induced him to become a partner in the Partnership and then breached the partnership agreement and their fiduciary duties in the conduct of the Partnership's business. Plaintiff also sought a constructive trust as to profits defendants accrued from their breach of contract and fiduciary duty. Defendants moved to dismiss certain claims and for summary judgment as to others. Finding that the plaintiff had not adequately pled facts that, if true, would prove that defendant made false statements, the court dismissed the fraud in the inducement claim. The court also dismissed all of the breach of contract claims against the controlling persons of the general partner finding that the plaintiff had pled no facts, or argued any law, that would indicate that a person that is not a party to a contract could be liable for a breach thereof. With respect to the breach of fiduciary duty claim, the court found that the same bad acts giving rise to the breach of contract claims allegedly gave rise to the breach of fiduciary duty claims and held that because the fiduciary duty counts in the complaint arose not from general fiduciary principles but from specific contractual obligations agreed upon by the parties, the fiduciary duty claims were precluded by the contract claims. The plaintiff had somewhat greater success with regard to the court's summary judgment holdings. Because the court found there were still genuine issues of material fact with respect to whether the plaintiff was offered an opportunity to participate in another investment as required by the partnership agreement, summary judgment on that claim was denied, and for the same reason, plaintiff's claim for constructive trust upon the profits made by defendants in connection with such investment also survived the motion for summary judgment.

2. *Lazard Debt Recovery GP, LLC v. Weinstock*, 864 A.2d 955 (Del. Ch. 2004)

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M. Distributions

*Pomeranz v. Museum Partners, L.P.*, C.A. No. 20211 (Del. Ch. Jan. 24, 2005)

Plaintiffs, who were limited partners of a Delaware limited partnership, brought this action against the general partner and the majority limited partner of the partnership alleging breach of partnership agreement and breach of fiduciary duty in connection with the withdrawal of the majority limited partner from the partnership. The majority limited partner's withdrawal purportedly triggered a right to a distribution equal to the majority limited partner's pro rata share of the partnership's liquidation value. The partnership did not have sufficient cash at the time of the withdrawal to make the distribution and instead entered into a withdrawal agreement with the majority limited partner that was extraordinarily favorable to the majority limited partner. Plaintiffs had originally filed their complaint against only the general partner and did not add the majority limited partner as a defendant until over three years had elapsed following the withdrawal. The majority limited partner moved to dismiss the action against it as being time-barred.

Among plaintiffs' claims was a claim based on DRULPA Section 17-607, which provides in relevant part that "[u]nless otherwise agreed, a limited partner who receives a distribution from a limited partnership shall have no liability under [DRULPA] or other applicable law for the amount of the distribution after the expiration of 3 years from the date of the distribution." Plaintiffs argued that the payments under the withdrawal agreement were distributions and had been received by the majority limited partner within three years of the majority limited partner's addition to the complaint. The court held that Section 17-607 was inapplicable in this case but noted that even if it were applicable, the entry into the withdrawal agreement, pursuant to which the majority limited partner compromised its demand for a cash payment, was the "distribution" to the majority limited partner and thus the three year period would have begun to run for purposes of Section 17-607 on the date the withdrawal agreement was entered into, rather than on the dates the payments were made under the withdrawal agreement.

N. Capital Contributions

1. *In re LJM2 Co-Investment, L.P. Limited Partners Litigation*, No. C.A. 300-N (Del. Ch. Dec. 21, 2004)

In another case spawned by the Enron bankruptcy, (see the *Alpine Investment Partners* case discussed in Section II.C above) the plaintiff, a liquidating trust formed in connection with the bankruptcy of LJM2 Co-Investment, L.P. (the "Partnership") and the trustee of the trust brought an action against the limited partners of the Partnership to enforce the obligation of the limited partners to make capital contributions to the Partnership sufficient to pay former bank creditors of the Partnership who were the sole beneficiaries of the liquidating trust. The case arose in the context of a loan to the Partnership and an agreement by the general partner to call capital from the limited partners in the event that the Partnership defaulted on payment of the loan. The Partnership did default and the general partner made a capital call in December 2001 on the limited partners (the "December Capital Call"). However, prior to the effectiveness of the December Capital Call, the limited partners removed the general partner, appointed a new general partner that purported to rescind the December Capital Call and purported to amend the partnership agreement to require a majority interest of limited partners to approve any further capital calls. The case came before the court on a motion to dismiss and the court denied the motion to dismiss as to all counts. Plaintiffs had alleged numerous bases on which the limited partners would be obligated to make capital contributions pursuant to the December Capital Call as well as pursuant to a capital call made in September 2003 (the "September Capital Call") ranging from claims based on Section 17-502 of the DRULPA to claims for breach of the credit agreement between the Partnership and the bank creditors, tortious interference with contract, aiding and abetting a breach of fiduciary duty and unjust enrichment. However, the court focused its discussion on whether the defendants had effectively compromised or rescinded the December 2001 Capital Call and whether the purported amendment to the Partnership's limited partnership agreement was effective to require the consent of a majority interest of the limited partners to the September Capital Call.

In addressing the effectiveness of the amendment, the court noted that the partnership agreement provided that it could be amended in any respect upon agreement by the majority limited partners. However, this power to amend was subject to a limitation that no amendments could change the percentage in interest of the limited partners necessary for any consent "required hereunder to the taking of any action" unless such amendment were approved by the requisite percentage in interest. The question thus presented to the court was whether the default unanimity requirement found in Section 17-502(b)(1), which requires the consent of all partners to compromise the obligation of a partner to make a capital contribution unless otherwise provided in the partnership agreement, was "required hereunder" within the meaning of the amendment section of the partnership agreement. Noting that in the corporate law context it was clear that the DGCL was a part of the certificate of incorporation of every Delaware company, the court concluded that the unanimity requirement of Section 17-502(b)(1) was in effect incorporated by reference into the partnership agreement. Thus, the court held that the purported amendment of that section by less than the consent of all of the limited partners was ineffective (the court also noted that the purported use of a power of attorney by the general partner on behalf of all the limited partners to approve the amendment was similarly ineffective to bind the non-consenting limited partners). The court also considered whether the December Capital Call could be rescinded and whether that would be different from a compromise and concluded that the power to rescind is not the same as the power to compromise. The court noted, however, that the complaint fairly alleged facts supporting the argument that the action taken by the successor general partner to rescind the December Capital Call was both a breach of contract and a breach of fiduciary duty sufficient to render that action ineffective. Further, the court found that the plaintiffs had alleged sufficient facts for the court to conclude that the September Capital Call could be enforced without regard to the majority limited partner consent provisions found in the purported amendment. Finally, the court agreed with plaintiffs that they had alleged sufficient facts to provide a basis for reasonable reliance by the creditors on the capital contribution obligation of the limited partners within the meaning of Section 17-502(b)(1) of the DRULPA.

## III. LIMITED LIABILITY COMPANIES

### A. Fiduciary Duties

1. *U.S. Bank Nat'l Assoc. v. U.S. Timberlands Klamath Falls, L.L.C.*, 864 A.2d 930 (Del. Ch. 2004), vacated, C.A. No. 112 (Del. June 6, 2005)

Plaintiff, an indenture trustee, acting on behalf of unsecured noteholders of a Delaware LLC, alleged, among other claims, breach of fiduciary duty by the directors of the LLC to the noteholders in connection with certain transactions between the LLC and a related third party. Defendants moved to dismiss the fiduciary duty claim on the grounds that the complaint failed adequately to allege that defendants owed fiduciary duties to the noteholders and on the grounds that the LLC's operating agreement deemed the transactions at issue not to constitute a breach of any duty.

The court first addressed defendants' argument that the complaint did not establish that defendants owed fiduciary duties to the noteholders. Defendants admitted that under Delaware law when a debtor enterprise is insolvent, the fiduciary duties of those managing the debtor enterprise extend to the interests of creditors. While fiduciary duties to creditors have been recognized by Delaware courts in the context of insolvent Delaware corporations and limited partnerships (*see Bren v. Capital Realty Group Senior Housing, Inc.* discussed in Section II.A. above), this is the first decision by a Delaware court in which such a fiduciary duty was recognized in the LLC context. Defendants contended that the complaint did not allege sufficient facts from which the court could infer that the LLC was insolvent. The court stated that to meet its burden to plead a breach of fiduciary duty to creditors, plaintiff must plead facts sufficient to support a finding that the LLC was insolvent. According to the court, insolvency is defined in two ways in Delaware. First, a company is insolvent if it is unable to pay its debts as they fall due in the usual course of business. Second, a company may be insolvent if it has liabilities in excess of a reasonable market value of its assets. The court noted that fiduciary duties to creditors may arise when the company is in the zone of insolvency. The court did not find sufficient evidence in the complaint that the LLC was not able to pay its debts as they fell due but did find that, given the LLC's status as a mature company as opposed to a start-up, the significant amount by which its liabilities exceeded its assets raised an issue of material fact as to whether the LLC was insolvent or in the zone of insolvency that was sufficient to survive a motion to dismiss.

The court then addressed defendants' argument that the fiduciary duty claim must be dismissed because the LLC's operating agreement deemed the transactions in question not to constitute a breach of any duty. The operating agreement contained a typical procedure for authorizing interested transactions through the approval of a conflicts committee. Upon such approval, the operating agreement provided that any such transactions would be deemed to be "fair and reasonable" and not a "breach of any duty." The defendants contended that the trustee's fiduciary duty claim was derivative in nature and must therefore be brought on behalf of the LLC, which pursuant to LLC Act Section 18-101(7) is bound by the provisions of the operating agreement including the provisions deeming the interested transaction not to constitute a breach of any duty. The court, however, found that defendants had not shown that the conflicts committee actually met and authorized the transactions at issue and, on that basis, denied the defendants' motion to dismiss the fiduciary duty claim.

In a subsequent decision in this case, the Delaware Supreme Court vacated the order issued by the Court of Chancery following the decision discussed above and remanded the case to the Court of Chancery for a trial that would include the issues determined by the Court of Chancery in such order. While the vacation of the order precludes citation of the Court of Chancery's opinion as precedent, the opinion is included because the Supreme Court did not reject its reasoning and it indicates how the Court of Chancery may address similar issues in the future.

2. *Blackmore Partners, L.P. v. Link Energy LLC*, 864 A.2d 80 (Del. Ch. Nov. 10, 2004)

This case arose from the approval by the board of directors of a Delaware LLC of the sale of substantially all of the LLC's assets for $290 million. Under the terms of the LLC's operating agreement, the board of directors had the power to effectuate the transaction without a vote of the LLC's unitholders, and no vote of the unitholders was sought. Out of the $290 million, $265 million was to be used to repay debt of the LLC, including certain unsecured notes, and the remaining $25 million was to be paid to the holders of the unsecured notes in return for their agreement to waive covenants in the notes that required any purchaser of the LLC to assume the notes. No proceeds from the sale were to be distributed to the LLC's unitholders, and the sale rendered the LLC's units worthless.

Plaintiff, a unitholder of the LLC, brought a class action against the LLC and its directors for breach of fiduciary duty, alleging that the board favored the noteholders, to whom they did not owe a fiduciary duty, at the expense of the unitholders, to whom they did owe a fiduciary duty, and also that the board failed to maximize unitholder value in a sale of control transaction and, thus, violated its duty of loyalty under the principles of the corporate *Revlon* doctrine. Defendants moved to dismiss the complaint for failure to state a claim upon which relief can be granted, and this opinion was the court's decision with respect to such motion.

The court stated that under the *Revlon* doctrine, "once a board of directors determines to sell the corporation in a change of control transaction, its responsibility is to endeavor to secure the highest value reasonably attainable for the stockholders." The court then applied the principles of the *Revlon* doctrine in this case involving an LLC. The court noted that the LLC's operating agreement contained a clause that exculpated the directors from liability for breach of the duty of care and stated that under *Revlon* precedent in order to survive the motion to dismiss in such a case, the complaint must allege particularized facts that support an inference of disloyalty or a lack of good faith. Defendants argued that the complaint must be dismissed because it did not allege self-interest or lack of independence by the directors. The court acknowledged that the absence of allegations of self-interest or lack of independence is often a fatal defect in a complaint for breach of the duty of loyalty, but did not find that to be true in this case. Under these circumstances, where the allegations supported an inference that the LLC's units had significant value prior to the announcement of the sale and that the LLC was neither insolvent nor on the verge of bankruptcy at such time, the court held that plaintiff's allegations raised a reasonable inference of disloyalty or intentional misconduct by the board of directors. The court went on to state that while a more complete record may show that defendants were justified in acting as they did, at this stage it was reasonable to infer that a properly motivated board would not have agreed to a transaction that wiped out the value of the LLC's units and surrendered all of that value to the LLC's creditors. The court thus denied defendants' motion to dismiss.

F. Removal of Members and Forfeitures of Interests

*Milford Power Company, LLC v. PDC Milford Power, LLC*, 866 A.2d 738 (Del. Ch. Dec. 17, 2004)

Plaintiffs in this case were a Delaware LLC and the majority member of the LLC, which held a 95% interest in the LLC. They sought a declaration that defendant, who was the other member of the LLC and held a 5% interest, had lost its membership interest in the LLC as a result of defendant's filing a petition for bankruptcy. Although the defendant's bankruptcy petition was dismissed, plaintiffs alleged that both under the terms of the LLC agreement and the operation of Section 18-304 of the Delaware LLC Act, defendant ceased to be a member of the LLC upon filing its bankruptcy petition and, pursuant to the LLC agreement, defendant was not entitled to any compensation in respect of its LLC interest.

Defendant resisted plaintiffs' claims on several grounds. First, defendant argued that it was wrongly forced into a bankruptcy filing by the majority member of the LLC and certain lenders to the LLC and that the doctrine of unclean hands prevented plaintiff from profiting by the application of the *ipso facto* clause in the LLC agreement. The court acknowledged that it was possible to conceive of circumstances in which the improper conduct of one member of an LLC towards a fellow member could cause that member's insolvency and resulting bankruptcy filing, and that under those circumstances the member that had improperly caused the bankruptcy filing could be estopped from relying upon that event to deprive the other member of its ownership interest in the LLC. The court noted that such an argument was better characterized as a contractual defense under the implied covenant of good faith and fair dealing preventing one party from relying upon the occurrence of a condition its own behavior had brought about. Unfortunately for defendant, although agreeing with the legal principle it expounded, the court found no factual basis whatsoever to support its argument. However, with regard to defendant's second argument, namely that the operation of the *ipso facto* clause in the LLC agreement and under the Delaware LLC Act was preempted by the Federal Bankruptcy Code, the court took a different view. Plaintiffs had argued that under the Bankruptcy Code and applicable Delaware law, both the automatic withdrawal of defendant as a member of the LLC and the relinquishment of its interest without payment were enforceable notwithstanding the Bankruptcy Code's provisions regarding the unenforceability of certain *ipso facto* clauses. In contrast, defendant had argued that neither the deemed withdrawal of defendant nor the forfeiture of its interest without consideration were enforceable and that it should be returned to its position as it existed prior to its bankruptcy filing as a member with its full membership rights. The court acknowledged the arguments of both sides and the provisions of the Bankruptcy Code, applicable decisions and commentary that supported such arguments. The court ultimately adopted a position between those advocated by plaintiffs and defendant, based on the Bankruptcy Code's provisions that limit the right of a debtor to assume and assign an executory contract if under applicable law a party to such a contract, other than the debtor, would be excused from accepting performance from or rendering performance to an assignee of such contract. The court, in part in reliance on the case of *In re IT Group, Inc.*, 302 B.R. 483 (D. Del. 2003), *aff'g In re IT Group, Inc.*, No. 02-10118 (Bankr. D. Del. June 20, 2002), held that the interest of a member in a Delaware LLC (at least the interest of a member with management rights) is composed of both assignable rights and non-assignable rights -- the former being the purely economic rights and the latter being the management and all other non-economic rights. The court therefore concluded that defendant, by virtue of its bankruptcy filing and the operation of Section 18-304 of the LLC Act and the terms of the LLC agreement, had withdrawn as a member of the LLC and thus had no management voting or other non-economic rights, but would be treated as an assignee under Section 18-702 of the Delaware LLC Act and thus retained its economic rights.

G. <u>Dissolution</u>

*Haley v. Talcott*, 864 A.2d 86 (Del. Ch. 2004).

Matthew James Haley ("Haley") and Gregory L. Talcott ("Talcott") were the only members of a Delaware LLC in which each held a fifty percent interest. The principal asset of the LLC was certain real property leased by a restaurant jointly operated by Haley and Talcott. When the parties had a falling out regarding the operation of the restaurant, Haley asserted several positions as a member of the LLC following the expiration of the restaurant's lease, including voting to reject a new lease for the restaurant, voting to terminate any existing lease arrangement by which the restaurant asserted a right to possession of the property and voting to put the real property up for sale. Talcott, on the other hand, took no action, content to maintain the status quo, with the restaurant continuing to occupy the property under a month-to-month arrangement. Haley sought judicial dissolution of the LLC under Section 18-802 of the Delaware LLC Act alleging that it was not reasonably practicable to carry on the business of the LLC in conformity with the LLC agreement because the two members of the LLC were deadlocked. This was the court's decision on Haley's motion for summary judgment.

In analyzing this case under Section 18-802 of the Delaware LLC Act, the court found it was appropriate to analogize to Section 273 of the DGCL, which provides for judicial dissolution of a joint venture corporation having two stockholders who are deadlocked. The court stated that there are three prerequisites for a judicial order of dissolution under DGCL Section 273: (1) the corporation must have two 50% stockholders, (2) those stockholders must be engaged in a joint venture and (3) the stockholders must be unable to agree upon whether to discontinue the business or how to dispose of its assets. The court found each of these prerequisites to be satisfied in the context of the LLC.

Talcott argued that the LLC should not be judicially dissolved, however, because the business of the LLC could be carried on in conformity with the LLC agreement through the operation of an exit mechanism in the LLC agreement. The exit mechanism a procedure under which a member would purchase for fair market value the membership interest of another member who wished to "quit" the LLC. The court found that the exit mechanism was not a reasonable alternative for carrying on the business of the LLC because neither party desired to leave the LLC and because, if Haley were forced to use the exit mechanism to leave the LLC as Talcott suggested, the exit mechanism would not provide for the removal of Haley as a personal guarantor of the mortgage on the property owned by the LLC even though he would no longer have any interest in the LLC. The court determined that it would not be equitable for Haley to remain personally liable for the guaranty when he retained no interest in the LLC and concluded that judicial dissolution was the only equitable way to break the deadlock and effect the separation of the parties.

K. Procedural Issues

1. *Arbitration*

a. *CAPROC Manager, Inc. v. The Policemen's & Firemen's Retirement System of the City of Pontiac*, C.A. No. 1059-N (Del. Ch. Apr. 18, 2005)

Prior to the commencement of this case, defendants had sought to remove one of the plaintiffs as the managing shareholder of an LLC in which defendants and plaintiff were members. This action by the defendants prompted plaintiffs to seek a declaration under Section 18-110 of the LLC Act that the plaintiff who had been the managing shareholder remained the managing shareholder as well as the entry of a status quo order. Defendants moved to have the action dismissed in favor of arbitration based on a broad arbitration clause in the LLC Agreement requiring arbitration of any "dispute or controversy arising under" the LLC Agreement. The court noted that it did not have jurisdiction over claims that were properly committed to arbitration because the availability of arbitration provided an adequate legal remedy and that Delaware public policy favored resolution of disputes through arbitration and required that any doubt regarding the arbitrability of a dispute be resolved in favor of arbitration. The court stated the issue as whether a removal action by defendants arose under the LLC agreement so as to come within the mandatory arbitration provision. Plaintiffs argued that it did not because the LLC agreement contained no provision for removal. Defendants disagreed arguing that removal by a majority vote pursuant to the default rule for management in Section 18-402 of the LLC Act as well as removal as a remedy implicitly available as a response to breach of contract would both arise under the LLC agreement. However, although plaintiffs argued that the removal question did not arise under the LLC agreement, in their complaint, they noted that the managing shareholder derived its authority from the LLC agreement and could cease to be a manager under the LLC agreement only by resignation or amendment pursuant to the terms of the LLC agreement and further alleged that defendants' conduct violated the LLC agreement. The court found this to suggest strongly that plaintiffs' claims did arise under the LLC agreement. This finding was bolstered by the court's conclusion that the intent of the parties in entering into the LLC agreement would also need to be determined to resolve the dispute. In addition, the court found no evidence that there was an express provision in the LLC agreement excluding removal from arbitration or forceful evidence of a purpose to exclude it (the sole exceptions to the arbitration requirement). Based on the foregoing, particularly the breadth of the arbitration clause and the fact that to resolve the dispute the court would necessarily have to address factual and legal questions that involved interpretation of the LLC agreement, the court concluded that the dispute was subject to mandatory arbitration and dismissed the complaint.

M. Mergers and Consolidations

*Acadia Brandywine Town Center, LLC v. New Castle County*, C.A. No. 03C-09-040 WCC (Del. Super. Ct. Sept. 10, 2004).

Following a reverse merger of several Delaware LLCs for the sole business purpose of transferring certain real property, the parties to the merger sought a ruling from the State of Delaware Division of Revenue (the "DOR") that the merger was exempt from the Delaware Realty Transfer Tax, 30 Del. C. §§ 5401 *et seq*. (the "Transfer Tax"). The DOR concluded that the merger was subject to the Transfer Tax. The merger parties then brought this action seeking a declaratory judgment that the Transfer Tax was not applicable to the merger.

Holding that the merger was subject to the Transfer Tax, the Superior Court stated that the Transfer Tax applied to a conveyance of intangible interest in an entity that can be characterized as a sale of real estate. The Superior Court held that for purposes of the Transfer Tax the merger was a conveyance of the membership interest in the constituent LLCs that constituted a conveyance of an intangible interest for purposes of the Transfer Tax, and that thus the merger should be characterized as a sale of real property because the merger was simply a means to transfer real property, which was the only valued asset at stake.

The Supreme Court reversed the Superior Court's decision, noting that, if there is doubt regarding the breadth of a taxing statute, that statute must be construed against the taxing authority and in favor of the taxpayer. The Supreme Court stated that mergers involving unrecorded real estate transfers had been specifically exempted from the Transfer Tax under regulations promulgated in 1984. Because subsequent legislation and accompanying regulations designed to close existing loopholes did not evince a clear intent to eliminate mergers as one of the putative abuses of the Transfer Tax, the Supreme Court held that reverse mergers involving real estate therefore continue not to be subject to the Transfer Tax.

N. Veil Piercing

*U.S. Bank Nat'l Assoc. v. U.S. Timberlands Klamath Falls, L.L.C.*, C.A. No. 112-N (Del. Ch. Mar. 30, 2005)

In this decision in the *U.S. Bank v. U.S. Timberlands Klamath Falls* case (*see* Section III.A. for summaries of earlier decisions in this case), plaintiff sought to amend its complaint to add several claims, including a veil-piercing claim with respect to three Delaware LLCs and a Delaware corporation. The court, citing corporate precedent, stated that to state a veil-piercing claim in Delaware, plaintiff must plead facts supporting an inference that defendants created a sham entity designed to defraud investors and creditors and that the factors considered by a court in a veil-piercing analysis include (i) whether the company was adequately capitalized for the undertaking, (ii) whether the company was solvent, (iii) whether corporate formalities were observed, (iv) whether the dominant shareholder siphoned corporate funds and (v) whether, in general, the company simply functioned as a façade for the dominant shareholder. Although the precedent cited in the court's discussion was all in the corporate context, the court did not distinguish between the test for piercing the veil of a corporation as opposed to that of an LLC, which implies that the corporate standard would be applied in the context of an LLC. The court stated that the fact-intensive inquiry associated with the veil-piercing claim would involve substantial discovery and denied plaintiff's request to add the veil-piercing claim because it found that, given the relatively late stage of this proceeding and the nearness of the trial, the addition of the veil-piercing claim at this time would unreasonably prejudice the defendants.

O. Change of Control Transactions

*Blackmore Partners, L.P. v. Link Energy LLC*, 864 A.2d 80 (Del. Ch. Nov. 10, 2004)

This case arose from the approval by the board of directors of a Delaware LLC of the sale of substantially all of the LLC's assets for $290 million. Under the terms of the LLC's operating agreement, the board of directors had the power to effectuate the transaction without a vote of the LLC's unitholders, and no vote of the unitholders was sought. Out of the $290 million, $265 million was to be used to repay debt of the LLC, including certain unsecured notes, and the remaining $25 million was to be paid to the holders of the unsecured notes in return for their agreement to waive covenants in the notes that required any purchaser of the LLC to assume the notes. No proceeds from the sale were to be distributed to the LLC's unitholders, and the sale rendered the LLC's units worthless.

Plaintiff, a unitholder of the LLC, brought a class action against the LLC and its directors for breach of fiduciary duty, alleging that the board favored the noteholders, to whom they did not owe a fiduciary duty, at the expense of the unitholders, to whom they did owe a fiduciary duty, and also that the board failed to maximize unitholder value in a sale of control transaction and, thus, violated its duty of loyalty under the principles of the corporate *Revlon* doctrine. Defendants moved to dismiss the complaint for failure to state a claim upon which relief can be granted, and this opinion was the court's decision with respect to such motion.

The court stated that under the *Revlon* doctrine, "once a board of directors determines to sell the corporation in a change of control transaction, its responsibility is to endeavor to secure the highest value reasonably attainable for the stockholders." The court then applied the principles of the *Revlon* doctrine in this case involving an LLC. The court noted that the LLC's operating agreement contained a clause that exculpated the directors from liability for breach of the duty of care and stated that under *Revlon* precedent in order to survive the motion to dismiss in such a case, the complaint must allege particularized facts that support an inference of disloyalty or a lack of good faith. Defendants argued that the complaint must be dismissed because it did not allege self-interest or lack of independence by the directors. The court acknowledged that the absence of allegations of self-interest or lack of independence is often a fatal defect in a complaint for breach of the duty of loyalty, but did not find that to be true in this case. Under these circumstances, where the allegations supported an inference that the LLC's units had significant value prior to the announcement of the sale and that the LLC was neither insolvent nor on the verge of bankruptcy at such time, the court held that plaintiff's allegations raised a reasonable inference of disloyalty or intentional misconduct by the board of directors. The court went on to state that while a more complete record may show that defendants were justified in acting as they did, at this stage it was reasonable to infer that a properly motivated board would not have agreed to a transaction that wiped out the value of the LLC's units and surrendered all of that value to the LLC's creditors. The court thus denied defendants' motion to dismiss.

IV. GENERAL PARTNERSHIPS & JOINT VENTURES

E. Withdrawal of Partners

1. *Lost Creek Land & Cattle Co., Inc. v. Wilson*, C.A. No. 1516-K (Del. Ch. Aug. 19, 2004)

Plaintiff and defendant entered into a joint venture to grow, harvest and sell a potato crop pursuant to an oral agreement. After becoming dissatisfied with plaintiff's work ethic, defendant advised plaintiff that he was terminating the joint venture, even though the potato crop was still in the ground and had not yet been harvested or sold, and offered to pay plaintiff $300 an acre plus certain out-of-pocket expenses to "buy out" plaintiff's interest in the venture. Plaintiff failed to deliver a statement of his out-of-pocket expenses to defendant in a timely manner, and defendant purported to withdraw the buy-out agreement. Plaintiff then brought this action to enforce the buy-out agreement.

The court found that the joint venture constituted a partnership for a particular undertaking, which, pursuant to DRUPA Sections 15-601 and 15-801, was dissolved when defendant unilaterally dissociated himself from the partnership. The court noted that under DRUPA Section 15-602 a partner's dissociation in a partnership for a particular undertaking is wrongful where the partner withdraws by express will before the completion of the undertaking. The court found that defendant's dissociation was wrongful in this case because he withdrew before the potato crop had been harvested and sold. The court stated that, pursuant to DRUPA Sections 15-602 and 15-807, unless the partners agree otherwise, upon such a dissociation, the dissociated partner is liable for any damages caused by his dissociation and the partnership is required to be wound up, with each partner entitled to an accounting and a sharing of the profits or losses on a 50-50 basis. In this case, the court held that the partners had agreed otherwise through the buy-out agreement, that plaintiff had accepted the buy-out agreement and that defendant was obligated to perform under such agreement., C.A. No. 112-N (Del. Ch. Mar. 30, 2005)

2. *Holland v. Moore-Kenton*, C.A. No. 2318-S (Del. Ch. Mar. 2, 2005)

Plaintiff, who dissociated from a Delaware partnership of which she and defendant were the only partners, brought this action to value her share of the partnership as of the date of the dissociation. As the court noted, plaintiff's dissociation was not wrongful.

In determining the value of plaintiff's share, plaintiff and defendant disagreed as to the value that should be attributed to the cash-on-hand of the partnership at the time of the dissociation. Plaintiff contended that she was entitled to an accounting with respect to the cash-on-hand while defendant maintained that plaintiff was only entitled to a share of the actual amount of the cash in the partnership's account as of the date of the dissociation. Based on plaintiff's review of the partnership books, she claimed that the cash-on-hand should have been five thousand dollars more than the actual amount of cash in the partnership's account. Further, plaintiff testified that the disparity between the two figures was primarily attributable to defendant's conduct of the business in the period immediately preceding plaintiff's dissociation, during which time plaintiff's involvement in the business was significantly reduced. Defendant countered this assertion with testimony that loose accounting and handling of the partnership's assets was the normal practice of the partnership and that this, not malfeasance, led to the discrepancy. The court, citing DRUPA Section 15-404, found that the cash-on-hand as demonstrated by plaintiff's accounting was the basis for calculating plaintiff's share. The court also rejected defendant's analogy to "lost asset" cases in Delaware Family Court, which provide that the division of property upon a divorce cannot make reference to assets of a marriage that were lost during the course of the marriage. The court held that the rationale underlying such a rule had no application in the context of a partnership in which one partner exercised her statutory right to dissociate from the partnership and the other partner retained the business that was the subject of the partnership. The court held that equity required that the cash-on-hand as demonstrated by plaintiff's accounting be used in computing the plaintiff's share.

Separately, defendant took exception to the court's failure to reflect depreciation in the valuation of the hard assets of the partnership. The court used the acquisition cost of such costs in the valuation of the plaintiff's share. The court denied this exception, stating that the issue was not whether the assets had less market value at the time of the dissociation than when they were acquired. Rather, the issue was their value to the ongoing business, now operated by defendant, at the time of the dissociation. The court held that the record did not demonstrate that the value of the assets to the business had deteriorated or that depreciating the assets was appropriate. The court therefore denied defendant's exception.

J. Liability of Partners

*Tuoni v. Binkley*, C.A. No. 2002-10-339 (Del. Com. Pleas Nov. 18, 2004)

Plaintiff brought this action in the Delaware Court of Common Pleas to recover a debt from the three partners of a Delaware partnership. One of the partners claimed that he was not liable for the debt because the debt resulted from the wrongful conduct of the other two partners. The court stated that under the DRUPA the partnership is liable for the wrongful act of a partner acting in the ordinary course of business and that all partners are jointly and severally liable for the actions of the partnership. The court thus rejected this claim and held that the three partners were jointly and severally liable for the debt.

K. Partnership Opportunities

*Quill v. Malizia*, C.A. No. 2239-S (Del. Ch. March 4, 2005)

This case involved an informal partnership between plaintiff and defendants and plaintiff's claim that a property that defendants purchased from the mother of one of the defendants was a partnership opportunity which should have been offered to plaintiff. Although the court recognized that plaintiff and defendants had formed an informal partnership to purchase and sell for profit certain real estate properties, given the very informal nature of the partnership, the court was reluctant to find that the opportunity to acquire the property at issue was a partnership opportunity. This property had been initially under contract for purchase by the partnership. However, when the partnership was unable to finance the acquisition of the property, it was bought by the father of one of the defendants and the court found that there was never an enforceable agreement between the partnership and the defendant's father to reacquire the property. The property remained with the father for several years and then passed to the mother on the father's death. (Plaintiff had sought a constructive trust over the property arguing the father held it on behalf of the partnership, but the court found no evidence to support this argument.) Notwithstanding the informal nature of the partnership, the court assumed for purposes of its analysis that the eventual opportunity to acquire the property was an opportunity of the partnership. However, the court found that the defendants had in fact offered to allow plaintiff to participate in their acquisition of the property and, therefore, they had satisfied whatever obligations might have arisen under the partnership opportunity doctrine.

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