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Developments in Delaware Alternative Entity Law

The Delaware Court of Chancery has issued three significant decisions involving Delaware limited liability companies (LLCs) over the past few months. In the first decision, the court held that the *Revlon* doctrine, which in the corporate context requires a board of directors to maximize stockholder value in a sale of control, is also applicable to Delaware LLCs; in the second decision, the court, by analogy to Section 273 of the Delaware General Corporation Law (the “DGCL”), granted judicial dissolution of an LLC in which the two 50% members were deadlocked; and, in the third decision, the court held that a member upon the filing of a bankruptcy petition had automatically withdrawn as a member of an LLC, and thus had no management, voting or other non-economic rights, pursuant to the provisions of the LLC agreement and Section 18-304 of the Delaware LLC Act but, by operation of the Federal Bankruptcy Code, such member retained the economic rights associated with its membership interest as if it were an assignee under Section 18-702 of the Delaware LLC Act.

Application of *Revlon* Doctrine to a Delaware LLC

Blackmore Partners, L.P. v. Link Energy LLC, C.A. No. 454-N (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 purchase price, \$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, therefore, 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 could 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 to the LLC without commenting that the corporate *Revlon* doctrine had not previously been applied to an LLC. The court did note 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 a 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 was 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 might 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.

Judicial Dissolution Upon Deadlock

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 provided 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.

Member Withdrawal Upon Bankruptcy Filing

Milford Power Company, LLC v. PDC Milford Power, LLC, C.A. No. 506-N (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.

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