BUSINESS LAW TODAY

Delaware Insider:

Inadvertently Waiving Right to Seek Judicial Dissolution of LLC: It is Easier to do than You Think

By Jason C. Jowers

Attorney: How can I help you?

Client: I am a 50 percent holder in a two-member LLC. Things were great at the beginning. Back then I got along really well with my partner. Now, we simply cannot agree on the future of the business. We cannot agree on any big decision.

Attorney: Does your agreement provide for a method to resolve a deadlock between the two of you?

Client: No.

Attorney: Well, does your agreement allow you to force the other member to buy your interest or permit you to force the other member to sell her interest to you?

Client: No. We never thought we would need something like that.

Attorney: In that case, one of the few options may be to seek judicial dissolution and the appointment of a liquidating trustee to wind-up the affairs of the business. Does your LLC agreement bar judicial dissolution?

* * *

Almost every attorney who regularly represents the members of Delaware limited liability companies (LLCs) has engaged in a variation of the conversation above. Pursuant to 6 *Del. C.* § 18-802 of the Delaware Limited Liability Company Act (LLC Act), "[o]n application by or for a member or manager the Court of Chancery may decree dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement." In the past, the Court of Chancery has generally exercised its ability to order judicial dissolution of an LLC in two situations: (1) when there is a deadlock between two 50 percent holders and the LLC agreement provides no method to resolve the deadlock and (2) where the defined purpose of the entity is either fulfilled or impossible to carry out. Enforcing the primacy of the freedom of contract as required by the LLC Act, the Court of Chancery in 2008 found that an LLC agreement may waive the statutory default right to seek judicial dissolution. However, in the recent decision of *Huatuco v. Satellite Healthcare*, 2013 WL 6460898 (Del. Ch. Dec. 9, 2013), the Court of Chancery carried this logic a step further, finding that a provision in the LLC agreement generally limiting the members' rights to the rights expressly enumerated in the LLC agreement also served to waive Section 18-802's right to seek judicial dissolution since the LLC agreement did not explicitly provide for such a right.

Prior to the *Huatuco* decision, the answer to the final question in the dialogue above was almost always "No." In the wake of *Huatuco*, attorneys for clients seeking judicial dissolution must do more than confirm there is no provision expressly disavowing the right to judicial dissolution. They must examine the agreement to determine if there is broader language waiving or opting out of whole sets of default rights, including the right to seek judicial dissolution. Likewise, drafters of LLC agreements wishing to preserve members' rights to seek judicial dissolution must do more than simply avoid a specific express waiver. If parties intend to use language limiting members' rights to those expressed in the agreement (as opposed to default rights in the LLC Act where the agreement is silent), they should expressly provide the members the right to seek judicial dissolution unless the parties truly intend to waive that right.

LLC Agreement May Expressly Waive Right to Judicial Dissolution

The Delaware Court of Chancery first addressed the waiver of members' right to seek judicial dissolution in *R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC*, 2008 WL 3846318 (Del. Ch. Aug. 19, 2008), which involved several LLCs owning land and race horses. The petitioners sought judicial dissolution, and the respondents opposed, arguing that the LLC agreements at issue expressly waived the members' right to seek judicial dissolution. Emphasizing Delaware's policy of freedom of contract in LLC agreements, then-Chancellor Chandler stated: "For Shakespeare, it may have been the play, but for a Delaware limited liability company, the contract's the thing." Each LLC agreement provided:

> Waiver of Dissolution Rights. The Members agree that irreparable damage would

> occur if any member should bring an action for judicial dissolution of the Company. Accordingly each member accepts the provisions under this Agreement as such Member's sole entitlement on Dissolution of the Company and waives and renounces such Member's right to seek a court decree of dissolution or to seek the appointment by a court of a liquidator for the Company.

The court found this provision enforceable. First, then-Chancellor Chandler noted that 6 *Del. C.* § 18-1101(b) of the LLC Act "itself explicitly provides that '[i]t is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.'" This freedom for members to structure an LLC differently than an entity governed primarily by statute, such as a corporation, including the ability to provide for different methods to resolve business relationship problems, is part of the allure of LLCs. Second, the court found that the right to seek dissolution is not among the few provisions of the LLC Act that may never be waived. For example, 6 *Del. C.* § 18-1101 expressly provides that "the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing." Section 18-802, by comparison, does not contain similar language. Accordingly, the court ruled that the LLC agreements at issue waived the members' rights to seek judicial dissolution.

Identification of Non-Exclusive Methods of Dissolution Does Not Bar Judicial Dissolution

Although *R&R Capital* made clear that members of an LLC could waive judicial dissolution through an express waiver specifically referencing and disavowing such a right, it left open the question of whether something less than an express waiver would also abandon such a right. In *Lola Cars Intern. Ltd. v. Krohn Racing, LLC*, 2009 WL 4052681 (Del. Ch. Nov. 12, 2009), although one member owned 51 percent of the company and the other 49 percent, the LLC was managed by a board of directors and each member had the right to appoint one board member. The plaintiff sought judicial dissolution, among other reasons, because the board was deadlocked as to whether to replace the CEO. Additionally, the plaintiff pleaded that the current CEO's failure to manage the business properly, along with the business's poor performance, made it "not reasonably practicable" to continue the business.

Like many LLC agreements, the one at issue in *Lola Cars* contained a section addressing dissolution. The defendants moved to dismiss the request for judicial dissolution, arguing in part that the LLC agreement addressed dissolution and failed to expressly provide for judicial dissolution. In other words, the defendants interpreted Section 18-802 as a gap-filler that could only be invoked if the LLC agreement failed to address dissolution. Emphatically rejecting this argument, the Court of Chancery stated:

> Assuming for current purposes that judicial dissolution under § 18-802 may be precluded contractually, the fact that this particular Operating Agreement merely contains several self-termination options and does not expressly provide for judicial dissolution does not make that statutory remedy unavailable. Each of the termination provisions contained in the Operating Agreement is permissive and may be triggered at a member's election. Moreover, the Operating Agreement nowhere requires that a member terminate the Operating Agreement solely in accord with its stipulated termination provisions. Thus, the Court cannot conclude that these terms are exclusive. It simply cannot be true that a number of nonexclusive, permissive termination clauses in the Operating Agreement can preclude judicial dissolution as provided for in the Act.

Waiving Right to Judicial Dissolution if that Right is Not Enumerated

Reading *R&R Capital* and *Lola Cars* together, although the right to judicial dissolution could be waived, Delaware law required that LLC agreements must do more than provide for non-exclusive dissolution provisions to find such a waiver. However, the question remained whether parties to an LLC agreement could still waive the right to seek judicial dissolution by doing something less explicit than saying "the members waive the right to seek judicial dissolution." *Huatuco v. Satellite Healthcare* answers that question in the affirmative.

In *Huatuco*, the defendant moved to dismiss the petition for dissolution, arguing that the LLC agreement waived all default rights under the LLC Act, including the right to seek judicial dissolution. Section 202 of the LLC agreement at issue provided:

> The respective rights of each Member to share in the capital and assets of the LLC, either by way of distributions or upon liquidation, will be determined by reference to the Percentage Interest of such Member; and each Member's interest in the profits and losses of the LLC shall be established as provided herein. *Except as otherwise required by applicable law, the Members shall only have the power to exercise any and all rights expressly granted to the Members pursuant to the terms of this Agreement.* No Member shall have any preemptive right to purchase or subscribe for additional Membership Interests in the LLC by reason of the admission of any new Member or the issuance of any new or additional Membership Interests or other debt or equity interests in the LLC.

In analyzing these provisions, Vice Chancellor Glasscock began by noting that the LLC Act "provides default provisions applicable to Delaware LLCs where the parties' agreement is silent; where they have provided otherwise, with limited exceptions, such agreements will be honored by a reviewing court." The plaintiff argued that Section 2.2 should not be read as a waiver of all default rights under the LLC Act, including the right to seek judicial dissolution, because the parties embedded the sentence italicized above in a section only dealing with the members' economic

rights. In other words, if read in context, the opt-out did not apply to all default provisions of the LLC Act. Refusing to adopt plaintiff's reading, the court explained:

> While Section 2.2 addresses two kinds of economic rights – rights to distributions of assets upon liquidation, and preemptive rights – it also provides more generally that "the Members shall only have the power to exercise any and all rights expressly granted to the Members." This statement is not qualified by reference to "economic" rights, but instead applies to "any and all" rights, that is, both economic and noneconomic, including a right – or lack thereof – to seek judicial dissolution.

Because the members opted out of all default rights, the court then was left to examine what rights to dissolution were left in the LLC agreement. Failing to enumerate judicial dissolution as a membership right, the dissolution section of the LLC agreement provided:

> Section 8.1 Dissolution. The LLC shall be dissolved, its assets disposed of, and its affairs wound up, on the first to occur of the following: (i) the approval of a Super Majority-in-Interest of the Members to dissolve the LLC; (ii) the sale or other disposition of all or substantially all of the LLC's assets and distribution to the Members of the net proceeds thereof; or (iii) upon the happening of any other event of dissolution specified in the Certificate of Formation or this Agreement. The defendants argued that the second sentence of the above-quoted language barred the plaintiff from seeking judicial dissolution.

Because Section 8.1 did not provide for a right to seek judicial dissolution, the court determined that "the members have effectively opted out of the statutory default contained in 6 *Del. C.* § 18-802."

Conclusion

In the past, when irreconcilable disagreements arose between LLC members and the LLC agreement did not provide for a method to resolve the dispute, judicial dissolution under Section 18-802 became a rational alternative. However, given the *Huatuco* ruling, deadlocked members of LLCs must now carefully examine the LLC agreement to determine if the parties waived all default rights, including the default right to seek judicial dissolution. Unfortunately, when two partners engage in a "business marriage" by creating an LLC to carry out some joint undertaking, they often are much more focused on the formation of marriage rather than any potential disagreements or a "business divorce" if a serious disagreement cannot be resolved. This is not surprising. The LLC agreement is drafted at a time when the members want to be in business together, and have a meeting of the minds as to how to run that business. Furthermore, in order to avoid certain default rights, such as default traditional fiduciary duties, some LLC agreements adopted during this honeymoon period contain broad waiver language such as was the case in *Huatuco.* If parties do have such broad waiver language, in the wake of *Huatuco*, one step parties may want to take now is to reexamine their respective LLC agreements and consider whether they truly intended to waive the members' right to seek judicial dissolution, and amend the LLC agreement if they did not.

If judicial dissolution has been waived, either expressly as in *R&R Capital* or pursuant to a more general opt-out provision as in *Huatuco*, in the event of a deadlock, the parties must seek a more creative solution. First, one member could attempt to buy out the other. However, in such a situation, the seller would likely use the other party's inability to seek judicial dissolution as a method to extract a premium. Second, part of the reason the *R&R Capital* court felt comfortable in finding that the right to judicial dissolution *could* be waived was because the implied covenant of good faith and fair dealing *could not* be waived. Accordingly, because of the implied contractual covenant, then-Chancellor Chandler wrote that "[t]here is no threat to equity in allowing members to waive their right to seek dissolution, because there is no chance that some members will be trapped in a limited liability company at the mercy of others acting unfairly and in bad faith." Unfortunately, the court did not further explain how the implied covenant could be used in practice to remedy the waiver of judicial dissolution. Finally, in *Huatuco*, in a footnote, the court left open the possibility of judicial dissolution even in the face of a waiver under the right circumstances. According to the court:

> Whether the parties may, by contract, divest this Court of its authority to order a dissolution in *all* circumstances, even where it appears manifest that equity so requires – leaving, for instance, irreconcilable members locked away together forever like some alternative entity version of Sartre's Huis Clos – is an issue I need not resolve in this Memorandum Opinion. As I find below, considerations fundamental to equity are absent here.

Significantly, the petitioner in *Huatuco* filed a notice of appeal on January 7, 2014, so practitioners should continue to monitor developments in this case.

Jason C. Jowers *is a partner at Morris James LLP in Wilmington, Delaware, where he practices in the areas of corporate, alternative entity, and complex commercial litigation.*