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Re: Lola Cars International Limited v. Krohn Racing, LLC, et al.
C.A. No. 4479-VCN
Lola Cars International Limited v. Krohn Racing, LLC, et al.
C.A. No. 4886-VCN
Date Submitted: October 20, 2009

Dear Counsel:

This letter opinion addresses the Defendants' motions to dismiss both of these related actions.

I. BACKGROUND[1]

Plaintiff Lola Cars International, Ltd. ("Lola") is a company registered under the laws of England and Wales specializing in the manufacture and sale of race car

[1] The facts are drawn from the complaints in the two actions.

chassis and parts. Defendant Krohn Racing, LLC ("Krohn") is a Delaware limited liability company and racing team that competes in the Grand American Rolex Racing Series (the "Grand Am Series"). Defendant Jeff Hazell ("Hazell") has managed Krohn since its inception in late 2005.

On March 5, 2007, Lola and Krohn established Proto-Auto, LLC ("Proto-Auto" or the "Company") through the execution of a limited liability company operating agreement (the "Operating Agreement"). Lola owns 51% of Proto-Auto, while Krohn holds the Company's remaining membership interests. Despite Lola's majority interest, the two companies agreed to equal representation on Proto-Auto's governing board with each member initially appointing one director.[2] Krohn appointed Hazell, and he has served in this post since the Company's inception. Krohn also agreed to provide Hazell's services as Proto-Auto's chief executive officer as one of its primary obligations under the Operating Agreement.

Proto-Auto's stated purpose was to acquire and sell specific "Daytona prototype" race cars licensed by the Grand American Road Racing Association, the sanctioning body for the Grand Am Series. To this end, the parties agreed to acquire

[2] Operating Agmt. §§ 5.1, 5.2.

a Grand Am Constructor's License from third-party Multimatic Motorsports. The Operating Agreement anticipated the development of the business on a sound, profit-making basis in accordance with its business plan and budget, with the not-unusual goal of maximizing and maintaining profits for distribution to its members. The Operating Agreement defined Proto-Auto's function in a generalized fashion: to manufacture the vehicles and parts for sale, to strengthen its position in the market, and to improve the Company's business.[3]

The parties each also took on specific responsibilities: Lola agreed to evaluate, test, and develop a Lola chassis for the prototype race car mentioned above, while Krohn agreed to purchase and test two of these vehicles for competition in the Grand Am Series. The Operating Agreement also required Krohn, as the party providing the chief executive officer, to fulfill a number of budgetary and accounting duties. For example, Krohn had to prepare an annual budget and ensure that Hazell undertook "all reasonable endeavors" to make certain that the budget not exceed Proto-Auto's income.[4] Krohn also had to produce monthly management accounts, which included several financial statements, and to send these accounts to the board for review.

[3] *Id.* § 3.2.
[4] *Id.* § 6.2.

Lastly, Krohn had to ensure that its designated chief executive officer—in this case, Hazell—would not commit to expenditures beyond Proto-Auto's budget.

A. *The First Action*[5]

Lola's Amended Complaint (the "First Complaint") in the First Action asserts several claims against the Defendants related to their respective obligations and it seeks various forms of relief. Lola alleges that Krohn breached the Operating Agreement by failing to provide Lola with vehicle test reports, as well as many of the accounting reports described above. Krohn also has allegedly failed to pay interest owed Lola on loans Lola has made to Proto-Auto beyond its obligation to support the enterprise.[6] In addition, Lola claims that Krohn's engineers assembled several Proto-Auto vehicles for which they were compensated; this responsibility, however, belonged to Lola by the terms of the Operating Agreement.[7] Lastly, Lola argues that Krohn violated the implied covenant between contracting parties to act fairly and in

[5] C.A. No. 4479-VCN (filed April 6, 2009).
[6] The parties agreed to make loans to the Company if its balance sheet for any fiscal year showed negative net assets. Lola agreed to provide 51% of the deficit and Krohn 49%. Operating Agmt. § 8.3. If any party fails to pay its prorated share, the other party may make up the difference and be entitled to interest on the loan amount that exceeds its obligation. Operating Agmt. § 8.4.
[7] The Operating Agreement is attached as Exhibit A to the First Complaint.

good faith when it refused to meet with Lola's board representative in March 2009 to discuss replacing Hazell as chief executive officer.

Lola also alleges that Hazell has breached his fiduciary duties of loyalty and care. It argues that Hazell has mismanaged Proto-Auto, rendering the Company insolvent and unable to fulfill its commercial purpose as stated in Operating Agreement. Specifically, Lola claims that Hazell has failed to create and pursue an effective marketing and sales strategy, and for this reason, Proto-Auto has secured material income from only one source—Krohn. To make matters worse, a significant portion of this income has come by sale of the two vehicles Krohn had agreed to purchase when it entered into the Operating Agreement. Lola also claims that Hazell failed to implement an internal control system to monitor inventory levels and costs, as well as to account properly for tax and engineering expenses. For example, Hazell's alleged inefficient management caused Proto-Auto's engineering costs to rise to more than $1.2 million above the budgeted amount, and his failure to timely pay Georgia state sales tax resulted in an assessed penalty of over $27,000.[8]

[8] First Compl. ¶¶ 12(f), 12(h).

Lola also claims that Hazell breached his duty of loyalty by acting on Krohn's behalf to Proto-Auto's detriment. Hazell purportedly allowed Krohn to misappropriate or underpay for parts, resulting in a gross profit on the sale of inventory far less than what should have been realized given the number of parts sold.[9] Further, Lola charges Krohn with aiding and abetting Hazell's disloyalty. Lola concludes that, due to Hazell's mismanagement and fiduciary violations, Proto-Auto sustained approximately $2.2 million in losses from the time of its inception until January 2009. Lola claims that Proto-Auto is now insolvent as its total liabilities exceed its total assets by more than $2 million.

Through the First Complaint, Lola seeks several remedies. It asks this Court to dissolve Proto-Auto on the ground that the Company can no longer realize or attempt to realize its stated business purpose. Connected with this request for relief, Lola asks that the Court appoint a liquidating receiver to oversee the dissolution and wind up the company's affairs. It also requests the Court to enjoin the Company from taking any actions outside the ordinary course of business, and it has requested the

[9] *Id.* ¶ 12(b) ("From its inception through February 2, 2009, the Company realized gross profits of only $120,736 on part sales to Krohn of $1,450,076 . . . [when] it should have realized gross profits of $715,799 on sale of parts.").

appointment of a receiver *pendete lite* to preserve the Company's assets; the Court generally denied these interim injunctive requests but, instead, imposed a Status Quo Order that continues to govern the Company. Lola also seeks damages against Krohn and Hazell on its breach of contract allegations, both express and implied, and its fiduciary duty claims.

B. *Defendants' Motion to Dismiss the First Complaint*

Defendants moved to dismiss most of the counts in the First Complaint. They concede that Lola sufficiently pled a claim against Krohn for breaching the Operating Agreement, but otherwise argue that Lola failed to state a cause of action on its remaining claims. The Defendants first challenge Lola's request for dissolution and the appointment of a liquidating trustee. They believe that the facts as alleged do not support the conclusion that Proto-Auto can no longer meet, or make an effort to attain, its business purpose. They claim that insolvency alone does not support judicial dissolution, nor does a company's failure to attain a profit within its first two years of operation. They also note that the Operating Agreement provides its own scheme for bringing and resolving member disputes, including a buy-out provision in the event of a board deadlock. Krohn contends that, because Lola failed to state a

cause of action for dissolution, it follows that Lola's request for the appointment of a liquidating trustee should be denied as well.

The Defendants also move to dismiss Lola's claims against Hazell for breach of fiduciary duty. They argue that Lola failed to make a demand upon Proto-Auto's board to consider its derivative claim, and that Lola has not pled demand futility with particularity. Specifically, the Defendants argue that Lola failed to plead sufficiently that Hazell, as Krohn's board designee, is not independent or disinterested and that his decisions were not the product of valid business judgment. Because a fiduciary duty claim cannot be brought against Hazell, Krohn argues that it cannot be held liable on Lola's aiding and abetting count since there is no properly pled primary claim from which to derive liability.

Lastly, the Defendants argue that Lola failed to state a claim against Krohn for breaching the implied covenant to act in good faith. They argue that Krohn's rights and obligations regarding the appointment and retention of Hazell as chief executive officer are defined by the Operating Agreement, and that Krohn is under no obligation to consent to Lola's demands for Krohn's removal. The Defendants conclude that because this issue is expressly addressed by the contract, any

obligations arising under the implied covenant to act in good faith regarding the matter have been necessarily precluded.

C. *The Second Action*[10]

Lola filed its complaint (the "Second Complaint") in the Second Action, in reliance upon Section 10.1 of the Operating Agreement—a termination clause that may be invoked by one member after a breach of the Operating Agreement by the other. Under this provision, the non-breaching party must notify the other party of the breach as well as the consequences of a failure to rectify the breach.[11] If the breaching party does not cure the breach within twenty-one days, the non-breaching party may terminate the Operating Agreement. Lola claims that Krohn materially breached the Operating Agreement and that it served proper notice and advised Krohn of the consequences of any failure to cure; it also contends that upon termination of the Operating Agreement, it should be given the right to manage and control Proto-Auto, given its majority stake.[12] It cites Delaware's Limited Liability

[10] C.A. No. 4886-VCN (filed September 11, 2009).
[11] Operating Agmt. § 10.1.
[12] Second Compl. ¶ 17.

Company Act (the "Act"),[13] which by default grants control of a limited liability company to its members in proportion to their respective equity interests, with a controlling authority inuring to those members owning a majority of such interests, unless of course otherwise stated in the operating agreement.[14] Lola argues that the First Complaint served notice upon Krohn of its material breaches, and because at least twenty-one days have elapsed without cure between the filing of the First Complaint and the Second Complaint, the Operating Agreement should be terminated and control of Proto-Auto should pass to Lola.

In the Second Complaint Lola also requested both a temporary restraining order and a permanent injunction prohibiting Hazell and Krohn from interfering with Lola's control of the Company, or acting as its agents. Lola argued that Hazell and Krohn have caused, and will continue to cause, Proto-Auto irreparable harm. In support of its argument, Lola alleged that Krohn and Hazell had ceased all efforts to promote or sell Proto-Auto cars.[15] Krohn supposedly issued an August 2009 press release stating its unwillingness to race Proto-Auto cars in light of its broader dispute

[13] 6 *Del. C.* ch. 18.
[14] 6 *Del. C.* § 18-402.
[15] Second Compl. ¶ 27.

with Lola, while communicating to other customers that it would no longer sell these vehicles. Lola also claims that Krohn potentially damaged Proto-Auto's relationship with the Grand-Am racing circuit by withdrawing its race cars from a circuit event in violation of Proto-Auto's Grand Am license and proclaiming that it would not race a Proto-Auto vehicle in future Grand Am events. Lola accuses Krohn of communicating with Grand Am authorities to its exclusion, and of obstructing an inventory audit by a neutral third party.[16] It believes that Krohn's actions, in particular its unwillingness to sell Proto-Auto cars and its deleterious comments to the marketplace and individual customers, damaged Proto-Auto's reputation and caused it to lose potential sales.

This Court denied Lola's request for interim injunctive relief. Because it could not reconcile the differing facts laid forth in the parties' respective affidavits, it concluded that a temporary restraining order would be inappropriate. Lola, at the time, simply could not demonstrate a reasonable likelihood of success on the merits. The Court also refused to declare a termination of the Operating Agreement pursuant to Section 10.1; it questioned, first, whether the First Complaint informed Krohn of

[16] *Id.*

the consequences of its failure to cure the alleged breaches, and, second, if not, whether it would meet the notice standard set forth in the Operating Agreement.

On October 9, 2009, Lola moved for leave to file a supplemental complaint. It now contends that it sent Krohn a letter on September 22, 2009 giving notice that Krohn had materially breached the Operating Agreement and stating the consequences of Krohn's failure to cure within twenty-one days. It argues that allowing it to file a supplemental complaint would work a just and efficient result: a determination of whether Krohn materially breached the Operating Agreement and whether it cured any of these defects, if they ever existed, could and should properly be resolved at trial of the matters addressed in the First Complaint. In the alternative, Lola suggests that the Court should dismiss its Second Complaint without prejudice so it may file a new complaint that incorporates the September 22 letter.

D. *Defendants' Motion to Dismiss the Second Complaint*

Defendants have also moved to dismiss the Second Complaint pursuant to Court of Chancery Rule 12(b)(6). They argue that Lola's allegations must stand as pled, and they maintain that the First Complaint did not serve proper notice upon Krohn of its obligation to cure its alleged breaches and of Lola's authority to

terminate the Operating Agreement in the event such breaches have not been remedied. They also argue that Lola failed to state a cause of action: although a member may terminate the Operating Agreement pursuant to Section 10.1, it does not follow that the terminating member is thereafter entitled to manage and control the company. Instead, the Defendants argue that termination of the Operating Agreement pursuant to section 10.1 triggers dissolution. They ask that the Second Complaint be dismissed with prejudice.

II. ANALYSIS

The Court will not dismiss the First Complaint, but it will dismiss the Second Complaint, although without prejudice. From the facts as alleged, there is good reason to believe that a potentially irreconcilable conflict exists between the parties. Such a conflict would likely render Proto-Auto unable to pursue its business objectives as stated in the Operating Agreement. Indeed, it is possible that this has already come to pass. The First Complaint therefore states a claim for dissolution; Lola has also sufficiently pled its claims for both breach of fiduciary duty and the implied covenant to act in good faith for the reasons explained below. The Second

Complaint, however, fails to allege compliance with the Operating Agreement's notice provision. Thus, it was filed too soon.

A motion to dismiss for failure to state a claim under Court of Chancery Rule 12(b)(6) will be granted "[i]f the Court determines with reasonable certainty that there is no set of facts which would entitle the plaintiff to relief."[17] This Court will assume the truth of all well-pled facts as alleged, and will draw all inferences in a light most favorable to the plaintiff.[18] To survive this motion, a plaintiff must plead enough facts to suggest plausible, ultimate entitlement to the relief sought.[19] As an important ancillary matter, the Court may also consider documents presented to it outside the pleadings when such documents are integral to, and incorporated within, the complaint.[20]

A. *Dissolution*

The Defendants first move to dismiss Lola's request for judicial dissolution. Section 18-801 of the Act provides, without qualification, that a limited liability

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[17] *Palese v. Del. State Lottery Office*, 2006 WL 1875915, at *2 (Del. Ch. June 29, 2006).
[18] *DeSimone v. Barrows*, 924 A.2d 908, 928 (Del. Ch. 2007).
[19] *Id.* at 929.
[20] *Vanderbilt Income & Growth Assocs. v. Arvida/JMB Managers, Inc.*, 691 A.2d 609, 613 (Del. 1996). Without any objection from the parties, the Court considers the Operating Agreement to be an incorporated document.

company may be dissolved and its affairs wound up upon "the entry of a decree of judicial dissolution."[21] Specifically, upon application by a member or manager, this Court may decree the 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"[22]

The Defendants claim that, upon the facts as alleged, this Court cannot conclude that it is no longer reasonably practicable for Proto-Auto to carry on its business in accord with its Operating Agreement. In particular, the Defendants focus on Lola's averments that Proto-Auto is insolvent, has two members who apparently can no longer cooperate, and its allegations concerning Hazell's breach of his fiduciary duties and Krohn's breach of the Operating Agreement. They argue that each of these facts, standing alone, or in concert, cannot support a finding that Proto-Auto can no longer carry on its business based upon the statutory reasonable practicability standard, which they interpret to mean that the business "has been abandoned or that its purpose is not being pursued."[23]

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[21] 6 *Del. C.* § 18-801(a)(5).
[22] 6 *Del. C.* § 18-802.
[23] Defs.' Opening Br. (First Compl.) at 12.

To hold that judicial dissolution is appropriate only when the business has been abandoned would belie the language of the Act.[24] Section 18-802 makes clear that the standard to be applied in this context is whether the Company can carry on its business with reasonable practicability in conformity with its operating agreement. The Court in *Fisk* laid out three factual scenarios this Court should consider when ordering judicial dissolution under Section 18-802's reasonable practicability standard: 1) whether the members' vote is deadlocked at the Board level; 2) whether there exists a mechanism within the operating agreement to resolve this deadlock; and 3) whether there is still a business to operate based on the company's financial condition.[25] The *Fisk* court explained that none of these factors is individually conclusive, nor must each be found for a court to order dissolution. Rather they provide guidance to the ultimate inquiry of whether the company can continue to pursue its stated business purpose with reasonable practicability.[26]

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[24] *See Fisk Ventures, LLC v. Segal (Fisk I)*, 2009 WL 73957, at *3 (Del. Ch. Jan. 13, 2009) (finding that a party need not show complete frustration to satisfy the judicial dissolution standard set forth in § 18-802).
[25] *Id.* at *4.
[26] *See id.* (asking whether the board deadlock prevented the company from furthering its stated business purpose).

All three of the circumstances laid out in *Fisk* are at issue here. For one, Lola and Krohn are allegedly deadlocked over whether to replace Hazell as chief executive officer.[27] The Operating Agreement provides a buy-out mechanism in the event of a member dispute; this self-help disentanglement provision, however, is entirely voluntary.[28] Lastly, there is doubt as to whether Proto-Auto can continue to operate in its current financial condition. Lola argues that the Company is insolvent insofar as its liabilities significantly exceed its assets. The Defendants counter that these liabilities largely represent loans required to be made by its members in the event that Proto-Auto's balance sheet shows negative net assets for a given year and that, under the Operating Agreement, the members are limited in their ability to demand repayment.[29] Turning back to the Act once again, the relevant inquiry is not whether the Company cannot possibly continue its business in accord with the Operating Agreement, but rather whether to do so would be reasonably practicable. The fact that Proto-Auto's members have extended it significant additional working capital

[27] Deadlock may be an understatement as Krohn has allegedly refused even to consider the matter.
[28] Operating Agreement § 10.2 ("If a dispute relating to the affairs of the Company cannot be resolved within 15 days of such dispute arising either party *may* serve a written notice that it intends to implement the deadlock procedure set out in this clause.") (emphasis added).
[29] Defs.' Opening Br. (First Compl.) at 20-21.

raises an inference that it is no longer reasonably practicable for the Company to exist even if these loans, if granted on a continual basis, could stave off ultimate business failure. Thus, Lola's allegations can satisfy two of *Fisk*'s three criteria.

Stepping aside from the particular factors articulated in *Fisk*, there are important other facts alleged that allow for a reasonable conclusion that Proto-Auto's dissolution would be appropriate. The Company's primary purpose is to develop and manufacture race cars for sale in the Grand Am market with the long-term goal of continually strengthening and expanding its position in this market. Lola was tasked with designing and manufacturing the vehicles, while Krohn was responsible for testing the vehicles and, of perhaps of greater importance, providing Hazell as Proto-Auto's chief executive officer. The Operating Agreement does not specify who is to be responsible for marketing and selling the vehicles, but it is not unreasonable for one to assume that duty belonged to Hazell as, not only the chief executive officer, but also one of two named officers in the Operating Agreement.[30] In addition, Hazell's services were expressly agreed to be provided by Krohn in the Operating

[30] The other is the secretary. Operating Agmt. § 5.2. Moreover, Hazell would appear to have extensive contacts within the Grand Am Series community. Indeed, the Operating Agreement tasked the chief executive officer with handling "relationships with [racing] competitors, including driers, teams, team formation . . . ." Operating Agmt. § 5.4(c).

Agreement—perhaps as Krohn's primary obligation—which speaks to Hazell's central role in Proto-Auto's management..

The First Complaint alleged Hazell's failure to manage properly Proto-Auto's business, which included the lack of vehicle sales. More importantly, Lola claimed that Hazell managed Proto-Auto more for Krohn's benefit than for the Company's, and that Krohn refuses even to consider Hazell's replacement. Lola's allegations of mismanagement and disloyalty, coupled with Proto-Auto's poor performance and Hazell's apparent entrenchment as chief executive officer allow for the conclusion that it is no longer reasonably practicable for Proto-Auto to continue its stated business purpose. In fact, it is difficult to imagine how any company can attain commercial success with, as alleged here, a careless and disloyal chief executive.

The Defendants also argue that the Operating Agreement clearly defines the circumstances upon which it may be terminated and that, because such circumstances do not include judicial dissolution, that option is necessarily precluded. 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.[31]

B. *Lola's Derivative Claims and Demand Excusal*

The Defendants have also moved to dismiss Lola's fiduciary claims on the ground that Lola has failed to plead demand futility with particularity as required by Section 18-1003 of the Act. This provision mandates that, in any derivative action brought by a member of a limited liability company, the complaint states with particularity the plaintiff's effort to either require the limited liability company's

[31] Indeed, the Act provides for dissolution upon "the happening of events specified in a limited liability company agreement" *in addition* to a number of events specified in the statute, including the end of the limited liability company's term, at any time there are no members, and, of course, upon judicial dissolution. 6 *Del. C.* § 18-802(a)(2).

manager to initiate suit or explain why such effort was not made.[32] Since this provision originates with Court of Chancery Rule 23.1, which governs corporate derivative suits, this Court has relied upon corporate precedent to interpret § 18-1003's meaning and application, especially concerning whether demand is properly excused.[33]

In the corporate derivative context, demand will be considered futile and thus excused when the particularized factual allegations contained in the complaint create a reason to doubt that 1) "the directors are disinterested and independent [or that] 2) the challenged transaction was otherwise the product of a valid exercise of business judgment."[34] When dealing with a two-member board of directors, this Court has previously held that a finding of interestedness on the part of one director

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[32] 6 *Del. C.* § 18-1003.

[33] See *VGS, Inc. v. Castiel*, 2003 WL 723285, at *11 (Del. Ch. Feb. 28, 2003) ("[C]ase law governing corporate derivative suits is equally applicable to suits on behalf of an LLC.").

[34] *Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008) (citing *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984)). There is some debate over whether the test articulated in *Rales v. Blasband*, 634 A.2d 927 (Del. 1993), applies to this action instead of the test prescribed in *Aronson*. The *Rales* test essentially eliminates inquiry into the second *Aronson* prong and focuses entirely upon the first. Because the First Complaint sufficiently alleges that Hazell is interested in the litigation, demand has been excused under both tests, and thus determining which one applies is unnecessary.

will excuse demand on the board.[35] A director may be considered interested in the litigation that might be the subject of pre-suit demand if that litigation threatens a materially detrimental effect upon the director but not the company or its shareholders.[36] When making this determination, this Court requires a particularized showing that the director faces a substantial likelihood of personal liability, and not simply the mere risk of damages.[37]

Lola's claims against Hazell for breach of the duties of care and loyalty are plainly derivative, and thus Section 18-1003 applies. Because Lola did not make a demand upon Proto-Auto's board, the inquiry then turns to whether it alleged demand excusal with particularity. The Defendants rely heavily upon this Court's opinion in *Spellman v. Katz* to support their argument that Lola failed to meet the particularized pleading standard; however, the First Complaint stands in stark contrast to the pleadings put before the Court in *Spellman*. In that case, the Court held that the

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[35] *Beneville v. York*, 769 A.2d 80, 82 (Del. Ch. 2000). The Court in *Beneville* recognized that the "central question" in determining demand excusal is whether there "is a sufficient number of impartial directors who can cause the corporation to act favorably on a demand by bringing suit." *Id.* Thus, where the directors of a two-director board have equal voting power and one is interested, demand should be excused because that one interested director alone has the power to preclude litigation.

[36] *Rales*, 634 A.2d at 936.

[37] *Id.*

counterclaim plaintiff failed to plead a substantial risk of adverse litigation consequences with particularity.[38] The Court concluded that the counterclaim plaintiff simply did not put forward sufficient facts to support his claim, and instead merely concluded that the counterclaim defendant's behavior had cost the company significant savings without explaining how those savings would have been achieved.[39]

The Court is persuaded that Lola has satisfied the particularized pleading standard to allege that Hazell is interested under the *Rales* test. Lola claims that Hazell faces a substantial risk of liability, detailing his alleged mismanagement, lack of oversight, and disloyalty. Without delving into the facts of the First Complaint, it should be emphasized that it pleads with particularity Hazell's failure to maintain appropriate inventory levels, pay state taxes in a timely fashion, and perhaps most importantly, his use of Proto-Auto assets for Krohn's benefit in violation of his duty

[38] *See Spellman v. Katz*, 2009 WL 418302, at *6 (Del. Ch. Feb. 6. 2009) (finding that the plaintiff failed to "articulate any particularized facts supporting his claim and thus ha[d] not satisfied his pleading obligations").
[39] *Id.*

of loyalty. In fact, Lola details with specificity the amount of profits lost in parts and inventory that it contends Hazell undersold or allowed Krohn to misappropriate.[40]

Lola's board consists of only two directors with equal voting power: Hazell and Lola's representative. Because these directors share equal control over the board, Lola need only show that only one is interested and therefore may prevent litigation. Hazell faces a substantial risk of liability under the facts as alleged; for this reason, he may be considered interested, and thus Lola has satisfied the demand excusal standard.[41]

C. *Breach of the Implied Covenant of Good Faith and Fair Dealing*

Lola alleges that Krohn breached the implied covenant of good faith and fair dealing by unreasonably withholding its consent for removing and replacing Hazell as Proto-Auto's chief executive officer, which thereby harmed Lola's interests in the

[40] *See supra* note 9. Lola is unable to document exactly which parts were misappropriated or sold under value due to Hazell's failure to implement an accurate reporting system for inventory, and because of Krohn and Hazell's alleged refusal to submit to an internal audit. First Compl. ¶ 12(b).

[41] Hazell perhaps could also be said to lack independence. He has served as the manager of Krohn's racing team since 2005; however, there are no particularized allegations as to the importance of this status to Hazell. Because Hazell's interest in this litigation has been sufficiently pled, an inquiry into his independence is unnecessary.

Company. Contracts under Delaware law[42] contain an implied covenant among and between the parties to act fairly and in good faith.[43] This covenant restrains a contracting party from engaging in arbitrary or unreasonable conduct that has the effect of frustrating the contract's overarching purpose and denying the other party the benefit of its bargain.[44] The Court, however, may not substitute its own notions of fairness for the terms of the agreement reached by the parties, and will therefore only invoke the implied covenant when the contract does not expressly address the subject at issue.[45] Instead, the Court will impose obligations upon the contracting parties under the implied covenant only when the contract is silent to the disputed topic, and where "it is clear from the contract that the parties would have agreed to that term had they thought to negotiate the matter."[46]

The Defendants argue, correctly, that the implied covenant may not apply to matters covered by the contract. They contend that the Operating Agreement

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[42] The parties agreed that the Operating Agreement would be governed by Delaware law. Operating Agmt. § 19.2.
[43] *Fisk Ventures v. Segal (Fisk II)*, 2008 WL 1961156, at *10 (May 7, 2008).
[44] *Id.*
[45] *Superior Vision Servs. v. Reliastar Life Ins. Co.*, 2006 WL 2521426, at *6 (Del. Ch. Aug. 25, 2006).
[46] *Fisk II*, 2008 WL 1961156, at *10.

expressly "mandates that Hazell shall be CEO" and "specifically addresses" his retention.[47] Indeed, the Operating Agreement grants Krohn exclusive power to replace Hazell when he resigns on his own volition.[48] For these reasons, they argue that Lola has no right to remove Hazell, and that Krohn has no obligation to assent to Lola's demands. Krohn reasons that if Lola wanted to the right to remove Hazell, it could have bargained for that right when the parties established the Company.

Krohn mischaracterizes Lola's implied covenant claim, which rests upon Krohn's failure even to consider Hazell's termination or to attend board meetings to that end, and not upon Krohn's obligation (or lack thereof) to assent to Lola's demands. This is especially so when one considers the damage that Hazell has allegedly inflicted upon Proto-Auto's ability to market and sell vehicles, which in turn has allegedly frustrated Lola's purpose for entering into the Operating Agreement. Although Krohn may indeed be under no obligation to agree to Hazell's termination, the Court, in the context of this motion to dismiss, may draw a

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[47] Defs.' Reply Br. (First Compl.) at 22; Defs.' Opening Br. (First Compl.) at 25.
[48] See Operating Agmt. § 3.7 (making Krohn "responsible for providing to the company free of charge . . . the services of Jeff Hazell, or a suitably qualified replacement of Mr. Hazell should *Mr. Hazell determine not to continue in such duties, as Chief Executive Officer*") (emphasis added).

reasonable inference that Krohn acted inappropriately and in bad faith by failing to consider Lola's request to have Hazell removed.

D. *Lola's Second Complaint and Whether it Should be Dismissed with Prejudice*

The Court will dismiss the Second Complaint, but without prejudice. Court of Chancery Rule 15(aaa) allows a party to respond to a motion to dismiss under Rule 12(b)(6) or Rule 23.1 by amending its complaint, but such amendment can come no later than when that party's answering brief is due to be filed. The Rule goes further to state that, in the event a party fails to file an amended complaint, and the Court thereafter finds that the Complaint should be dismissed, the dismissal is to be with prejudice. Rule 15(aaa), however, gives this Court authority to dismiss a complaint without prejudice, but only for good cause shown when dismissal with prejudice would not be just under the circumstances.

Here, Lola chose to answer Krohn's motion to dismiss instead of amending the Second Complaint. This complaint, as filed, should be dismissed for failure to state a claim. In the Second Complaint, Lola claims that the First Complaint, filed May 20, 2009, constituted proper notice upon Krohn in accordance with Section 10.1 of the Operating Agreement. Because Krohn purportedly failed to cure the material

breaches described in the First Complaint, Lola claims it now has the right to terminate it. Section 10.1 allows a member to terminate by written notice if the other party materially breaches the Operating Agreement, and *is advised in writing of the breach and the consequences of failure to rectify the breach*. The First Complaint fails to serve as proper notice under this provision because it did not state the consequences of failure to cure the alleged breaches. Indeed, in the First Complaint, Lola specifically sued for damages upon the alleged breaches, not for termination pursuant to Section 10.1 of the Operating Agreement.

Lola's September 22, 2009, letter, on the other hand, provides proper notice as required by Section 10.1.[49] The September 22 letter advises Krohn of its material breaches by reference to an earlier letter sent on September 10, 2009.[50] The September 10 letter lists five alleged breaches,[51] and the September 22 letter properly

[49] September 22, 2009, Letter, Ex. C to Pl.'s Answering Br. (Second Compl.).
[50] The September 10 letter has been filed as Exhibit B to the Second Complaint.
[51] Specifically, Lola advised Krohn that it had materially breached the Operating Agreement by 1) failing to furnish Lola with track and performance data as required by Section 3.7(b) of the Operating Agreement; 2) failing to furnish Lola with proposed budgets, comparative analysis of projected and actual accounts or profit and cash flow forecasts for Proto-Auto as required by Article 6 of the Operating Agreement; 3) failing to furnish Lola with Proto-Auto financial statements in a timely fashion as required by Section 6.6 of the Operating Agreement; 4) failing to cause Proto-Auto to repay Lola its disproportionate share of the members' loan imbalance as

served notice of these breaches by reference. The September 22 letter also advised Krohn that if it failed to cure the breaches within twenty-one days "of this letter," it would consider the Operating Agreement terminated. By specifying the material breaches and informing Krohn of the consequences of failing to remedy, the September 22 letter meets the Operating Agreement's notice standard.

Dismissing the Second Complaint without prejudice and allowing Lola to file a complaint anew that relies upon the September 22 letter as notice will work a just result. The Operating Agreement grants both Lola and Krohn the contractual right to terminate in the event the other party commits a material breach. By dismissing with prejudice, the Court would arguably deprive Lola of this bargained-for right. Such a right promotes efficiency by preventing one party from being trapped in a business arrangement that may have suddenly taken a turn for the worse.

The question of whether Krohn has materially breached the Operating Agreement was also raised in the First Complaint, and is bound in part with the final determination of whether Proto-Auto should be dissolved. For this reason, the factual

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required by Section 11.3 of the Operating Agreement; and 5) failing to cause Proto-Auto to hold regular meetings of its Board as required by Section 5.3 of the Operating Agreement.

resolution of the issues raised by the Second Complaint will likely be resolved at trial of the matters raised in the First Complaint with or without the later-filed action. Dismissing without prejudice and allowing Lola to file a new complaint will do little to change the calculus of the now-pending trial.

The Defendants argue as a final point that even if the Court were to find the Operating Agreement terminated pursuant to Section 10.1, it does not follow that Lola should be granted control of the Company. For this reason, the Defendants maintain that Lola is simply not entitled to the relief requested by the Second Complaint and it therefore failed to state a cause of action. The Defendants may be correct that Lola is not entitled to control of the Company if the Operating Agreement is terminated pursuant to Section 10.1; however, this does not mean that Lola failed to state a claim. The main issue tendered by the effort to gain dismissal of the Second Complaint is whether or not the Operating Agreement will terminate by virtue of Krohn's material breaches, and not the specific relief that might accrue to Lola following that determination.

III. CONCLUSION

For the foregoing reasons, Defendants' Motion to Dismiss the First Complaint is denied, and Defendants' Motion to Dismiss the Second Complaint is granted, but without prejudice.

IT IS SO ORDERED.

Very truly yours,

/s/ John W. Noble

JWN/cap
cc: Register in Chancery-K