Purpura Novak

Think Carefully Before Amending LLC and Partnership Agreements: Understanding *NextMedia*

Mark V. Purpura and Joshua J. Novak
Special to the Delaware Business Court Insider | July 27, 2011

Under the Delaware Limited Liability Company Act and the Delaware Revised Uniform Limited Partnership Act, if a limited liability company agreement or a limited partnership agreement "provides for the manner in which it may be amended ... it may be amended only in that manner or as otherwise permitted by law."

In interpreting amendment provisions contained in LLC agreements and partnership agreements, Delaware courts have historically ruled in favor of protecting nonmanaging investors. Despite this history, managers and controlling members of limited liability companies and general partners of limited partnerships frequently take advantage of amendment provisions contained in their LLC agreements and partnership agreements that grant authority to amend such agreements unilaterally or with the consent of less than all members or partners, so long as such an amendment does not have an "adverse effect" or "material adverse effect" on a member or limited partner. Before doing so, however, such managers, controlling members and general partners should carefully consider the Delaware Court of Chancery's decision in *In re NextMedia Investors LLC.*

In *In re NextMedia*, the court was faced with the issue of whether a member's consent was needed to amend the LLC agreement of NextMedia Investors LLC to extend the term of NextMedia and delay its otherwise imminent dissolution. As the end of NextMedia's term approached, the United States was in the middle of one of the greatest economic crises in its modern history, and NextMedia's board sought to extend the dissolution date in hopes that NextMedia's assets would become more valuable once the economy improved. NextMedia's LLC agreement provided that "without the consent of each member to be adversely affected, the agreement shall not be amended so as to ... amend [the section of the LLC agreement addressing dissolution] ... to affect adversely any member."

NextMedia's board sought the consent of all of NextMedia's members to amend the dissolution provision to extend its term, and approximately 97 percent of the holders of NextMedia's Class A and Class C limited liability company interests approved. The petitioners were among the 3 percent in interest of members that objected and brought suit after the board proceeded to amend the LLC agreement to extend the term, notwithstanding the objection.

The petitioners argued that unanimous consent of NextMedia's members was required in order to extend the term because doing so would adversely affect all members. The court agreed, stating that whether a member is adversely affected "is necessarily a before-the-fact question ... Thus, the question of who is entitled to vote is best judged by who can be reasonably expected to be adversely affected."

In applying this test, the court found that "the ability to withdraw from an investment and take one's capital elsewhere is an important one ... A reasonable investor would regard this guaranteed investment end point that could not be changed without her consent to be a material economic provision of the LLC agreement."

In interpreting the amendment provision, the court found that the provision "gave investors greater protection [than a class vote provision] by requiring the consent of 'each member' on an individual basis." Noting that the petitioners had very few voting rights under NextMedia's LLC agreement, the court found that "this suggests that the matters over which [they] do have voting rights are of particular importance." As a result, because nothing in the LLC agreement provided otherwise, "the plain meaning of 'to adversely affect' encompasses a situation where an investor will be adversely affected in the sense that a material economic term of the LLC agreement is subject to alteration ... In other words, the obvious purpose of [the amendment provision] was to allow individual investors to veto changes to specific, economically substantive terms of the LLC agreement if they deem those changes inadvisable" (emphasis added). The court held that because the petitioners did not consent to the amendment extending the term of NextMedia, such amendment was not properly adopted and the petitioners were entitled to the dissolution of NextMedia.

Similar to NextMedia's LLC agreement, many LLC agreements and partnership agreements governing the affairs of private equity funds and other types of limited liability companies and limited partnerships only

provide investors with limited voting rights, which often include the right to vote on certain amendments. Many such agreements have, as a general amendment vote requirement, a provision requiring the consent of a majority of the investors in order to amend the agreement. Many also contain provisions that allow a general partner, manager or controlling member to amend the agreement without obtaining the consent of any investor, so long as such provision does not "adversely affect" or "materially adversely affect" any investor, as well as a provision similar to that at issue in *In re NextMedia.*

In light of *In re NextMedia,* it is important for general partners, managers and controlling members to carefully navigate the amendment provisions of their LLC agreement or partnership agreement to analyze an amendment's potential effect on an investor before proceeding with an amendment in certain circumstances, including the following situations that we have experienced in our practice and that are fairly common in the private equity fund context. (The following factual scenarios presume that the applicable fund agreement has an amendment provision similar to that at issue in *In re NextMedia* and that such amendment provision applies to the amendments discussed.)

INCREASING THE MAXIMUM AMOUNT OF CAPITAL COMMITMENTS

Many fund agreements place limits on how much capital may be committed to such funds. One effect of such a provision is to provide a limit on how much an investor's interest in such fund may be diluted by current or prospective investors subscribing for additional interests. Indeed, when an investor invests in a fund that caps the amount of capital that may be committed to the fund, such investor has an expectation that it will always maintain at least a minimum percentage interest in the fund. An investor would likely view this limitation as an important provision, for when an investor's interest in a fund is diluted, amounts distributable to such investor may similarly decrease, as might an investor's ability to influence key decisions requiring the consent of investors.

Amending a fund agreement to increase a fund's maximum amount of capital commitments could be contrary to the investors' expectations and may affect an investor's return on capital, thereby altering an economic term of the fund agreement. Furthermore, as additional capital is committed to the fund beyond the maximum amount originally agreed to by the investors, it stands to reason that any investor not increasing its capital commitment to the fund could reasonably be expected to be adversely affected. Similar to how a finite term in *In re NextMedia* provided investors therein with an "end point" for their investment, a cap on how much capital may be committed to a fund provides investors with a bottom point below which their percentage interest in the fund will not fall. As discussed above, having a diminished percentage interest in a fund could have negative repercussions to an investor. Consequently, amendments that affect the maximum amount of capital commitments to a fund should be carefully analyzed.

EXTENDING THE OUTSIDE DATE

Another provision commonly found in fund agreements is a limit on the amount of time during which additional investors may be admitted or additional capital commitments may be made to such fund (an outside date). Extending the outside date would allow additional time during which an investor's interest in the fund could be diluted. Such a scenario raises similar analytical issues as altering the maximum amount of capital that may be committed to a fund.

For example, if a fund agreement contains a limit on the maximum amount of capital commitments that may be made to such fund (and such limit is not amended), even if the outside date is extended, the minimum possible percentage interest that an investor could have in the fund, or the investor's "minimum interest," would not change. If a fund agreement does not contain any limit on the maximum amount of capital commitments that may be made, the investor would typically have no reasonable expectation of maintaining a minimum interest in the fund. An investor's interest in a fund could be diluted (either to its "minimum interest" or without limitation) prior to the outside date, and the investor arguably has no reasonable expectation that such dilution would not occur. A general partner, manager or controlling member may thus be able to argue that such lack of expectation dictates that the outside date is not a material economic provision of the fund agreement, and therefore such an amendment could not reasonably be expected to adversely affect the investors.

Conversely, an investor may argue that the outside date is analogous to the "end point" discussed in *In re NextMedia,* and that amending such a provision would affect the investor's "minimum investment" as

discussed above (i.e., once the agreed-upon outside date passes, the investor is assured that its percentage interest in the fund will remain at its then-current level). Therefore, an amendment affecting the outside date could, in fact, alter a material economic term of the fund agreement.

INCREASING FIDUCIARY DUTIES

Amending a fund agreement to increase the fiduciary duties of a manager, controlling member or general partner may not seem like it would implicate *In re NextMedia.* To the contrary, on its face, such an amendment appears to positively impact investors. By increasing the manager's, controlling member's or general partner's fiduciary duties, an investor may gain additional assurances that the manager, controlling member or general partner would act in the investors' and the fund's best interests.

However, some investors may view a manager's, controlling member's or general partner's diminished or eliminated fiduciary duties as beneficial. For example, if a fund agreement restricts or eliminates fiduciary duties, the manager, controlling member or general partner may be able to take actions in its discretion (or otherwise in compliance with such restricted duties), including actions that may involve added risk (which could yield greater rewards), without fearing a lawsuit for breach of its fiduciary duties. Indeed, allowing experienced managers, controlling members and general partners to exercise greater discretion and take increased risks, with the lure of heightened returns, may help to induce an investor to invest in a particular fund.

Such an investor may argue that increasing a general partner's, manager's or controlling member's fiduciary duties may affect the amount of distributions the investor might otherwise receive and therefore could reasonably be expected to have an adverse effect on the investors. While this scenario may seem less likely than those previously discussed, it is illustrative of the lesson that careful consideration should be given to the potential effect of an amendment when it is subject to the consent of "adversely affected" members or limited partners.

Even though *In re NextMedia* is two years old, it is an important case that informs the analysis on amendments to LLC agreements and partnership agreements that frequently occur. The court's analysis in *In re NextMedia* should cause managers, controlling members and general partners to think carefully before amending an LLC agreement or partnership agreement that contains an amendment provision similar to that at issue in *In re NextMedia.*

Mark V. Purpura *(purpura@rlf.com) is a director of Richards Layton & Finger. His practice includes providing advice on limited liability company, partnership and statutory and common-law trust transactional matters, as well as bank and trust company regulatory matters.*

Joshua J. Novak *(novak@rlf.com), an associate at Richards Layton, focuses his practice on matters involving Delaware limited liability companies and partnerships, including providing advice regarding private equity fund, hedge fund and structured finance transactions. The views expressed in this article are those of the authors and not necessarily those of Richards Layton & Finger or its clients.*

Reprinted with permission from the July 27, 2011 issue of Delaware Business Court Insider. © 2011 ALM Media Properties, LLC. Further duplication without permission is prohibited. All rights reserved.