Recent Delaware Alternative Entity Law Decisions

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Judicial Dissolution – Fisk Ventures, LLC v. Segal

In *Fisk Ventures, LLC v. Segal*, CA No. 3017-CC (Del. Ch. January 13, 2009), the Court of Chancery granted petitioner's motion for judgment on the pleadings and ordered dissolution of a limited liability company. This case provides further insight into the standards applied by a court for a petition for judicial dissolution of a limited liability company.

Andrew Segal and Fisk Ventures, LLC were each investors and members of Genitrix, LLC, a Delaware limited liability company (the "Company"). The Company was managed by a board of managers consisting of five members appointed by Fisk and Segal. Pursuant to the limited liability company agreement (the "LLC Agreement"), the Company's board could only act pursuant to approval of 75% of its members, and neither Fisk nor Segal individually had enough votes to meet such standard. Fisk and Segal disagreed on a wide range of issues relating to the management of the Company and were often in deadlock over important decisions without any means to resolve such deadlocks. Although Fisk had a vested "put right" that permitted it to cash out at its sole discretion, it had not opted to exercise such right. Fisk filed a petition for judicial dissolution of the Company and sought judgment on the pleadings.

Under Section 18-802 of the Delaware Limited Liability Company Act (the "Act"), judicial dissolution may be decreed when it is not reasonably practicable to carry on the business of a limited liability company in conformity with a limited liability company agreement. In interpreting this section of the Act, the court looked by analogy to the dissolution statute for limited partnerships and related cases.

The court found that there was a board deadlock, that the LLC Agreement did not provide a way to navigate around the board's deadlock, and that the Company was in dire financial condition, thereby making it not reasonably practicable to carry on the business operations of the Company. Segal unsuccessfully argued, among other things, that Fisk should be forced to exercise its put option to avoid the deadlock. The court rejected Segal's arguments, finding that Fisk was not required to exercise its put option to avoid deadlock. Given the circumstances surrounding the Company, judicial dissolution was warranted, and the court granted Fisk's motion for judgment on the pleadings.

In Kind Distributions – Schuss v. Penfield Partners, L.P.

In *Schuss v. Penfield Partners*, CA No. 3132-VCP (Del. Ch. June 13, 2008), the plaintiffs were limited partners who withdrew from Penfield Partners, L.P., a Delaware limited partnership (the "Partnership"), that functioned as a hedge fund. The plaintiffs expected to receive a distribution equal to their liquidating share at the time they withdrew and requested that such distributions be in kind and ratable. The defendants included the Partnership, Pine Creek Advisers Limited Partnership as the general partner of the Partnership (the "GP"), and William D. Witter, Inc. as the general partner of the GP ("Witter"). The defendants made non-ratable, in kind distributions to the plaintiffs, and, due to a decline in value of the designated securities by the time of the distribution, the securities distributed had a value significantly below the plaintiffs' capital accounts. The plaintiffs' complaint alleged, among other things, that the Partnership breached the limited partnership agreement of the Partnership (the "LPA") by not making full and timely final distribution to the plaintiffs and by failing to make pro rata, in kind distributions. The defendants responded by filing a motion to dismiss for failure to state a claim.

The Court of Chancery addressed, *inter alia*, whether the general partner breached the LPA in failing to make ratable, in kind distributions to the plaintiffs. The plaintiffs, citing Section 17-605 of the Delaware Revised Uniform Limited Partnership Act, argued that the Partnership could not compel them, as withdrawing limited partners, to accept securities in an amount exceeding their pro rata share in the capital of the Partnership. Section 17-605 provides that unless otherwise provided for in the partnership agreement, a partnership may compel a partner to accept an in kind asset distribution, but as to each asset, not in an amount exceeding the partner's pro rata share in the capital of the partnership. Section 17-605 is a default rule that defers to the parties' wishes when the partnership agreement specifies how in kind distributions are to be made. The plaintiffs conceded that Section 17-605 could be overridden by the LPA, but argued that the LPA did not override Section 17-605 because it did not contain specific language trumping such provision. Applying principles of contract interpretation, the court stated that the LPA did not require in kind distributions to be ratable and that the LPA trumped the default rule. Thus, the court granted the defendants' motion to dismiss as to that part of the breach of contract and fiduciary duties claims.

Fiduciary Duties and Voluntarily Assumed Duties – In re Cencom Cable Income Partners, L.P. Litigation

The Delaware Court of Chancery issued a decision in *In re Cencom Cable Income Partners, L.P. Litigation,* CA No. 14634-VCN (Del. Ch. Nov. 26, 2008), adding to a series of decisions stemming from ongoing litigation by class representatives of limited partners of Cencom Cable Income Partners, L.P., a Delaware limited partnership (the "Partnership"), against the Partnership, its general partner (the "GP"), and the GP's executive officers (collectively, the "Defendants"). The Partnership owned nine geographically disparate cable television systems (the "Assets"), which the GP agreed to sell to its various affiliates pursuant to provisions of the limited partnership agreement of the Partnership (the "Partnership Agreement") and based on an appraisal process set forth therein. Plaintiffs had previously, but unsuccessfully, asked the court to enjoin preliminarily the sale of the Assets and, when unsuccessful, alleged that the GP breached its fiduciary duty of loyalty. In its previous decision, the court granted summary judgment for the Defendants on all but three issues, which were before the court again in this decision. The court addressed various new arguments presented by the Defendants.

One argument dealt with the issue of whether the GP breached its fiduciary duties to the limited partners with respect to its retention of a law firm (the "Firm") that provided a legal opinion to the limited partners in connection with the sale of the Assets. Although not required to do so by the Partnership Agreement, the GP retained the Firm to act as special outside counsel on behalf of the limited partners in connection with the sale of the Assets. The GP set forth in a disclosure statement that the Firm would deliver an opinion to the limited partners that the appraisal process, the Partnership's solicitation of consent, and the sale of the Assets were each completed in compliance with the Partnership Agreement. The plaintiffs alleged that under the disclosure statement, the GP voluntarily undertook to set up an independent evaluation of the fairness of the process and that the GP breached this duty because the opinion by the Firm did not meet this obligation to the limited partners. In its earlier decision, the court found that the GP voluntarily assumed a duty to ensure that the Firm would fulfill its obligations to the limited partners but that the scope of such duty was unclear. The Defendants had previously argued that the Firm was hired to ensure procedural compliance and not the fairness of the transaction.

The Defendants attempted to reframe the issue. The Defendants argued that the plaintiffs could not enforce the Defendants' voluntarily assumed duties because the plaintiffs neither bargained for nor gave the Defendants some promise to assume such a duty. As a result, the plaintiffs' rights necessarily rested on the contractual defense of promissory estoppel. Given that the plaintiffs had not read the disclosure statement, did not know the Firm's role in the transaction, and did not rely on the disclosure, the Defendants argued that the elements of promissory estoppel were not met and therefore summary judgment was warranted. The court rejected this argument, explaining that the proper inquiry concerned the scope of the duty assumed by the GP in hiring the Firm. The court further explained that the Defendants' promissory estoppel theory was misplaced because the duty at issue arose not out of contract, but out of the common law. While parties to a partnership agreement are free to alter common law fiduciary principles by contract, the GP, by voluntarily undertaking to deliver an opinion by the Firm to the limited partners, imported fiduciary duties into its relationship with the limited partners.

Except for granting partial summary judgment to the Defendants on an unrelated issue and notwithstanding the Defendants' new arguments, the court denied the parties' motions for summary judgment on all of the outstanding issues.

Indemnification – TravelCenters of America LLC v. Brog

In *TravelCenters of America LLC v. Brog*, CA No. 3751-CC (Del. Ch. Dec. 5, 2009), the Delaware Court of Chancery granted the defendants' motion for judgment on the pleadings in a case addressing whether shareholders of a Delaware limited liability company were contractually obligated to indemnify the limited liability company for costs related to an unsuccessful proposal to nominate two persons for election to the board of directors.

The defendants were shareholders of the plaintiff, TravelCenters of America LLC (the "Company"), and submitted notice to the Company of their intent to nominate two persons to the board of directors at the 2008 annual meeting. The Company subsequently obtained a declaratory judgment that the notice provided by the defendants to nominate the new directors was invalid and insufficient under the Company's limited liability company agreement (the "LLC Agreement"). The Company then brought the current action seeking indemnification of its costs and fees in obtaining the declaratory judgment, pursuant to a provision in the LLC Agreement that provided for indemnification to the Company for expenses resulting from a shareholder breach of the LLC Agreement. The defendants moved for judgment on the pleadings, and the Company moved for partial summary judgment.

In granting the defendants' judgment on the pleadings, the court confirmed that limited liability companies are creatures of contract. The court recognized the distinction under contract law between promises or covenants to perform and mere conditions. Nonperformance of a promise or covenant may result in a breach of contract, while the nonoccurrence of a condition is not a breach of contract unless the party promised that such condition would occur. The court found that the defendants' defective notice was not a failure to perform a promise or covenant but was merely a failure to fulfill a condition. Since there was not therefore a breach of the LLC Agreement, the indemnification provision was not applicable.

Fiduciary Duties/Demand Futility – Kahn v. Portnoy

As part of the same case as *TravelCenters* discussed above, the Delaware Court of Chancery also issued a decision in *Kahn v. Portnoy*, CA No. 3515-CC (Del. Ch. Dec. 11, 2008), denying the defendants' motion to dismiss by finding that the contractual modifications of a board of director's fiduciary duties did not alter the pleading standards for either a motion for failure to state a claim or for a motion to dismiss for failing to comply with the demand requirement in a derivative claim.

The plaintiff was a shareholder of TravelCenters of America LLC, a publicly traded Delaware limited liability company (the "Company"), and the individual defendants were the directors of the Company. The defendants were also directors or otherwise affiliated with several other companies or affiliates of the Company, including Hospitality Properties Trust ("HPT"). The plaintiff alleged that the directors breached their fiduciary duties when they approved a lease transaction between HPT and the Company, which the plaintiff contended was designed to benefit HPT, the directors, and other affiliate companies at the expense of the Company.

In denying the defendants' motion to dismiss, the court first noted that the Company was governed by a limited liability company agreement (the "LLC Agreement") in which the fiduciary duties of the board were identical to those of a Delaware corporation, except as specifically modified in the LLC Agreement. Section 7.5(a) of the LLC Agreement (the "Provision") modified the fiduciary duties of directors in certain interested transactions by creating a presumption that certain board decisions would be proper and in accordance with the fiduciary duties of its directors notwithstanding certain conflicts of interest, and that such presumption could only be overcome by clear and convincing evidence. The court stated that the Provision was ambiguous because it was unclear what types of conflicted decisions of the board it would apply to. Specifically, the court said it was reasonable to read the Provision so as not to apply to decisions of the board when there was a conflict between the directors and the Company, as was the situation in this case. The court also noted that the Provision's clear and convincing standard was an evidentiary standard that did not apply to pleadings, but only to a trial on the merits. The court found that the plaintiff had sufficiently stated a claim upon which relief could be granted and had therefore met its pleading burden.

Additionally, the court ruled that the plaintiff met the requirements of demand futility in the context of a derivative suit. The court looked to corporate case law for guidance and applied the *Aronson* test to evaluate demand futility. *Aronson* requires showing a reasonable doubt that "(1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." In applying the *Aronson* test, the court concluded that a majority of the Company's directors were interested or not independent and that demand on the Company was excused as futile. Thus, the court denied the defendants' motion to dismiss. In reaching this conclusion, the court did, however, state that a limited liability company agreement may modify the *Aronson* test and the requirements of demand futility.