CHOOSING BETWEEN THE DELAWARE LLC ACT AND OTHER LLC ACTS FOR USE IN PRIVATE EQUITY DEALS – OUTLINE OF A METHODOLOGY

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OVERVIEW

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I. INTRODUCTION

For sophisticated investors and their counsel, the Delaware Limited Liability Company Act (the "Delaware Act") is normally the LLC act of choice in private equity deals involving significant stakes. While, in the case of some investors, this preference may be attributable to a reflexive pro-Delaware bias that has little to do with choosing among competing LLC acts on the merits,[2] the preference can also be justified on the basis of

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[2] The principal tax reason for using unincorporated entities such as LLCs or limited partnerships rather than corporations in private equity deals is to exploit the unique federal tax advantages of Subchapter K, the portion of the Internal Revenue Code ("IRC") that contains the main IRC provisions governing the federal income taxation of partnerships and partners. Under applicable U.S. Treasury Department regulations (which practitioners normally refer to as the "Check-the-Box Regulations"), Treas. Reg. §1.7701-1 *et seq.*, partnership taxation is unavailable to state-law business corporations and their shareholders. The advantages of partnership taxation over IRC Subchapters C and S (the federal tax regimens available to corporations) include, among others:

three important merit-based considerations that many LLC practitioners view as objectively sound.

1. The Delaware Courts. High-stakes deals can lead to high-stakes disputes. In resolving complex business disputes, many business litigators view the Delaware Court of Chancery and Supreme Court as substantially more likely to render a prompt, expert and impartial decision than the courts of other U.S. jurisdictions. The fact that Delaware selects its Court of Chancery and Supreme Court judges specifically on the basis of their experience and expertise as business lawyers, rather than on the basis of political or other nonmerit-based considerations, goes far to explain the preeminent capability of Delaware judges in resolving business disputes as compared with judges in other states.

2. Delaware LLC Case Law. In negotiating and drafting LLC operating agreements in high-stakes private equity deals,[3] all parties are likely to want maximum certainty concerning the meaning of key statutory terms and the outcome of reasonably foreseeable disputes that involve these terms. A principal source of this certainty is the relevant case law. The body of LLC case law under the Delaware Act on complex statutory issues is already far more extensive than that available under any other LLC act.[4] Furthermore, because of the large and

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- The availability of pass-through taxation under Internal Revenue Code ("IRC") Section 701 without the restrictions of Subchapter S;
- The availability of "special allocations" under IRC Section 704(a);
- The availability of tax deferral on appreciated contributions of property under IRC Section 721(a) without the restrictions of the IRC Section 351(a) "80% control rule;"
- The availability of "inside basis step-ups" on partnership interest dispositions under IRC Sections 734 and 743; and
- The ability of partners to include entity debt in the basis of their partnership interests under IRC Section 752 and related IRC provisions and case law thereunder.

Both LLCs and limited partnerships can qualify for partnership tax classification under the Check-the-Box Regulations. The principal reason for using LLCs rather than limited partnerships in private equity deals is to avoid the requirement of limited partnership statutory law that each limited partnership have a general partner with unlimited personal liability for limited partnership debt.

However, there are several states, including California, Florida, Nebraska, Pennsylvania and Texas, where, for reasons of state business organization law or tax law, the limited partnership will normally be superior to the LLC in private equity deals and other types of high-stakes deals. In these deals, the general partner is normally a limited liability entity such as a single- or multi-member LLC.

[3] Most LLC acts use the term "operating agreement" to define the agreement among the members of an LLC concerning the LLC's internal affairs and the conduct of its business – in effect, the LLC's partnership agreement. The statutory term for this agreement in the Delaware Act is "LLC agreement." In this article, the term "operating agreement" will be used generically to refer to this type of agreement under LLC acts in general; the term "LLC agreement" will be used to refer to operating agreements of LLCs formed under the Delaware Act.

[4] *Drafting LLC Operating Agreements* contains a comprehensive survey of LLC case law. The survey is updated at least annually and currently includes discussion of a total of 352 cases, including 47 cases decided under the Delaware Act. Many of these Delaware cases have important implications for parties to

growing number of sophisticated LLCs formed and existing under the Delaware Act and the proclivity of many members and managers of these LLCs to turn to the Delaware courts, rather than to those of other jurisdictions, to resolve the disputes involving these LLCs, this preeminence of Delaware LLC case law is only likely to increase.[5]

3. The Statutory Amendment Process in Delaware. The Corporate Section of the Delaware Bar Association continually monitors LLC statutory and case law developments nationwide; on the basis of this monitoring and the well-known business organization law sophistication and creativity of its members, the Section proposes every year to the Delaware legislature one or more amendments designed to enhance the usefulness of the act and thus to preserve the act's status as the preeminent U.S. LLC act for implementing these deals, and each year since the enactment of the Delaware Act, the Delaware legislature has enacted all of these proposed amendments. Over the years, no other state legislature has demonstrated the same level of continuing commitment to the excellence of its LLC act.

However, as important as the above three considerations unquestionably are in choosing the Delaware Act over the other 50 U.S. LLC acts for use in high-stakes private equity deals, the most important issue that investors, investees and their counsel must address in making the choice is this: Which of these acts is best on the *statutory merits – i.e.*, on the basis of a section-by-section comparison among the relevant competing acts?

The issue is hardly an abstract one. Rather, it arises in many specific private equity deals in which one or more prospective parties or their lawyers:

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high-stakes private equity deals that intend to make use of LLCs formed under the Delaware Act. *See, e.g.*, *Arbor Place, LP v. Encore Opportunity Fund, LLC*, 2002 WL 205681 (Delaware. Ct. of Chancery, Jan. 29, 2002), (right of LLC members to have access to the books and records of their LLC); *Elf Atochem v. Jaffari*, 927 A.2d 286, 1999 Delaware. LEXIS 111 (Delaware Supreme Court 1999), (enforceability under Section 18-1101(b) of the Delaware Act of LLC agreement provisions arguably in conflict with a mandatory provision of that Act); *VGS, Inc. v. Castiel et al*., 2000 Del. Ch. LEXIS 122 (fiduciary duty of majority members of Delaware LLC toward minority member). With the exception of Connecticut (which has 35 LLC cases, but whose LLC act is not generally viewed as suitable for high-stakes private equity deals), no other U.S. jurisdiction has more than a small number of such cases under its LLC act.

[5] My inquiries among a reasonably representative sampling of Secretaries of State suggest that as of July 15, 2003, there were very roughly 2.5 million LLCs formed and existing under the LLCs of the 50 U.S. states and the District of Columbia. About 208,000 of these LLCs were formed and existing under the Delaware Act.

The courts of Delaware have also developed an extensive body of case law under the Delaware Limited Partnership Act and, of course, under the Delaware General Corporation Law. Many provisions of the Delaware Limited Liability Company Act are identical or closely similar to provisions in Delaware's limited partnership and corporate statutes. Delaware limited partnership and corporate case law thus constitutes a major supplement to Delaware LLC case law. See generally *Elf Atochem v. Jaffari, supra*, in which the Delaware Supreme Court noted the identity or close similarity between many provisions of the Delaware LLC Act and the Delaware Limited Partnership Act and interpreted the latter in light of case law and commentary under the former.

- Are unfamiliar with the Delaware Act and need to be convinced of its statutory merits;

- Have at least a general knowledge of the Delaware Act but also have a strong preference for another act – usually their home state act - because of their greater familiarity with it; or

- Are concerned that if they use a Delaware LLC in their deal, they may have to litigate LLC issues in the Delaware courts rather than in home state courts.

All 50 states and the District of Columbia have their own LLC acts, and each of these acts has at least a significant number of unique statutory features. As will become clearer in the discussion that follows, this and other factors make any merit-based comparison of the provisions of the Delaware act with those of another LLC act a complex and challenging task. In this article, I will not make any such comparison. Rather, my purpose is to outline a *general methodology* that will facilitate such a comparison in the case of *any* such act and, to the extent possible, will ensure that its outcome is correct. In addition, I will suggest at least briefly in the article why I think that in most private equity deals - but by no means in all of them – a competently conducted comparison will lead to the conclusion that on the statutory merits, the Delaware Act is superior to any competing act.[6]

The focus of this article will be on choosing between the Delaware Act and other LLC acts as the act under which the *operating* entity in a private equity investment should be formed. However, many of the article's conclusions will be equally applicable in choosing the best LLC act for investor entities.

II. CONTRACTUAL FREEDOM AND CONTRACTUAL ENFORCEABILITY - THE DELAWARE ACT VS. OTHER LLC ACTS

Every private equity deal is unique, and the specific LLC business organization law advantages that particular parties to private equity deals involving LLCs may want in their operating agreement will vary greatly from deal to deal. Furthermore, it is not necessarily the case that all parties to each such deal will want to employ an LLC act that gives them maximum contractual freedom to achieve their goals. On the contrary, as discussed in Part III of this article, some parties may want an act whose mandatory provisions – i.e., provisions that the parties may not alter in their operating agreement - will guarantee them specific LLC business organization law rights favorable to their interests or that will deny these rights to other parties.

[6] The focus of this article is on Delaware and the other 50 U.S. LLC acts. A number of foreign jurisdictions, including Nevis and St. Kitts, Anguilla and the Marshall Island also have LLC acts, and all of these acts are based on U.S. acts. Thus, the methodology for comparing LLC acts outlined in the article can also be used with non-U.S. acts. Obviously, however, a wide range of considerations other than statutory merits must be taken into account in deciding whether to use non-U.S. LLC acts in private equity deals. These considerations are beyond the scope of this article.

However, it is unquestionably true that in the great majority of cases, most or all parties to a private equity deal involving an LLC will view themselves as benefiting from forming their LLC under an LLC act that provides them with maximum freedom to tailor their operating agreement to meet their specific needs and interests and with maximum assurance that the provisions of these agreements will be enforced.

These benefits are more likely to be available under the Delaware Act than under any other act. The primary reason is Section 18-1101(b) of the Delaware Act, which provides as follows:

> It is the policy of this Chapter [*i.e.*, Chapter 18 of Title 6 of the Delaware statutes, the chapter that consists of the Delaware Act] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.

Section 18-1101(b) has both a permissive and a mandatory function.

- First, it permits and validates virtually any LLC agreement provision to which the LLC's members agree that does not directly conflict with the mandatory provisions of the Delaware Act or with Delaware public policy.

- Secondly, Section 18-1101(b) effectively requires the courts of Delaware to enforce all such LLC agreement provisions to the extent that they are challenged in these courts.

Furthermore, the obligation imposed on the Delaware courts under Section 18-1101(b) to accord maximum effect to freedom and enforceability of contract has been resoundingly acknowledged and validated in the landmark decision of the Delaware Supreme Court in *Elf Atochem v. Jaffari, supra.* Indeed, in *Elf Atochem*, the court not only confirmed its obligations under Section 18-1101(b) but applied the section to validate an operating agreement provision that, in the view of many commentators, directly conflicted with a mandatory provision of the Delaware Act itself as then in effect. Moreover, the *Elf Atochem* court went so far as to suggest that facially mandatory rules of the act that conflict with provisions of an LLC agreement may be construed as mere default rules where no third parties are affected. *Elf Atochem* at 292.

Furthermore, the contractual freedom and enforceability provided under Section 18-1101(b) are strongly supported by the provisions of Section 18-1101(a). This section provides in its entirety as follows:

> The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.

The effect of Section 18-1101(a) is to guarantee that any contractual arrangement of the parties to an LLC agreement under the Delaware Act that is inconsistent with existing

case law will trump that case law unless, presumably, the arrangement directly conflicts with public policy.

Finally, on the often highly sensitive issue of the fiduciary duties and liabilities of LLC managers, the Delaware Act provides extremely broad contractual flexibility, since (i) none of its provisions imposes any such duties or liabilities, including fiduciary duties of care or loyalty or "quasi-fiduciary" duties of good faith or fair dealing; and (ii) Section 1101(c) provides LLC members with great flexibility to alter any fiduciary duties or liabilities arguably applicable under applicable case law. Section 1101(c) provide in pertinent part as follows:

> (c) To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) and liabilities relating thereto to a limited liability company or to another member or manager or to an other person that is a party to or is otherwise bound by a limited liability company agreement. . .
>
> (2) The member's or manager's or other person's duties and liabilities may be expanded or restricted by provisions in the limited liability company agreement.[7]

It is true that a small number of other LLC acts – e.g., those of New Hampshire and Oklahoma – contain provisions identical or similar to Section 18-1101(b). However, no other jurisdiction has a decision comparable to the *Elf Atochem* decision.

In short, under Section 18-1101(b) of the Delaware Act, as construed and confirmed by the Delaware Supreme Court in *Elf Atochem*, and under Sections 18-1101(a) and 18-1101(c)(2), the parties to high-stakes private equity deals involving LLCs enjoy a substantially greater likelihood that the provisions of their operating agreements will be upheld by the courts under that act than under any other LLC act.

III. OUTLINE OF A METHODOLOGY FOR COMPARING THE DELAWARE ACT AND OTHER U.S. LLC ACTS

A. Introduction

Every U.S. LLC act consists principally of three main categories of statutory provisions – namely, provisions that the courts and LLC practitioners generally refer to as *default* provisions, *mandatory* provisions and *permissive* provisions.[8] In comparing two or more competing LLC acts to determine which is more likely to meet the needs and interests of clients in high-stakes private equity deals, lawyers must compare each of the provisions

[7] It should be noted, however, that under *Gotham Partners, L.P., v. Hallwood Realty Partnerships, L.P.*, 817 A.2d 160 (Del. S. Ct., August 9, 2002), the Delaware Supreme Court has stated in dicta that Section 17-1101(d)(2) of the Delaware Limited partnership Act, a partner agreement may not *eliminate* fiduciary duties. Since Section 18-1101(c)(2) is substantively identical to Section 17-1101(d)(2), the dicta also undoubtedly applies to Section 18-1101(c)(2).

[8] All LLC acts also contain numerous definitional provisions, but this type of statutory provision is not relevant to the subject matter of this article.

in each of these three categories as set forth in each competing act with the corresponding provisions of the other relevant acts. For each such party, the prevailing act will be the one whose provisions are most favorable to its particular interests on an overall basis. Because these statutory provisions are numerous and may sometimes be difficult to interpret and categorize, the process is unavoidably challenging and time-consuming and may result in substantial legal fees. However, for particular parties to private equity deals, it will often be a crucial step in the process of achieving the deal they want.

Discussed below are:

- The definition and practical meaning of each of the above three categories of LLC statutory provisions;
- The general significance of each category to LLC organizers and their counsel in choosing between competing LLC acts; and
- The impact of each category in choosing between the Delaware Act and other LLC acts.

B. Default Provisions – General Considerations

Most of the provisions in any LLC act that are likely to be important to one's clients in a high-stakes private equity deal are default provisions – that is, provisions whose very terms authorize their valid alteration by the parties to the operating agreement that contractualizes the deal.

Most default provisions in most LLC acts are signaled by an express statutory phrase such as "except as otherwise provided in the operating agreement." See, *e.g.*, Section 18-502(a) of the Delaware Act, which provides as follows:

> *Except as provided in a limited liability company agreement*, a member is obligated to a limited liability company to perform any promise to contribute cash or property or to perform services, even if the member is unable to perform because of death, disability or any other reason. (Italics added.)

However, all LLC acts also contain at least a few default provisions – perhaps best described as "covert" default provisions – that lack this express statutory signal. These "covert" default provisions often deal with potentially critical LLC business organization law issues. An example of a covert default provision in the Delaware Act is section 18-601, which addresses the issue of when the members of an LLC will be entitled to receive interim distributions (that is, distributions other than in connection with the liquidation of their individual LLC interests or of the LLC itself after its dissolution). The section provides as follows:

> [At] the times or upon the happening of the events specified in a limited liability company agreement, a member is entitled to receive from a limited liability

company distributions before the member's resignation from the limited liability company and before the dissolution and winding up thereof.

Despite the fact that Section 18-604 includes no "except as otherwise provided" clause of the type described above, the section is substantively a default provision; it provides, in effect, that unless the LLC agreement provides otherwise, *no* member shall be entitled to *any* interim distribution from the LLC.

The principal legislative purpose of the default provisions of LLC acts is to provide LLC organizers with workable "off-the-shelf" rules for their LLCs and thus to save them the time and money that would be required if they were to have to create these rules from scratch in particular deals. Thus, in high-stakes private equity deals in which all parties have sophisticated lawyers, a comparison of the default rules of two or more competing LLC acts may to some extent be irrelevant, since these lawyers and their clients will normally be willing and able to develop and document the content of their operating agreement virtually without reference to these rules.

However, even in high-stakes private equity deals, the default provisions of an LLC act have two important functions.

- First, as illustrated in Part II.C of this article, they provide certainty to the parties to the deal that specific arrangements for which their operating agreements provide and also any tailored variations of those arrangements that are not inconsistent with the public policy of the state under whose LLC act they are forming their LLC will be legally valid.

- Secondly, the default provisions of an LLC act provide the parties and their counsel with a statutory basis for legal opinions on the issue of validity.[9]

C. Default Provisions – the Delaware Act vs. Other LLC Acts

On LLC business organization law issues likely to be important in forming LLCs, including LLCs that will serve as vehicles for high-stakes private equity deals, the Delaware Act contains some 88 default provisions.[10] Many of these provisions cover

[9] In LLC negotiations in which particular parties believe that one or more specific default rules of the governing LLC act are likely to benefit them or to disadvantage other parties to the deal in question, these parties may often be well advised to avoid express negotiation of any issue covered by these rules, since, if they can do so, then once the operating agreement is signed, the rules will apply to the LLC automatically. However, in high-stakes private equity investment deals in which all parties are represented by sophisticated LLC counsel, this negotiation technique is unlikely to be effective.

[10] See Exhibit 9-13, *Drafting LLC Operating Agreement.* Chapter 9 of *Drafting LLC Operating Agreements* contains a general discussion of the Delaware Act, and Exhibits 9-1 through 9-14 contain, among other things, detailed tables of the provisions of the Delaware Act comprehensively identifying and briefly discussing each of the default, mandatory and permissive provisions of the Delaware Act as currently in effect. The discussion of these provisions in this article is based on these tables. On June 6, 2003, the Delaware legislature published Senate Bill 128, which proposed various amendments to the Delaware Act. The legislature has adopted S.B. 128, and the amendments to the Delaware Act contained in

issues also covered by the default rules of most or all other Acts, and often the rules reflected in Delaware Act default provisions are the same as in the default provisions of other LLC acts. To cite but a few examples from the Delaware Act that are (i) likely to be important in private equity deals, (ii) generally similar to the default provisions of other LLC acts; and (iii) likely to be of particular relevance in private equity deals involving LLCs:

- LLC Management Structure. Section 18-402 provides that unless the LLC agreement provides otherwise:

  > The management of a limited liability company shall be vested in its members in proportion to the then current percentage or other interest of members in the profits of the limited liability company owned by all of the members

- Duty to Contribute Despite Death, Etc. Section 18-502(b) provides that unless the LLC agreement provides otherwise:

  > [A} member is obligated to a limited liability company to perform any promise to contribute cash or property or to perform services, even if the member is unable to perform because of death, disability or any other reason.

- Allocations of Profits and Losses. Section 18-503 provides that unless the LLC agreement provides otherwise:

  > [P]rofits and losses shall be allocated on the basis of the agreed value (as stated in the records of the limited liability company) of the contributions made by each member to the extent they have been received by the limited liability company and have not been returned.

However, many default provisions of the Delaware Act address operating agreement issues that few, if any, other acts address. For example:

- Delegations. Section 18-407 provides that:

  > Unless otherwise provided in the limited liability company agreement, a member or manager of a limited liability company has the power and authority to delegate to 1 or more other persons the member's or

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it will become effective on August 1, 2003. However, in the author's view, none of these amendments is relevant to the subject matter of this article.

The Delaware Act contains a total of about 284 provisions potentially relevant to LLC formations. Some of these provisions consist of complete sections or subsections of that act; others consist of one or two sentences within a particular section or subsection. Of this total of 284 provisions, about 88 are (as noted above) default provisions, 65 are mandatory, and 49 are permissive.

manager's, as the case may be, rights and powers to manage and control the business and affairs of the limited liability company.

Comment. Most other LLC acts are simply silent concerning the power and authority of LLC members and managers to delegate their management rights and powers; thus, there is significant doubt under these acts about whether these delegations, which can so often be of significant practical value in creating an efficient LLC management structure, are legally valid. Section 18-407 eliminates this doubt.

- Manager Resignations. Section 18-602 provides that:

> A manager may resign as a manager of a limited liability company at the time or upon the happening of events specified in a limited liability company agreement and in accordance with the limited liability company agreement.

Comment. This "covert" default provision validates provisions in operating agreement under the Delaware Act prohibiting managers from resigning from their LLCs unless they meet specified conditions or are willing to be subject to specified penalties. The validity of any similar provision in an operating agreement under any other LLC act could well be subject to legal challenge.

- Mergers, Etc. Section 18-209(b) (second sentence) provides that:

> Unless otherwise provided in the limited liability company agreement, a merger or consolidation shall be approved by each domestic limited liability company which is to merge or consolidate by the members or, if there is more than one class or group of members, then by each class or group of members, in either case, by members who own more than 50 percent of the then current percentage or other interest in the profits of the domestic limited liability company owned by all of the members or by the members in each class or group, as appropriate.

Comment. Section 18-209(b) validates, among other things, provisions in LLC agreements that reserve to the managers of an LLC the decision whether an LLC shall merge with another entity. For promoters of private equity enterprises who plan to conduct these enterprises as LLCs and who want maximum management control over major LLC transactions, such a provision may be highly desirable. However, under LLC acts that lack a provision similar to Section 18-209(b), the validity of an operating agreement provision effectively barring non-manager members from voting on an organic LLC change such a merger could be of doubtful validity.[11]

[11] See also Section 18-302(a) (second sentence), which provides as follows:

> Provisions similar to Section 18-209(c) also validate the reservation to LLC managers of decisions concerning LLC conversions. See Section 18-216 (second sentence).

In short, the default provisions of the Delaware Act provide a substantially broader and more detailed statutory basis than that of other LLC acts both for creative operating agreement arrangements and for legal opinions validating these arrangements.

D. Mandatory provisions – General Considerations

The mandatory provisions of an LLC act are those that set forth rules that, by their terms, may not be altered by LLC members in their operating agreement. While it is not always immediately clear whether a specific LLC statutory provision is mandatory, the use in a particular statutory provision of imperative verb forms such as "shall," "must" or "may not" and the absence of any phrase such as "unless otherwise provided in the operating agreement" usually resolves the question.

Section 18-201(a) of the Delaware Act sets forth a significant mandatory provision of that act in classic mandatory terms. The section provides in pertinent part that:

> In order to form a limited liability company, 1 or more authorized persons *must* execute a certificate of formation. The certificate of formation *shall* be filed in the office of the Secretary of State and [*shall*] set forth:
>
> (1) The name of the limited liability company;
> (2) The address of the registered office and the name and address of the registered agent for service of process required to be maintained by § 18-104 of this title; and
> (3) Any other matters the members determine to include therein.
>
> (Italics added.)

In high-stakes private equity deals, there are two main reasons why mandatory provisions may be important in choosing between competing LLC acts.

> A limited liability company agreement may provide for the taking of an action, including the amendment of the limited liability company agreement, without the vote or approval of any member or class or group of members, including an action to create under the provisions of the limited liability company agreement a class or group of limited liability company interests that was not previously outstanding.

One may reasonably argue that Section 18-302(a) suffices by itself to validate LLC agreement provisions reserving decisions about mergers, conversions and other LLC organic changes. However, given the importance and sensitivity of these transactions, Section 18-209(b) provides, at the very least, a useful backup to Section 18-302(a).

- First, in many of these deals, all of the parties for their various respective reasons want maximum statutory flexibility to achieve their contractual goals in the operating agreement. However, the greater the number of mandatory rules in an act, the greater the possibility that this flexibility will be lacking.

  > For example, assume that in a given private equity deal to finance and construct a large office park in Phoenix, Arizona, major prospective investors from foreign countries are concerned to preserve their anonymity in public records concerning the deal. However, all of the parties want to implement the deal through a multi-member LLC. Section 29-632(5)(a) of the Arizona Limited Liability Company Act, a mandatory provision of that act, requires the public disclosure of the identities of members of any LLC formed under that act who have at least a 20-percent interest in the LLC.[12] This requirement may well suffice by itself to persuade the parties not to form their LLC under the Arizona Act. By contrast, the Delaware Act contains no such mandatory provision. On the contrary, Section 18-201 of the Delaware Act requires that certificates of formation filed under that act disclose only the name of the LLC, the name of its registered agent, and the address of its registered office.

- Secondly, one or more mandatory provisions of a particular LLC act may provide a legal advantage or disadvantage to a particular party to a high-stakes private equity deal as compared with the other parties. Thus, in comparing two or more competing acts for use in such a deal, lawyers must determine whether any of these provisions favors or disfavors their clients on any pertinent issues.

For example, Section 13.1-1024.1.A of the Virginia LLC Act provides, in effect, that in defending themselves against claims that they have violated their fiduciary duty of care, managers may rely on the business judgment rule. Few if any other acts contain such a provision.[13] Prospective parties in private equity deals involving the use of LLCs who will serve as managers of those LLCs may want to form their LLCs under the Virginia

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[12] Section 29-632 provides in relevant part that:

> A. The articles of organization shall set forth. . .
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> 5. The name and business, residence or mailing address of either of the following:
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> (a) If management of the limited liability company is vested in a manager or managers, each person who is a manager of the limited liability company and each member who owns a twenty per cent or greater interest in the capital or profits of the limited liability company. . .

[13] Section 13.1-1024.1.A provides in its entirety as follows:

> A manager shall discharge his or its duties as a manager in accordance with the manager's good faith business judgment of the best interests of the limited liability company.

LLC Act in order, by virtue of Section 13.1-1024.1.A, to reduce their potential liability as managers. Conversely, prospective parties who want to keep the managers on a short leash may want to avoid that act in order to increase this potential liability.

E. Mandatory Provisions – the Delaware Act vs. Other LLC Acts

On LLC business organization law issues likely to be important in forming LLCs, included LLCs that will serve as vehicles for high-stakes private equity deals, the Delaware Act contains some 64 mandatory provisions potentially relevant in forming LLCs to implement these deals.[14] However, most of these provisions are likely either:

- Not to create problems for any of the parties to the deal in question; or
- To favor or disfavor all of the parties equally.

An example of the former type of mandatory provision is Section 18-102(1), which requires that the name of an LLC must contain the words "limited liability company" or an abbreviation of those words. It is hard to imagine that this requirement could burden or inconvenience any party to a private equity deal.

An example of the latter type of provision is Section 18-703(f), which provides, in effect, that creditors of LLC member-debtor in default may not force the sale of LLC assets in satisfaction of creditor claims. Far from creating problems for any participant in a private equity deal, this section is likely to benefit all of them (except, possibly, for participants who are or may become creditors of other participants).

There is one mandatory provision in the Delaware Act – namely, Section 18-305(a) (relating to member informational rights) – and one set of related provisions – namely, the 10 provisions of the Act specifically addressing LLC dispute resolution matters – that may give at least momentary pause to participants in high-stakes private equity deals who, because they are the promoters of the deal in question or will be managers of the LLC that will implement it, want to minimize the LLC involvement of investor members and their ability to challenge management initiatives and actions. However, as briefly shown below, these sections, if properly addressed in the pertinent LLC agreement, are unlikely to cause significant problems for private equity deal promoters and managers.

Section 18-305(a). Section 18-305(a) provides that each member of a Delaware LLC has a mandatory right to inspect a broad range of LLC books and records concerning, among other LLC matters, the LLC's business and financial condition. However, Section 18-305(g) substantially reduces the risk of adverse consequences under Section 18-305(a) for private equity investor promoters and LLC managers by providing that:

> The rights of a member or manager to obtain information as provided in this section may be restricted in an original limited liability company agreement or in any subsequent amendment approved or adopted by all of the members and in

[14] See Exhibit 9-12, *Drafting LLC Operating Agreement.*

compliance with any applicable requirements of the limited liability company agreement.

The above risk is also substantially reduced by Section 18-305(c), which permits managers to withhold from members LLC information if, among other things, the managers believe in good faith that the information is proprietary or that its disclosure would not be in the best interest of the LLC or could damage the LLC or its business.[15]

Section 18-109(d) and other Delaware Act dispute resolution provisions. The Delaware Act contains a total of 10 provisions addressing issues relating to the resolution of member disputes among themselves and with managers. No other act contains anywhere near so many provisions covering dispute resolution. A detailed discussion of these 10 provisions is beyond the scope of this article. However, even the following brief discussion may suffice to allay any concerns about these provisions on the part of private equity investment promoters such as those described above.

(1) Section 18-109(d). Section 18-109(d) provides, in effect, that no provision in an LLC agreement of a Delaware LLC that limits the rights of members to seek third-party review of matters relating to the organization and internal affairs of an LLC shall be valid if it has the effect of prohibiting this review *both* in the Court of Chancery *and* in arbitration.[16] In other words, the section effectively requires that if the LLC agreement bars these members from obtaining review of such matters in the Chancery Court, it must expressly provide for this review in arbitration (whether in Delaware or in any other jurisdiction). The purpose of Section 18-109(d) is apparently twofold – namely, to ensure that at least in some specific and meaningful forum, minority members of LLCs formed under the Delaware Act have a right to third-party review of their LLC grievances relating to internal LLC affairs; and to impede the development of a body of case law under the Delaware LLC Act in non-

[15] Section 18-305(c) provides in its entirety as follows:

> The manager of a limited liability company shall have the right to keep confidential from the members, for such period of time as the manager deems reasonable, any information which the manager reasonably believes to be in the nature of trade secrets or other information the disclosure of which the manager in good faith believes is not in the best interest of the limited liability company or could damage the limited liability company or its business or which the limited liability company is required by law or by agreement with a 3rd party to keep confidential.

[16] Section 18-109(d) provides in its entirety as follows:

> In a written limited liability company agreement or other writing, a manager or member may consent to be subject to the nonexclusive jurisdiction of the courts of, or arbitration in, a specified jurisdiction, or the exclusive jurisdiction of the courts of the State of Delaware, or the exclusivity of arbitration in a specified jurisdiction or the State of Delaware, and to be served with legal process in the manner prescribed in such limited liability company agreement or other writing. Except by agreeing to arbitrate any arbitrable matter in a specified jurisdiction or in the State of Delaware, a member who is not a manager may not waive its right to maintain a legal action or proceeding in the courts of the State of Delaware with respect to matters relating to the organization or internal affairs of a limited liability company.

Delaware courts that is inconsistent with cases rendered by the Delaware courts themselves.

However, while Section 18-109(d) limits the ability of LLC organizers to exclude members from obtaining third-party review of such rights as these members may have in respect of their LLC's internal affairs, it does not bar these organizers from limiting or even excluding these rights themselves to the extent permitted under other provisions of the Delaware Act. These other provisions are discussed below.

(2) Section 18-1001. Section 18-1001 confers subject matter jurisdiction (which, as indicated, is nonexclusive under Section 18-109(d)) on the Court of Chancery to hear derivative suits involving LLCs formed under the Delaware Act.[17] The section also appears to confer on LLC members themselves a mandatory right to bring these suits (subject, of course, to the provisions of Section 18-109(d)). Few other LLC acts expressly confer on LLC members the right to bring derivative suits.

However, it is hard to imagine that a court of any state would impute validity to an operating agreement provision providing that members shall have the right neither to bring derivative actions nor to bring direct actions in which they claim that LLC managers have violated their fiduciary duties and other duties toward the LLC. Furthermore, few if any sophisticated investors would sign such an agreement.

Finally, the existence of Section 18-1001 will often prevent members from bringing direct actions. For this reason, promoters of private equity deals involving LLCs are generally more likely to benefit from the section than to be disadvantaged by it.

Thus, except in rare cases, the fact that Section 18-1001 provides members of Delaware LLCs with a mandatory right to bring derivative actions should not deter any private equity investment promoter from using an LLC formed under the Delaware Act to conduct the business in question.

(3) Section 18-110(a). Section 18-110(a) confers nonexclusive subject matter jurisdiction on the Court of Chancery to decide disputes relating to manager elections and removals and other specified manager matters, and the section arguably confers on members a mandatory right to seek third-party resolutions of disputes they may raise that involving their right to elect or remove managers.[18] However, the Delaware

[17] Section 18-1001 provides as follows:

> A member or an assignee of a limited liability company interest may bring an action in the Court of Chancery in the right of a limited liability company to recover a judgment in its favor if managers or members with authority to do so have refused to bring the action or if an effort to cause those managers or members to bring the action is not likely to succeed.

[18] Section 18-110(a) provides in pertinent part as follows:

Act does not provide members with the right to elect or remove managers. Thus, promoters concerned about the above mandatory right under Section 18-110(a) may effectively eliminate it by omitting in their LLC agreement any provisions giving members the right to elect or remove managers.

(4) Section 18-110(b). Section 18-110(b) addresses the subject matter jurisdiction of the Court of Chancery with respect to disputes by LLC members in respect of their voting rights.[19] Its effect with respect to member voting rights is essentially the same as that of Section 18-110(a) with respect to manager matters. However, since Section 18-302(a) of the Delaware Act provides that an LLC agreement may provide for nonvoting members, Section 18-110(b), like Section 18-110(a), need not concern private equity investment promoters who want to minimize third-party resolution of member disputes.

(5) Section 18-111. Section 18-111 confers nonexclusive subject matter jurisdiction on the Court of Chancery to decide matters arising under LLC agreements.[20] However, the section is probably best read as not providing LLC members with any statutory right to raise these matters.

(6) Section 18-205(a). Section 18-205(a) confers nonexclusive subject matter jurisdiction on the Court of Chancery to decide matters relating to certain required filings of documents with the Delaware Secretary of State.[21] In addition, the section

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> Upon application of any member or manager, the Court of Chancery may hear and determine the validity of any admission, election, appointment, removal or resignation of a manager of a limited liability company, and the right of any person to become or continue to be a manager of a limited liability company, and, in case the right to serve as a manager is claimed by more than 1 person, may determine the person or persons entitled to serve as managers; and to that end make such order or decree in any such case as may be just and proper, with power to enforce the production of any books, papers and records of the limited liability company relating to the issue.

[19] Section 18-110(b) provides in pertinent part as follows:

> Upon application of any member or manager, the Court of Chancery may hear and determine the result of any vote of members or managers upon matters as to which the members or managers of the limited liability company, or any class or group of members or managers, have the right to vote pursuant to the limited liability company agreement or other agreement or this chapter (other than the admission, election, appointment, removal or resignation of managers).

[20] Section 18-111 provides in its entirety as follows:

> Any action to interpret, apply or enforce the provisions of a limited liability company agreement, or the duties, obligations or liabilities of a limited liability company to the members or managers of the limited liability company, or the duties, obligations or liabilities among members or managers and of members or managers to the limited liability company, or the rights or powers of, or restrictions on, the limited liability company, members or managers, may be brought in the Court of Chancery.

[21] Section 18-205(a) provides in its entirety as follows:

> If a person required to execute a certificate required by this subchapter fails or refuses to do so, any other person who is adversely affected by the failure or refusal may petition the Court of Chancery to direct the execution of the certificate. If the Court finds that the execution of the

is probably best read as conferring both on members and on third parties a mandatory right to seek third-party resolution of these matters. However, it is difficult to conceive of a situation in which a material dispute about a required filing will arise among the members of an LLC used to implement a private equity investment.

(7) Section 18-210. Section 18-210 confers nonexclusive subject matter jurisdiction on the Court of Chancery to decide matters relating to any appraisal rights that members may have under their LLC agreement.[22] However, neither the section itself nor any other provision of the Delaware Act confers appraisal rights themselves on members. Thus, the section need not trouble any private equity investment promoter concerned about member recourse to third-party dispute resolution.

(8) Section 18-305(f). Section 18-305(f) confers nonexclusive subject matter jurisdiction on the Court of Chancery to decide matters relating to member informational rights.[23] However, as discussed above, private equity investment promoters concerned about member informational rights may substantially restrict these rights under Sections 18-305(c) and (g).

(9) Section 18-802. Section 18-802 confers nonexclusive subject matter jurisdiction on the Court of Chancery to decide matters relating to LLC dissolutions "whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement."[24] In addition, the section is probably best read as conferring on LLC members a mandatory right to seek third-party resolution of these matters.

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certificate is proper and that any person so designated has failed or refused to execute the certificate, it shall order the Secretary of State to record an appropriate certificate.

[22] Section 18-210 provides in its entirety as follows:

> A limited liability company agreement or an agreement of merger or consolidation may provide that contractual appraisal rights with respect to a limited liability company interest or another interest in a limited liability company shall be available for any class or group of members or limited liability company interests in connection with any amendment of a limited liability company agreement, any merger or consolidation in which the limited liability company is a constituent party to the merger or consolidation, any conversion of the limited liability company to another business form, any transfer to or domestication in any jurisdiction by the limited liability company, or the sale of all or substantially all of the limited liability company's assets. The Court of Chancery shall have jurisdiction to hear and determine any matter relating to any such appraisal rights.

[23] Section 18-305(f) provides in pertinent part as follows:

> Any action to enforce any right arising under this section shall be brought in the Court of Chancery.

[24] Section 18-802 provides in pertinent part as follows:

> On 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.

However, private equity investment promoters concerned about the possible adverse impact of Section 18-802(a) will often be able to avoid this impact by specifying in the LLC agreement an LLC purpose that is so broad as to minimize the risk of member claims under it.[25]

(10) Section 18-803(a). Section 18-803(a) confers nonexclusive subject matter jurisdiction on the Court of Chancery to decide matters relating to the winding-up of LLCs after their dissolution. In addition, the section is probably best read as conferring on LLC members a mandatory right to seek third-party resolution of matters involving LLC wind-ups.[26] However, the section should not generally be troublesome to private equity investment promoters concerned about member rights to obtain third-party dispute resolutions, since, among other considerations, it is difficult to conceive that under any other LLC Act, a court would refuse to review a colorable claim of manager wrongdoing with regard to an LLC's winding-up.

In addition, Section 18-803(a) applies only "for cause shown." It is unlikely that the Court of Chancery would, for purposes of winding up an LLC, step into the shoes of persons duly appointed as LLC managers except upon a showing of compelling need.

In short, the mandatory provisions of the Delaware Act, although numerous, are unlikely to create business organization law problems for any high-stakes private equity deal; indeed, these provisions are far more likely to support these deals. However, in particular deals, it is possible that mandatory provisions contained in other LLC acts but not in the Delaware Act may favor one or more parties to the deal.

F. Permissive Provisions – General Considerations

As their name implies, permissive provisions in LLC acts are provisions that, rather than imposing particular LLC business organization law default or mandatory rules, authorize and validate these rules when adopted by LLC organizers in their operating agreements. An example is Section 18-301(d) of the Delaware Act, which, in effect, authorizes and validates operating agreement provisions that permit LLCs to admit persons as LLC

[25] However, Section 18-802 also applies in situations in which the members seek to dissolve the LLC because of manager misconduct or mismanagement. Obviously, no mere drafting strategy can suffice to bar an otherwise valid claim based on these grounds.

[26] Section 18-803(a) provides in pertinent part as follows:

> Unless otherwise provided in a limited liability company agreement, a manager who has not wrongfully dissolved a limited liability company or, if none, the members or a person approved by the members or, if there is more than 1 class or group of members, then by each class or group of members, in either case, by members who own more than 50 percent of the then current percentage or other interest in the profits of the limited liability company owned by all of the members or by the members in each class or group, as appropriate, may wind up the limited liability company's affairs; but the Court of Chancery, upon cause shown, may wind up the limited liability company's affairs upon application of any member or manager, the member's or manager's personal representative or assignee, and in connection therewith, may appoint a liquidating trustee.

members and to grant them economic rights in the LLC without making a contribution to the LLC. Section 18-301(d) provides as follows:

> A person may be admitted to a limited liability company as a member of the limited liability company and may receive a limited liability company interest in the limited liability company without making a contribution or being obligated to make a contribution to the limited liability company.

The significance of the permissive provisions of LLC acts for parties to high-stakes private equity deals is twofold. First, these provisions provide assurance to parties to these deals that if they adopt in their operating agreement the rules authorized in these provisions, they can be confident of the validity and enforceability of these rules.

Secondly, to the extent that it is important to any of the parties to obtain a legal opinion on an issue of the enforceability or validity of an operating agreement provision based on a particular permissive provision, the permissive provision in question obviously will make such an opinion both possible and reliable.

G. Permissive Provisions – the Delaware Act vs. Other LLC Acts

On LLC business organization law issues likely to be important in forming LLCs, including LLCs that will serve as vehicles for high-stakes private equity deals, the Delaware Act contains some 49 permissive provisions.[27] In high-stakes private equity deals, the more important business organization law rules that these provisions authorize and validate are likely to include the following:

- Managers May Be Individuals or Entities. Under Section 18-101(10) (when read together with Section 18-101(12)), the manager of an LLC may be either an individual or an entity.
- LLC Purpose. Under Section 18-106(a), an LLC may carry on any lawful business, purpose or activity, whether or not for profit.
- Indemnifications. Under Section 18-108, an LLC may indemnify any member or manager or other person from any and all claims and demands whasoever.
- Mergers. Under Section 18-209, LLCs may merge with domestic and foreign LLCs and non-LLC entities. .
- Conversions. Under Section 18-214(a), LLCs may convert into non-LLC entities and non-LLC entities may convert into LLCs.
- Membership without Contribution. As noted, under Section 18-301(d), a person may be admitted to an LLC and may receive an LLC interest without making a contribution or being obligated to do so.

[27] See Exhibit 9-14, *Drafting LLC Operating Agreement.*

- Nonvoting Members. Under Section 18-301(d), an LLC agreement may provide that any class or group of members shall have no voting rights. Section 18-302(a)(3).
- Voting Per Capita, Etc. Under Sections 18-304(a) and 404(a), an LLC agreement may prove for member and manager voting on a per capita, financial or any other basis.
- Penalties. Under Sections 18-306 and 405, an LLC agreement may (despite the normal rule of contract law prohibiting contractual penalties) impose penalties on members or managers for breaches of the agreement. .
- Allocations of Profits and Losses. Sections 18-503 and 504, the operating agreement may provide for the allocation of the LLC's profits and losses and the distribution of its profits and other assets "in any manner."
- Contractual Freedom. As discussed in Part II of this article, under Section 18-1101(b), an LLC agreement may provide for any other contractual arrangement among the members that does not materially conflict with Delaware public policy.[28]
- Expansion and Restriction of Fiduciary Duties. As discussed in Part II of this article, under Section 18-1101(c)2), the LLC agreement may expand or restrict any fiduciary duties and liabilities that a member, manager or other person may have toward the LLC or the members.

All other LLC acts contain at least a small number of permissive provisions. However, I am aware of no other LLC act that contains even a small fraction of the number of permissive provisions contained in the Delaware Act. In many high-stakes private equity deals, the fact that the Delaware Act contains so many more permissive provisions covering potentially important LLC arrangements can be an important factor in choosing the Delaware Act over other LLC acts as the act governing these deals.

IV CONCLUSION

There are several issues that parties to high-stakes private equity deals involving LLC formations must consider in determining whether the Delaware LLC Act will better

[28] The permissive provisions of the LLC acts of most larger states authorize most or all of the more important types of arrangements authorized by the permissive provisions of the Delaware Act. There are three types of arrangements that, to my knowledge, are permitted only by the Delaware Act – namely, transfers, domestications and series LLCs. Domestication is a process by which a non-U.S. entity becomes a Delaware LLC. Transfer is a process by which a Delaware LLC becomes a non-US entity. Series LLCs are those that have two or more "series" of members, managers or assets, each of which is immune from third-party claims against any other series o the same LLC. It is unlikely that the parties to any private equity deal will ever wish to avail themselves of a transfer or domestication, since, among other considerations, this will require enabling provisions under the laws of the relevant non-U.S. jurisdiction; but, to my knowledge, the laws of no jurisdiction except the Island of Nevis contain such provisions. In addition, although series LLCs can be useful in, among other things, simplifying the management structure of complex multi-asset enterprises, it is questionable whether the insulation of each series of such an LLC from each other series will be respected in non-Delaware courts.

advance their interests than the LLC acts of other jurisdictions. These include, for example, the availability of competent judges in the event of LLC disputes; the availability of LLC case law helpful to the parties in question; and the likelihood that as the years go by, the LLC act in question will be updated to address the parties' current business organization law needs and interests.

However, in more than a few such deals, the key factor in making the choice will be the specific statutory terms of the various competing acts. In addressing this factor, the parties and their lawyers must conduct a provision-by-provision comparison of the default, mandatory and permissive provisions of these acts and must make their choice on the basis of the overall impact of these provisions. If they conduct this comparison competently, they will usually – but by no means always – choose the Delaware Act.

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