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## Careful What You Wish For – Freedom of Contract and the Necessity of Careful Scrivening

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## Careful What You Wish For – Freedom of Contract and the Necessity of Careful Scrivening

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# Careful What You Wish For — Freedom of Contract and the Necessity of Careful Scrivening

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Led by Delaware, a bevy of states have inserted “Contract is God” provisions into their respective LLC statutes.<sup>1</sup> Freedom has its risks, and a trio of recent cases illustrate that “she or he who lives by the contractarian sword can get skewered by that sword” – especially if he or she is a transactional lawyer. This essay first provides some context by recalling a Delaware limited partnership case from 1998 and a Delaware LLC case from 2000 and then recounts and analyzes the trio of recent cases.

## “A Rose Is a Rose Is a Rose”<sup>2</sup> But a Cell Phone Might Not Be a Cell Phone

It is fitting to begin with a Delaware limited partnership case, because, as the Delaware Supreme Court has explained, “The Delaware [LLC] Act has been modeled on the popular Delaware LP Act. In fact, its architecture and much of its wording is almost identical to that of the Delaware LP Act ... The policy of freedom of contract underlies both the [LLC] Act and the LP Act.”<sup>3</sup>

In 1998, the Delaware Supreme Court decided *Cincinnati SMSA Ltd. P’ship v. Cincinnati Bell Cellular Sys. Co.*,<sup>4</sup> which concerned a limited partnership formed to develop a cell phone business. One partner invested in a competing venture that used “PCS” technology, and the limited partnership cried foul. The limited partnership agreement had specifically defined the partners’ non-compete duties, and – unfortunately for the plaintiff – the agreement phrased those duties in terms of technology rather than markets. The agreement prohibited competition as to cellular service but was silent as to PCS technology.

The plaintiff therefore had recourse to the implied covenant of good faith and fair

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<sup>1</sup> DEL. CODE ANN. tit. 6, § 18-1101(b) (West 2006) provides that:

“It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.” Similar or identical provisions appear in CONN. GEN. STAT. ANN. § 34-242(d) (West 2006); COLO. REV. STAT. ANN. § 7-80-108(4) (West 2006); GA. CODE ANN. § 14-11-1107(b) (West 2006); IDAHO CODE ANN. § 53-668(1) (2006); KAN. STAT. ANN. § 17-76,134(b) (2005); KY. REV. STAT. ANN. § 275.003 (West 2006); ME. REV. STAT. ANN. tit. 31, § 753 (2006); MISS. CODE ANN. § 79-29-1201(2) (West 2006); MO. REV. STAT. § 347.081(2) (West 2006); N.H. REV. STAT. ANN. § 304-C:78(II) (2006); N.J. STAT. ANN. § 42:2B-66(a) (West 2006); N.M. STAT. ANN. § 53-19-65(A) (West 2006); OKLA. STAT. tit. 18, § 2058(D) (2006); UTAH CODE ANN. § 48-2c-1901 (West 2006); VA. CODE ANN. § 13.1-1001.1(C) (West 2006); WASH. REV. CODE ANN. § 25.15.800(2) (West 2006); WIS. STAT. ANN. § 183.1302(1) (West 2006).

<sup>2</sup> Gertrude Stein, *Sacred Emily* (1913).

<sup>3</sup> *Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286, 290 (Del. 1999).

<sup>4</sup> *Cincinnati SMSA Ltd. P’ship v. Cincinnati Bell Cellular Sys. Co.*, 708 A.2d 989 (Del. 1998).

dealing, which at first thought seems quite plausible. “[T]he implied covenant of good faith and fair dealing requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain.”<sup>5</sup>

However, where contract is deity, you shall know the fruit by reading narrowly the words of the contract. “[I]mplying obligations based on the covenant of good faith and fair dealing is a cautious enterprise,”<sup>6</sup> and the implied covenant is not a safety net for less-than-prescient drafting:

In this case, the plaintiff articulates a policy argument, which is cogent at first blush, in support of implying an additional noncompete obligation with respect to PCS. The Limited Partnership sets forth two circumstances underlying its case: (1) the development and licensing of PCS was unforeseen at the time the parties entered into the Agreement; and (2) from a subscriber’s perspective, PCS and “Cellular Service” are indistinguishable. The Limited Partnership concludes that, based on principles of good faith and fair dealing, partners are also forbidden to compete with the Limited Partnership through independent interests in PCS, even though PCS does not fall within the strict definition of “Cellular Service” in the Agreement. Cogent as this argument might have been ex ante when the Agreement was negotiated, it is not a persuasive argument to vary the Agreement ex post.<sup>7</sup>

Thus the plaintiff lost, because “[i]t is the task of the parties [not the courts] to refashion the agreement to reflect new developments.”<sup>8</sup> Translation: if the limited partnership wanted a noncompete based on markets [well, duh], its business people and lawyers should have figured that out and written it down.<sup>9</sup>

## Walker [not the Texas Ranger], at the Turn of the Century

In 2000, the Delaware Chancery Court decided a case involving an LLC member’s failure to provide part of the consideration he had promised in return for his membership interest, as well as sundry other misconduct.<sup>10</sup> The other three members apparently believed that the failure of consideration warranted cancellation of the membership interest, but the operating

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<sup>5</sup> *Chrin v. Ibrix Inc.*, No. Civ. A 20587, 2005 WL 2810599, at \*7 (Del. Ch. Oct. 19, 2005) (citing *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 442 (Del. 2005)).

<sup>6</sup> *Cincinnati SMSA Ltd. P’ship*, 708 A.2d at 992.

<sup>7</sup> *Id.* at 993 (footnote omitted).

<sup>8</sup> *Id.* at 993, n.20 (quoting *Coca-Cola Bottling Co. of Elizabethtown, Inc. v. The Coca-Cola Co.*, 988 F.2d 386, 404 (3d Cir. 1993)).

<sup>9</sup> The result is even more noteworthy given the court’s delineation of the proper province for using good faith as a gap filler: “where obligations can be understood from the text of a written agreement but have nevertheless been omitted in the literal sense, a court’s inquiry should focus on what the parties likely would have done if they had considered the issue involved.” *Id.* at 992 (quoting *DuPont v. Pressman*, 679 A.2d 436, 443 (Del. 1996)).

<sup>10</sup> *Walker v. Res. Dev. Co. Ltd., L.L.C. (DE)*, 791 A.2d 799 (Del.Ch. 2000).

agreement did not so provide. The result was a lesson in drafting from the Vice Chancellor and a constructive trust in favor of the miscreant member “for the expropriation of [his] equity interest.”<sup>11</sup>

Article XXII [of the Operating Agreement], does address the voluntary and involuntary withdrawal from membership but identifies no instance even arguably applicable in this case. The absence of such a provision is surprising, considering what the three Bills [the controlling members] knew about Walker [the minority member] at the time they entered into this agreement. They knew that he had embarrassed the company, experienced bouts of drunkenness and alcohol abuse, misrepresented his sophistication in financing transactions and borrowed money from the very person with whom he was supposed to be negotiating on [the company’s] behalf. Most importantly, they knew or had every reason to know that if the Appian deal fell through, they could not rely on Walker to find an alternative source of financing for [the company]. Thus, the three Bills could easily have protected themselves in the Operating Agreement against the failure of negotiations [in the Appian deal] by simply making Walker’s [LLC] interest contingent on successfully closing a deal with Appian. They failed to do so for reasons that are unexplained. Since the Operating Agreement does not justify Walker’s removal, defendants are left to the default rules [which provided no recourse].<sup>12</sup>

## Case One of the Trio — The Duty to Scriven Carefully

A more recent Delaware case contains a similar lesson on careful drafting, this time including the elegantly-phrased admonition to “scriven with precision.”<sup>13</sup> *Willie Gary LLC v. James & Jackson LLC* involved an LLC whose operating agreement purported to require the arbitration of disputes pertaining to the operating agreement while also permitting members to bring to court claims for injunctive relief and for dissolution.<sup>14</sup> The result was an arbitration provision empty of force, since virtually any contractual dispute can be styled so as to appear to warrant injunctive relief and any serious contractual dispute can justify an attempt to apply the “not reasonably practicable” standard for dissolution.<sup>15</sup>

The Vice Chancellor was direct in his criticism of the drafting: “With the contractual freedom granted by the LLC Act comes the duty to scriven with precision. Regrettably for J & J

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<sup>11</sup> Id. at 801.

<sup>12</sup> Id. at 813-814.

<sup>13</sup> *Willie Gary LLC v. James & Jackson LLC*, No. Civ.A. 1781, 2006 WL 75309, at \*2 (Del.Ch. Jan. 10, 2006), *aff’d*, No. 59, 2006, 2006 WL 659300 (Del. Mar 14, 2006).

<sup>14</sup> Id.

<sup>15</sup> Like many LLC statutes, the Delaware LLC Act empowers a court to dissolve a limited liability company “Whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement.” Del. Code Ann.tit. 6 § 18- 802 (West 2006). For a detailed analysis of this standard, which derives from the Revised Uniform Limited Partnership Act, see CARTER G. BISHOP & DANIEL S. KLEINBERGER, *LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW* ¶ 9.02[7][a][i].

[the party seeking to compel arbitration], the drafters of the MBC LLC Agreement crafted an unwieldy dispute resolution scheme that gives parties alleging claims for compulsory relief the right to litigate, rather than arbitrate, their claims.”<sup>16</sup>

## Case Two of the Trio — Is That an Offer in Your Pocket or Are You Just Glad to See Me ...Go?

Georgia was an early convert to Delaware’s contract-as-deity approach, enacting the “maximum effect” language in 1993.<sup>17</sup> Georgia courts take seriously the legislative instruction, and a recent decision by the Georgia Court of Appeals illustrates that in Georgia, as in Delaware:

- “in the alternative entity context, it is frequently impossible to decide fiduciary duty claims without close examination and interpretation of the governing instrument of the entity giving rise to what would be, under default law, a fiduciary relationship”<sup>18</sup> and, as result,
- seemingly straightforward provisions in “the governing instrument” can have unanticipated consequences on questions of fiduciary duty.

The case, *Ledford v. Smith*,<sup>19</sup> involved an LLC that had as members both “hands on” folks and a passive investor (Dyna-Vision). The operating agreement labeled the former “Active Members” and contained a provision permitting either the Active Members or Dyna-Vision to trigger a “Mandatory Put and Call” by giving a “Notice of Offer to Sell or Purchase.”<sup>20</sup> Under that provision, the Notice had to specify the buy/sell price. Then:

The Members receiving the Notice of Offer to Sell or Purchase shall have thirty (30) calendar days to decide whether to sell all their Interest at that price or to purchase all the Interest of the group giving Notice of Offer to Sell or Purchase at the Price set forth in the Notice of Offer to Sell or Purchase.<sup>21</sup>

The Active Members triggered the Mandatory Put and Call, and Dyna-Vision decided to sell. Later, Dyna-Vision learned that, when the Active Members gave the Notice, they had in

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<sup>16</sup> *Willie Gary LLC*, 2006 WL 75309 at \*2. The Vice Chancellor was equally blunt with regard to J & J’s efforts to construe the LLC agreement as permitting resort to the court only if arbitration failed to timely address an urgent situation. He characterized J & J’s argument as “a litigator’s invention that is not supported in any manner by the text of the LLC Agreement.” *Id.* at \*9. See *Ishimaru v. Fung*, No. Civ.A. 929, 2005 WL 2899680, at \*12 (Del.Ch. Oct 26, 2005) (“As is common in LLC Agreements these days, the provisions dealing with the managing member’s duties and rights ... can be read as contradictory and confusing.”).

<sup>17</sup> Charles R. Beaudrot, Jr. and Kendall Houghton, *Effective Use of Limited Liability Companies in Georgia: An Overview of Their Characteristics and Advantages*, 45 Mercer L. Rev. 25, 29 (1993) (“The first principle that the drafters used in preparing the Georgia statute was to endorse freedom of contract to the fullest extent possible.”).

<sup>18</sup> *Douzinias v. ABS Nautical Sys., LLC, Nominal Defendant*, 888 A.2d 1146, 1149-1150 (Del. Ch. 2006).

<sup>19</sup> *Ledford v. Smith*, 618 S.E.2d 627 (Ga. Ct. App. 2005), cert. denied (Nov. 18, 2005).

<sup>20</sup> *Id.* at 630.

<sup>21</sup> *Id.* At 630.

hand an offer from a third party to purchase the LLC's assets:

On April 30, 2002, Dyna-Vision and the Active Members closed on the sale of Dyna-Vision's interest in SHC [the LLC] to the Active Members for \$3.5 million, which the Active Members financed with a loan from Peeples [the third party]. On May 7, 2002, SHC sold its assets to PFLC, a company controlled by Peeples. PFLC paid SHC \$2.5 million for its assets and Peeples forgave the \$3.5 million loan to the Active Members.<sup>22</sup>

Naturally, Dyna-Vision cried foul, invoking the affirmative duty of disclosure owed by those in a fiduciary relationship.<sup>23</sup> The Court of Appeals said no, giving a narrow reading to an operating agreement provision that required each member to disclose offers to purchase membership units (inapplicable, stated the court, to *asset* purchase offers)<sup>24</sup> and an expansive interpretation to another provision that delineated and restricted the fiduciary duty not to compete.

The latter provision appeared to be a fairly standard, limited authorization to compete:

The Members and their respective Affiliates may engage in all such other business ventures, including without limitation ventures involving the purchase, sale and operation of other businesses, but no Active Member shall engage in businesses similar to the business of the Company by competing with the business of the Company while they are employed with the Company<sup>25</sup>

The Court of Appeals, however, read between the lines and discovered a quite unusual ramification:

This provision gave the Active Members wide latitude to engage in all other business activities except those 'similar to the business of' SHC, that is, a 'competing' carpet company. The provision was broad enough to allow the Active Members to negotiate with Peeples for the purpose of obtaining financing to fund their buy-out of Dyna-Vision's interest in SHC. This activity did not 'compete' with SHC; thus, it did not fall within the exception. Any fiduciary duty of disclosure that the Active Member's may have owed Dyna-Vision with respect to such a business arrangement was eliminated by the terms of an operating agreement that allowed the business activity which occurred.<sup>26</sup>

Evidently, the contractual permission to compete with the LLC as a business meant (implicitly) that the members were at arm's length when deciding who would own the business.

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<sup>22</sup> Id. at 633.

<sup>23</sup> Id. at 633-635. For a discussion of the duty of disclosure under Delaware law, see BISHOP & KLEINBERGER, *supra* note 15, at ¶ 14.05(3A).

<sup>24</sup> Id. at 633-635.

<sup>25</sup> Id. at 631.

<sup>26</sup> Id. at 636.

## Case Three of the Trio — The Books Might Be Cooked But At Least the Deal Is Final

*American Anglian Environmental Technologies, v. Environmental Management Corporation* involved a two member LLC with the same type of “buy or sell” provision as was at issue in *Ledford v. Smith*.<sup>27</sup> The American Anglian operating agreement “contained a buy/sell provision allowing either [member] to make an unconditional offer/acceptance at a price it chose — forcing the offeree to choose either to buy the offeror’s entire interest, or to sell the offeree’s entire interest.”<sup>28</sup>

Environmental Management Corporation (EMC) triggered the buy-sell provision, and American Anglian Environmental Technologies (AAET) decided to buy.<sup>29</sup> “Throughout the company’s life, EMC managed the financial affairs and day-to-day business operations of the company,” which included maintaining the LLC’s books,<sup>30</sup> and after the closing AAET discovered that EMC’s accounting methods violated generally accepted accounting principles. Asserting that the accounting irregularities breached EMC’s duties under the operating agreement and inflated the company’s value by \$713,000, AAET sued EMC for damages.<sup>31</sup>

The Court could have disposed of this claim on causation grounds. Missouri law precludes recovery of damages for “a contingent, speculative possibility”<sup>32</sup> and “AAET never state[d] that it would have sold — rather than bought — half of the company [had accurate accounting figures been provided]. AAET’s strongest statement is that it would have ‘considered’ selling.”<sup>33</sup>

Unfortunately, the Court made this point only as part of a broader pronouncement about “freedom of contract” under the Missouri LLC Act. Invoking “the policy of Missouri [which is] to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements,”<sup>34</sup> the Court:

- stated that “[t]he buy/sell provision in the Operating Agreement is intended to achieve finality, expeditiousness, fairness and continuity”<sup>35</sup> and
- held that the member’s “requested relief is prohibited by the Operating Agreement [which] provides: once the buy/sell offer is made, it is ‘irrevocable,’ ‘shall not be conditioned on anything,’ and ‘requires no representations and warranties.’”<sup>36</sup>

In sum, the operating agreement “preempts recalculating the price and ‘other steps’ for relief (other than enforcing the buy/sell provision).”<sup>37</sup>

It does not seem that MET accused EMC of acting with *scienter*, and the opinion does not mention that concept. However, read broadly the holding could encompass even active

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<sup>27</sup> *Am. Anglian Envtl. Tech., L.P. v. Envtl. Mgmt. Corp.*, 412 F.3d 956 (8th Cir. 2005).

<sup>28</sup> *Id.* at 957.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at 959.

<sup>31</sup> *Id.* at 957.

<sup>32</sup> *Id.* at 962.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* at 961-962

<sup>37</sup> *Id.* at 962.



misrepresentation.

## **Aesop**

An old man that had travell'd a great way under a huge burden of sticks, found himself so weary, that he cast it down, and call'd upon Death to deliver him from a more miserable life. Death came presently at his call, and asked him his bus'ness. Pray good sir, says he, do me but the favour to help me up with my burden again.<sup>38</sup>

Unbridled fiduciary duty is not exactly a huge burden of sticks, and contract-as-deity is not Death. However, for lawyers drafting operating agreements in a "freedom of contract" regime, Aesop's fable is worth remembering.

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<sup>38</sup> Aesop fable, *The Old Man and Death*, <http://tomsdomain.com/aesop/id98.htm> (last visited 9/27/2006).