Business Divorce: Dissolving LLCs Under Delaware Law

Kurt M. Heyman

PROCTOR HEYMAN LLP

PRACTICING THE ART OF LAW

Wilmington, Delaware

I. Dissolution of LLCs vs. Other Business Forms

A. LLCs serve same essential tax function as S corporations and limited partnerships: Pass-through taxation, limited liability.

B. Delaware LLC Act (6 *Del. C.* § 18-101, *et seq.*) tracks Delaware Revised Uniform Limited Partnership Act (6 *Del. C.* § 17-101, *et seq.*).

C. LLCs are creatures of contract, so the first place to look for standards governing dissolution is the LLC agreement itself. 6 *Del. C.* § 18-1101("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.")

D. Statute provides little guidance on its face (6 *Del. C.* §§ 18-801, 802), as discussed more fully below.

E. Courts have looked to corporate law for guidance on dissolution, particularly issue of deadlock, while insolvency plays a lesser role.

II. Dissolution of LLCs: Statutory Framework

A. Statutory Provisions

1. Section 18-801. Dissolution.

(a) A limited liability company is dissolved and its affairs shall be wound up upon the first to occur of the following:

(1) At the time specified in a limited liability company agreement, but if no such time is set forth in the limited liability company agreement, then the limited liability company shall have a perpetual existence;

(2) Upon the happening of events specified in a limited liability company agreement;

(3) Unless otherwise provided in a limited liability company agreement, upon the affirmative vote or written consent of the members of the limited liability company 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 2/3 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;

(4) At any time there are no members . . . .

*Judicial assistance may be sought to enforce or declare these events of dissolution. In re NextMedia Investors, LLC, 2009 WL 1228665, *1 (Del. Ch.) (finding that event of dissolution had occurred under agreement). But this is different than "judicial dissolution," discussed below.*

2. Section 18-802. Judicial Dissolution

Not a great deal of statutory guidance:

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.

B. Standing to Seek Dissolution

1. Member: Section 18-101(11).

"Member" means a person who is admitted to a limited liability company as a member . . . .

2. Manager: Section 18-101(10).

"Manager" means a person who is named as a manager of a limited liability company in, or designated as a manager of a limited liability company pursuant to, a limited liability company agreement or similar instrument under which the limited liability company is formed.

Not same for purposes of service of process. Section 18-109(a) ("As used in this subsection (a) ..., the term "manager" refers (i) to a person who is a manager as defined in § 18-101(10) of this title and (ii) to a person, whether or not a member of a limited liability company, who, although not a manager as defined in § 18-101(10) of this title, participates

materially in the management of the limited liability company; provided however, that the power to elect or otherwise select or to participate in the election or selection of a person to be a manager as defined in § 18-101(10) of this title shall not, by itself, constitute participation in the management of the limited liability company.").

3. Assignment and Effect on Standing

Counterintuitive presumptions:

1. Section 18-702(b)(3)

Unless otherwise provided in a limited liability company agreement … A member ceases to be a member and to have the power to exercise any rights or powers of a member upon assignment of all the member's limited liability company interest.

2. Section 18-702(b)(1)

Unless otherwise provided in a limited liability company agreement … An assignment of a limited liability company interest does not entitle the assignee to become or exercise any rights or powers of a member . . . .

C. Judicial Interpretation of Dissolution Standards/Illustrative Cases

Judicial Dissolution and "Reasonable Impracticability" (to carry on the business in conformity with a limited liability company agreement)

1. Ability to Continue Pursuing Defined Purpose of LLC

a. Broad Purpose (e.g., "any lawful activity")

Difficult to establish reasonable impracticability.

Wiggs v. Summit Midstream Partners, LLC, 2013 WL 1286180 (Del. Ch.)

b. Narrow Purpose (e.g., to promote a specific brand)

Easier to establish reasonable impracticability if the ability to achieve the limited purpose is impaired.

Vila v. BVWebTies LLC, 2010 WL 3866098, *7 (Del. Ch.) ("Now that Vila has withdrawn the Vila IP, it is silly to think that WebTies can continue to operate 'BobVila.com.' It cannot.")

In re Silver Leaf, LLC, 2005 WL 2045641, *11 (Del. Ch.) (noting that where the LLC had lost its operative asset - a sales and marketing agreement - it had no more business to operate and an order of judicial dissolution was proper)

2. Insolvency

Common basis for dissolution of corporations. Not always relevant when considering purpose of LLC (although insolvency may go hand-in-hand with losing sole operating asset, as in *Sliver Leaf, supra*).

PC Tower Center, Inc. v. Tower Center Development Associates, 1989 WL 63901 (Del. Ch.) (dissolving insolvent LP under analogous statute where stated purpose was to operate for profit).

But see Cincinnati Bell Cellular Systems Co. v. Ameritech Mobile Phone Service of Cincinnati, Inc., 1996 WL 506906, *19 (Del. Ch.) (refusing to dissolve unprofitable partnership under analogous statute where agreement provided for *capital calls* and was silent as to performance, profitability or even expected time for limited partners to receive particular return on their investment).

3. Deadlock

Not mentioned in LLC dissolution statute, but has become most common basis for seeking dissolution of two-member LLCs.

a. Availability of Exit Mechanism

Court will look to availability of exit mechanisms before ordering judicial dissolution based on deadlock. Will consider judicial dissolution if exit mechanisms are not viable, *e.g.*, if they are voluntary rather than mandatory*, see Lola Cars Intern. Ltd. v. Krohn Racing, LLC,* 2009 WL 4052681, *6 (Del. Ch.), or inadequate because it would leave the departing member liable for the debt of an entity over which he had no further control, *see Haley v. Talcott*, 864 A.2d 86, 88 (Del. Ch. 2004).

b. *Haley v. Talcott* makes analogy to Section 273 of DGCL:

If the stockholders of a corporation of this state, having only 2 stockholders each of whom own 50% of the stock therein, shall be engaged in a joint venture and if such stockholders shall be unable to agree upon the desirability of discontinuing such joint venture and disposing of the assets used in such venture, either stock holder may, unless otherwise provided in the certificate of incorporation of the corporation or in a written agreement between stockholders, file with the Court of Chancery a petition stating that it desires to discontinue such joint venture and to dispose of the assets used in such venture in accordance with a plan to be agreed on by both stockholders or that, if no such plan shall be agreed upon by both stockholders, the corporation be dissolved.

Note that this statute actually references something like "deadlock," unlike the LLC statute.

c. Prerequisites to Dissolution Based on Deadlock in *Haley v. Talcott*

1. Two 50% members of LLC. This might be a limiting factor but for the apparent existence of many two-member LLCs. Plus, Court has expanded beyond precise situation:
2.

See, e.g., Lola Cars Intern. Ltd. v. Krohn Racing, LLC, 2009 WL 4052681, *6 (Del. Ch.) (unequal ownership between two members but equal representation on board); *Fisk Ventures, LLC v. Segal,* 2009 WL 73957 (Del. Ch.) (multiple members but dissolving on basis of deadlock of five board members).

3. Engaged in a joint venture. This essentially means that neither member agreed to be a passive investor. There can be litigation over the "joint venture" prong.

4. Unable to agree on whether to discontinue the business or how to dispose of its assets. This essentially means that even a disagreement over whether to dissolve can be a deadlock for dissolution purposes, which is arguably circular.

d. Other Recognized Grounds for Finding Deadlock

1. Inability to reach threshold for board vote on any issue

2. Inability to agree to hold board meeting or to vote on an issue

3. Inability to agree on terms for raising and use of operating capital

5. Disagreement over whether to replace CEO

6. Disputes over strategic vision, current operation, major initiatives

7. Disagreement over renewing LLC office lease or renewing lease to tenant of LLC

III. Contractual Restrictions on LLC Dissolution

A. Waiver

R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, 2008 WL 3846318, *6 (Del. Ch.):

Sections 18-802, 18-803, and 18-805 are not mandatory provisions of the LLC Act that cannot be modified by contract. … Because the waiver of a member's right to petition for dissolution or the appointment of a receiver does not violate the LLC Act and does not interfere with the rights of third parties, the waiver is valid and enforceable under the statute.

Surprise Ruling: Section 18-802 does not contain the qualification "unless otherwise provided in a limited liability company agreement," unlike many other sections of the LLC Act, so many practitioners believed that judicial dissolution was non-waivable.

B. Compulsory Buy-Out

1. Due to policy of freedom of contract, Court likely to enforce contractual terms.
2. Availability of viable buy-out mechanism could result in denial of judicial dissolution. *Haley v. Talcott*, 864 A.2d 86, 88 (Del. Ch. 2004).
3. No compulsory buy-out under statutory or common law, although it could be a remedy in dissolution.

C. Forfeiture

Equity, of course, abhors a forfeiture, but the dissolution case law is essentially silent on the issue of forfeiture, suggesting that dissolution in accordance with the terms of an LLC agreement or judicial dissolution on grounds of deadlock are not viewed as resulting in a forfeiture.

IV. Remedies in LLC Dissolution

A. Winding Up and Liquidation/Receivership

1. Section 18-803. Winding Up.

(a) 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, or the member's personal representative or assignee, and in connection therewith, may appoint a liquidating trustee.

(b) Upon dissolution of a limited liability company and until the filing of a certificate of cancellation as provided in § 18-203 of this title, the persons winding up the limited liability company's affairs may, in the name of, and for and on behalf of, the limited liability company, prosecute and defend suits, whether civil, criminal or administrative, gradually settle and close the limited liability company's business, dispose of and convey the limited liability company's property, discharge or make reasonable provision for the limited liability company's liabilities, and distribute to the members any remaining assets of the limited liability company, all without affecting the liability of members and managers and without imposing liability on a liquidating trustee.

2. Section 18-804. Distribution of Assets.

(a) Upon the winding up of a limited liability company, the assets shall be distributed as follows:

(1) To creditors, including members and managers who are creditors, to the extent otherwise permitted by law, in satisfaction of liabilities of the limited liability company (whether by payment or the making of reasonable provision for payment thereof) other than liabilities for which reasonable provision for payment has been made and liabilities for distributions to members and former members under § 18-601 or § 18-604 of this title;

(2) Unless otherwise provided in a limited liability company agreement, to members and former members in satisfaction of liabilities for distributions under § 18-601 or § 18-604 of this title; and

(3) Unless otherwise provided in a limited liability company agreement, to members first for the return of their contributions and second respecting their limited liability company interests, in the proportions in which the members share in distributions.

(b) A limited liability company which has dissolved:

(1) Shall pay or make reasonable provision to pay all claims and obligations, including all contingent, conditional or unmatured contractual claims, known to the limited liability company;

(2) Shall make such provision as will be reasonably likely to be sufficient to provide compensation for any claim against the limited liability company which is the subject of a pending action, suit or proceeding to which the limited liability company is a party; and

(3) Shall make such provision as will be reasonably likely to be sufficient to provide compensation for claims that have not been made known to the limited liability company or that have not arisen but that, based on facts known to the limited liability company, are likely to arise or to become known to the limited liability company within 10 years after the date of dissolution.

If there are sufficient assets, such claims and obligations shall be paid in full and any such provision for payment made shall be made in full. If there are insufficient assets, such claims and obligations shall be paid or provided for according to their priority and, among claims of equal priority, ratably to the extent of assets available therefor. Unless otherwise provided in the limited liability company agreement, any remaining assets shall be distributed as provided in this chapter. Any liquidating trustee winding up a limited liability company's affairs who has complied with this section shall not be personally liable to the claimants of the dissolved limited liability company by reason of such person's actions in winding up the limited liability company.

(c) A member who receives a distribution in violation of subsection (a) of this section, and who knew at the time of the distribution that the distribution violated subsection (a) of this section, shall be liable to the limited liability company for the amount of the distribution. For purposes of the immediately preceding sentence, the term “distribution” shall not include amounts constituting reasonable compensation for present or past services or reasonable payments made in the ordinary course of business pursuant to a bona fide retirement plan or other benefits program. A member who receives a distribution in violation of subsection (a) of this section, and who did not know at the time of the distribution that the distribution violated subsection (a) of this section, shall not be liable for the amount of the distribution. Subject to subsection (d) of this section, this subsection shall not affect any obligation or liability of a member under an agreement or other applicable law for the amount of a distribution.

(d) Unless otherwise agreed, a member who receives a distribution from a limited liability company to which this section applies shall have no liability under this chapter or other applicable law for the amount of the distribution after the expiration of 3 years from the date of the distribution unless an

action to recover the distribution from such member is commenced prior to the expiration of the said 3-year period and an adjudication of liability against such member is made in the said action.

(e) Section 18-607 of this title shall not apply to a distribution to which this section applies.

3. Section 18-805. Trustees or receivers for limited liability companies; appointment; powers; duties.

When the certificate of formation of any limited liability company formed under this chapter shall be canceled by the filing of a certificate of cancellation pursuant to § 18-203of this title, the Court of Chancery, on application of any creditor, member or manager of the limited liability company, or any other person who shows good cause therefor, at any time, may either appoint 1 or more of the managers of the limited liability company to be trustees, or appoint 1 or more persons to be receivers, of and for the limited liability company, to take charge of the limited liability company's property, and to collect the debts and property due and belonging to the limited liability company, with the power to prosecute and defend, in the name of the limited liability company, or otherwise, all such suits as may be necessary or proper for the purposes aforesaid, and to appoint an agent or agents under them, and to do all other acts which might be done by the limited liability company, if in being, that may be necessary for the final settlement of the unfinished business of the limited liability company. The powers of the trustees or receivers may be continued as long as the Court of Chancery shall think necessary for the purposes aforesaid.

4. Section 18-806. Revocation of dissolution.

If a limited liability company agreement provides the manner in which a dissolution may be revoked, it may be revoked in that manner and, unless a limited liability company agreement prohibits revocation of dissolution, then notwithstanding the occurrence of an event set forth in § 18-801(a)(1), (2), (3) or (4) of this title, the limited liability company shall not be dissolved and its affairs shall not

be wound up if, prior to the filing of a certificate of cancellation in the office of the Secretary of State, the limited liability company is continued, effective as of the occurrence of such event:

(1) In the case of dissolution effected by the affirmative vote or written consent of the members or other persons, pursuant to such affirmative vote or written consent (and the approval of any members or other persons whose approval is required under the limited liability company agreement to revoke a dissolution contemplated by this paragraph);

(2) In the case of dissolution under § 18-801(a)(1) or (2) of this title (other than a dissolution effected by the affirmative vote or written consent of the members or other persons or the occurrence of an event that causes the last remaining member to cease to be a member), pursuant to such affirmative vote or written consent that, pursuant to the terms of the limited liability company agreement, is required to amend the provision of the limited liability company agreement effecting such dissolution (and the approval of any members or other persons whose approval is required under the limited liability company agreement to revoke a dissolution contemplated by this paragraph); and

(3) In the case of dissolution effected by the occurrence of an event that causes the last remaining member to cease to be a member, pursuant to the affirmative vote or written consent of the personal representative of the last remaining member of the limited liability company or the assignee of all of the limited liability company interests in the limited liability company (and the approval of any other persons whose approval is required under the limited liability company agreement to revoke a dissolution contemplated by this paragraph).

If there is no remaining member of the limited liability company and the personal representative of the last remaining member or the assignee of all of the limited liability company interests in the limited liability company votes in favor of or consents to the continuation of the limited liability company, such personal representative or such assignee, as applicable, shall be required to agree in writing to the admission of a nominee or designee as a member, effective as of the occurrence of the event that terminated the continued membership of the last remaining member. The provisions of this section

shall not be construed to limit the accomplishment of a revocation of dissolution by other means permitted by law.

5. Judicial Nullification of Dissolution.

In *Metro Commc'n Corp. BVI v. Advanced Mobilecomm Techs., Inc*., 854 A.2d 121 (Del. Ch. 2004), plaintiff filed a breach of contract claim against both a limited liability company which had already filed its certificate of cancellation as well as the LLC's former managers. *Id*. at 129-130. The dissolved LLC moved to dismiss, relying on common law supposedly providing that no claim may be brought against a dissolved entity absent statutory authority, and 6 *Del. C.* § 18-803(b) for the proposition that suit may be brought against an LLC only until its certificate of cancellation is filed. *Id*. at 138. In denying defendants' motion, then-Vice Chancellor Strine noted that plaintiff had "explicitly sought to have the certificate of cancellation nullified on the ground that [the LLC's] affairs were not 'wound up in compliance' with the LLC Act." *Id*. at 138-39 (citation omitted). In particular, plaintiff alleged that defendants knew plaintiff's claim would arise within ten years yet nevertheless prior to filing a certificate of cancellation, "failed to 'make such provision as will be reasonably likely to be sufficient to provide compensation' for that claim, in violation of 6 *Del. C.* § 18-804(b)(3)." *Id*. at 139. The Court concluded that "because the complaint pleads facts that support the inference that [the LLC] was wound up in contravention of the LLC Act, the complaint also pleads facts that support an application to nullify the certificate of cancellation." *Id.*

B. Buyout as a Remedy

Delaware does not recognize the tort of "minority oppression," nor is there a statutory or common law right of minority equity holders to be bought out in the absence of a contractual buyout mechanism. That said, a

buyout or bidding process is becoming a preferred remedy in dissolution cases, with the exact procedures for the buyout varying on a case-by-case basis. *See, e.g., McGovern v. General Hldg., Inc.*, 2006 WL 1468850, *24 (Del. Ch.) (ordering a bidding process in an LLC dissolution case while precluding one party from bidding, noting this Court's "capacious remedial discretion . . . to address inequity"); *Haley v. Talcott*, 864 A.2d 86 (Del. Ch. 2004) (ordering dissolution of LLC and sale of property held by LLC and permitting parties to bid on it); *In re Interstate General Media Holdings, LLC,* 2014 WL 1697030 (Del. Ch.) (ordering dissolution of LLC and sale in a private "English-style" open ascending auction between the members with a minimum bid).