

***“Benefits of Being a Delaware Company
and Recent Developments in the Governance of LLCs”***

By: Francis G.X. Pileggi, Esquire*
and Sophia Siddiqui, Esquire*

The advantages of a Delaware corporate domicile and of governance by Delaware’s corporate laws are well-known and have been the subject of many articles.¹ One of the many benefits enjoyed by Delaware companies is Delaware’s court system.²

Two examples of the favorable view that many around the country have for the Delaware Court system illustrate the point. First, in CA, Inc. v. AFSCME Employees Pension Plan, No. 329, 2008 (Del., July 17, 2008), the Securities and Exchange Commission (“SEC”) certified novel questions of law regarding corporate bylaws to the Delaware Supreme Court. The SEC utilized a procedure created by an amendment to the Delaware State Constitution just last year to allow the SEC to address questions of Delaware law to the Delaware Supreme Court.³ Previously, Delaware’s high court was only procedurally authorized to accept certified questions of Delaware law from trial courts in Delaware and federal courts across the country, as well as the highest courts of each state.

In sum, the issue involved a shareholder of CA, Inc., the trillion dollar pension fund of AFSCME, who proposed a bylaw amendment that would require the company to reimburse a shareholder for expenses related to nominating a less than full slate to the board of directors.⁴ The SEC asked the Delaware Supreme Court to determine: (1) whether the AFSCME proposal was a proper subject for action by shareholders as a matter of Delaware law; and (2) whether the AFSCME proposal, if adopted, would cause CA, Inc. to violate any Delaware law to which it is subject.⁵ The Court answered both questions affirmatively, holding that although bylaws generally address procedures related to board elections, the bylaw proposed would impermissibly restrict the managerial and fiduciary duties of the board. However, the Court suggested that the same goal could be achieved by other means, such as amending the certificate of incorporation.⁶

AFSCME illustrates the predictable efficiency and expertise of the Delaware Courts. The state’s highest court rendered the AFSCME decision within a week of hearing oral argument – even though the briefs were submitted merely two days prior to oral argument.

A second example also has a national scope. In its annual survey of the legal systems of the 50 states based on corporate lawyers who were polled, and for the seventh year in a row, the U.S. Chamber of Commerce concluded that the Delaware Court system retained its number 1 ranking among the states in most categories, such as judicial competence, judicial impartiality, timeliness

¹ See e.g., Timothy P. Glynn, *Delaware’s Vantagepoint: The Empire Strikes Back In the Post-Enron Era*, 102 NW. U.L. Rev. 91, 128 (Winter 2008).

² See, e.g., Stephen Bainbridge, *Delaware’s Dominance*, available at http://www.businessassociationsblog.com/lawandbusiness/comments/delawares_dominance1/.

³ See DEL. CONST. art. IV, § 11.

⁴ AFSCME, No. 329, 2008, slip. op. at 2.

⁵ Id. at 4.

⁶ Id. at 23-24.

of summary judgment or dismissal, treatment of class action suits, and overall treatment of tort and contract litigation.⁷ A recent article also described the national preeminence of Delaware as a preferred forum for resolving corporate issues:

In its more than 200 years, the Court of Chancery has become the forum of choice for determining disputes that involve the internal affairs of corporations and other business entities. It has developed a respected body of case law interpreting the Delaware General Corporation Law and earned a worldwide reputation for fairness, experience, and expertise in presiding over corporate disputes.⁸

Statistics:

- Delaware is the legal home of more than 846,000 business entities, including:⁹
 - More than 280,000 corporations and 400,000 alternative entities,¹⁰
 - 61 percent of the Fortune 500 companies,¹¹
 - More than 90 percent of all U.S.-based public offerings in 2007,¹²
 - More than 50% of all publicly-traded companies in the U.S.,¹³
 - 81 percent of the publicly traded companies to make initial stock purchase offerings in the last five years.¹⁴
- Delaware Department of State, Division of Corporations prides itself as a service organization.¹⁵

⁷ See 2007 U.S. Chamber of Commerce State Liability Systems Ranking Study, United States Chamber of Commerce Institute for Legal Reform (March 17, 2006), available at http://www.instituteforlegalreform.com/lawsuitclimate2007/pdf/Liability_System_Ranking_Study.pdf (last visited July 26, 2008).

⁸ Donald F. Parsons Jr. and Joseph R. Slight III, *The History of Delaware Business Courts, Their Rise to Preeminence*, Business Law Today (March/April 2008). (Parsons is a vice-chancellor on Delaware's Chancery Court.)

⁹ See 2007 Annual Report, Delaware Department of State Division of Corporations, at 1, <http://corp.delaware.gov/2007DivCorpAR.pdf> (last visited June 10, 2008). See also Ann E. Conway, Lessons to be Learned: How the Policy of Freedom to Contract in Delaware's Alternative Entity Law Might Inform Delaware's General Corporation Law, Widener University School of Law Symposium, The Delaware General Corporation Law for the 21st Century, at 10, (May 5, 2008) (listing 846,497 Delaware business entities in 2007).

¹⁰ See About the Agency, Delaware Department of State Division of Corporations, <http://corp.delaware.gov/aboutagency.shtml> (last visited June 16, 2008). See also Conway, supra note 8, at 10 (listing 553,349 Delaware alternative non-corporation entities in 2007). As of December 31, 2007 Delaware was home to 68,133 limited partnerships, 20,821 statutory trusts, 376 limited liability partnerships, and 464, 019 limited liability companies. See id. The author concluded that there is an evolution away from Delaware corporations toward the formation of Delaware LLCs.

¹¹ See 2007 Annual Report, Delaware Department of State Division of Corporations, supra note 1, at 1.

¹² See id.

¹³ See About the Agency, Delaware Department of State Division of Corporations, <http://corp.delaware.gov/aboutagency.shtml> (last visited June 16, 2008).

¹⁴ See Larry Nagengast, First Court for the First State, Del. Bus., at 47 (May/June 2008).

¹⁵ See Secretary's Letter, Delaware Department of State Division of Corporations, <http://corp.delaware.gov/corpsosbio.shtml> (last visited June 16, 2008).

- The agency has specialists that answer questions and assist in the filing of corporate and tax documents.
- Many documents can be filed online and filings can be expedited through “one hour service.”

Specific Benefits that Attract Businesses: The following are the most cited advantages of incorporating in Delaware:

- No state residency requirement.¹⁶
- Delaware has no sales tax or personal property tax or intangible property tax.
- Corporations not doing business in Delaware are exempt from Delaware corporate taxes; no inheritance tax upon non-resident shareholders.¹⁷
- Same-day incorporation - a business may incorporate in less than 24-hours.¹⁸
- No minimum capital requirement.
- One person may hold all of the corporation’s offices.¹⁹
- Directors may fix any price on shares of stock they are selling.²⁰

Alternative Entities: Delaware offers alternatives to incorporation. These “alternative entities” include limited partnerships (LPs) and limited liability companies (LLCs).²¹

- There is a nationwide trend towards LLCs and away from corporations. This trend is reflected in Delaware.²²
- Delaware, however, does not dominate the market for LLCs.²³
- Treatment of LLC charters is garnering more attention by Delaware Courts.²⁴

¹⁶ See 8 Del. C. § 101(a) (“Any person, partnership, association or corporation, singly or jointly with others, and without regard to such person’s or entity’s residence, domicile or state of incorporation, may incorporate or organize a corporation”); but see 8 Del. C. § 131, § 132 (requiring registered office and registered agent in Delaware).

¹⁷ See 30 Del. C. § 1902(b)(6) (“A corporation maintaining a statutory corporate office in the State but not doing business within the State” shall be exempt from taxation.)

¹⁸ See Expedited Services, Delaware Department of State Division of Corporations, <http://corp.delaware.gov/expserv.html> (last visited June 15, 2008).

¹⁹ See 8 Del. C. § 141(b)

²⁰ See 8 Del. C. § 151 et seq.

²¹ See generally 6 Del. C. § 17-101 et seq.; 6 Del. C. § 18-101 et seq.

²² See Glynn, *supra* note 7, at 128.

²³ *Id.* at 130, n.220 (noting that Delaware is second to Florida as the leader in LLCs and neither hold a majority of LLC charters).

Against the backdrop of reliability offered by the Delaware corporate common law, is the nationwide trend towards forming “alternative entities”, such as LLCs.²⁵ These alternative entities provide certain advantages compared to corporations. The number of new alternative entities formed in Delaware, such as LLCs, far exceeds the number of new Delaware corporations being formed.

However, this nationwide trend towards formation of LPs and LLCs has required the Delaware Courts to address the governance and related issues regarding the operation of these new forms of entities.

Admittedly, despite the plethora of Delaware case law discussing the mature contours of fiduciary duties in the corporate context, the development of Delaware decisional law applying fiduciary duties in the LLC context is still young compared to its older “corporate brother.”

What standards govern alternative entities?

To be sure, the Delaware Court of Chancery has directly addressed the issue of fiduciary duties applicable to alternative entities.²⁶ Alternative entities require the Delaware courts to address whether contract principles should govern interpretation of LLC and partnership agreements or whether the traditional fiduciary duties of due care, loyalty and good faith applicable in the corporate context should govern such disputes.²⁷

In August 2004, the Delaware General Assembly amended the Delaware Limited Liability Act (DLLCA) and the Delaware Revised Uniform Limited Partnership Act (DRULPA) to state that a partner who acts in “good faith” reliance on the provisions of a partnership agreement, escapes liability at law or in equity.²⁸ Further, under DLLCA and DRULPA, an operating agreement or a

²⁴ See Wood v. Baum, C.A. No. 621, 2007, slip op. at 3 (Del. July 1, 2008) (holding that plaintiffs failed to establish demand futility in light of exculpatory provision in LLC agreement where plaintiffs did not allege with particularity any facts from which it could be inferred that directors knew or should have been on notice of alleged accounting improprieties, or any facts suggesting that the board knowingly allowed or participated in a violation of law). See also Glynn, supra note 1, at 131 (“[A]t least currently, the difference between Delaware’s substantive laws and the laws of other states in the alternative entity context are less pronounced than in the publicly traded context because Delaware has not had the opportunity to develop as uniquely robust a body of judicial decisions for LLCs.”) But see Larry E. Ribstein, LLCs and ‘good corporate governance’ (April 9, 2008), available at <http://busmovie.typepad.com/ideoblog/2008/04/lles-and-good-c.html> (last visited June 16, 2008) (citing generally TravelCenters of America, LLC v. Brog, No. 3516-CC, 2008 WL 868107 (Del.Ch. March 31, 2008)). Delaware’s Chancery Court recognizes the distinction between the law of corporate and “uncorporate” entities. See id. There exists a judicial tendency to apply corporate rules to unincorporate business entities that resemble corporations. See id. (citing generally Larry E. Ribstein, The Uncorporation and Corporate Indeterminacy, U. Illinois Law & Economics Research Paper No. LE08-012 (April 1, 2008), available at http://papers.ssrn.com/pape.tar?abstract_id=1115876 (last visited June 16, 2008)). The Delaware Chancery Court recognizes the differences between the entities and will not force LLCs to fit the “rigid corporate mold.” See id.

²⁵ See Glynn, supra note 1.

²⁶ See, e.g., Venhill Ltd. P’ship v. Hillman, C.A. No. 1866-VCS, 2008 WL 2270488, at *22 (Del. Ch. June 3, 2008); Miller v. Am. Real Estate Partners, L.P., C.A. No. 16788, 2001 WL 1045643 (Del. Ch. Sept. 6, 2001).

²⁷ Myron T. Steele, *Judiciary Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, Delaware Journal of Corporate Law, at 5 (2007).

²⁸ See 6 Del. C. § 17-1101(b)-(d) and 6 Del. C. § 18-1101(d).

partnership agreement may provide for the “limitation or elimination” of any and all liability for breach of contract or breach of fiduciary duties provided that the party to the agreement does not violate the covenant of good faith and fair dealing.²⁹

Chief Justice Myron T. Steele of the Delaware Supreme Court, in his landmark article of last year, described the August 2004 amendment to DLLCA and DRULPA as “clear legislative intent to enable parties to negotiate contractual relationships based upon free exchange of consideration for a set of rights and risks unfettered by common law fiduciary duty principles”.³⁰ The legislature’s statement that “the policy of this chapter is to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements”³¹ seems to stand for the proposition that the contract itself, rather than typical corporate fiduciary duties apply.³²

However, as Chief Justice Steele notes, “what the amendment potentially does is takes away from the courts a well-developed framework of doctrine from the corporate law arena and requires the courts to delve into an area of *ex post* scrutiny where Delaware has little developed law”.³³

Recent Delaware cases highlight the development of this relatively new area of the law by Delaware Courts on these issues. For example, in *Miller v. Am. Real Estate Partners, L.P.*, 2001 WL 1045643, at *1 (Del. Ch.), a general partner of a limited partnership claimed that the partnership agreement eliminated the applicability of corporate fiduciary duties. The Delaware Chancery Court found that the drafters of the agreement did not make their intent to eliminate typical corporate fiduciary duties sufficiently clear to bar a fiduciary duty claim.³⁴

The partnership agreement at issue specifically stated that “the General partners shall be entitled to consider only such interests and factors as it desires and shall have no duty or obligation to give any consideration to any interest of or factors affecting the partnership”, and that the General Partner “shall act under such express standard *and shall not be subject to any other or different standards*”.³⁵

Defendants argued that this provision took away any default principles of fiduciary duty because the general partner could act in its “sole and complete discretion”. The Court, however, found that the agreement did not “expressly preclude the application of default principles of fiduciary duty”, and that the provision said “nothing about default principles of law being subordinated when the sole discretion standard applies”.³⁶

²⁹ *Id.* at § 17-1101(f) and § 18-1101(e).

³⁰ *See* Steele, *supra* note 27, at *12.

³¹ 6 *Del. C.* § 17-1101(c) and § 18-1101(b).

³² *See also* Larry E. Ribstein, *The Battle for the Heart of Delaware Uncorporation Continues* (May 9, 2008), available at <http://busmovie.typepad.com/ideoblog/2008/05/the-battle-for.html> (stating that focus on the contract in the alternative entity context “is an important part of what I view as the heart of uncorporation. Nevertheless . . . the judicial tendency to apply corporate rules is always lurking and . . . the courts have not yet completely severed the unincorporate cases from corporate indeterminacy”).

³³ *See* Steele, *supra* note 27, at *14.

³⁴ *Miller*, 2001 WL 1045643, at *1.

³⁵ *Id.* at *6 (emphasis added).

³⁶ *Id.* at *8.

At first glance, the partnership agreement seems to have attempted to eschew the applicability of typical corporate fiduciary duties. However, the Court’s message was obvious – although investors will be bound by partnership agreements and must use due care in entering into such transactions, drafters of partnership agreements must set forth the restrictions on fiduciary duties “*clearly and unambiguously*”.³⁷ If they do not, they may be vulnerable to typical notions of fiduciary duties applicable in the corporate context. Thus, the Court, although respecting the principles of freedom of contract, held that the general partner owed “certain loyalty-based duties to the limited partners”.³⁸

Another more recent example of Delaware courts upholding parties’ freedom to contract is Venhill Ltd. P’ship v. Hillman, 2008 WL 2270488 (Del Ch.). In Venhill, the trustees of a family trust formed a family partnership, for which one of the family members, Howard Hillman, served as sole general partner and had sole discretion to make business decisions on its behalf.³⁹ Hillman imprudently and selfishly poured massive funds from the partnership into a corporation he had formed that was insolvent, on terms grossly unfair to the partnership.⁴⁰ Eventually, the limited partners removed Hillman as general partner, and sued Hillman for breach of the duty of loyalty, seeking to hold Hillman liable for losses suffered by the family partnership, and the profits that would have been made had the profits been prudently invested for the three years prior to filing of their claims.⁴¹

Hillman argued that the exculpation provision in the partnership agreement should control and was intended to reach claims implicating “the general partner’s duty of loyalty under traditional default principles of fiduciary responsibility”.⁴² In short, the partnership agreement stated that the general partner was not liable for any act or omission for errors in judgment so long as the general partner acted in “good faith” and was not guilty of “gross negligence or willful or wanton misconduct”.⁴³ The plaintiffs argued that any modification of the default rules of fiduciary duty must be *plain*, and that the exculpation provision, at most, applied to due care claims.⁴⁴

Significantly, the Court held that the limited partners could only hold Hillman liable under the express provisions of the exoneration provision – i.e., if he acted in bad faith, with gross negligence, or engaged in willful or wanton misconduct.⁴⁵ Based on his extreme acts to deplete the assets of the partnership, the Court held that Hillman did just that, and was liable to the plaintiffs.

The Chancery Court here applied the “entire fairness” test, a standard typically used when a fiduciary engages in “self-dealing” and is required to bear the burden of proof”.⁴⁶ Thus, although

³⁷ Id. (emphasis added).

³⁸ Id. at *10.

³⁹ Venhill, 2008 WL 2270488, at *7.

⁴⁰ Id. at *3.

⁴¹ Id. at *15.

⁴² Id. at *22.

⁴³ Id.

⁴⁴ Id.

⁴⁵ Id. at *23.

⁴⁶ Id. at **24-27, 31.

the contract analysis was central in Venhill, typical fiduciary duty principles still applied due to the terms of the agreement.

Recently, the Chancery Court in TravelCenters of America, LLC v. Brog, 2008 WL 1746987 (Del. Ch.), addressed another important issue in the LLC context. In this case, the court was asked to decide if a bylaw was consistent with “corporate governance practices”.⁴⁷ Plaintiff intended to introduce testimony to rebut defendant’s contention that the advance notice bylaw disenfranchised LLC members.⁴⁸ The Court flatly rejected the notion that the bylaw had to comply with “notions of good corporate governance”, stating that:

“Delaware does not impose a legal requirement on LLCs to draft their bylaws to be consistent with some abstract notion of ‘good corporate governance’. On the contrary, limited liability companies are creatures of contract, ‘designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved’.”⁴⁹

Delaware Courts respect the freedom of parties to contract away corporate fiduciary duties but with that right comes the responsibility to draft agreements that leave no ambiguity.⁵⁰ If the parties’ agreement does not clearly reject without qualification the application of corporate principles to LLCs, Delaware Courts will refer by analogy, where appropriate, to the large body of corporate decisions.⁵¹

In his article last year, Chief Justice Steele wrote that, in the alternative entity context, the “contractual relationship between the parties to limited partnership and limited liability company agreements should be the analytical focus for resolving governance disputes – not the status relationship of the parties.”⁵² Thus, he added that “. . . Delaware courts should look to the statutes and fill any gaps in the parties’ express intent by following the statutory mandate to apply the implied covenant of good faith and fair dealing, rather than the enigmatic ‘good faith’ fiduciary duty at common law.”⁵³

⁴⁷ TravelCenters, 2008 WL 1746987, at *1.

⁴⁸ Id.

⁴⁹ Id. (quoting In re Grupo Dos Chiles, LLC, 2006 WL 668443, at *2 (Del. Ch. March 10, 2006)); see also Elf Atochem N. Am. Inc. v. Jaffari, 727 A.2d 286, 290 (Del. 1999) (“The [LLC] Act can be characterized as a ‘flexible statute’ because it generally permits members to engage in private ordering with substantial freedom of contract to govern their relationship, provided they do not contravene any mandatory provisions of the Act.”); Bernstein v. Tractmanager, Inc., 2007 WL 4179088, at *4 (Del. Ch. Nov. 20, 2007) (“Limited liability companies and corporations differ in important ways”).

⁵⁰ See generally, Larry Ribstein, *The Rise of Uncorporation* (2007), available at <http://ssrn.com/abstract=1003790>.

⁵¹ See TravelCenters, 2008 WL 868107 at n.2 (Del. Ch. March 31, 2008) (“Because of the lack of reported decisions in the LLC context, the court may look to cases interpreting similar Delaware statutes concerning corporations and partnerships.”)

⁵² Steele, *supra* note 27, at *25.

⁵³ Id. at *32. Compare, Miller, 2001 WL 1045643, at n.32 (describing the complaint as pleading the implied covenant of good faith and fair dealing as a substitute for fiduciary duties which would preclude the exercise of contractual powers in bad faith so as to advantage the defendant at the expense of the entity and its members).

Another recent Delaware case followed a similar line of reasoning. In Wood v. Baum, C.A. No. 621, 2007 (Del.), the Delaware Supreme Court made an important ruling regarding the defense by LLC managers to fiduciary duty and Caremark claims against them in light of the exculpatory terms of an LLC agreement.⁵⁴ The LLC Agreement in Wood exempted directors from any liability “except in the case of fraudulent or illegal conduct”.⁵⁵ The Court noted that under the Delaware LLC Act, an LLC could provide for limitation or elimination of fiduciary duties, except for “the implied contractual covenant of good faith and fair dealing”.⁵⁶ Thus, based on the terms of the agreement, the directors could only be held liable for either fraudulent or illegal conduct, or breach of the covenant of good faith and fair dealing.

The Wood Court held that plaintiffs failed to plead particularized facts that, if proven, would show that the directors acted with “scienter”, i.e. actual or constructive knowledge.”⁵⁷ In light of the paucity of development of the contours of the “implied covenant of good faith and fair dealing” in the LLC context, the Court’s clarification is especially important:

The implied covenant of good faith and fair dealing is a creature of contract, distinct from the fiduciary duties that the plaintiff asserts here. The implied covenant functions to protect stockholders’ expectations that the company and its board will properly perform the contractual obligations they have under the operative organizational agreements.⁵⁸

Thus, in Wood, the Court adhered to the bounds created by the contract, and the implied covenant of good faith and fair dealing in the LLC context, rather than open-ended fiduciary duties.⁵⁹

The Delaware Courts are addressing more and more frequently the relatively new issues raised in the alternative entity context, and whether the contract and the implied covenant of good faith and fair dealing, or the traditional corporate fiduciary duties should apply to such entities. What is clear is that, with its two hundred-year history of dealing with complex corporate disputes, the Delaware Courts are also likely to continue as a preferred forum to decide disputes involving alternative entities.

**Francis G.X. Pileggi is the founding partner of the Wilmington, Delaware, office of Fox Rothschild LLP, an AmLaw 200 firm. His blog at www.delawarelitigation.com summarizes all*

⁵⁴ No. 621, 2007, slip op. at 3.

⁵⁵ Id.

⁵⁶ Id. at 6.

⁵⁷ Id. at 7.

⁵⁸ Id. at 11.

⁵⁹ See Larry Ribstein, *Wood v. Baum: yes you can opt out of fiduciary duties in publicly held LLC* (2008), available at <http://busmovie.typepad.com/ideoblog/2008/07/wood-v-baum.yes.html> (last visited July 26, 2008).

the key decisions on corporate and commercial law from the Delaware Court of Chancery and Delaware Supreme Court. His e-mail address is: fpileggi@foxrothschild.com.

**Sophia Siddiqui is an associate in the Wilmington, Delaware office of Fox Rothschild LLP. She handles corporate and commercial litigation matters. Her email address is ssiddiqui@foxrothschild.com.*

**We also appreciate the contributions to this article by Maura Burke, one of our firm's summer associates this year.*