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Expert Analysis

Why a Handshake Might Not Be Enough for Members of Delaware Limited Liability Companies

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Ruling on an issue of first impression, Vice Chancellor Stephen Lamb of the Delaware Chancery Court issued a decision Oct. 22 applying the statute of frauds to limited liability company agreements even though state law expressly permits oral operating agreements for limited liability companies.

Background

Vice Chancellor Lamb was presented with “a dispute between the founders of a hedge fund regarding the appropriate amount owed to one of the founders upon his removal from the company.”¹ Plaintiff Brian Olson argued that an unsigned long-form limited liability company operating agreement entitled him to a percentage of the company’s income over six years following his departure as a member. Defendants Andreas Halvorsen and David Ott denied that they reached agreement with Olson on the terms of the operating agreement, specifically the “earnout” provision.

The court’s opinion in Olson v. Halvorsen places new emphasis on the formalities of entrepreneurship.

The parties were the founders of a series of Delaware business entities through which the Viking Global hedge funds operated. One of these entities was Viking Global Founders LLC, which is at the center of the controversy.

Initially, written short-form operating agreements were entered into for each of the entities except for Founders. Later, long-form operating agreements were drafted for each entity, but a long-form operating agreement for only one entity was executed. Only the unsigned long-form operating agreement for Founders contained the earnout provision at issue in this case.

In spring 2005 Olson took a six-month sabbatical from Viking to travel with his family. Upon his return, he was informed that Halvorsen and Ott voted to remove him from his position at Viking. Olson was paid more than \$100 million, representing the balance of his capital account and the remainder of his 2005 salary, but Halvorsen and Ott rejected his demand for an earnout pursuant to the unsigned Founders operating agreement. Unsatisfied with this result, Olson filed a complaint alleging, among other things, breach of contract for failure to pay him the earnout.

On cross-motions for summary judgment, the Chancery Court was presented with a question of first impression under Delaware law: whether the statute of frauds rendered unenforceable the earnout provision of the unsigned Founders operating agreement.

Competing Statutes

The policy of the Delaware Limited Liability Company Act is “to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.”² Consistent with this policy, the statute defines a limited liability company agreement as “any agreement (whether referred to as a limited liability company agreement, operating agreement or otherwise), written, oral or implied, of the member or members as to the affairs of a limited liability company and the conduct of its business.”³ In other words, the LLC Act specifically permits members of a Delaware limited liability company to agree orally to the terms of an operating agreement.

The court noted that notwithstanding this policy, commentators had competing viewpoints regarding the application of the statute of frauds to oral limited liability company operating agreements.⁴ Some commentators argued that in the absence of an express provision in the LLC Act to overrule a statutorily enacted provision of common law, the statute of frauds should still apply.⁵ Opponents of this position said the “freedom of contract” policy of the LLC Act created the inference that the Delaware Legislature intended to override the statute of frauds with respect to limited liability company agreements.⁶

The Court’s Ruling

Ultimately, the court sided with those who believe that the statute of frauds should apply because of the absence of an express indication of intent to overrule

the statute of frauds. The court held that this result was consistent with strong policy protecting defendants against “unfounded or fraudulent” claims that require performance over an extended period of time. The court squared its decision with the freedom-of-contract principles of the LLC Act by concluding that all other aspects of a limited liability company agreement that could be performed within one year would remain enforceable.⁷

The safest course of action in the wake of this decision is to commit any agreement regarding the operations of a limited liability company to writing and have all members add their signatures.

After concluding that the earnout provision could not be performed within a year, the court held that the provision was unenforceable because of the statute of frauds. The court also rejected Olson’s attempt to invoke common-law exceptions to the statute of frauds, such as multiple writings and part performance. After concluding that there was no writing signed by the defendants with a clear reference to the earnout provision, the court also held that under Delaware law, part performance does not except from the statute of frauds contracts not to be performed within one year.

Impact on Setup of Limited Liability Companies

The court’s opinion puts new emphasis on the formalities of entrepreneurship. Although, as the court noted, “[f]ew oral LLC operating agreements are likely to contain any term or provision that cannot possibly be performed within one year,” members of limited liability companies must be wary of the potential pitfalls of the statute of frauds.⁸ The safest course of action in the wake of this decision is to commit any agreement regarding the operations of a limited liability company to writing and have all members add their signatures.

Notes

¹ *Olson v. Halvorsen*, 2008 WL 4661831, *1 (Del. Ch. Oct. 22, 2008).

² *Id.* at *3 (citing 6 Del. C. § 18-1101[b]).

³ 6 Del. C. § 18-101(7).

- ⁴ *Olson*, 2008 WL 4661831 at *3. The statute of frauds requires certain contracts to be made in writing and signed by the party against whom the contract will be enforced. Agreements that fall within the statute of frauds include those made upon consideration of marriage, for the sale of an interest in land, for the assumption of another person's debt, for the sale of goods for \$500 or more, and, importantly for this opinion, any agreement that cannot be performed within one year.
- ⁵ See CARTER G. BISHOP & DANIEL S. KLIENBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW § 14.03 (2008).
- ⁶ See ROBERT L. SYMONDS JR. & MATTHEW J. O'TOOLE, SYMONDS & O'TOOLE ON DELAWARE LIMITED LIABILITY COMPANIES § 4.02 (2007).
- ⁷ *Olson*, 2008 WL 4661831 at *3.
- ⁸ *Id.*



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